THE REGULATION OF FOREIGN INVESTMENT IN POST-WTO CHINA: A POLITICAL ECONOMY ANALYSIS

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Since 2001, when China joined the WTO, foreign investment enterprises in China have grown considerably and exhibited significant developmental trends. In response, the Chinese government has been trying hard to reform its laws to keep pace with market developments. This article will undertake a political economy analysis to tease out the interplay and relevance of contextual factors contributing to the quality and direction of legal change in this area, giving important insights on how the social, political and economic conditions in China combine to shape China's legal regime for foreign investment enterprises. It will focus on the practical problems arising from the troubled relationship between the general company law and the specific laws for foreign investment enterprises. The political economy of law reforms suggests that although evolutionary trends point towards convergence in the long term, the dual systems of foreign investment regulation are likely to persist, at least to some degree, in the foreseeable short term.

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I. INTRODUCTION

China has been quite successful in attracting foreign investment since the late 1970s with the introduction of the policy of *gaige kaifang* (改革开放) (reform and opening up). Indeed, China overtook the United States to become the world's largest foreign direct investment (FDI) recipient in 2003 and has since maintained top three ranking.[1] With rapid economic development and mounting concern over the possibility of "foreign domination" of its national economy, China has reached a new phase in its utilization of foreign capital. On November 10, 2006, the National Development and Reform Commission (NDRC) of the People's Republic of China (PRC) issued the 11th Five-Year Plan on Foreign Capital Utilization, marking a significant reorientation of China's policy towards foreign investment.[2] This document prioritizes quality over quantity of foreign investment, emphasizing advanced technologies, management experience, and talent.[3] It sets forth an industrial policy ranking geographical areas, industrial sectors, levels of technology, environmental protection and efficient use of natural resources, with a view to upgrading and optimizing China's domestic industrial structure and technological level.[4]

FDI can be made in two main ways: mergers and acquisitions (M&A) and Greenfield investment. At the international level, M&A has been the preferred mode of FDI. M&A transactions worldwide account for a high percentage of global FDI, ranging from 62% to 82% in recent years.[5] However, M&A has not yet found favor with foreign investors in China. According to research by the Development Research Center of the State Council, M&A makes up only an average of 5% of FDI in China.[6] But M&A is becoming increasingly attractive for foreign investors, particularly the leading players in their fields, because it offers foreign investors immediate market access with minimal business risk. A more detailed

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[1] 曹和平等，外国直接投资研究的新进展 [Cao Heping et al., *The New Developments of Foreign Direct Investment Research*], 中国社会科学学术前沿 [SOCIAL SCIENCES FRONTIER STUDIES IN CHINA] 2006–2007, *available at* http://www.china.com.cn/book/zhuanti/kxxsqy/2008-01/17/content_9549162.htm.

[2] 利用外资"十一五"规划 [11th Five-Year Plan on the Utilization of Foreign Investment (P.R.C.)], (promulgated by the State Dev. and Reform Comm'n, Nov. 10, 2006) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[3] *Id.* art. 2.

[4] *Id.* at Preamble.

[5] 李咏, 增强利用外资与挑战被外资利用 [LI YONG, IMPROVING THE UTILIZATION OF FOREIGN INVESTMENT AND AVOIDING EXPLOITATION BY FOREIGN INVESTMENT] 10 (中国政法大学出版社 [China University of Politics and Law Press]) (2007).

[6] 赵晋平, 国务院发展研究中心对外经济研究部 [ZHAO JINPING, STATE COUNCIL DEV. AND RESEARCH CTR., FOREIGN ECON. RESEARCH DEP'T], 中国利用外资十大新趋势 [TEN NEW TRENDS OF FOREIGN INVESTMENT IN CHINA], http://www.cass.net.cn/file/200305286690.html.

discussion of foreign M&A in China is beyond the scope of this article.[7]

This article focuses on greenfield investment, the second mode of FDI. There are three principal forms of greenfield investment in China: equity joint venture (EJV), contractual or co-operative joint venture (CJV) and wholly foreign-owned enterprise (WFOE). Traditionally, they represent the overwhelming majority of total FDI in China and can be collectively referred to as foreign investment enterprises or foreign-invested enterprises (FIE). This article seeks to illustrate the central features of each of the three forms of FIEs and analyze their legal and regulatory framework. The laws governing FIEs have undergone significant changes since China joined the World Trade Organization (WTO) in 2001. As a prerequisite for WTO accession, China carried out major revision of its FIE laws and regulations to make them WTO-compliant in the period of 2000–2001.[8] In more recent years, foreign investors and Chinese investors have called for further reforms, particularly over the FIE parallel governance systems—the "general company law" and "specific FIE law." Practical problems have arisen as a consequence of the parallel operations of these laws. By examining the political economy surrounding FIEs in China, this article illuminates how the regulatory regime for FIEs has evolved and whether or not the parallel systems of FIE regulation are likely to converge in the future.

II. OVERVIEW OF THE LEGAL REGIME FOR FIES

There are a large number of laws, regulations and rules governing various aspects of FIEs in China. This article analyzes the interaction between specific FIE laws and the Company Law. First, this section describes EJV, CJV and WFOE, the three types of FIE.

A. *Equity Joint Venture*

The first law governing FIEs in China and the primary statute regulat-

[7] For discussion of foreign M&A in China, see, for example, Hui Huang, *China's New Regulation on Foreign M&A: Green Light or Red Flag?*, 30(3) U.N.S.W. L.J. 802 (2007).

[8] The laws were amended and cleaned up in accordance with WTO principles to ensure national treatment for FIEs. The amendments include, *inter alia*, removal of the requirement of submitting production and operation plans to the government for its records, deletion of the rule of giving priority to domestic products in purchase of raw materials by FIEs, cancellation of the requirement of purchasing certain materials through government channels, removal of the rule concerning sale of products in domestic markets, cancellation of the requirement of balancing foreign exchange receipts and expenditure, and removal of the requirement of opening accounts only with the Bank of China. For a more detailed discussion, see, for example, CHENG WEIQI, INVESTING IN CHINA: LEGAL PERSPECTIVES 110–124 (Butterworths) (2003).

ing the EJV today is the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (EJV Law), promulgated in 1979 and amended in 1990 and 2001.[9] The 2001 amendment made significant changes to the EJV Law in accordance with China's WTO commitments. The EJV Law has only sixteen articles, expressed in very broad and general terms, giving little legal guidance to EJVs. For practical purposes, its implementing regulation is crucial: Implementing Regulation of the Law of the PRC on Chinese-Foreign Equity Joint Ventures (EJV Implementing Regulation).[10] This implementing regulation comprises sixteen chapters and 105 articles, setting out detailed rules for every aspect of EJV regulation.

1. Scope of Investors

An EJV is a business entity formed between foreign investors and their Chinese partners. The term "foreign investor" is broad enough to include almost all sorts of foreign businesses, such as foreign companies, enterprises, other economic organizations and individuals. The term "Chinese partners" encompasses all the above categories except individuals.[11]

This seemingly strange exclusion can only be understood by reference to the historical context in which the EJV Law was established. At the very beginning of the economic reform, there were very few Chinese individuals, if any, who were wealthy enough to enter business relationships with foreigners. Also, at that time, China was a country of strong communist color, and many of its economic restrictions, including that barring individuals from private business, were yet to be relaxed. Finally, the government was better able to regulate and supervise foreign investment without the involvement of individuals.

With the rapid development of the Chinese economy, this exclusion can no longer be sustained. In the past, Chinese individuals could participate in an EJV under certain circumstances. For example, if foreigners take over a Chinese business and then convert the acquired entity into an EJV, the individual Chinese shareholders of the target become parties to

[9] 中华人民共和国中外合资经营企业法 [Law on Chinese-Foreign Equity Joint Ventures (P.R.C.)], (promulgated by the Nat'l People's Cong., July 1, 1979) (amended Apr. 4, 1990, Mar. 15, 2001) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter EJV Law].

[10] 中华人民共和国中外合资经营企业法实施条例 [Implementing Regulation of the Law on Chinese-Foreign Equity Joint Ventures (P.R.C.)], (promulgated by the State Council, Sept. 20, 1983) (amended Jan. 15, 1986, Dec. 21, 1987, July 22, 2001) STATE COUNCIL GAZ. [hereinafter EJV Implementing Regulation].

[11] *See* EJV Law, *supra* note 9, art. 1.

the newly converted EJV.[12] The real impact of this exclusion rule is unclear, since it is easy to escape: Chinese individuals can simply set up a domestic business entity, such as a company, through which to form an EJV with foreign partners in accordance with the law.

2. Organizational Form and Legal Status of Equity Joint Ventures

An EJV must take the form of a limited liability company incorporated in China.[13] As a company, the EJV enjoys the legal status as a Chinese legal person with a separate legal personality independent of its investors. Consequently, the EJV can sue and be sued in courts, and has the capacity to own property and bear debts. The capital contributed by joint venture partners becomes the property of the EJV, and the investors are liable up to the extent of their respective subscribed capital to the EJV.[14]

In order to qualify as a foreign-invested enterprise, the foreign investor's investment must be 25% or more of the EJV's registered capital.[15] This sets 25% as the threshold level in the definition of foreign investment, making the rule also applicable to CJVs. The question of an upper limit on the percentage of foreign contribution to an FIE is more complicated. Generally, no ceiling is imposed on foreign ownership in FIEs, but there are some important exceptions. The Catalog for the Guidance of Foreign Investment Industries 2007 sets out varying levels of foreign ownership that are not to be exceeded in FIEs in certain industries.[16] For example, foreign ownership is capped at 50% for life insurance companies,[17] one third for securities firms,[18] and 49% for securities investment fund management companies.[19] Other administrative regulations may fix an upper limit on foreign investment in some specified industries such as civil aviation.

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[12] For more discussion of the law governing foreign takeover in China, see, for example, Huang, *supra* note 7, at 804.

[13] *See* EJV Law, *supra* note 9, art. 4; EJV Implementing Regulation, *supra* note 10, art. 16. It should be noted that some local governments have promulgated special regulations to the effect of permitting venture capital EJVs to use other forms of business associations such as limited liability partnerships. *See, e.g.*, 中关村科技园区条例 [Zhongguancun Technology Park Regulation] (promulgated by the Standing Comm. People's Cong. of Beijing, Dec. 8, 2000, effective Jan. 1, 2001) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[14] *See* EJV Implementing Regulation, *supra* note 10, art. 16.

[15] *See* EJV Law, *supra* note 9, art. 4.

[16] 外商投资产业指导目录 [Catalogue for the Guidance of Foreign Investment Industries (P.R.C.)], (promulgated by the Nat'l Dev. and Reform Comm'n, Oct. 31, 2007, effective Dec. 1, 2007) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter Catalogue].

[17] *Id.* at Enclosure (2)(9)(2).

[18] *Id.* at Enclosure (2)(10)(1).

[19] *Id.* at Enclosure (2)(10)(2).

3. Operation and Management Rules

Since EJVs are in the form of a company, they generally operate in accordance with a set of rules governing company law issues. For example, the EJV needs to have registered capital, and capital contributions can be in the form of cash, individual property rights, machinery, equipment, and land use rights.[20] The value of the non-cash consideration is subject to assessment and negotiation between the joint venture partners and must be specified in the joint venture contract and the articles of association of the EJV.[21] The net profit of an EJV shall be distributed among the parties to the venture in accordance with each party's contribution to the registered capital.[22]

Due to the special nature of the EJV, there are certain areas in which the EJV form is regulated differently from the company form. Traditionally, unlike ordinary Chinese companies, an EJV does not have shareholders' meetings and is managed exclusively by a board of directors and managerial staff.[23] The board of directors is the decision-making body of the EJV, and its membership is to be appointed and removed by the joint venture partners. EJV boards of directors are composed of at least three members, representing joint venture partners in accordance with their respective capital contribution.[24] The choice of the chairperson is to be decided by the joint venture partners through consultation or by election by the board. Either the foreign or the Chinese party can assume the office of the chair. The board must meet at least once a year and operate in accordance with relevant laws, regulations and the EJV's articles of association. It is important to note that in contracts with companies, unanimous approval of all directors is required for decisions on certain matters in an EJV, such as revision of the articles of association, capital increase or reduction and so on.[25]

Finally, unlike the perpetual character of companies, the duration of an EJV can usually be set by the parties in the joint venture contract, though there is an exception for some lines of business which are required by laws and regulations to have a specified period of operation.[26] In practice, the joint venture partners often specify an operation term for the EJV,

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[20] *See* EJV Law, *supra* note 9, art. 5; EJV Implementing Regulation, *supra* note 10, art. 22.
[21] *See* EJV Law, *supra* note 9, art. 5.
[22] *Id.* art. 7.
[23] *Id.* art. 6. This situation has changed since 2006, when it was clarified that the Company Law applies to EJVs, requiring the establishment of a board of supervisors. For more discussion of this issue, see Part IV(C) below.
[24] *See* EJV Implementing Regulation, *supra* note 10, art. 31.
[25] *See id.* art. 33.
[26] *See* EJV Law, *supra* note 9, art. 13; EJV Implementing Regulation, *supra* note 10, art. 89.

which they can extend upon its expiration. The specified operation period varies from EJV to EJV but normally ranges from ten to thirty years. For instance, the German automaker Volkswagen set up an EJV in 1984 for a term of twenty-five years and in 2002 extended the term to year 2030.[27]

B. Contractual Joint Venture

The main law regulating the contractual joint venture is the Law of the PRC on Chinese-Foreign Contractual Joint Ventures (CJV Law), which was promulgated in 1988, nine years after the EJV Law, and was amended in 2000 to comply with WTO requirements.[28] Similar to the EJV Law, the CJV Law sets up a general regulatory framework for CJVs, leaving much detail to be fleshed out by implementing regulations. In 1995, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), then the regulatory body for FIEs, took this clarifying step by promulgating the Implementing Regulation of the Law of the PRC on Chinese-Foreign Contractual Joint Ventures (CJV Implementing Regulation).[29] To clarify ambiguities in that document, MOFTEC issued the Interpretation on the Implementation of Certain Articles of the Implementing Regulation of the Law of the PRC on Chinese-Foreign Contractual Joint Venture (CJV Interpretation) on October 22, 1996.[30]

There are similarities between the EJV and the CJV. First is the role of foreign and Chinese investors in the joint venture. As their names suggest, both EJVs and CJVs are economic entities formed between foreign investors and Chinese investors. Like the EJV, foreign investors of the CJV can be foreign companies, economic organizations, and individuals, while Chinese partners can be Chinese enterprises or other economic organizations but not individuals.[31]

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[27] 国际投资与跨国公司案例库 [CASES OF INTERNATIONAL INVESTMENT AND TRANSNATIONAL CORPORATIONS] 133 (卢进勇 [Lu Jinyong] et al. eds., 对外经济贸易大学出版社 [University of International Business and Economics Press]) (2005).

[28] 中华人民共和国中外合作经营企业法 [Law on Chinese-Foreign Contractual Joint Ventures (P.R.C.)] (promulgated by the Nat'l People's Cong., Apr. 13, 1988, effective Oct. 31, 2000) STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (P.R.C.) [hereinafter CJV Law].

[29] 中华人民共和国中外合作经营企业法实施细则 [Implementing Regulation of the Law on Chinese-Foreign Contractual Joint Ventures (P.R.C.)], (promulgated by the Ministry of Foreign Trade and Econ. Cooperation, Sept. 4, 1995) STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (P.R.C.) [hereinafter CJV Implementing Regulation].

[30] 关于执行《中华人民共和国中外合作经营企业法实施细则》若干条款的说明 [Interpretation of Certain Clauses of the Implementation of the Implementing Regulation of the Law on Chinese-Foreign Contractual Joint Ventures (P.R.C.)], (promulgated by the Ministry of Foreign Trade and Econ. Cooperation, Oct. 22, 1996), *available at* www.chinalawlib.com/9929739.html [hereinafter CJV Interpretation].

[31] *See* CJV Law, *supra* note 28, art. 1.

Second, both CJVs and EJVs are established in China under Chinese laws, and therefore are considered Chinese economic organizations. This means that as a general rule, if a CJV or EJV creates a new subsidiary enterprise, the subsidiary will not be able to enjoy the status of a FIE because it is established by a Chinese rather than a foreign business entity. But there exist a number of important exceptions. For instance, in a bid to reduce the geographical disparity of economic development, it is stipulated that if FIEs invest to set up new enterprises in the middle or western regions of China and the foreign investment is of more than 25% of their registered capital, the subsidiary enterprise will be entitled to preferential treatment as FIEs.[32] Another exception allows foreign investors to establish a special investment company[33] and then use this vehicle to invest in China or set up additional enterprises with the status of FIEs as long as foreign investment represents more than 25% of their registered capital. A prime example of this is the American IT giant, Hewlett Packard, which set up such an investment company in 1995 and has since made significant investments to expand its business in China.[34]

The CJV differs from the EJV in some significant aspects due to the fact that the former is established and managed according to a joint venture contract while the latter is managed on the basis of the shareholding structure. First, the organizational forms EJVs and CJVs can adopt are different. As discussed earlier, the EJV must take the form of limited liability companies and thus is a legal person. However, the CJV is not necessarily a legal person. If it is, it must take the form of a limited liability company.[35] A CJV without legal person status is like a partnership in that it is not separate from the joint venture partners. As such, the partners bear joint and several liability for debt of the CJV.[36]

The second difference lies in the method of profit distribution. For EJVs, the profit is distributed among the joint venture partners in proportion to the shares they hold. In contrast, distribution of profit among parties in a CJV is based on a joint venture contract which can be freely negotiated within the limits of relevant laws.[37] Therefore, sharing of prof-

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[32] 关于外商投资企业境内投资的暂行规定 [Provisional Rules on the Domestic Investment by Foreign-Invested Enterprises] art. 16, (promulgated by the Ministry of Foreign Trade and Econ. Cooperation and the State Admin. for Indus. and Commerce, July 25, 2000) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[33] 关于外商投资举办投资性公司的规定 [Provisions on the Establishment of Investment Companies by Foreign Investors], (promulgated by the Ministry of Commerce, June 10, 2003) (amended Feb. 13, 2004, Nov. 17, 2004) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[34] *See* Lu, *supra* note 27, at 161.

[35] *See* CJV Implementing Regulation, *supra* note 29, art. 14.

[36] *Id.* art. 50.

[37] *See* CJV Law, *supra* note 28, art. 21.

its in a CJV needs not be in proportion to the parties' respective capital contribution.

Third, the forms of consideration investors can contribute toward the registered capital are different for CJVs and EJVs. As discussed before, in the EJV context, the joint venture parties can invest cash, materials, industrial properties and land use rights. In establishing a CJV, the parties may contribute not only the sort of cash or non-cash properties mentioned above, but also "other property rights,"[38] a term not clearly defined in the statute but in practice commonly referring to services, business reputation and technology consultancy.

Fourth, the rules on ownership of assets differ between EJVs and CJVs. In an EJV, the assets contributed by parties towards the registered capital become the property of the EJV. The CJV rule is more complicated. The assets of a CJV without legal person status are owned personally by the joint venture parties. Even the assets of a CJV incorporated as a limited liability company with legal person status are not necessarily owned by the CJV. Depending on the terms of the CJV contract, they can either belong to the newly established CJV or to the parties, with only the right to use granted to the CJV company.

Fifth, CJVs have different rules regarding withdrawal of investment. The joint venture parties in an EJV can only retrieve their investment when the company is wound up. However, it is possible for the foreign party in a CJV to retrieve its capital before the expiration of the agreed duration of the CJV. This is usually decided with a high degree of freedom through consultation by the CJV partners and specified in the CJV contract.[39] If there is an agreement to the effect of granting early retrieval rights to the foreign party, the Chinese party will receive the fixed assets of the CJV in return upon expiration of the term of the CJV.[40]

The advance withdrawal of investment by the foreign party can be effected in a number of ways. For example, over the duration of the CJV, the foreign party can have an increased proportion of earnings distribution, recover its investment prior to the payment of income tax by the CJV, or recover its investment by taking the depreciation expenses for the fixed assets of the CJV.[41] To prevent abuse of this mechanism, on June 9, 2005, the Ministry of Finance (MOF) issued the Measures for Examining and Approving the Advance Recovery of Investment by Foreign Partners of

[38] *See* CJV Law, *supra* note 28, art. 8; CJV Implementing Regulation, *supra* note 29, art. 18.
[39] *See* CJV Law, *supra* note 28, art. 24; CJV Implementing Regulation, *supra* note 29, art. 47.
[40] *See* CJV Law, *supra* note 28, art. 21; CJV Implementing Regulation, *supra* note 29, art. 44.
[41] *See* CJV Law, *supra* note 28, art. 21; CJV Implementing Regulation, *supra* note 29, art. 44; CJV Interpretation, para. 3.

Chinese-Foreign Cooperative Joint Ventures.[42] It sets out the requirements to be satisfied when the foreign party exercises the advance retrieval right:

1. Upon expiration of the contractual duration, all fixed assets of the CJV after liquidation must be passed to the Chinese party without any payment;
2. The CJV must issue a letter of commitment promising the precedence of payment of its debts over the advance recovery of investments;
3. The foreign party who withdraws must give a letter of commitment promising its assumption of joint and several liability for the debts owed by the CJV within the scope of the advance recovery of investments;
4. The capital of the CJV must be virtually contributed; and
5. The CJV must have a sound operational and financial standing and not have any undisclosed deficit.[43]

Finally, CJVs and EJVs differ in management structure. As noted earlier, the board of directors of the EJV is the ultimate management authority of the joint venture, and the general manager executes decisions made by the board. In contrast, the management structure of a CJV depends on whether it is a legal person or not. CJVs which are not legal persons are controlled by a joint management committee.[44] For those that have legal personhood and take the form of a limited liability company, the highest management authority is to be a board of directors or a joint management committee.[45] There must be no fewer than three members in the board or committee, appointed by the parties to the CJV in accordance with their respective capital contributions to the CJV. Either the foreign party or the Chinese party can serve as chairperson of the board of directors as long as

[42] 中外合作经营企业外国合作者先行回收投资审批办法 [Measures for Examining and Approving the Advance Recovery of Investment by Foreign Partners of Chinese-Foreign Cooperative Joint Ventures], (promulgated by the Ministry of Fin., June 9, 2005, effective Sept. 1, 2005) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter CJV Measures]. The implementation of this regulation has been further clarified by 财政部关于中外合作经营企业外方合作者先行回收投资有关问题的通知 [Notice of the Ministry of Finance on Issues Concerning the Advance Recovery of Investment by Foreign Partners of Chinese-Foreign Cooperative Joint Ventures] (promulgated by the Ministry of Fin., Aug. 6, 2008) LAWINFOCHINA, *available at* http://www.lawinfochina.com (setting out several matters to which the approval authorities must pay particular attention when examining the issue of advance retrieval of investment by the foreign party).

[43] CJV Measures, *supra* note 42, art. 4.

[44] *See* CJV Implementing Regulation, *supra* note 29, art. 52.

[45] *Id.* art. 24.

such an arrangement is suitable to the CJV. The rules on calling and holding CJV board meetings are similar to those for EJVs in such facets as quorum, the minimum number of meetings per year and passing of resolutions.[46]

C. *Wholly Foreign-Owned Enterprise*

The main regulatory framework for the WFOE is set up by the Wholly Foreign-Owned Enterprise Law of the People's Republic of China (hereinafter WFOE Law).[47] It was promulgated on April 12, 1986, after the EJV Law but before the CJV Law, and was amended on October 31, 2000 in compliance with China's WTO obligations. Like the legal regimes governing the EJV and the CJV, there is a set of administrative regulations to supply the details for the implementation of the WFOE Law. On December 12, 1990, the then FIE regulator, the Ministry of Foreign Economic Relations and Trade (MOFERT), promulgated the Implementing Regulation of the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises (hereinafter WFOE Implementing Regulation), which was amended on April 12, 2001.[48]

The WFOE fundamentally differs from the EJV and CJV by its nature as wholly foreign-owned, unconnected with Chinese investors. The definition of WFOE includes enterprises established inside China solely by foreign investors with their capital, excluding the branches of foreign enterprises established in China.[49] Foreign investors can be enterprises, other economic organizations or individuals.[50] The WFOE can take the form of a limited liability company as of right or other corporate forms subject to governmental approval.[51] The WFOE Law and Implementing Regulation do not specify these other forms. In practice, most, if not all, WFOEs incorporate as limited liability companies; for this reason, the discussion here will focus on this type of WFOEs.

WFOEs in the form of limited liability companies are governed by rules broadly similar to those for companies in many respects. First, the

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[46] *Id.* art. 28.

[47] 中华人民共和国外资企业法 [Wholly Foreign-Owned Enterprise Law (P.R.C.)], (promulgated by the Nat'l People's Cong., Apr. 12, 1986) (amended Oct. 31, 2000) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter WFOE Law].

[48] 中华人民共和国外资企业法实施细则 [Detailed Implementing Regulation for the Law on Wholly Foreign-Owned Enterprises (P.R.C.)], (promulgated by the Ministry of Foreign Econ. Relations and Trade, Dec. 12, 1990) (amended Apr. 12, 2001) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter WFOE Implementing Regulation].

[49] *See* WFOE Law, *supra* note 47, art. 2.

[50] *Id.* art. 1.

[51] *See* WFOE Implementing Regulation, *supra* note 48, art. 18.

WFOE is a legal person separate from the foreign investors who set it up. Second, the foreign investors have the benefit of limited liability with regards to the debt of the WFOE. Third, investors can contribute capital in the form of foreign currency, machinery, equipment, industrial property rights, proprietary technologies, and profits derived from other foreign investment enterprises established in China (this form is subject to governmental approval).[52] Fourth, neither the WFOE Law nor the Implementing Regulation contains specific rules on the organizational or management structure of the WFOE. Hence, the organizational structure of WFOEs follows the relevant provisions in the Company Law. Finally, the WFOE shall have a specified term of operation subject to approval upon application of its establishment, and the term can be extended with approval.[53]

D. The Rules for Setting Up Foreign Investment Enterprises

The steps towards setting up FIEs are very practical and complicated. The establishment of FIEs is subject to examination and approval by the relevant governmental authorities. The nuts and bolts of this procedure can be found elsewhere,[54] and are not the focus of this article. Rather, the discussion here aims to provide a succinct account of relevant issues involved in establishing FIEs.

For foreign investors investing in China for the first time, it is a daunting task to assess China's business environment, regulatory regime and political system, which are quite different from many other market-oriented developed or developing countries. This was particularly so in the early period of foreign investment in China. Many foreign companies have therefore proceeded with caution, choosing to first establish a representative office in China before making any substantial investment. With a representative office, foreign companies can have a commercial presence in China and get acquainted with the local investment environment. It is a good starting point only and the representative office is not meant to be used as a vehicle to actually engage in business in China. The law strictly limits the activities conducted through these offices, even though many foreigners go beyond these confines in reality.

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[52] *Id.* art. 25.
[53] *Id.* art. 71.
[54] *See, e.g.*, CHINA BUSINESS LAW GUIDE Vol. 1, ¶ 25-050 (Jianfu Chen & Suiwa Ke eds., Kluwer Law International) (2005).

1. Categorization of FIE Projects

To facilitate the decision-making process of foreigners considering investment in China, the Chinese government has promulgated guidance documents governing the examination and approval of foreign investment. Foreign investors need to consult these documents to assess the feasibility of their proposed investment. The first such document is entitled "Provisions Guiding the Direction of Foreign Investment" (Foreign Investment Guiding Provisions), promulgated by the State Council on February 11, 2002 and effective from April 1, 2002.[55] Under this document, all foreign investment projects (including EJVs, CJVs and WFOEs) are divided into four broad categories: encouraged, permitted, restricted and prohibited.[56] It further lists the broad categories of "prohibited projects,"[57] "restricted projects"[58] and "encouraged projects."[59] The category "permitted projects" is not listed in the 2002 document, marking a major difference from its predecessor promulgated in 1995.[60] This is because industry sectors previously listed as "permitted" are now "encouraged," and projects not falling into any of the three listed categories are deemed to be "permitted."

It should be noted that the categorization of particular projects is not inflexible and may change in certain circumstances. For instance, foreign investment projects classified as "permitted projects" will be treated as "encouraged" if all their products are exported directly.[61] Further, projects classified as "restricted" may be treated as "permitted" upon approval by the relevant authorities if their product export sales amount to more than 70% of their total product sales.[62] Finally, projects classified as "permitted" or even "restricted" can enjoy the same treatment as "encouraged" projects if they are considered to be particularly conducive to economic development in western and central China.[63]

The Foreign Investment Guiding Provisions serves as a merely gener-

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[55] 指导外商投资方向规定 [Order of the State Council on Promulgation of Provisions on Guiding the Orientation of Foreign Investment] (promulgated by the State Council, Feb. 11, 2002, effective Apr. 1, 2002) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter Foreign Investment Guiding Provisions].

[56] *Id.* art. 4.

[57] *Id.* art. 7.

[58] *Id.* art. 6.

[59] *Id.* art. 5.

[60] 指导外商投资方向暂行规定 [Provisional Regulations Guiding the Direction of Foreign Investment] (promulgated by State Planning Comm'n, State Econ. and Trade Comm'n and Ministry of Foreign Trade and Econ. Cooperation, June 20, 1995, effective June 28, 1995) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[61] *See* Foreign Investment Guiding Provisions, *supra* note 55, art. 10.

[62] *Id.* art. 10.

[63] *Id.* art. 11.

al guide to examination and approval of foreign investment projects; a more detailed list of "encouraged," "restricted" and "prohibited" projects is to be found in the 2007 version of the Catalog for the Guidance of Foreign Investment Industries (Catalog).[64] The Catalog requires certain projects to be carried out only as joint ventures, not WFOEs, and sometimes mandates that the Chinese party hold the majority or relative majority of shares. The Chinese party will be considered to be holding the majority of shares when the proportion of its investment in the joint venture is 51% or more. A "relative majority" indicates the party's investment represents a plurality.

2. Verification and Approval Requirements

Once the parties have decided where to invest, they must apply to the relevant examination and approval authorities. The following discussion will first cover this time-consuming and somewhat unpredictable process for joint ventures and then for WFOEs.

Foreign investors in joint ventures must first draft a letter of intent or memorandum of understanding with their Chinese partner or partners. This document is a simple statement of the parties' intention to establish the joint venture and generally is not legally binding. The next step is for the Chinese partners to follow one of the following three procedures: (1) *shen pi zhi* (审批制) (examination and approval); (2) *he zhun zhi* (核准制) (verification and approval); or (3) *bei an zhi* (备案制) (record-filing).[65] As a general rule, state-funded projects are subject to the "examination and approval" procedure, but other projects need only comply with the less rigorous procedures of "verification and approval" or "record filing."

Foreign investment projects are on the list of projects that trigger the second procedure, verification and approval.[66] The relevant verification and approval authority can be the State Council, the National Development and Reform Commission (NDRC), local development and reform departments, or the Ministry of Commerce (MOFCOM), depending on the nature and amount of the proposed investment project.[67] A project application report, along with specified supporting documents, must be

[64] *See* Catalogue, *supra* note 16.
[65] 国务院关于投资体制改革的决定 [Decision of the State Council on Reforming the Investment System] art. 2, (promulgated by the State Council, July 16, 2004) STATE COUNCIL GAZ. (P.R.C.).
[66] *Id.* at Annex.
[67] *Id.*; *see also* 外商投资项目核准暂行管理办法 [Provisional Measures Governing Verification of Foreign Invested Projects], (promulgated by the Nat'l Dev. and Reform Comm'n, Oct. 9, 2004) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

prepared and submitted for verification and approval.[68]

After obtaining the verification document for the project but before the approval of the joint venture contract and articles of association, the investors must apply to register the name of their joint venture enterprise with the State Administration for Industry and Commerce (SAIC) or its local offices to preserve the name. The parties to the joint venture then must negotiate, draft and sign the joint venture contract and articles of association. Finally, they apply for approval of the establishment of the joint venture. The relevant approval authority is normally the MOFCOM, but in certain circumstances, it can also be the provincial government or the relevant department of the State Council.[69] Upon receiving the approval certificate, the parties must register with the SAIC within a specified period to acquire a business license. Before engaging in business, there remain a number of matters to address, including tax registration, application under the official seal and enterprise code, and opening a bank account.

It is simpler to establish a WFOE than a joint venture, presumably in part because no Chinese investment is involved. The first step is submission of a project report to the local government at or above the county level at the location where the proposed WFOE is to be set up.[70] After obtaining preliminary approval from the local authority, foreign investors submit a formal application to the relevant examination and approval authority through the local authority mentioned above. Similar to the joint venture, the examination and approval authority for WFOEs is normally the MOFCOM, but in certain circumstances it can be the government of the relevant province, autonomous region, municipality directly under the central government, city listed on the state planning or special economic zone.[71] The examination and approval authority shall make a decision within ninety days upon receipt of the application form and relevant supporting documents such as a feasibility study report and articles of association.[72] Like the joint venture, the WFOE, after being granted the approval, shall then apply to the SAIC for registration and obtain a business license to start operation.[73]

[68] *See* Provisional Measures Governing Verification of Foreign Invested Projects, *supra* note 67, art. 5–6.

[69] *See* EJV Implementing Regulation, *supra* note 10, art. 6; CJV Implementing Regulation, *supra* note 29, art. 6.

[70] *See* WFOE Implementing Regulation, *supra* note 48, art. 9.

[71] *Id.* art. 7.

[72] *Id.* art 11.

[73] *Id.* art 12.

III. CHINA'S FOREIGN INVESTMENT ENTERPRISE LAW IN CONTEXT

A. Explaining the Chinese Characteristics

The Chinese legal regime governing foreign investment enterprises is very different from that of developed countries, with three distinctive characteristics as shall be discussed below. What explains these characteristics? Will they persist or disappear? The following portion of this article will shed light on the above questions by demonstrating that Chinese FIE law bears the mark of China's historical political economy. It will also point to the exogenous and endogenous factors shaping the pattern of foreign investment regulation in China.

1. Separate, Specific Foreign-Invested Enterprise Legal Regime

First and foremost, China has a long-established, relatively well-developed distinct legal regime for FIEs, contrasting China with many Western countries where the single legal framework surrounding corporate and partnership law generally governs the incorporation requirements for both domestic and foreign investors. In China, domestic and foreign-invested enterprises are traditionally segregated, subject to different laws with different requirements for their establishment and operation.

There are two main reasons for this dichotomy. The first one is historical. When China embarked on its effort to attract foreign capital through FIEs in the late 1970s, the company and partnership were utterly nonexistent in China, and there was no trace of a framework of law to support those legal notions. When the Law of the PRC on Chinese-Foreign Equity Joint Ventures (EJV Law) was first passed in 1979, it was among the first batch of laws constituting the first step in the re-creation of a Chinese legal system. Within a decade, the Law of the PRC on Chinese-Foreign Contractual Joint Ventures (CJV Law) in 1988 and the Law of the PRC on Foreign-Capital Enterprises (WFOE Law) in 1986 followed on its heels. Although these bodies of law referenced the concept of the limited liability company, the Company Law of the PRC (hereinafter referred to as "Company Law") was not enacted until 1994.[74] With the legal structure for foreign-invested enterprises predating the notion of the company, China had no choice but to create a standalone, self-sufficient legal regime for FIEs to meet the pressing needs at the early stage of the econom-

[74] 中华人民共和国公司法 [Company Law (P.R.C.)], (promulgated by the Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) (amended Dec. 25, 1999, Aug. 28, 2004, and Oct. 27, 2005) STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (P.R.C.) [hereinafter Company Law].

ic reform.

The other reason behind the dual system is political. At the beginning of the economic reform, the Chinese government was of two minds towards foreign investors. On one hand, China desperately took whatever action was necessary to attract foreign investment in an effort to rescue its economy, which teetered at the brink of collapse. To that end, the government traditionally offered a number of substantial benefits to foreign investors, including tax concessions and various operational privileges. On the other hand, after many years of confrontation with the Western world, the Chinese government was understandably cautious about the impact of foreign investment in China. The experimental nature of the economic reform mandated that the government closely monitor the investment process, intervening at the sign of trouble to suspend or even terminate it quickly to control damage. To implement these protective measures, China utilizes a separate legal regime for foreign investment which facilitates identification of foreign investors to grant them preferential treatment. It also has the advantage of adaptability to the particular needs of foreign investors. A separate regime can operate like a firewall between domestic and foreign-invested businesses, allowing the Chinese government to better administer foreign investment.

However, the parallel system also has significant weaknesses. It increases both regulatory costs for the Chinese government and compliance costs for foreign investors. Foreign-invested enterprises are now subject to FIE-specific laws and general laws, like the Company Law. As shall be discussed in more detail later, there may be conflict between the two legal systems, in which case the specific laws shall generally prevail over the Company Law.[75] But the key criticism leveled at the parallel system is that it is fundamentally antithetical to the notion of fairness. Given those negative aspects of the legal dichotomy as described above, it will be informative to observe whether and how these two systems converge in the future.

2. Underpinned by the Concept of "Enterprise" Rather than "Company"

The second characteristic of China's foreign investment law is that it is based on the concept of enterprise rather than company. This trait also reflects the historical background of the FIE laws. The concept of enterprise bears the imprint of the era of China's pre-reform planned economy. Under the traditional communist system, enterprises were the commercial production units under the direction of the government. As discussed

[75] *See* Part IV below.

above, the notion of company did not exist in the early days of China's move to attract foreign investment, and thus, it is natural that China decided to invite foreign investment via the then prevailing business form of enterprise. Such a policy enabled China to quickly open up and utilize foreign investment without first establishing a company-based legal system.

Though effective in the short term, as China continues to transform from a planned economy to a market-oriented economy, this enterprise-based legal system has proven to be out of step with economic developments. The term "enterprise" lacks a legally defined meaning, and its legal characteristics are undetermined—for example, whether it has separate legal personality or not. China has gradually modernized its commercial law framework in line with international norms and has been encouraging enterprises to convert to company form. It is just a matter of time before all enterprises, both domestic and foreign-invested, are converted to companies or other types of modern business associations. Consequently, the enterprise-based legal system for foreign investment will then become obsolete and eventually disappear in favor of the modern commercial law system.

3. An Ad Hoc Approach to Economic Reform

The third characteristic of China's foreign investment legal regime is its piecemeal ad hoc approach, resulting in a complex body of relevant laws, regulations and rules at both national and local levels. This is a common feature of China's underdeveloped legal system consistent with the trial-and-error nature of Chinese economic reform. The key government agencies in charge of FIE have been evolving in this manner. Initially, the Ministry of Foreign Economic Relations and Trade (MOFERT) had the primary responsibility for the FIE regulation. It was later renamed the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). In 2003, the Ministry of Commerce (MOFCOM) was established to take on the functions previously exercised by the MOFTEC.

The step-by-step approach of modern Chinese lawmaking is compatible with the rapidly changing Chinese political and economic scene. When China embarked on the "reform and opening up" economic policy after the Cultural Revolution, it had to develop almost from scratch a new legal regime to attract foreign trade and foreign investment. It established a basic legal framework to meet the urgent need, continuing on to fill the gaps in the legal framework, adjusting and refining as necessary. This approach seems reasonable in light of the impracticability of instantaneously inventing a legal system, especially in a transition economy like that of China.[76]

While an ad hoc approach has the advantage of flexibility to adjust to rapid-changing realities, it suffers from a range of significant problems. The bewildering array of legal provisions in this field has increased regulatory and compliance costs. In the course of constant legal reform, it is not uncommon for new laws to be introduced while old ones remain in force. Coupled with other aspects of the legal system, such as multiple legislative authorities with an unclear division of powers, this has produced many inconsistencies and conflicts within China's FIE legal regime. In recognition of these issues, the Chinese government has been trying to regularly clean up and compile FIE-related laws. This falls short of addressing the difficulty created by the accretive and fragmented way in which China's FIE law evolves, but it does considerably alleviate the problems and improve the workability of the law.

B. Utilization of Foreign-Invested Enterprises and Post-WTO Trends

Since China joined the WTO in 2001, foreign-invested enterprises in China have grown significantly. Also, there are interesting developmental trends of foreign investment in terms of the relative attractiveness of each of the three FIE forms. This section of the article provides important insights into determinants and directions of change in the choice of form.

1. Choice of Form for Foreign-Invested Enterprises

Each of the three FIE forms discussed above, EJVs, CJVs and WFOEs, has its advantages and disadvantages. For foreign investors wishing to invest and establish business in China, the calculus of choice rests on a number of considerations.

The first step is to choose between a WFOE and a joint venture. There are several important considerations in favor of the WFOE. First, the foreign investor in a WFOE enjoys exclusive management control of the business. Due to difference in culture, management style or interests, many foreign partners may encounter tremendous difficulties in dealing with their Chinese partners in joint ventures. In a joint venture, even when the foreign investor holds a majority interest, his ability to actually control the entity is limited. This is due both to legal restraints on the free-

[76] *See, e.g.*, Volker Behr, *Development of a New Legal System in the People's Republic of China* 67 LA. L. REV. 1161, 1179 (2007) (contending that the Chinese step-by-step legal development is a success and can serve as a paradigm for other developing countries).

dom of the parties to choose their own structural arrangements in the joint venture and to practical issues of control. For instance, in EJVs and CJVs, decisions on many matters require unanimous approval of the board of directors, effectively giving the minority partner a veto and making deadlock a constant risk for the entity; also, the equity interests are quite illiquid because of the statutory requirement that the consent of other parties and the approval authorities be obtained to transfer an equity interest.[77]

Furthermore, because the WFOE is owned and managed solely by foreigners, there can be no disputes with Chinese partners, resulting in less interference with the business from the Chinese authorities.[78] Yet another advantage for foreign investors taking the WFOE path is that it does not nurture a potential future Chinese competitor. In a joint venture, both parties grow as they learn from each other and benefit from each other's resources. Upon termination of the joint venture, the once partners will become rival players in the market. This issue is exacerbated by the perceived risk of technology or know-how leakage during the operation of the joint venture.[79]

On the other hand, several factors weigh against the WFOE. First, without the benefit of a Chinese partner guiding the business through the less transparent legal system and the unique Chinese commercial environment, the WFOE may run more legal and business risks than EJVs and CJVs. This is particularly true when the foreign investors are new players unfamiliar with the Chinese regime. Indeed, in a joint venture, the chief benefit accruing to foreign investors may be the partner's local knowledge and connections as well as its market share and access to local distribution channels. Second, as discussed earlier, there are certain areas off limits to WFOEs in which foreign entities can only invest in conjunction with Chinese partners.[80]

Assuming that a joint venture is to be established, the next decision is between the EJV and CJV forms. In comparison with the EJV, the CJV is much more flexible. As discussed above, the investors in a CJV will not only enjoy the benefit of limited liability, but also have wide discretion in relation to matters such as profit distribution, ownership and management. These perquisites have been very attractive in the early period of foreign investment in China for two main reasons.

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[77] EJV Implementing Regulation, *supra* note 10, art. 20; CJV Implementing Regulation, *supra* note 29, art. 23.

[78] 刘俊海，新公司法的制度创新：立法争点与解释难点 [LIU JUNHAI, INSTITUTIONAL INNOVATIONS OF CHINA'S NEW COMPANY LAW: LEGISLATIVE AND INTERPRETIVE DIFFICULTIES] 513 (法律出版社 [Law Press]) (2006).

[79] XIAOWEN TIAN, MANAGING INTERNATIONAL BUSINESS IN CHINA 89 (Cambridge Univ. Press) (2007).

[80] *See* Part II(D) above.

First, in those early days, China just emerged from the chaos of the Cultural Revolution, and the economic reforms were experimental in nature. Foreign investors may have entertained legitimate concerns about the commercial and political risks of investment. In such uncertain circumstances, the CJV could be a safer option, allowing foreigners to minimize investment risk through early retrieval of investment, collection of profit in proportion to capital contribution, design of management structure to exert more control, and so on.[81] Second, foreign investors had the opportunity to take advantage of the contractual freedom in the CJV at a time when they had the upper hand in negotiation. When China embarked on its economic reforms in the early 1980s, its economy was on the verge of collapse and in dire need of foreign investment. Unsurprisingly, Chinese parties to transactions had to make significant concessions to the needs of their foreign partners. The generous treatment of foreign investors in the CJV may have been necessary at the time, but it may well be criticized in modernity as excessively deferential at the expense of Chinese parties.

The CJV does suffer some weaknesses vis-à-vis the EJV. For instance, the foreign investors' early retrieval right may weaken the stability of the EJV, limiting its effectiveness for longer-term ventures.[82] In addition, the increased negotiation costs of dickering the many open terms of a CJV contract may, for some parties, tilt the balance toward the default-heavy EJV, which utilizes a set of standardized terms codified in the EJV laws and regulations to facilitate off-the-rack contracting.

The relative weight of the above pros and cons in the decision-making process over the form of a foreign-invested enterprise may change over time, necessitating reassessment in light of the social, commercial and legal context in which the FIE operates. At the early stages of China's economic reform and solicitation of foreign investment, the advantages of the joint venture, especially the CJV, may have outweighed its disadvantages. With China's continued opening up and rapid economic development, foreign investors have gradually become more familiar with the investment environment, increasing their confidence in the Chinese market. Looking down the road, foreign investors may select EJVs over CJVs as they plan for long-term investment in China. The contractual flexibility to foreigners of CJVs may become unavailable in practice as Chinese parties wield greater bargaining power with less pressure to sacrifice to attract foreign investment.

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[81] THE CHINESE COMMERCIAL LEGAL SYSTEM 237 (Patricia Blazey & Kay-Wah Chan eds., Thomson Lawbook) (2008).

[82] KUI HUA WANG, CHINESE COMMERCIAL LAW 118 (Oxford University Press) (2000).

An increasing number of foreign investors may even feel confident stepping out alone without the assistance of a Chinese partner, choosing the wholly foreign-owned enterprises business form. China continued liberalization of its foreign investment legal regime and opening up of more industry sectors to WFOEs make this feasible. Prior to the 2000 amendment of the WFOE Law, the government required WFOEs to use advanced technology and equipment or sell all or most of their products outside China, a condition said to have had a restricting effect on the establishment of WFOEs.[83] The 2000 amendment changed this, stating that WFOEs are "encouraged" rather than "required" to be export-oriented and technologically advanced.[84] Moreover, the 2001 amendment to the WFOE Implementing Regulation has removed the lists of industry sectors to which WFOE access was closed (such as foreign trade and insurance) or restricted (such as real estate and trust investment), referring only to the general guidance document regarding foreign investment industries in China which will be discussed in the next section.[85] As indicated by these changes, the Chinese government has recently taken a more facilitative approach to the examination and approval requirements for establishing a WFOE.

2. The Empirical Evidence

The preceding analysis is well supported by empirical evidence, including relevant statistics at the macro level and case study at the micro-level. In the early stages of foreign investment, joint ventures were the primary form of foreign-invested enterprise in China, accounting for as much as 97% of the total number of FIEs in 1983, with CJVs and EJVs occupying 73% and 24%, respectively.[86] In 1985, joint ventures made up 93% of total FDI in value.[87] But in recent times, as explained earlier, the expansion of foreign investment in China has tilted the scales in favor of the WFOE, and to a lesser extent, the EJV. In 1986, EJVs outnumbered CJVs; in 2001, the number of WFOEs exceeded that of EJVs and CJVs combined for the first time.[88] The WFOE has replaced the joint venture as the predominant mode of FDI,[89] and its share among all FIEs has grown every year thereafter.

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[83] LIU, *supra* note 78, at 507.
[84] WFOE Law, *supra* note 47, art. 3.
[85] *See* WFOE Implementing Regulation, *supra* note 48.
[86] 王玉梅，中国的外国直接投资法律制度研究 [WANG YUMEI, RESEARCH ON CHINA'S FOREIGN DIRECT INVESTMENT LAW] 33 (法律出版社 [Law Press] 2003).
[87] *See* TIAN, *supra* note 79, at 79–80.
[88] *See* WANG YUMEI, *supra* note 86, at 33.
[89] *See* TIAN, *supra* note 79, at 80–81.

In 2008, WFOEs constituted 81% of the total number of FDI projects while EJVs and CJVs each represented 17% and 2% only; in terms of the utilized FDI value, the figures were 78%, 19% and 3% for WFOEs, EJVs and CJVs respectively.[90] There are also some prominent individual examples of this trend. The Japanese company Panasonic first entered into an EJV in 1987 and converted into a WFOE in 2002. Similarly, the German company Hankel started with an EJV in 1993 and later transformed it into a WFOE in 2001.[91] In short, the WFOE is now the preferred mode of FIE, and the CJV is the least preferred.

IV. RELATIONSHIP BETWEEN THE FIE LAW AND THE COMPANY LAW: PROBLEMS AND PROSPECTS

As discussed before, the form FIEs generally take is the limited liability company, although other forms are possible for CJVs and WFOEs. Article 218 of the Company Law applies that body of statute to FIEs established in the form of limited liability companies or joint stock limited companies, unless other provisions in those laws relate more specifically.[92] This position was confirmed by the Notice on the Implementing Opinion on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign Invested Enterprises (FIE Law Application Opinion) in April 2006.[93]

In short, the relationship between the Company Law and FIE laws is that of general to specific laws. As a consequence, where the FIE laws conflict with the Company Law, the former will prevail; where the FIE laws are silent on certain matters, the Company Law will come into play to complement the FIE laws. This guiding principle on the interplay between the Company Law and the FIE legal system is referred to as the "FIE Law-Company Law Relationship Principle."

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[90] *See* US-China Business Council, *Foreign Direct Investment in China*, http://www.uschina.org/statistics/fdi_cumulative.html (statistics issued by the Ministry of Commerce of the PRC).

[91] *See* Lu et al., *supra* note 27, at 117–122, 154–156.

[92] Company Law, *supra* note 74, art. 218.

[93] 关于外商投资的公司审批登记法律适用若干问题的执行意见 [Implementing Opinion on Several Issues Concerning the Application of the Law on the Examination, Approval and Registration of Foreign Invested Enterprises] art. 10, (promulgated by the State Admin. for Indus. and Commerce, the Ministry of Commerce, the Gen. Admin. of Customs and the State Admin. of Foreign Exch., Apr. 24, 2006) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter FIE Law Application Opinion].

A. Complement

Since the Company Law has general application with respect to FIEs in the form of limited liability companies, it is applied by way of implication to supplement the specific FIE laws. This complementary role of the Company Law is important in light of the frequently incomplete or broad terms of this other body of doctrine.

For instance, Article 26 of the Company Law stipulates RMB 30,000 as the minimum amount of registered capital for limited liability companies subject to a higher requirement under other laws or administrative regulations.[94] The Company Law also sets out special rules for single shareholder limited liability companies, stating that minimum registered capital of RMB 100,000 is required and a natural person is allowed to establish only one one-person limited liability company.[95] This is relevant to so-called single-owner WFOEs, or those WFOEs established by a single foreign investor. Article 27 of the Company Law provides that the cash contribution by all shareholders of a limited liability company must be not less than 30% of its registered capital.[96] This means that non-cash capital contributions cannot exceed 70% of the registered capital. With no contrary provision on those matters in the specific FIE laws, the relevant Company Law rules apply.

Another example concerns the procedures for dissolution and winding up of FIEs. The EJV will be dissolved in any one of the following situations: (1) its specified duration has expired; (2) there is a serious deficit and the EJV has no capacity to operate continuously; (3) the EJV is unable to continue operation due to a party's breach of the joint venture contract or the articles of association; (4) the EJV has suffered serious losses due to force majeure; (5) the EJV cannot attain its business purposes and has no development future; or (6) a cause of dissolution as specified in the joint venture contract or articles of association occurs.[97] The issue of EJV dissolution was further addressed by a special administrative regulation promulgated by the MOFTEC in July 1996: Measures for Liquida-

[94] It should be noted that there are also other administrative regulations applying specifically in relation to the registered capital requirements of FIEs. For instance, the State Administration for Industry and Commerce has promulgated such regulations to stipulate the minimum amount of registered capital for EJVs depending on their total amount of investment, defined as the aggregate of the funds used to carry out the EJV's business including the capital contribution and loans. *See* 关于中外合资经营企业注册资本与投资总额比例的暂行规定 [Provisional Regulations for the Proportion of Registered Capital to Total Amount of Investment of Chinese-Foreign Equity Joint Ventures], (promulgated by the State Admin. for Indus. and Commerce, Mar. 1, 1987) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[95] Company Law, *supra* note 74, art. 59.

[96] Company Law, *supra* note 74, art. 27.

[97] EJV Implementing Regulations, *supra* note 10, art. 90.

tion of Foreign-Invested Enterprises (FIE Liquidation Measures).[98]

The Company Law sets out additional circumstances for corporate dissolution, for example, when the company's business license is cancelled and when it is necessary to dissolve it due to merger or split-up of the company.[99] On January 15, 2008, in response to uncertainty over the proper application of Company Law provisions to EJVs, the State Council issued a decree annulling the FIE Liquidation Measures. It is now clear that the Company Law provisions relating to dissolution are applicable to EJVs.[100]

B. Conflict

The Company Law complements the specific FIE legal regime with respect to certain matters, but there are circumstances where conflict occurs between the dual systems. In that case, the specific FIE laws prevail pursuant to Article 218 of the Company Law and relevant administrative regulations such as the FIE Law Application Opinion. Some uncertainty remains over the scope of the term "FIE laws" used in those documents: specifically, whether the term "laws" is to be strictly interpreted to mean law only or liberally interpreted to include administrative regulations and rules.

Under the Chinese legislative system, the term *falü* (法律) (law), in its narrow sense, refers only to the national law enacted by the National People's Congress or its standing committee, but it can also be used in a broad sense to encompass all legal documents including administrative regulations and rules. It is critically important to determine the scope of the term "law" to resolve the frequent conflicts between the Company Law and administrative regulations or rules relating specifically to FIEs rather than the specific FIE laws. A broad interpretation of the word "law" would include specific administrative FIE regulations or rules within the meaning of the FIE Law-Company Law Relationship Principle set out above, preempting the general Company Law. Alternatively, if the term "law" is used in the narrow sense, those administrative regulations or rules do not constitute "laws," and the Company Law takes priority as a "law" with a higher level of legal force than "regulations" or "rules." This

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98 外商投资企业清算办法 [Measures for Liquidation of Foreign-Invested Enterprises (P.R.C.)], (promulgated by Ministry of Foreign Trade and Econ. Cooperation, July 9, 1996) LAWINFOCHINA, *available at* http://www.lawinfochina.com [hereinafter FIE Liquidation Measures].

99 Company Law, *supra* note 74, art. 181.

100 关于废止部分行政法规的决定 [Decision on the Annulling of Certain Administrative Regulations (P.R.C.)], (promulgated by the State Council, Jan. 25, 2008) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

point is illustrated in the issues below arising from the conflict between the Company Law and specific FIE regulations.

As an example, the WFOE Implementing Regulation set a maximum amount of 20% registered capital contribution in the form of industrial property rights and proprietary technology,[101] but the Company Law as amended in 2005 removed this restriction.[102] A second example involves the installment amount and timeframe for capital subscription by installments. The Company Law provides that the first installment be no less than 20% of the registered capital, with the balance to be paid off within two years (or five years for investment companies) of the establishment of the company.[103] In contrast, the WFOE Implementing Regulation stipulates that the first installment be no less than *15%* of the total capital contribution and the balance be paid off within *three* years of the establishment of the WFOE.[104]

In the above examples, the resolution of the discrepancies between the Company Law and specific FIE regulations will depend on the sense in which the term "law" is used in the relevant provisions. There has been a difference of opinion among scholars and regulators, but the majority view appears to be that the term "law" should be strictly interpreted, causing the Company Law to prevail over FIE regulations and rules.[105] Some proponents of this view cite Article 1 of the FIE Law Application Opinion as support. It sets out an order of priority for the application of laws and other legal sources: first, laws applying specifically to FIEs; second, the Company Law and its related regulations; and third, regulations, provisions and other legal documentation concerning FIEs. As a cautionary note, application of Article 1 in this context should be treated with some suspicion because the text refers only to the administration of FIE registration. Hence, although the FIE Law Application Opinion has provided clarification on some specific matters,[106] there is a great need for a principled answer to the question whether the term "law," as used in the FIE Law-Company Law Relationship Principle, includes administrative regulations and rules. Furthermore, the validity and applicability of the FIE Law Application Opinion itself as a product of subordinate bodies to the

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[101] WFOE Implementing Regulation, *supra* note 48, art. 27.

[102] *See* Company Law, *supra* note 74.

[103] *See* Company Law, *supra* note 74, art. 26.

[104] WFOE Implementing Regulation, *supra* note 48, art. 30.

[105] *See, e.g.*, LIU, *supra* note 78, at 516; Neal A. Stender et al., *China's Foreign Invested Companies Changing & Converging with Domestically Owned Companies*, 9 HONG KONG LAWYER 45, 49 (2006).

[106] Article 9 of the FIE Law Application Opinion, *supra* note 93, provides that the WFOE Implementing Regulation prevails over the Company Law as to the minimum amount of the first installment for the establishment of WFOEs.

State Council attempting to rank the legal forces of laws and administrative regulations promulgated at or above the State Council level is not without doubt.

C. Future Developments: A Level Playing Field for All?

At a more fundamental level, the issue concerning the interpretation of the term "law" reflects a conundrum inherent in China's parallel FIE legal systems. The application of the Company Law to FIEs will have an impact on the prospect of a future merger of the parallel systems. As discussed earlier, due to the special nature of FIEs, the FIE-specific laws and regulations contain special rules. Even if these dual systems are likely to converge in the future, the process will be gradual and perhaps bumpy for reasons discussed below.

From a pessimistic perspective, there are too many vested interests on the part of foreign investors for the convergence to happen anytime soon. The historical preferential treatment for foreign investors has been enshrined in various administrative regulations. In addition, the FIE-specific legal system appears to be more flexible and permissive than the Company Law. The CJV regime, for example, provides enormous autonomy in terms of profit distribution, investment retrieval and management structure, and the WFOE form also gives considerable flexibility over management structure. This stands in stark contrast with the more stringent and onerous Company Law rules, which impose tight restrictions on capital reduction and require all companies to establish three management bodies (shareholders' meetings, a board of directors and a board of supervisors). There are also many areas where the FIE legal system is silent, allowing room for foreign investors to maneuver.

When the Company Law applies to FIEs, it strengthens regulation of FIEs by closing legal gaps, introducing more stringent rules and removing preferential treatment. For foreign investors, although the specific FIE system may have the problem of uncertainty due to its silence on certain issues, it has the advantage of flexibility. Despite the compliance benefits of convergence, foreign investors may find the application of Company Law to FIEs unfavorable to their interests.[107] It follows that foreign investors may choose to object when the term "law" is interpreted broadly so as to allow the Company Law to override the more generous treatment offered under specific administrative FIE regulations.

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[107] *See, e.g.*, Vivienne Bath, *The Company Law and Foreign Investment Enterprises in the PRC—Parallel Systems of Chinese-Foreign Regulation* 30(3) U.N.S.W. L.J. 777 (2007) (stating that as a result of the Company Law's application to FIEs, foreign investors in a WFOE have the disadvantage of having to disclose their shareholder agreement to the approval authority).

The attempt to apply the Company Law to FIEs as indicated in the FIE Law Application Opinion has suggested a move towards convergence of the dual systems of FIE regulation. This trend is due to the call from foreign investors for a single, unitary, clear FIE regulatory regime and to the outcry from Chinese investors over the privileges for outsiders associated with FIEs. In an effort to level the playing field, China has been taking steps to reduce or even eliminate the preferential treatment for foreigners. For example, the 2008 Enterprises Income Tax Law abolished the tax preferences granted to almost all FIEs in favor of preferences awarded on the basis of technology transfer, environmental protection and other factors.[108]

Another incentive for China to merge the dual systems is the reduction in regulatory cost incumbent upon the transition to a single administrative system. This may be an opportune time for China to repeal the separate FIE legal system and require all FIEs to take the same organizational forms as domestic enterprises, given that China has now established a relatively complete and modernized business law system consisting primarily of the Company Law and the Partnership Law.

However, the Chinese government will have to proceed with care. First, as noted above, foreign investors may react negatively to the loss of their privileges. As implied by its policy shift from quantity to quality, China is relatively secure in its ability to attract foreign investment, but caution would not be out of place nonetheless. Second, there is no urgent need to radically change the parallel regulatory structure, which has functioned reasonably well in the past. The Chinese government's practice of improving the workability of the current dual systems gradually, through tidying up and compiling FIE laws and regulations, is a safe and rational policy.

Finally, it may be problematic to apply the Company Law wholesale to FIEs without considering their special nature. In a joint venture, for example, directors are appointed directly by the joint venture parties and are expected to represent their interests. This raises the question of whether—and if so, how—directors' duties under the Company Law apply to this distinct business form. Another difficult issue is the role and function of the board of supervisors. Traditionally, EJVs and CJVs are managed only by a board of directors, but the Company Law also requires convening shareholders' meetings and establishing a board of supervisors. Is it workable or meaningful to have a board of supervisors in EJVs and

[108] 中华人民共和国企业所得税法 [Enterprise Income Tax Law (P.R.C.)] art. 27, (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

CJVs? Under the Company Law, the supervisors have the power to recommend that the shareholders remove directors, but in a joint venture, the recommendation would be made to the joint venture partners who actually hand-picked the directors in question. Under the Company Law, one third of the members of a supervisory board must be elected by the company employees. Since management power is delicately balanced between the joint venture parties, the establishment and composition of the supervisory board will be highly sensitive due to its effect on the balance of power. Some scholars have expressed concern as to whether the employee representative should be considered to be truly independent or effectively another vote for the Chinese party.[109]

Hence, although the dual systems of FIE regulation are likely to converge in the long term, they will probably persist in the short term to some degree. The Chinese government should be careful in timing the move towards convergence and be prepared for difficulties and uncertainties along the way. An admirable illustration of this balance is the SAIC's treatment of the issue of whether the Company Law requirement of establishing a supervisory board should apply to FIEs.

On April 24, 2006, the SAIC issued the FIE Law Application Opinion to require that the management structure of FIEs comply with both the specific FIE legal system and the Company Law.[110] However, because of a textual conflict between the Company Law and the FIE law as to whether FIEs were required to have a board of supervisors, the SAIC issued a circular one month later stating that FIEs have discretion over the establishment of a supervisory board.[111] But after determining this position to be inconsistent with the FIE Law-Company Law Relationship Principle (when the FIE legal system is silent on a given issue, the general Company Law applies), the SAIC revised its public stance on September 22, 2006, just four months after publishing the circular, issuing an interpretation to clarify that the Company Law does apply to require FIEs to establish a supervisory board.[112] Confusion reigned in practice, and the SAIC has faced heavy criticism. This controversy indicates the coordina-

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[109] *See* Bath, *supra* note 107, at 778.

[110] *See* FIE Law Application Opinion, *supra* note 93.

[111] 关于实施《关于外商投资的公司审批登记管理法律适用若干问题的执行意见》的通知 [Circular on Implementation of the 'Implementing Opinion on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign Investment Enterprises' (P.R.C.)], (promulgated by the State Admin. of Indus. and Commerce, May 26, 2006) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

[112] '关于外商投资的公司审批登记管理法律适用若干问题的执行意见' 重点条款解读 [Interpretation of Key Provisions of the 'Implementing Opinion on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign Investment Enterprises' (P.R.C.)], (promulgated by the State Admin. of Indus. and Commerce, Sept. 22, 2006) LAWINFOCHINA, *available at* http://www.lawinfochina.com.

tion problems resulting from dual systems of FIE regulation and the challenges likely to arise in a move towards convergence.

V. CONCLUSION

China's foreign-invested enterprise regulatory regime has changed significantly since China's accession to the WTO in 2001. The wholly foreign-owned enterprise is now the preferred form of foreign investment and the contractual joint venture the least favored. This transition can be explained in part by the central features of FIEs in China as discussed in this article with respect to organizational form, capital contribution, profit distribution, and management structure, demonstrating the advantages and disadvantages of the three types of FIEs.

At present, the regulatory regime exhibits several distinctive characteristics, the most significant being the dual FIE regulation system consisting of the FIE-specific legal system and the general system implemented by general Company Law. The general company law system supplements the specific FIE legal system, filling in gaps, but also leading to areas of conflict. Resolution of that conflict goes to the heart of China's foreign investment policy. The application of the company law system to FIEs is a move towards convergence of the dual systems of FIE regulation. For a variety of political and economic reasons, this legal move is not likely to be quick or smooth; nonetheless, readily observable evolutionary trends point towards convergence in the long term. For the foreseeable short term and to some degree, the dual systems of FIE regulation are likely to persist.