doing business in china

CANADIAN LAWYERS

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BLAKES GUIDE TO DOING BUSINESS IN CHINA

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Doing Business in China is intended as an introductory summary of the key issues relating to investing in China. Specific advice should be sought in connection with particular transactions.

Blakes produces regular reports and special publications on Canadian legal developments, including a general guide to *Doing Business in Canada*. For further information on Chinese business and investment law, contact Robert Kwauk, Chief Representative, Beijing, by phone at +86-10-6530-9001, by facsimile at +86-10-6530-9008 or by e-mail at bob.kwauk@blakes.com.

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BLAKES GUIDE TO DOING BUSINESS IN CHINA

I. AN OVERVIEW FOR FOREIGN INVESTORS

Despite the opportunities for Canadian investors in the Chinese market and the relative openness that China has shown to foreign investment, it is important to remember that there are fundamental differences between the way business is conducted in Canada and in China. From a legal perspective, despite the tremendous volume of statutes, regulations, rules and circulars that have been and continue to be promulgated by various levels of the Chinese government, the Chinese legal system is still immature and underdeveloped. China does not function under the rule of law as Canadians understand that concept, and Chinese courts cannot be expected to act in a manner that is familiar or acceptable to Canadians.

This paper sets out a summary of the principal vehicles that foreign investors may use to establish a presence in China. However, there is no template for entering the China market. Every case is specific and an investor's approach will necessarily depend upon the industry that the investor is engaged in, the area of China in which the investor wishes to invest, and the level of investment the investor is willing to make. As such, this paper should be viewed simply as a general starting point.

II. FOREIGN DIRECT INVESTMENT AND BUSINESS VEHICLES

1. Representative Office

A representative office (RO) is an easy and inexpensive vehicle for a foreign company to enter the Chinese market. Generally speaking, approvals are granted relatively quickly and as a matter of routine, so long as the establishing company is a legitimate enterprise. Many foreign businesses choose to open an RO in China as a way to explore the market before making a more substantive investment.

ROs have the advantage of not having any minimum registered capital requirements, which enables foreign investors to enter China without investing large sums of money. That being said, ROs are limited in their operational scope, while minimum registered capital requirements for foreign-invested companies, which can carry on active business, have in recent years decreased significantly. As a result, an RO may be less appealing if the ultimate goal of the foreign investor is the establishment of an operating company.

Under Chinese law, a representative office may only be established to act as a liaison between the Chinese market and the establishing foreign company. Such liaison activities are restricted to research, marketing, introduction of products to the Chinese market, technical exchanges with Chinese companies, and other activities that facilitate business between the Chinese market and the foreign company. ROs are not permitted to engage in any direct business activities. In other words, an RO is not permitted to accept payment for goods, issue invoices, or enter into business contracts on behalf of the head office or on its own behalf. All business contracts must be entered into by the foreign company and payment must be remitted directly to the foreign company overseas.

Prior to May 2004, foreign companies engaging in trade, manufacturing, consulting, advertising, investment, leasing and freight forwarding that wished to set up an RO in China were required to obtain preliminary approval from the Ministry of Commerce (MOC), as well as approval and registration from the State Administration of Industry Commerce (SAIC). This procedure has been simplified and now a single application to the local branch of the SAIC is all that is required to establish an RO. With respect to certain key industries, however, such as banking and law, various regulatory approvals are still required before an RO can be established. Establishing an RO in a non-specialized sector can take as little as four to six weeks.

2. Corporate Vehicles

Two types of business vehicles are generally used by foreign companies to conduct business operations in China: joint ventures and wholly foreign-owned enterprises. Joint ventures and wholly foreign-owned enterprises can be established as greenfield operations or by way of the purchase of assets from, or the purchase of an equity interest in, an existing domestic or foreign-invested enterprise.

2.2 Tax Incentives

In the past, domestic and foreign-invested enterprises were subject to separate tax regimes, and significant tax incentives were granted to foreign-invested enterprises engaged in manufacturing and export. However, at the most recent session of the National People's Congress, a new tax law was passed

that unifies the enterprise income tax, at a basic rate of 25 per cent, and repeals the tax incentives previously available to manufacturing and export-oriented companies (subject to grandfathering rules). This new tax law, effective as of January 1, 2008, evidences a shift in economic policy away from a manufacturing base towards other industry sectors, such as agriculture, forestry, high tech, and the environment, as the new tax law provides that tax incentives may be made available in such sectors.

3. Permissible Activities

Before establishing or acquiring an interest in a business entity in China, foreign investors need to consult the *PRC Foreign Investment Industrial Guidance Catalogue (Revised),* and any relevant industry specific laws and regulations to determine whether foreign investment is allowed in the contemplated industry sector. The catalogue classifies industries into three categories – encouraged, restricted and prohibited. Any industries that are not listed in the catalogue are deemed to be permitted. These categories generally indicate the extent to which foreign investment in those areas is supported and encouraged by the Chinese government.

As a general rule, industries in the encouraged and permitted categories will be approved more readily, while those in the restricted category are generally subject to closer scrutiny during the approval process. Foreign investors are not permitted to invest in industries that fall under the prohibited category.

It is important to note that in some industries foreign investors are required to form a joint venture with a Chinese party and are prohibited from establishing a wholly foreign-owned enterprise, even where investment in such industry sectors is encouraged (for example, in the case of development of petroleum and natural gas projects). Certain industries are also subject to specific regulations that set minimum capitalization thresholds in order to obtain the certification necessary to conduct business (for example, the construction industry).

3.2 Joint Ventures

Two types of Chinese-foreign joint ventures are permitted under Chinese law: the equity joint venture (EJV) and the co-operative (or contractual) joint venture (CJV), both of which can be established as limited liability companies.

Where a joint venture with a Chinese party is not required by law, foreign investors should carefully consider whether there is a genuine need to work with a local equity partner, or whether it may ultimately be more cost-effective to establish a wholly foreign-owned enterprise. The costs of dealing with a local partner, who will often resist managing the joint venture in accordance with Western practices, may ultimately be greater than simply starting from scratch. In dispute situations, the Chinese partner to the joint venture will often have the upper hand, no matter how carefully agreements are drafted. In most Chinese jurisdictions, foreign investors can work directly with the government and regulators without the assistance of a local business partner. The decision to work with a Chinese business partner should be made on the same commercial grounds that would be applied in Canada. Promises of access to or special treatment from local government should not be the basis for forming a business relationship.

In an equity joint venture, each party may contribute registered capital in the form of cash, land, buildings, intellectual property, equipment and/or technology. The parties then share in the management, profits, risks and losses of the joint venture in proportion to their relative equity interests. Co-operative

joint ventures are in many ways similar to equity joint ventures, but are somewhat more flexible in that the joint venture contract may provide for the foreign party to recoup its investment before the end of the term of the co-operative joint venture. The form of the parties' capital contributions to a co-operative joint venture may also be more flexible and its management may be contracted out to a third party. In the past, it was generally required that the foreign party contribute at least 25 per cent of the registered capital of the joint venture. This is no longer the case.

Unlike the approval process for a representative office, which is largely a matter of routine, the authorities responsible for approving the establishment of joint ventures (and wholly foreign-owned enterprises) have the power to reject or suggest revisions to application documents if they determine that the documents contravene Chinese law or government policy. Interpretations of Chinese law and the application of policies can differ greatly from region to region. As such, practices in one Chinese jurisdiction may not be applicable in any other jurisdiction in the country. Since, in practice, there is limited administrative recourse available, foreign investors have no choice but to accept determinations and rulings made by local government authorities.

3.3 Wholly Foreign-Owned Enterprise (WFOE)

Instead of a joint venture, a foreign company may choose to establish **a wholly foreign-owned enterprise** (WFOE). WFOEs, like joint ventures, are usually established in the form of limited liability companies. The main advantage of a WFOE is that the foreign investor, not having Chinese partners, has sole control over the management and financial affairs of the company. Several foreign investors may partner to establish a WFOE either by investing directly or by establishing an offshore entity to invest in the WFOE.

In comparison to a joint venture, establishing a WFOE is relatively simple, although by no means as fast and simple as establishing a corporate entity in Canada since there is no requirement to enter into a joint venture contract with a local partner.

At present, WFOEs are still prohibited in certain industries.

4. Timing and Documentation

In order to establish a joint venture, the Chinese and foreign party must jointly prepare a feasibility study of the operations to be undertaken in China, enter into a joint venture contract, and agree upon articles of association that must then be submitted to the relevant Chinese authorities for approval and registration. In addition to the foregoing, numerous ancillary documents and a bank letter, from the foreign investor's bank, confirming the foreign investor is in a position to contribute its committed registered capital, must be filed with the regulatory authorities.

Documentation necessary to apply to establish a WFOE is similar, except that no joint venture contract is required. It is realistic to budget for a time period of between three to six months from the date the application for a foreign-invested enterprise is submitted to the government authorities to the date on which the enterprise has all of the licences and certificates necessary for it to be operational. It is, however, customary for government authorities to request documents and additional clarifications that may slow down the process.

Whether a foreign-invested enterprise requires local, provincial or central government approval depends on the nature and size of the investment. Central government approvals, since they invariably involve larger investments or investments in key sectors, tend to take longer than local and provincial approvals.

5. Limited Liability Companies

As mentioned above, both WFOEs and joint ventures are typically established in the form of limited liability companies. A limited liability company, in China, is a legal entity in which the liability of each investor therein is limited to the investor's committed contribution to the registered capital of the entity. WFOEs and joint ventures are Chinese companies and are subject to Chinese company law, as well as to the laws specifically related to foreign-invested enterprises.

5.2 Articles of Association and Joint Venture Contracts

The articles of association of a limited liability company are its governing document. In the case of a joint venture established as a limited liability company, there is typically significant overlap between the terms of the joint venture contract and the provisions of the articles of association. Articles of association typically deal with issues such as business scope, governance, management, financial reporting, pre-emptive rights on the proposed transfer of equity (as provided for under Chinese law), registered capital, total investment and profit repatriation. Joint venture contracts usually contain the same provisions, as well as terms of the business deal between the parties. Articles of association and joint venture contracts as well as any amendments thereto must be approved by Chinese government authorities.

5.3 Business Scope

The business scope of a company established in China must be set out in its articles of association (and joint venture contract, where applicable) and approved by the regulators. It must be precise and correspond to the type of business the company will undertake upon establishment. Companies established in China are not entitled to enter into business activities beyond their approved business scope. Imprecise or overly broad business scopes may be rejected by the regulators and substituted with narrower scopes. Each government approval authority has its preferred business-scope wording, which may vary from jurisdiction to jurisdiction. Deviation from the generally approved standard wording in the articles of association and application documents can lead to the business scope being modified by the regulators. Ultimately, the legal business scope of the company will be the one that is printed on its business licence, and this business scope may differ from the business scope provided for in the articles of association.

Should a company wish to expand or change its operations post-establishment, its business scope will have to be amended in its articles of association, subject to proper government approval, and a new business licence evidencing the amended business scope will have to be issued.

5.4 Legal Address and Operational Address

The legal address of a Chinese company and the address at which it carries on its main operations must be the same. Although a company may have more than one operating facility, it may not have a "paper office" as its legal address. Foreign investors are sometimes wrongly advised by agents or even local governments in this regard, and in the hope of benefiting from certain tax incentives or simply due to a lack of proper planning, will establish a "registered office" in one location and carry on operations at a separate location. This can cause significant administrative problems.

5.5 Capitalization

It is important for foreign investors to understand the concept of the registered capital of a limited liability company, as it is a key concept that is frequently misunderstood. The registered capital of a limited liability company is a commitment of funds[1] that has to be directly invested by the investors into the limited liability company in accordance with the law and the company's articles of association (and joint venture contract, where applicable). Typically, 15 per cent of the registered capital must be contributed within 90 days of issuance of the preliminary business licence and the remaining 85 per cent must be invested within one to two years of the date of establishment, depending on the total amount of registered capital. An investor in a limited liability company does not hold shares in the company, but rather an interest equal to the percentage of the registered capital it has committed to contribute. The liability of each investor is limited to the amount of registered capital it has committed regardless of whether or not such registered capital has been contributed.

Each contribution by an investor to the registered capital is evidenced by an auditors report, called a capital verification report, which must be filed with Chinese authorities. Following preparation of a capital verification report the company is obliged to issue a current "investment certificate" to the investor, which must evidence the total amount of registered capital contributed by the investor to date.

Chinese law also provides for what is called the "total investment" in a limited liability company. According to law, the total investment is defined as the total amount of investment necessary for the company to reach its production scale. In the case of non-manufacturing companies, total investment is generally understood to mean the amount of funding necessary to bring the company to a profit-making state.

Chinese law provides that the registered capital of a company must equal at least a defined percentage of the total investment, as set out in the chart below.

Total Investment (in US$)	Ratio of Registered Capital to Total Investment	Specified Minimum Investment (in US$)
Less than or equal to 3 million	7/10	- -
Greater than 3 million, up to and including 10 million	1/2	Where the total investment is 4.2 million or less, registered capital may not be less than 2.1 million.
Greater than 10 million, up to and including 30 million	2/5	Where the total investment is 12.5 million or less, registered capital may not be less than 5 million.
More than 30 million	1/3	Where the total investment is 36 million or less, registered capital may not be less than 12 million.

[1] A portion of the registered capital may be contributed by investors in a form other than cash, including machinery, equipment and proprietary technology. However, specific rules and criteria apply in order for such assets to be validly contributed as registered capital.

The difference between the total investment and registered capital is not a financial commitment on the part of the investors. However, that difference equals the total amount of funds the company may raise by way of loans, including shareholder loans. The rationale behind this policy is the avoidance of undercapitalized entities that will not be able to reach their operating goals.

Both the registered capital and the total investment of a company must be registered with Chinese authorities, and may only be modified following an additional approval process. In the event a limited liability company runs out of working capital and all its registered capital has been contributed by its investors, it will only be able to obtain additional funds through loans or through an increase to its registered capital, which increase must be approved by government authorities. As government approvals may take several weeks to be obtained, a lack of proper cash-flow planning may leave the company in financial difficulties. Therefore, the amount of total investment and registered capital of a company should be determined strategically. Investors need to balance the desire to limit their investment risk in China against the risk of cash-flow problems.

Although there has been a decrease in the minimum registered capital requirements of companies over the past few years, regulators still pay attention to these numbers and may refuse to approve the establishment of a foreign-invested enterprise where there is concern that the registered capital will not be sufficient to bring the enterprise to a productive level.

5.6 The Legal Representative and Company Seals

The legal representative of a limited liability company is the person with authority to legally bind the entity. Although a Canadian company will usually include in its by-laws a list of officers entitled to sign documents and legally bind the company, this is not the case in China.

In the case of joint ventures, the legal representative is the chairman of the board. Although in the case of a WFOE it is up to the investors to appoint a legal representative, Chinese regulators still generally expect that the chairman (or executive director where there is no board) will act as the legal representative. The legal representative must be registered with Chinese government authorities. It is difficult for a legal representative to delegate his or her powers to a third party where government filings are required, as most regulators will not recognize powers of attorney in cases where government forms require the signature of the legal representative. Chinese regulators have also, so far, generally refused to acknowledge the fact that foreign companies may not have an equivalent concept to the legal representative. As a consequence, a legal-entity investor in a foreign-invested enterprise will generally have to appoint a legal representative to act on its behalf.

The Chinese legal system also provides for various company seals (or "chops") that can be used to bind the company. Although the concept of company seals is now generally obsolete in Canada, in China, company seals often replace or supplement the signature of the legal representative. Needless to say the individual in control of the various seals needs to be a person who can be trusted not to abuse their position. While a company seal is mandatory for every company in China, there are various other non-mandatory seals that have more limited uses, such as the human resources seal and the contract seal. Although a financial seal is not mandatory at law, in practical terms, almost all banks will require the use of such seal for various banking operations. Each company may only have one company seal and such seal, as well as the non-mandatory seals, can only be obtained from government authorities.

5.7 General Steps in Establishing a Foreign Enterprise in China

- Preparation of feasibility study report, articles of association, and joint venture contract, where necessary, as well as ancillary application materials
- Obtain approval for the project from the National Development and Reform Commission or its local branch
- Obtain approval to establish a foreign-invested enterprise from the Ministry of Commerce or its local branch
- Apply for a national organization code
- Obtain a business licence from the State Administration of Industry and Commerce, or its local branch
- Register with the Public Security Bureau and obtain approval for preparation of seals
- Obtain foreign exchange registration certificate and approval to open a foreign currency registered capital account from the State Administration of Foreign Exchange
- Open bank accounts
- Register with state and local tax authorities
- Register with statistics authorities
- Register with labour and social securities authorities
- Register with customs
- Register with finance authorities

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