

China Enacts New Foreign Investment Law

Amid stark slowdown in output growth and trade disputes with U.S., PRC authorities speed up issuance of legislation to encourage investment from abroad.

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TAKEAWAYS

- Law affirms equal legal standing of foreign-backed enterprises and Chinese competitors.
- Local governments required to follow through on commitments made to foreign investors.
- Intellectual property protection and equality in government procurement enshrined in law.

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On March 15, 2019, the National People's Congress (**NPC**, China's legislative organ) of the People's Republic of China (**PRC**) passed the Foreign Investment Law. The Foreign Investment Law will come into effect on January 1, 2020.

The National Bureau of Statistics (**NBS**) of China released certain economic data on March 14, 2019. During January to February, China's year-on-year cumulative growth rate of industrial value added rose 5.3 percent, the lowest growth rate since early 2009, as U.S. tariffs and weakening domestic demand have impacted. Given the trade disputes and ongoing trade negotiations with the United States, the Chinese government has accelerated the issuance of the Foreign Investment Law to demonstrate its positions on major concerns of foreign investors, which may facilitate its trade negotiation with the U.S. government.

This article will discuss the general principles set forth in the new law, its major impact on foreign investors and foreign-invested enterprises (**FIEs**), and ambiguities to be clarified as soon as practical.

1. GOOD-FAITH PRINCIPLES

Pre-entry National Treatment and Negative List

In June 2018, the National Development and Reform Commission and the Ministry of Commerce issued the Negative List (2018 version) to officially establish the negative list system in China on a national level. The Foreign Investment Law confirms that the negative list system will continue to apply. The negative list includes (i) industries that foreign investors are prohibited from investing in, and (ii) industries that foreign investors are permitted to invest in only if they fulfill the restrictive requirements under the negative list. For industries not covered by the negative list, foreign investors have at least the same access to investment as PRC domestic investors and may be entitled to preferential treatment offered by the relevant regulations and policies. The Foreign Investment Law also expressly provides that after any investment is made (e.g. any foreign-invested enterprise is established), that foreign investment will be treated equally with its domestic counterpart unless any laws and administrative regulations provide otherwise.

Preferential Policies

Local governments may invite foreign investors to make investments in designated industries, areas and regions and may provide preferential policies to those foreign investors and FIEs. Local governments must implement their commitments made towards foreign investors and FIEs. Any change to previous commitments must be made through due process and within the government's statutory authority, and foreign investors and FIEs are entitled to indemnification for losses due to any such change.

This principle may have impact on resolving existing and potential disputes between foreign investors/FIEs and local governments due to changes of agreed preferential policies by local governments.

IP Protection

Foreign investors will conduct technology cooperation based on free will and subject to commercial practice. No governmental authority can force any technology transfer.

Equality

FIEs can equally participate in drafting standards, and any such national compulsory standards will be fairly applied to FIEs.

FIEs can equally participate in government procurement. Governments must treat products locally produced by FIEs in China and services provided by FIEs in China equally with purely domestic entities. This principle may encourage FIEs to provide actual production and services locally in China, if the government sector is a significant market for those FIEs.

2. MAJOR IMPACT ON FIEs

After China's market opening-up in the 1980s and 1990s, foreign investors would normally use three types of business vehicles for establishing FIEs in China: equity joint ventures (**EJV**), cooperative joint ventures (**CJV**) and wholly foreign-owned enterprises (**WFOE**). PRC Laws on (i) Sino-Foreign EJV (**EJV Law**), (ii) Sino-Foreign CJV (**CJV Law**), and (iii) WFOE (**WFOE Law**) and their implementing rules published in the 1970s-1990s, as amended from time to time, have served as the fundamental laws governing foreign investment in China. The EJV Law, CJV Law and WFOE law and their respective implementing rules are collectively referred to as the "**Three Laws**." The Foreign Investment Law has the following impact on existing FIEs and any future new FIEs to be established by foreign investors in China.

Decision-making Authority of EJV and CJV

After the PRC Company Law was amended for the third time on October 27, 2005 (which was further amended again in 2013 and 2018), differences arose between the Three Laws and the PRC Company Law, in particular with respect to the decision-making authority of an FIE. In [Appendix A](#), we have provided a sample of differences between EJV Law and the Company Law. Such conflicts were moderated by a 2006 notice jointly published by the State Administration for Industry and Commerce, the Ministry of Commerce, the General Administration of Customs, and the State Administration of Foreign Exchange (**2006 Notice**). Among the conflicts, as confirmed by the 2006 Notice, EJVs and CJVs will follow the decision-making authority set forth by the EJV Law and CJV Law, i.e., the board of directors continues to be the highest authority of the company; while the PRC Company Law applies to the decision-making authority of WFOEs, under which the shareholders' meeting of a limited liability company (including a WFOE) or the shareholders' general meeting of a company limited by shares is the highest authority of a company.

After enactment of the Foreign Investment Law and the abolishment of the Three Laws, FIEs will need to comply with the PRC Company Law, the PRC Partnership Law, etc.

Any existing EJV and CJV will need to review their joint venture contracts and articles of association (**AOA**) and revise the decision-making authority and voting mechanism accordingly. Article 42 of the Foreign Investment Law provides for a five-year transition period for existing FIEs to adjust their current organizational forms and other aspects to make necessary adjustments based on the Foreign Investment Law. Since this decision-making authority is a critical and sensitive topic during joint venture contract negotiations, we recommend clients do not wait until the last minute to take appropriate action.

More Financing Possibilities

Under current PRC law, a foreign investor is allowed to establish an FIE in China in the form of a company limited by shares, but establishment is subject to special approval by the PRC government and certain requirements for the investors. Also, current PRC laws and regulations impose restrictions on foreign equity ratio and other stricter requirements for a foreign-invested company limited by shares if the company is to be listed on the PRC's stock exchange. The Foreign Investment Law confirms that FIEs can raise financing through public offering of shares, issuing bonds, etc. We have not seen any reaction from the capital market regulators on this issue. It is a frequent request of foreign investors that the listing requirements and listing review and approval procedures for a foreign invested company limited by shares be the same as the ones currently applicable to domestic companies.

EJVs' Profit-Sharing

Under the EJV Law, shareholders shared profits based on their capital contribution ratio to the registered capital of the EJV. Under the Company Law, shareholders can determine more flexible profit-sharing mechanisms.

3. AMBIGUITIES TO BE CLARIFIED

The final Foreign Investment Law is much shorter than a 2015 draft. That brevity may have been due to a rush to issue a new law in order to facilitate the trade negotiations with the United States. The new law does not address many details, and the following issues need to be clarified as soon as practical.

Application of the Law

The Foreign Investment Law will apply to foreign direct and *indirect investments* in China, including:

- Establishing an FIE in the PRC;
- Acquiring shares, equity interest, property or other similar interest in any enterprise in the PRC;
- *Investing in newly built projects in the PRC*; and
- Other means.

China has separate *Interim Measures regarding Domestic Investment by Foreign-Invested Enterprises (Re-investment Measures)*. It is not yet clear whether the "indirect investment" referred to under the Foreign Investment Law is the same as the circumstance described under the Re-investment Measure, and if so, whether the Re-investment Measures will be abolished as well.

The definition of "Investing in newly-built projects in China" also needs to be clarified.

Period from March 15, 2019 to December 31, 2019

The Foreign Investment Law was published on March 15, 2019, and it will become effective on January 1, 2020. FIEs established before January 1, 2020 will have five years to keep their original organizational forms (e.g., continue using the board of directors as the highest decision-making body).

If a foreign investor wants to submit its application to register an EJV or CJV during the period from March 15, 2019 to December 31, 2019, it is not clear how it should determine the decision-making authority of the board. Will it be based on the new Foreign Investment Law or the original EJV Law or CJV Law? Can the foreign investor directly agree with its Chinese partner that the shareholders' meeting will be the highest decision-making body from the beginning, to avoid future amendment of the joint venture contract and AOA?

Total Investment

Each FIE has a defined total investment and a registered capital, but the Company Law only provides for registered capital.

Total investment is the total amount of funds required to establish and operate the enterprise, including capital required to build the operation site and required cash flow. There are statutory ratios between total investment and registered capital. The difference between the total investment and the registered capital does not need to be actually paid by shareholders, but it is the foreign debt quota that an FIE is allowed to borrow for financing in the future. Foreign investors normally set the total investment at the highest level permitted by law in order to keep flexibility for future financing.

It is unclear whether FIEs can borrow foreign loans in the future and, if so, whether there will be any foreign debt quota and how to determine it.

The PRC government is expected to issue detailed implementing rules to supplement the Foreign Investment Law, and we will keep you posted of the progress. Foreign investors and FIEs should take every opportunity to participate in drafting the implementation rules. This will be critical for filling in the many ambiguities in the newly approved Foreign Investment Law.

We are happy to assist any existing FIEs or new foreign investors in reviewing investment documents in China to comply with the Foreign Investment Law.

Appendix A - Major Differences between EJV Law and Company Law

ISSUE	EJV LAW	COMPANY LAW
Percentage of Foreign Ownership	As a principle, foreign investors shall own no less than 25 percent of the equity interest.	There is no principle regarding the minimum percentage of foreign ownership.
Total Investment	Each FIE has a defined total investment and a registered capital amount. There are statutory ratios between total investment and registered capital. The difference between the total investment and the registered capital does not need to be actually paid by shareholders, but it is the foreign debt quota that an FIE is allowed to borrow for financing.	The Company Law only provides for registered capital.
Decision-making Organ	The board of directors is the highest decision-making organ.	The shareholders' meeting of a limited liability company or the shareholders' general meeting of a company limited by shares is the highest decision-making organ.
Shareholders' Meeting	There is no shareholders' meeting.	<p>Decisions regarding (i) amendment of the company's AOA, (ii) increase or decrease of the registered capital, (iii) the merger, split, dissolution, or (iv) conversion of the company (e.g., from a limited liability company to a company limited by shares), must be approved by shareholders representing more than two-thirds of the voting rights.</p> <p>Besides matters described above, shareholder meetings are required to (i) determine operational and investment plans; (ii) appoint directors and supervisors (who are not employee representatives) and determine their remuneration; (iii) approve reports of board of directors/ executive director, or supervisors; (iv) approve annual budgets and final financial positions; (v) approve any profit distribution or loss make-up plans; (vi) issue company bonds, etc.</p>
Board of Directors	The board of directors shall consist of no fewer than three members. There is no option for appointment of an executive director in lieu of a board of directors.	A limited liability company with relatively few shareholders or of a relatively small size may have one executive director in lieu of a board of directors.
Powers of the Board	Decisions to (i) amend the AOA, (ii) increase or decrease the registered capital, (iii) terminate or dissolve the company, and (iv) merge or split the company, require unanimous affirmative vote of the directors attending a board meeting.	The authority of the board of directors under the Company Law is much less powerful than under the EJV Law. Under the Company Law, the board acts as an intermediary between the shareholder(s) and the management.
Term of Directors	Each term of a director is four years.	The term of a director shall not exceed three years.

ISSUE	EJV LAW	COMPANY LAW
Legal Representative	The chairman of the board is the legal representative.	The chairman of the board, the executive director or the general manager may be the legal representative.
Equity Transfer to Third Party	Unanimous consent of all other shareholders is required.	Consent of over half of the other shareholders is required unless otherwise provided by the articles of association.
Statutory Funds	An EJV is required to allocate a certain percentage of its after-tax profits to the <i>reserve fund</i> , <i>enterprise expansion fund</i> and <i>employee incentive and benefit fund</i> (together known as “ Three Funds ”) with the percentage determined by the board of directors of the EJV as the highest decision-making authority.	<p>A limited liability company must allocate 10 percent of its annual after-tax profits to a <i>statutory reserve fund</i> until the amount of such statutory reserve fund reaches 50 percent of the registered capital (not paid-in capital) of the company. After the company has accrued the statutory reserve fund, it may retain a <i>discretionary reserve fund</i> from its after-tax profits subject to a resolution of the shareholders’ meeting or the shareholders’ general meeting.</p> <p>Whether and how the amount of Three Funds that has been collected by an EJV can be converted to the statutory reserve fund under the Company Law is yet to be clarified in upcoming implementing measures.</p>