MEMBER CONTRIBUTION

China's New Foreign Investment Law brings changes to corporate structure

Since China decided to intensify the opening-up policies, it is trying to change the regulatory framework for foreign investment business with the New Foreign Investment Law. Basically, this law replaces the Equity Joint Venture ("EJV") Law, Contractual Joint Venture ("CJV") Law and Wholly Foreign Owned Enterprise ("WFOE")[1] Law, , in terms of the organization form, institutional framework and standard of conduct. As a result, all the foreign companies and domestic companies in Mainland China shall comply with the applicable Chinese laws, such as the Company Law and the Partnership Law.[2] For that reason, foreign investors will choose limited liability companies, companies limited by shares, partnership enterprises and other forms of organization specified by the applicable laws.

In China, the domestic and the foreign companies had different treatment. Therefore, the Chinese domestic companies were established in accordance with Chinese company Law and the foreign companies were required to operate as either an Equity Joint Venture ("EJV"),

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[1] Meichen Liu, The New Chinese Foreign Investment Law and Its Implication on Foreign Investors, (Northwestern Pritzker School of Law)p. 288. Available at https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1830&context=njilb (visted 12 Jun 2020).

[2] Jianwen Huang. The Foreign Investment Regulation Review. *The Law Review*. (October, 2019). Available at https://thelawreviews.co.uk/edition/the-foreign-investment-regulation-review-edition-7/1209421/china (visited 24 May 2020).

a Contractual Joint Venture ("CJV") or a Wholly Foreign Owned Enterprise ("WFOE")[3]. These entities usually also take the form of a company with limited liability ("LLC") under Chinese Company Law, but foreign companies were asked for additional requirements.

It is important to note for all the investors that the three existing laws on foreign investment, with the New Foreign Investment Law, will disappear. This means that the distinction between WOFE, EJV and CJV will no longer exist, and the current foreign investment structures will uniformly be referred to as foreign-invested enterprise (FIE).

The use of the three foreign investment laws make a distinction between foreign and domestic enterprises in the Chinese legal system. Moreover, foreign investors were not allowed to operate in the same business structures as domestic business entities[4]. Consequently, these two sectors have their own rules for the highest authority, the majority, the profit distribution, and the equity transfer.

One of the reasons is that the three existing laws are no longer serving the economy's needs. The governance structure of these companies was based on the old FIE. [5] For example, under the law of Sino-foreign joint ventures, the board of director is the highest authority with board seats allocated in proportion to each joint venture partner's capital contribution.

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[3] Meichen Liu, The New Chinese Foreign Investment Law and Its Implication on Foreign Investors, (Northwestern Pritzker School of Law)p. 288. Available at https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1830&context=njilb (visted 12 Jun 2020).

[4] Marius Stucki, China's New Foreign Investment Law – With A Special Note On Swiss-Chinese Investment (Beijing, December 14, 2019). Available at SSRN: https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=3503897.

[5] Qian Zhou . "China's New Foreign Investment Law: A Backgrounder". China Briefing.(2020). Available at https://www.china-briefing.com/news/china-new-foreign-investment-law-backgrounder/(visited 18 May 2020).

On the other hand, under the Company Law, the highest authority is shareholders' meeting that also requires the approval of more than two-thirds of the voting rights.

For an LLC, the highest corporate authority is its members meeting. Under the Company Law, certain fundamental matters, such as amending the articles of association, changing the registered capital, mergers, or dissolutions, require the approval of more than two-thirds majority of the member voting rights. The board of directors however acts through a simple majority, and the allocation of board seats does not have to follow the members' respective shareholding percentage.[6] Under the existing FIE laws, an EJV does not have members meetings. Instead the EJV's board of directors functions as its highest authority with board seats allocated in proportion to each joint venture partner's capital contribution and certain fundamental matters requiring unanimous board approval. Therefore, as a result of transition from an EJV to an LLC, the members will have more flexibility in corporate structuring and governance. To the extent contractually agreed, the supermajority shareholders can also enjoy a higher level of control than permitted under the default rules of the existing FIE laws[7]. Consequently, it is important to analyze how two different corporate structures will be fused in the future.

Since WFOEs are in the form of a limited liability company with its shareholders meeting as the supreme governance body, these changes will affect JVs such as equity joint

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[6] Latham & Watkins. China Introduces New Foreign Investment Law, Negative Lists, and Encouraged Industries Catalogue. (Client Alert White Paper, 2019). Available at https://www.lw.com/thoughtLeadership/china-introduces-new-foreign-investment-law-negative-lists-and-encouraged-industries-catalogue (visited 16 Jun 2020).

[7] Latham & Watkins. China Introduces New Foreign Investment Law, Negative Lists, and Encouraged Industries Catalogue. (n 2 above).

ventures and cooperative joint ventures.[8] Under the new legislation, foreign investors will have more or less the same power. For instance, this will include minority protections for Chinese investors in key areas like changes in the capital increase or decrease, termination and dissolution, merger and demerger and mortgages of assets or change of corporate form[9].

Moreover, the concept of total investment amount as unique to FIEs under the existing FIE laws does not exist under the Company Law. Therefore, the FIL will eliminate the capital rules applicable, which prevent a FIE from borrowing debt exceeding a certain percentage of its registered capital.[10] These will allow foreign investors to gain more flexibility in using shareholder loans rather than capital contribution to fund the capital needs of their portfolio FIEs.

Under the existing FIE laws, any proposed transfer of registered capital of an EJV is subject to the consent of the non-transferring party. By contrast, under the Company Law, the transfer by a shareholder of an LLC would be subject to the other shareholders' statutory right of first refusal.[11] In this sense, the shareholders may agree to certain transfers of registered capital in the articles of association.

Due to the important difference between the Company Law and the existing FIE laws, foreign investors with existing FIEs should consider revising their articles of association. Further, for EJVs and CJVs, it is necessary to review the joint venture contracts. These EJVs

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[8] China Market Watch, Confederation of Danish Industry In China. Available at https://cleantech-hub.dk/wp-content/uploads/2020/02/BRIEFING-ON-FOREIGN-INVESTMENT-LAW-2020-FINAL.pdf. (visited 12 Jun 2020)

[9] China Market Watch, Confederation of Danish Industry In China. (n 2 above)

[10] Latham & Watkins. China Introduces New Foreign Investment Law, Negative Lists, and Encouraged Industries Catalogue. (n 3 above).

[11] Latham & Watkins. China Introduces New Foreign Investment Law, Negative Lists, and Encouraged Industries Catalogue. (n 4 above).

and CJVs may need to renegotiate agreed joint venture terms between the joint venture partners. Foreign investors who plan to set up new operations in China will have to follow the laws applicable to domestic investors such as the Company Law and the Partnership Enterprise Law. Therefore, the biggest impact for foreign-invested companies will be to adjust their corporate structures to be compliant with the PRC Company Law or the Partnership Law.

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Meichen Liu, The New Chinese Foreign Investment Law and Its Implication on Foreign Investors, (Northwestern Pritzker School of Law)p. 288. Available at https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1830&context=njilb (visted 12 Jun 2020).
Marius Stucki, China's New Foreign Investment Law – With A Special Note On Swiss-Chinese Investment (Beijing, December 14, 2019). Available at SSRN: https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=3503897.
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China Market Watch, Confederation of Danish Industry In China. Available at https://cleantech-hub.dk/wp-content/uploads/2020/02/BRIEFING-ON-FOREIGN-INVESTMENT-LAW-2020-FINAL.pdf. (visited 12 Jun 2020)