
The Establishment of Operations in Shenzhen

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THE ESTABLISHMENT OF OPERATIONS IN SHENZHEN

1. INTRODUCTION

Shenzhen is the only city in the PRC that borders Hong Kong, giving it an unique regional geographical advantage in terms of logistics. Shenzhen is currently the headquarters to 58 out of the top 500 foreign invested enterprises in the PRC and 11 out of the nation's top 50 enterprises have set up businesses including Epson Engineering (SZ) Ltd., Ricoh Industry (SZ) Ltd., and Huaqiang Sanyo Electronics Ltd.. Up to 2001, there were 1860 projects involving foreign investment, with a total investment of US\$ 4 billion.

In 2002, foreign investment in Shenzhen has increased by 36.1% as compared to 2001 to reach a total amount of US\$5.186 billion, of which direct foreign investment comprises US\$3.191 billion.

Foreign investment covers a wide range of industries such as electronics, foodstuffs, textile and garments, pharmaceuticals, metals and plastics, real estate, finance, transport and catering businesses. The respective share of paid-in foreign investment in the primary, secondary and tertiary industries is 0.2%, 63.77% and 36.5%. The annual increase in actual use of foreign capital amounted to 45.9% in 2001.

Many foreign invested operations have enjoyed excellent performance and handsome returns by establishing in Shenzhen. Evidently, many other enterprises have followed suit in augmenting investments and expanding businesses in Shenzhen.

The majority of foreign investment has been focusing on the high-tech and manufacturing sectors. Shenzhen will continue to target foreign investments in these sectors in 2003.

2. FORMS OF OPERATION

Generally speaking, the majority of foreign investment in Shenzhen (like everywhere else in the PRC) is in the form of direct investment, by way of:

- sino-foreign equity joint ventures;
- sino-foreign contractual and co-operative joint ventures; or
- wholly foreign-owned enterprises (each referred to as "Foreign Investment Enterprise", and collectively referred to as "Foreign Investment Enterprises").

Additionally, foreign investors often set up representative offices and branch offices in Shenzhen.

FOREIGN INVESTMENT ENTERPRISES

3. LAWS AND RULES

Set out below is a list of laws, rules and regulations, at both the national and local level, which are relevant when establishing a Foreign Investment Enterprise in Shenzhen as well as to its operations thereafter. Together, these national and local laws and rules provide a legal framework establishing the independent operational rights of Foreign Investment Enterprises and to protect the legitimate rights and interests of both domestic and overseas investors in the PRC.

3.1 Basic Laws for Establishing a Foreign Investment Enterprise

The three basic laws, promulgated at the national PRC level, that one must consider in order to establish a Foreign Investment Enterprise in Shenzhen (as with everywhere else in the PRC) are:

- (a) the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (the “PRC Equity Joint Venture Law”) - for the establishment of Chinese-Foreign Equity Joint Ventures;
- (b) the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (the “PRC Contractual Joint Venture Law”)- for the establishment of Chinese-Foreign Contractual Joint Ventures; and
- (c) the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises (the “PRC Wholly Foreign-Owned Enterprise Law”) - for the establishment of Wholly Foreign-Owned Enterprises.

3.2 Implementing Rules And Other Laws Relevant To Establishing a Foreign Investment Enterprise

There are also detailed national rules for the implementation of these basic laws and to regulate incidental matters after having established Foreign Investment Enterprises, e.g. taxation and liquidation procedures:

- (a) Rules For the Implementation of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (12/1990);
- (b) Rules For the Implementation of the Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures (8/1995);
- (c) Rules For the Implementation of the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises;
- (d) The Company Law of the People's Republic of China;
- (e) The Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises;
- (f) Interim Provisions for Guiding Foreign Investment;
- (g) Industrial Catalogue for Foreign Investment;
- (h) Interim Provisions Concerning the Investment within China of Foreign-invested Enterprises;
- (i) Provisions Regarding the Merger and Separation of Foreign-invested Enterprises;
- (j) Provisions on the Contribution of Capital by Parties To Chinese-Foreign Equity Joint Ventures (8/1988);
- (k) Interim Provisions For the Duration of Chinese-Foreign Equity Joint Ventures (10/1990);
- (l) Provisional Regulations on the Establishment of Foreign-Funded Joint Stock Companies Limited (1/1995); and
- (m) Liquidation Measures for Enterprises with Foreign Investment.

Additionally, the PRC State government has also issued a “Directory of Industries for Foreign Investment” in order to provide guidance and approval of foreign-funded projects by giving four classifications of industries for foreign investment, namely industries which are encouraged; permitted; restricted; or forbidden.

Complementing the above national basic laws and rules, there are also local rules and policies for setting up Foreign Investment Enterprises pertinent to Shenzhen which are outlined below where appropriate.

3.3 Laws Affecting Operations of Foreign Investment Enterprises

Once approved and established, all of the Foreign Investment Enterprises (apart from the unlimited liability type of contractual joint ventures) are considered Chinese legal entities and as such must abide by all PRC laws, decrees, rules and regulations. These include the PRC Labour Law, the Unfair Competition Law, the Product Liability Law, the Advertising Law and various environmental protection laws. Given their Chinese legal entity status, Foreign Investment Enterprises (apart from the unlimited liability type of contractual joint ventures) are allowed to hire Chinese nationals as employees and are able to purchase land use rights on their own account (unlike representative offices which are not able to purchase land use rights on their own account).

Specific laws, many of which are applicable to one or more types of Foreign Investment Enterprises, have also been promulgated by the PRC government in relation to more specific areas of the law, such as taxation, business registration, accounting, foreign exchange, equity requirements and registered capital. These laws have been enacted with a view to increasing international economic co-operation and technological exchange between the Chinese parties and the Overseas Corporations. Through the various legislation, the Government protects the investments of Overseas Corporations, the profits due to them, and their other lawful rights and interests, pursuant to their government approved agreements, contracts and articles of association.

4. GENERAL ESTABLISHMENT PROCEDURES

Generally speaking, applications for the establishment of Foreign Investment Enterprises are usually dealt with at the provincial or local government level in charge of the geographical locality of the operation. Many of the policies of these local governments will vary depending upon their prevailing local, regional and national politics. In our case, application should be made to the Shenzhen Municipal Government. More specifically, stipulations by the Shenzhen Municipal Government provide that applications concerning the setting up of Foreign Investment Enterprises are to be submitted to the Shenzhen Municipal Foreign Investment Bureau (hereinafter referred to as “SMFIB”). However, major projects are nearly always approved at the central government level in Beijing, PRC.

Set out below is a description of the general steps and procedures that the Overseas Corporation must undertake when making an application for one of the three types of Foreign Investment Enterprises described above. These procedures are generally applicable for the applications of any of the Foreign Investment Enterprises, however references will be made where they differ for each different type of Foreign Investment Enterprises (for more specific details please see subsection “*Specific Requirements*” under the commentary for each type of Foreign Investment Enterprises) or where the Foreign Investment Enterprise engages in certain businesses and activities.

4.1 Materials To Be Submitted Upon Application

(a) Mandatory Documents

The Overseas Corporation must submit the following documents to the SMFIB in order to initiate its application for a Foreign Investment Enterprise:

- 10 copies of the “Project Clearance Form For Foreign Investment in Shenzhen” completed by the Overseas Corporation (including 2 original copies) - upon lodging the application by the Overseas Corporation, the SMFIB will also determine if the case qualifies for a project enjoying duty exemption for imported equipment. And if

so, the SMFIB shall issue a “Verification Paper for State Encouraged Projects” pursuant to “The Industry Catalogue for Guiding Foreign Investment”;

- upon the receipt of a preliminary clearance from the SMFIB, the Overseas Corporation (or the Chinese party, if setting up an equity or contractual joint venture) 5 original copies of a feasibility study report outlining the necessary steps for the success of the Foreign Investment Enterprise prepared, signed and chopped by the Overseas Corporation (and the Chinese party, if setting up an equity or contractual joint venture);
- for a project which impacts on the environment, the Overseas Corporation must also complete and submit 4 original copies of “Environmental Protection Examination and Approval Form For Construction Projects in Shenzhen” (the Overseas Corporation may first refer to the Municipal Environment Protection Bureau for clearance of its business);
- a copy of the “Notice of Advance Authorization of the Company Name” issued by the Industrial & Commercial Administrative Bureau to the Overseas Corporation for the approval of the proposed name of the Foreign Investment Enterprise;
- a copy of any legal business licence, certificate of incorporation, certificate of business registration, or their equivalent, of the Overseas Corporation issued by authorities its place of incorporation;
- a copy of legal registration papers of directors and shareholders or authorisation papers from the PRC embassy or consulate posted overseas for establishment of the Foreign Investment Enterprise;
- a copy of the Overseas Corporation’s “credibility papers” issued by the Overseas Corporation’s bank vouching for the financial history, trustworthiness and stability of the Overseas Corporation;
- an original copy of the resolution of the board of directors or shareholders' general meeting of the Overseas Corporation for the establishment of the Foreign Investment Enterprise;
- a copy of the Overseas Corporation’s capital verification report or its equivalent, such as an auditors’ report);
- a copy of the Overseas Corporation’s “liabilities sheet” or its equivalent, such as its balance sheet, clearing showing its liabilities, for the last 3 financial years;
- an original copy of a certificate issued by the relevant taxation authority of the Overseas Corporation’s place of incorporation confirming that the Overseas Corporation has no outstanding corporate income tax liability;
- where there is another party or parties involved in the establishment of the Foreign Investment Enterprise, the Overseas Corporation must submit 4 original copies of the agreement entered into by the Overseas Corporation with the party or parties, that have been signed and sealed by the representatives of the Overseas Corporation - wholly foreign-owned enterprises may be established without such an agreement, but instead it must complete and submit an original copy of the “Application Form For Establishing Foreign-invested Enterprise in China”;

- 4 original copies of the Foreign Investment Enterprise’s proposed articles of association that have been signed and sealed by the representatives of the Overseas Corporation;
- an original copy of the “SMFIB Ratification Paper” with the stub of the said form completed by the Overseas Corporation;
- the first page of the “Notice Sheet of National Institutions and Organisations Codes”;
- copy of any powers of attorney where the Overseas Corporation authorises any other person or persons to sign the required documents to be submitted to the SMFIB; and
- any other documents as required by the SMFIB.

In relation to sino-foreign equity joint ventures and sino-foreign contractual and co-operative joint ventures, there are additional documentary requirements. The Chinese party to these “partnership type” Foreign Investment Enterprises must submit, together with the above-mentioned documents to be submitted by the Overseas Corporation, the following additional documents to the SMFIB when making its application:

- an asset evaluation report for the assets to be contributed by the Chinese party towards the establishment of the Foreign Investment Enterprise; and
- if the said assets happens to be State-owned, an additional confirmation from the State Asset Administration for the assets evaluation results as well as a clearance from the department in question with the relevant asset ownership portfolio.

Once the above documents have been submitted to the SMFIB and assuming that the SMFIB approves, it will then issue a “Project Approval Form”, which the Overseas Corporation will then use to go through registration procedures with the Industry and Commerce Administration Bureau for a requisite business licence in order to carry out its intended business.

(b) Special Documents In Special Cases

For Foreign Investment Enterprises with proposed businesses in real estate development or property investment and management, or alternatively where part of the capital contribution or terms of cooperation of the Foreign Investment Enterprise comprises of self-owned property, the Overseas Corporation must also submit a copy of the valid documentation for land use rights and property and building ownership to the SMFIB.

For businesses in hotel, catering, recreations and warehousing, the Overseas Corporation must secure and submit to the SMFIB the valid approvals and licences from the relevant PRC authorities authorising its business and the use of its proposed facilities. Further, an approval issued by the Municipal Planning and Lands Bureau must also be obtained and submitted to the SMFIB for these businesses.

Special approvals and licences, pursuant to current national PRC laws and regulations, are required for Foreign Investment Enterprises engaged in areas such as investment, construction, trade and commerce, leasing, freight forwarding, and transport.

4.2 Points For Attention

Particular attention must be paid by the Overseas Corporation to the following matters when seeking approval for the establishment of a Foreign Investment Enterprise:

- (a) Under no circumstances should the Overseas Corporation make an investment in the form of property subject to an existing legal encumbrance such as a mortgage or a charge or property acquired under a capital leasing arrangement.
- (b) The Overseas Corporation is responsible for the legality and validity of all the above-mentioned documents submitted.
- (c) The SMFIB reserves the right to request the Overseas Corporation for documents to be resubmitted or revised or for further information and documents, within a prescribed time, when it is of the opinion that the submitted documents are inadequate or irrelevant to its consideration for approving a Foreign Investment Enterprise. In that event, the process of application and clearance will be subject to postponement.

5. SINO-FOREIGN EQUITY JOINT VENTURES

5.1 Introduction

A sino-foreign equity joint venture (“EJV”) is a limited liability company, with a governing board of directors, established in the PRC with joint investment from the Chinese and foreign parties.

EJV is considered a Chinese legal entity and as such must abide by all laws, decrees, rules and regulations of the PRC. In particular, EJVs are governed by the PRC Equity Joint Venture Law and its implementing rules. According to these laws, the foreign party to the venture, i.e. the Overseas Corporation, must invest at least 25% of the EJV’s registered capital. The underlying principle is joint effort and participation - the risks and losses of the EJV are shared by the parties in proportions to their contributions to the registered capital. Any profit that the Overseas Corporation receives may be remitted abroad in accordance with PRC foreign exchange regulations and in the currency specified in the joint venture agreement.

Given its Chinese legal entity status, an EJV is allowed to hire Chinese nationals as its staff and are able to purchase land on their own account (unlike representative offices which are not able to purchase land on their own account). Shareholdings in EJVs cannot be transferred without the prior approval from the government and the consent of all the other parties to the EJV.

5.2 Specific Requirements

The steps and procedures described under the section “*General Establishment Procedures*” applies to the establishment of an EJV. However, the following is various specific requirements particular to the establishment of an EJV.

Memorandum Of Understanding

The first step in forming a EJV is for the Overseas Corporation to find a suitable PRC partner to enter into a non-binding letter of intent, known as a Memorandum of Understanding (“MOU”). Once signed, the Chinese party will seek preliminary approval of the EJV from the SMFIB and relevant government bodies. The MOU usually contains a detailed description of the proposed project, an estimate of the amount of investment required, the equity split between the Chinese and the foreign party, and a general undertaking by both parties to jointly explore and exploit the business opportunities agreed upon. Albeit the non-binding nature of a MOU, its is important to draft the MOU concisely to define the business scope of

the EJV. If it becomes apparent that the submitted MOU is clearly inappropriate or requires modification, the SMFIB may require The Overseas Corporation to resubmit its application. It is paramount that the MOU reflects the preliminary views of the parties and state that the final agreement is subject to completion of the joint venture feasibility study and the execution of a binding joint venture contract between the parties and an articles of association of the proposed EJV.

Feasibility Study Report

The next step is for the parties to jointly prepare a feasibility study, which is again a non-legally binding document. Either the Overseas Corporation or the Chinese party may still opt not to proceed with the establishment of the EJV. The report must contain details of the EJV and its business, including:

- (a) the EJV partners;
- (b) location of its operation, including details of its factory and office premises;
- (c) the objectives, structure and form of the EJV, including the amount of investment and contributions from each of its parties and its financing arrangements;
- (d) its business and products, including a description of the technical standards of its products, output projections, testing and quality control;
- (e) its production technology and equipment, including estimates for the cost of equipment and any technology transfer fees;
- (f) a market analysis for its products both domestically and internationally, projected sales, methods of distribution, and an analysis of its competition;
- (g) an analysis of the environment impact, if any, caused the EJV's operation, including disclosure of the EJV's by-products and waste;
- (h) supply, utility, and transport and warehousing requirements;
- (i) foreign exchange requirements and projections;
- (j) staff requirements and training programmes; and
- (k) financial projections and economic cost and benefit analysis.

Once the feasibility study report is submitted (usually by the Chinese party of the EJV) to the SMFIB, it will be initially reviewed. Then passed, via the local planning commission, to other government organisations, including those involved in labour planning and raw material supplies, finance and utilities, concerned with, or affected by the operation of the EJV.

The contents of the report are important, as the various Chinese governmental organisations rely heavily on the report when making their decisions relating to the operation of the EJV. For example, if the electricity requirement of the EJV factory is underestimated, the Overseas Corporation could find the regular stoppages of the EJV's operation given the lack of power. Similarly, if export quotas are overestimated, failure to meet quotas may be reason for restricting the EJV's access to the domestic PRC market.

Joint Venture Agreement and Articles of Association

The joint venture agreement sets out the legal rights and obligations of the parties to the EJV and the articles of association deal with the internal organisation and operation of the EJV. They must be written in Chinese, although a version in an agreed second language will have equal validity. The joint venture agreement is governed by PRC laws. It is often supplemented by ancillary contracts, such as technology transfer contracts, technical assistance contracts, trademark licence contracts, and various supply and distribution agreements. The articles of association mirror many of the provisions of the joint venture agreement. However, in the case of conflict or inconsistency between the two, the joint venture agreement usually prevails.

5.3 Time

Once all the necessary documents have been submitted, the review process will normally be completed within 3 months of receipt of the application. If approved, the EJV registers with the Department of Industry and Commerce Administration, which will issue a business licence, allowing the joint venture to carry on business activities in the PRC as a Chinese legal person. After which, operations may begin. From then, the EJV will need to open a foreign exchange account, obtain funding from foreign banks (if required), register for taxation purposes with the local tax authority, register at the Custom House for customs and obtain insurance with Chinese insurance companies.

5.4 Capital Contribution

Under the PRC Equity Joint Venture Law, the Overseas Corporation must contribute at least 25% of the total investment: there is no minimum investment for the Chinese partner. The initial equity investment can take the form of cash, buildings, machinery, equipment, intellectual property rights, land-use rights, and technology, but cannot include labour.

The theory behind the formation of EJVs is that EJVs are usually established to exploit the market knowledge and manufacturing capabilities of the Chinese party, and the technologies, know how and marketing experience of the foreign partner. Accordingly, it is usually the Chinese partner who contributes the buildings, land and other assets from their existing operations, while the foreign party contributes machinery, equipment, industrial technologies and know how. All contributions must be recorded in the joint venture agreement or in the articles of association of the EJV, together with respective values.

In addition, there are strict ratios of debt to equity laid down by the PRC Equity Joint Venture Law according to the size of the EJV:

- (a) less than US\$3million - equity must constitute 70% of the investment;
- (b) more than US\$3 million, but less than US\$10 million - equity must constitute at least 50% of the investment;
- (c) more than US\$10 million but less than US\$30 million - 40% must be equity; and
- (d) more than US\$30 million - 33% of the investment must be equity.

Timing of the capital contributions, whether in cash or in kind, is also important. Failure to make timely contributions will result in financial penalties in the nature of default interest and may eventually result in a cancellation of the EJV's business licence. If the parties decide to make their contributions to the registered capital of the EJV in one lump sum, the contribution must be paid up within 6 months of the issuance of the EJV's business licence. If the contribution is to be made in installments, the first installment of not less than 15% of the EJV's registered capital must be paid within 3 months of the issuance of the EJV's business licence. Thereafter, the time frame for the payment of outstanding capital contributions is as follows:

<u>Amount:</u>	<u>Time following the issue of the EJV's business licence:</u>
US\$500,000 or under	one year;
US\$500,000 - US\$1 million	One and a half years;
US\$1 million -3 million	Two years;
US\$3 million -10 million	Three years; and
US\$10 million and above	Subject to specific approval.

5.5 Duration

The operation periods of EJVs vary according to the particular line of business and circumstances in each case. EJVs engaged in some business will specify the operation period of the in the joint venture agreement, while EJVs engaged in other types of business may choose not to do so. Where the operation period is specified, and if the parties decide to extend it, an application must be made to the SMFIB 6 months prior to the expiration of the operation period. The SMFIB shall decide whether to approve the extension within 1 month of the application.

Termination of the EJV may be affected by agreement of the parties, subject to approval by the SMFIB and registration with Industry and Commerce Administration Bureau.

6. CO-OPERATIVE/CONTRACTUAL JOINT VENTURES

6.1 Introduction

Broadly speaking, the aim of a co-operative or contractual joint venture (“CJV”) is to expand economic co-operation and technological exchange between China and foreign countries: export-oriented or technologically advanced CJVs are actively encouraged.

CJVs are governed by the PRC Contractual Joint Venture Law and its implementing rules, and must abide by Chinese laws and regulations and must not operate contrary to the public interests. Any transfer of rights to the CJV must be agreed by the other party to the CJV and approved by the SMFIB.

6.2 Legal Status

A CJV may be of limited liability with the status of a Chinese legal person, or alternatively, of unlimited liability in a non-legal person form, akin to a partnership.

The limited liability CJV in many ways resembles the structure of an EJV, with a joint venture agreement and an articles of association setting out the relationship between the parties and the internal organisation of the CJV respectively. However, there is a key difference being that in an EJV, profit distribution must be in proportion to the registered capital contributions of the parties to EJV, whereas for a CJV, profit distribution may be determined by contractual arrangements irrespective of the proportion of capital contributed by the parties. This allows for a more flexible schedule for return on investment where one investor provides cash while the other party's investment is primarily in kind.

The unlimited liability CJV is similar to a partnership whereby the parties jointly incur unlimited liability for the debts and obligations of the CJV. No separate legal personality is created. The precise division of liability and profit share is agreed between the parties in the joint venture agreement. Management, technical and marketing functions are also allocated contractually. A joint management committee is formed by representatives (delegated by the parties) to manage the joint venture. There are no articles of association for this kind of CJV.

6.3 Capital Contribution

Like an EJV, the investment contribution or the conditions of co-operation provided by each of the parties to the CJV may be in cash, in kind, or property rights such as industrial property rights, know-how and land-use rights.

For a limited liability CJV, the investment made by the Overseas Corporation must be at least 25% of the registered capital of the CJV. For an unlimited liability CJV, the specific requirements for the investment made are subject to Ministry of Foreign Trade and Economic Co-operation (“MOFTEC”) regulations.

Similar to an EJV, it is usually the foreign investor provides the majority of the funding, whilst the Chinese party provides land, equipment, industrial property rights, non-patent technology, and other facilities.

6.4 Specific Requirements

The SMFIB authorised by the State Council to grant approvals for the establishment of CJVs, which may approve CJVs in the following, amongst other, circumstances:

- (a) the total amount of investment is within the authorisation for approval as set by the State Council;
- (b) the capital will be raised by the applicants themselves; and
- (c) export quotas are not imposed upon the exportation of the CJV's products and do not require licences, or if they do, the consents of relevant competent departments have been obtained prior to submitting the application for establishing the CJV.

Approval will not be granted if the CJV:

- (a) is of detriment to PRC's sovereignty or public interests;
- (b) would jeopardise State security;
- (c) pollutes or damages the environment; or
- (d) violates any laws, administrative rules or State industrial policies.

The steps and procedures described under the section “*General Establishment Procedures*” applies to the establishment of a CJV. Further, the considerations involved when preparing the feasibility study report, the joint venture agreement and the articles of association for an EJV (please see subsection “*Specific Requirements*” under “*Sino-Foreign Equity Joint Ventures*”) applies equally to the establishment of a CJV. But emphasis must be place upon the joint venture agreement. This should contain details of the registered capital (which may be in Renminbi or any other freely convertible currency), investment contributions and/or the conditions for co-operation, management structure, ownership of property, and termination events. The parties shall stipulate in the joint venture agreement, based on the production and operation requirements of the CJV, the duration of the investment and/or the co-operation. Most importantly, it must provide for the distribution of earnings and sharing of risks and losses given that with CJVs such matters do not commensurate with each of the parties’ contributions. Any future modifications to the joint venture agreement will require further approval from the SMFIB.

6.5 Time

Normally, it may take up to 45 working days for the SMFIB to approve the application for the CJV. Upon approval, the SMFIB will grant a certificate of approval and then in turn submit the approval documents to MOFTEC within 30 days of approval being granted. Thereafter, the CJV should apply to the administrative authority for industry and commerce for registration and obtain a business licence.

6.6 Management And Operation

Once established, a CJV may, by presenting its business license, open a foreign exchange account, obtain loans from financial institutions, and purchase insurance. If within its approved scope of operation, the CJV may import its raw material requirements and, as strongly encouraged by the PRC State Government, export its products.

The board of directors (comprising of at least 3 members), which is the governing body of the CJV, shall meet at least once a year. Decisions which require unanimous resolution by the board of directors, including:

- (a) amendments to the CJV's articles of association;
- (b) increase or reduction of the CJV's registered capital;
- (c) dissolution of the CJV;
- (d) mortgage of CJV's assets;
- (e) merger or change in the form of the CJV; and
- (f) any other matters previously agreed upon by the parties.

For unlimited liability CJVs, a joint management committee, which essentially has the same functions as a board of directors, must be established.

With unanimous consent from the board of directors or the joint management committee and approval from the SMFIB, a limited liability CJV or an unlimited liability CJV respectively, may entrust a third party with the management and operation of the CJV. This type of arrangement is common, for example, in the hotel and hospitality industry, where an outside hotel management team is often appointed.

6.7 Taxation

For unlimited liability CJVs, each party may either compute and pay its own income tax in accordance with the relevant tax laws and regulations or alternatively may, with the approval of the local tax authority, compute and pay their taxes collectively as an entity.

Limited liability CJVs are required to pay a national income tax of 30% and a local income tax of 3%. Depending on its locality and business activities, there are several concessions that allow for either reductions or complete exemptions from taxation.

All CJVs are also subject to value-added tax, business tax, consumption tax, capital appreciation tax, customs duties, and import taxes.

6.8 Duration

The parties shall stipulate in the joint venture agreement, based on the production and operation requirements of the CJV, the duration of the investment and/or the co-operation. Any transfer of rights to the CJV must be agreed by the other party to the CJV and approved by the SMFIB.

Where there is no time limit as to the term of the CJV, the Overseas Corporation is allowed to withdraw its registered capital at any time. On the expiration of the joint venture, all the fixed assets belong to the Chinese party on a gratuitous basis. The Overseas Corporation may apply to the SMFIB for early recovery of its investment, provided that any losses have been fully paid. The profits it receives as its share, other legitimate income, and any equity returned as its share upon the termination of the venture, may be sent abroad by the Overseas Corporation.

6.9 Advantages of CJVs

In many instances, establishing a CJV can be a better option for a foreign investor rather than establishing an EJV. As a starting point, the Overseas Corporation does not need to set up a new corporation in China - the Overseas Corporation and the Chinese partner participate in the CJV by relying heavily on the Chinese party's existing business license, under a contractual arrangement. Often such an arrangement is used in land and hotel projects due to the tax advantages. If the business vehicle is a straightforward EJV, upon the Chinese party

transferring the land to the EJV, a liability to transfer tax will arise. However, under a CJV, the land stays in the possession of the Chinese partner and therefore no transfer taxes are payable. Also, where the Chinese partner is in possession of the land but does not have clear legal title (a common occurrence in China) - under an EJV the land would have to be bought from the Chinese Bureau of Land Control if the title was to be transferred to the EJV entity. Whereas under a CJV, provided that the status of the Chinese partner is high enough to maintain possession of the land, no such transfer will be required.

Flexibility is another key factor in choosing a CJV. The percentage of the CJV owned by each partner can change throughout the CJV's life, with the idea being that the Overseas Corporation can receive a faster return on their investment whilst ensuring that the Chinese partner maintains long term control. A Overseas Corporation usually want control over the joint venture at its inception because of the capital amount it has injected, such control being transferred over to the Chinese party as and when the CJV becomes profitable. The Chinese party is safe with the knowledge that even though initial changes may be made, they will maintain control in the long term and, in all likelihood, benefit from seeing modern management and marketing techniques being utilised by their foreign partner.

7. TERMINATION OF EJVs AND CJVs

The duration of an EJV or a CJV must be stated in the joint venture agreement. For most EJVs and CJVs, the approved term is usually between 10 to 30 years, although in cases where the amount of investment is large, or the construction time is long, the term may be extended to 50 years (with prior approval of the State Council). If an extension is required, a formal application must be made to the SMFIB 180 days before expiry of the current term. However, the duration will not be extended if the joint venture agreement allows the Overseas Corporation to first recover its investment and the said investment has been fully recovered.

An EJV or a CJV may be dissolved in the following situations:

- (a) end of its contractual term;
- (b) inability to continue operations due to financial losses or heavy losses caused by force majeure;
- (c) inability to continue operations due to the failure of one party to fulfil its contractual obligations under the joint venture agreement;
- (d) for any other reasons stipulated in the joint venture agreement and its articles of association; or
- (e) revocation ordered by PRC authorities according to law due to violation of laws and/or administrative regulations.

8. WHOLLY FOREIGN-OWNED ENTERPRISES

8.1 Introduction

Wholly foreign-owned enterprises (“WFOEs”) are governed by the PRC Wholly Foreign-Owned Enterprise Law and its implementing rules. Its investment are solely contributed the Overseas Corporation and takes profits and risks all on its own account. Although most WFOEs are established by one foreign investor, there are no legal restrictions on the number of foreign investors participating in such enterprises.

8.2 Legal Status

WFOEs are usually set up as limited liability companies with separate legal person status. Only upon general approval may a WFOE be established with other forms of liability. Its status as a limited liability company is confirmed in its articles of association.

The liability of the Overseas Corporation is limited to the amount of capital it contributed. However, the limited liability nature of the company should be distinguished from the unlimited potential liability of a WFOE's directors, managers, advisors or suppliers under product liability, worker safety or environmental protection regulations.

A WFOE must abide by all Chinese laws, decrees, rules and regulations. Given its separate legal entity status, it is allowed to enter into contracts with appropriate government authorities or Chinese business entities in order to acquire land use rights, rent buildings, and receive utility services etc. Labour must be employed in accordance with the applicable PRC labour laws.

8.3 Advantages Of WFOEs

The most striking difference between a WFOE and an EJV is the absence of a Chinese party, which brings about its own advantages and disadvantages. The procedures for the establishment of a WFOE is greatly shortened and simplified, as lengthy negotiations with a Chinese party are not required. As long as the relevant law and rules have been complied with, the Overseas Corporation is free to determine the scope of the WFOE's operation, the number of its employees, the percentage of its exports as compared to its imports etc.

A further advantage is the Overseas Corporation's technologies and commercially sensitive information remains confidential. Given the co-operative nature of an EJV or a CJV, the technologies, know how and commercial information of the Overseas Corporation must, to certain extent be disclosed and/or shared with its Chinese partner, which in turn may be tempted to make use of such information without the prior consent of the Overseas Corporation.

The other side to this argument is that its knowledge of China and the Chinese culture and its social connections, a Chinese partner may prove useful in dealings with PRC officials and maintaining good relations with the relevant local authorities. However, WFOEs often solve or ameliorate the disadvantages of not having a Chinese partner by hiring PRC nationals to assist with its interactions with the various authorities.

8.4 Specific Requirements

The underlying principle of the PRC Wholly Foreign-Owned Enterprise Law is that a WFOE must be conducive to the development of China's national economy and yield notable economic benefits, and accordingly must meet at least one of the following criteria:

- (a) use internationally advanced technology, the application of which is of benefit to China;
- (b) develop new products, save energy and raw materials, and upgrade and replace existing products that can be substituted for imports; or
- (c) export at least 50% of the total value of all its products manufactured and maintain a positive balance of foreign exchange in Renminbi.

There are also limitations in the types of business in which a WFOE may engage in. The following types of business are absolute prohibitions:

- (a) news, publishing, radio broadcasting or movie making;
- (b) postal industries; and
- (c) any other industry prohibited from time to time by the relevant authorities.

In general, the establishment of a WFOE engaged in the following businesses requires special approval from MOFTEC:

- (a) public utilities;
- (b) transportation;
- (c) real estate;
- (d) trust and investment; and
- (e) leasing.

Documentary requirements for the establishment of a WFOE vary slightly from those of an EJV or a CJV. The main difference being the requirement of a project proposal.

8.5 Approval

Approvals for WFOEs are granted more sparingly than for EJVs or CJVs. This is mainly due the fact that WFOEs enjoy exclusive management control of their business activities and are autonomous in their management, with little interference from the PRC government. The application process is usually also more expensive and lengthier due to the absence of a Chinese partner to guide the project through the approval process and regulatory issues.

REPRESENTATIVE OFFICES AND BRANCH OFFICES

9. REPRESENTATIVE OFFICES

9.1 Introduction

Representative offices are a favoured option for Overseas Corporations with a genuine need for a permanent presence in the PRC. Such offices may engage in non-direct business activities within the PRC. Their function is limited to representing an Overseas Corporation in conducting business liaison with trade organisations or related industries, product introduction, market surveys and research, and technological exchange within the business scope of the Overseas Corporation.

A representative office is a good way for the Overseas Corporation to gain experience and acquire a better understanding of the size and potential of the PRC market. The representative office is a means for the Overseas Corporation to work out its long-term PRC objectives, oversee its business operations running in the PRC (for example a CJV), and forge stronger links with the domestic PRC market.

It is important for Overseas Corporations to establish representative offices to signal their intention in conducting businesses in the PRC and that they view China as a long term investment. The presence of a representative office is often a good bargaining tool in subsequent joint venture negotiations, showing that the Overseas Corporation intends to further invest in the PRC.

9.2 Specific Requirements

To set up its representative office, the Overseas Corporation must:

- (a) be legally registered in its country of incorporation;
- (b) have good commercial credibility;
- (c) provide various “true and reliable” materials required by the implementation rules of the PRC; and
- (d) complete the application procedures in accordance with the implementation rules.

There are a number of prohibitions in relation to representative offices: only certain specified activities may be undertaken in the representative office, and the representative office cannot generate income including any fees received for services rendered or sign contracts that generate income. However, a representative office is allowed to negotiate contracts which are later executed in the name of the Overseas Corporation.

Under rules of the State Administration of Industry and Commerce, a Overseas Corporation must register a representative office within six months of establishing a business presence in China. Failure to comply, will result in a fine (around US\$1,150) and, in serious cases, the Overseas Corporation may be banned from engaging in further business activity in the PRC. The State Administration of Industry and Commerce enforces this requirement by carrying out random checks and using informants.

Unless a representative office is registered, the company will be unable to employ Chinese nationals, open a bank account, import duty-free personal effects, import office equipment without an import licence, obtain telephone lines, display company signs, or use business cards identifying the Overseas Corporation's presence in China. Further, the Overseas Corporation's representative will only be able to obtain a multiple entry visa for the PRC and legally rent accommodation once its representative office has been registered.

10. BRANCH OFFICES

A branch office does not have Chinese legal person status, but is permitted to carry out certain manufacturing and selling activities, as allowed by the Company Law of the PRC (enacted on 29 December 1993 and effective 1 July 1994). The Company Law was enacted for the purpose of allowing Overseas Corporations to conduct sales and manufacturing businesses in China without requiring them to make sizeable investments, as is required when setting up a WFOE.

Given that its lack of legal entity status, the branch office instead relies upon the separate legal entity status of the Overseas Corporation. Accordingly, the Overseas Corporation would be liable for all obligation, liabilities and wrongdoings of the branch office.

A representative office is unable to import products or sell samples, whereas under the Company Law, a branch office may do so and representatives of a branch office can engage in sales negotiations. However, a representative from the Overseas Corporation must execute and sign any sales agreements entered into in the PRC. All sales must be invoiced and imported from overseas.

11. HOW WE CAN HELP YOU?

If you are considering establishing business operations in Shenzhen, whether by way of an Equity Joint Venture, Contractual Joint Venture, or a Wholly Foreign-Owned Enterprise as outlined above, or otherwise, we can assist you in choosing on the structure best suited to your proposed business.

And, in consultation with PRC law firm with whom we are affiliated, we can:

- obtain advice on the formalities to be observed when establishing the business
- oversee the preparation of the necessary documents (both Chinese documents and their English translations) including submissions for any approvals and authorisations required to be obtained by the business, and liaise with the relevant authorities on your behalf

- obtain advice on commercial, company, property, intellectual property, tax, employment, immigration, pensions, insurance, banking and financial services law
- provide practical advice on ancillary matters that need to be considered when setting up a business

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