Start of a new era? – China’s new Foreign Investment Law

On March 15, 2019, China’s National People’s Congress promulgated the new Foreign Investment Law. This historically significant new law will enter into effect on January 1, 2020.

Vice Premier Deng Xiaoping decided in 1978 opening up China to international investors. Special economic zones were designed to allow initial foreign shareholdings. Only a year later, the first Equity Joint Venture Law entered into effect, which - with certain amendments - is still effective today. In 1986, the Wholly foreign-owned Enterprise Law was added, followed by the Contractual Joint Venture Law in 1988. On the basis of the original Equity Joint Venture Law for instance, the first joint venture between Volkswagen and SAIC was established in Shanghai in 1984. In contrast, Chinese-invested stock companies and equity based LLCs, had their legal basis in a different Company Law since 1993.

Equal treatment in small steps

In the middle of the 1990s, China started unifying the treatment of foreign and Chinese legal subjects and their investments. Examples include:

- The Labor Law of 1995, the principles of which are applicable to both to Chinese and foreign employees
- The Contract Law of 1999, simultaneously abolishing separate laws on contracts with a foreign element
- The comprehensive reform of the Company Law in 2006, under which wholly foreign owned enterprises were for the first time obliged to modify their internal organizational structure; in older wholly foreign owned enterprises set up before 2006, one can today sometimes still find differing internal structures more in analogy to the old joint venture law
- The unification of the Corporate Income Tax Law in 2008 had the goal to abolish special laws for foreign and foreign-invested enterprises. Transitional regulations provided for grandfathering and phasing out of past tax benefits and other incentives for joint ventures and wholly foreign owned enterprises.
- The Social Insurance Law of 2011 for the first time regulated equal treatment for foreigners and Chinese employees in the social insurance area.

Legal framework

Above examples show that China did not just start legal unifications in 2019, but has been in a respective process already for many years. With the promulgation of the Foreign Investment Law, one further important part of the legal framework is adjusted.

According to statistics of the Ministry of Commerce, in January 2019, approximately 4,650 foreign invested enterprises were newly established China-wide, out of which 21% as equity joint ventures and 79% as wholly foreign owned enterprises. For approximately 1 million foreign invested enterprises already existing in China, the Foreign Investment Law will apply from January 1, 2020. At the same time, the current Equity Joint Venture Law, Contractual Joint Venture Law and the Wholly Foreign Owned Enterprise Law are all abolished.

The legislative process started in 2015. A first draft contained approximately 170 rather detailed articles. Since then, the legislator decided in favor of a much leaner alternative. The finally promulgated law has only 42 articles and is of much more general nature than the first draft.

The law contains general principles which are currently being presented as positive developments of China’s further opening up. But they very likely will play a less important role in practice. It seems at least partially redundant to emphasize foreign investors’ protection of
intellectual property, involvement in formulation of standards, the prohibition of forced technology transfers, national treatment principles (for example also in case of public bidding), as well as available administrative legal remedies. Many of the current Chinese laws in substance already contain sufficient legal protection according to international standards. The actual implementation of these laws was often much more problematic in practice. Emphasizing the principles again in the Foreign Investment Law, will not necessarily change the practice, especially also since certain explicit references to other laws might even lead to currently unforeseen future legal restrictions.

Foreign investment framework

For the first time in one statutory piece, the Foreign Investment Law summarizes the general framework for direct and indirect foreign investments, including greenfield projects, M&A, and other projects. It contains principles on:

- Market entry (negative list, equal treatment)
- National security review in case of sensible projects
- Required merger control
- Definition of important legal terms
- Reporting obligations, violation of which can be fined up to 1 million RMB

Weather certain indirect investments, e.g. variable interest entities, or other structures like financing arrangements will also be covered by the Foreign Investment Law, still needs clarification.

Action needed for existing companies

One of the key components of the reform from a practical perspective is the equal treatment of shareholders regarding the internal organization of companies. The new law does not contain any rules regarding the legal form, internal organ structures and articles of association/bylaws of foreign invested companies. It refers into the Company Law and into the Partnership Enterprise Law, i.e. into laws that currently have mainly been used for Chinese invested companies.

During a transitional period of five years (until December 31, 2024), existing foreign invested enterprises may keep their corporate forms, organ structures and articles of association/bylaws. But from January 1, 2020, the new law applies already mandatorily to all newly established companies.

This means that actions may be needed for existing companies:

- All existing joint ventures have to be restructured on the basis of the Company Law until end 2024. This can lead to complex strategic questions in the individual case. It is currently also still unclear what would happen in case the joint venture partners are unable to achieve an agreement before expiry of above deadline.
- Also older wholly foreign owned enterprises established prior to 2006, with current structures still in analogy to joint ventures need to restructure accordingly.

Decision making in joint ventures

The largest effects will very likely be seen in case of joint venture companies: certain unanimous decision requirements for the board of directors have been abolished. This unanimity requirement was one of the main reasons why joint ventures had lost its attractiveness. A minority shareholder could block decisions through its veto power regarding all major changes within the joint venture. This lack of legal flexibility for instance also regarding equity transfer related preemptive purchase rights, or regarding dividend distributions, sometimes lead to complex offshore structures, e.g. via Hong Kong or Singapore. In the future, the same rules as for Chinese invested companies will
apply. Only a few decisions will then require a 2/3 majority on the level of the shareholders meeting. In all other areas, the joint venture partners will be free to decide and agree on different majority rules and more flexible structures.

**Open questions**

It is currently not clear whether the *Foreign Investment Law* will also abolish currently applicable minimum capital requirements for joint ventures and wholly foreign owned enterprises, for example on the basis of the total investment amount, or will also abolish current restrictions of cross-border financing. It is also still open weather current M&A related regulations or the regulations governing holding companies in China will be abolished or revised. The national treatment principle would be an argument in favor of such change.

Exciting new possibilities might in particular arise regarding minority participations, for instance in case of equity incentives to be granted to local management (i.e. participation in LLCs). But it seems currently less likely that the parties to joint venture contracts, M&A contracts and other contracts for foreign investment companies in the future would be able to freely choose the applicable law.

**Major reform**

In summary it can be stated that with the *Foreign Investment Law*, the so far largest legal reform for invested enterprises has been started since the opening of the country in 1978. Many foreign investors will need to take action. Joint ventures currently in the negotiation stage should already now consider potential changes and additions in their contracts and articles of association to reflect the future law, if a delayed establishment until 2020 is not feasible. Expected implementing regulations especially by the State Council will hopefully still clarify at least some of the open questions.

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