



China's New Foreign

Investment Law

What do you need to negotiate in your JV?



November 2019



INTRODUCTION

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The new Foreign Investment Law (“FIL”) was passed and published on March 15, 2019 and will take effect on January 1st, 2020.

According to the FIL and its draft implementing regulation published by the People’s Republic of China (“PRC”) Ministry of Justice for public comments on November 1st, 2019 (the “Draft Implementing Regulation”), foreign-invested enterprises (“FIE”) incorporated under the form of Wholly Foreign-Owned Enterprises (“WFOE”), Equity Joint Ventures (“EJV”) or a Cooperative Joint Ventures (“CJV”) (in the nature of limited liability company) before the effectiveness of the FIL shall now be subject to mandatory provisions of the PRC Company Law, as applicable.

- WHY NEGOTIATING WITH YOUR JV PARTNER?

For WFOEs, the change process should be straightforward as the PRC Wholly Foreign-Owned Enterprises Law was already quite similar to the PRC Company Law. Still, updating a WFOE’s articles of association may imply some negotiations with your partners if the governance is at the WFOE level. In our experience, most of the WFOEs are held by an offshore holding, the governance of which is generally determining the control on the decisions of the WFOE.

The real challenge for foreign investors falls on EJV and CJV (“JV”) as updating their articles of association and joint venture agreement will require to start new negotiations with their Chinese partner(s) and because the PRC Company Law offers more flexibility than the PRC Sino-foreign Equity Joint Ventures Law, for example. We will concentrate on these negotiations for the purpose of this article.

If a WFOE or a JV fails to complete change formalities before the prescribed deadline, the Chinese authorities may refuse to process registration matters for such company and may report such failure in the company’s information under the enterprise information publicity system, therefore potentially negatively impacting the company’s corporate social credit in the future.





- WHEN TO START THE NEGOTIATION?

If the organization form and corporate structure of such FIE is not consistent with the mandatory provisions of the PRC Company Law, as the case may be, such FIE shall complete change formalities within 5 years from the effective date of the FIL (i.e. at the latest on January 1st, 2025). An additional 6-months extension will be granted by the Draft Implementing Regulation to FIE failing to complete such change formalities within the 5-years deadline.

In terms of timing, we anticipate that the Chinese authorities will start requesting existing FIE to update their articles of association before the final deadline for a smooth and gradual transition. We also expect that new practices may take some weeks to be implemented by the Chinese authorities.

The timing for updating the articles of association and any JV agreement will be defined on a case-by-case basis. It will take consideration of an investor's interests in the update as well as the schedule of administrative procedures to be carried out by the JV in order to avoid delays or blockages with the Chinese authorities.

- THE NEW LAW WILL HAVE DIFFERENT IMPACTS FOR INVESTORS DEPENDING ON THE VOTING RIGHTS THEY ARE ENTITLED TO IN A JV:

- **Majority shareholder:** under the PRC Company Law, the following important decisions of a company can be passed upon approval of 2/3 of the voting rights:
 1. Amendment to the articles of association of the company,
 2. Increase or reduction of registered capital, and
 3. Company merger, division, dissolution or change of company structure.

For example, if you are entitled to at least 2/3 of the voting rights, your JV partner(s) will no longer have a veto right for important decisions.

However, if you are entitled to less than 2/3 of the voting rights, you may expect deadlock situations to occur when minority shareholder(s) are not willing to grant their approval for passing important decisions. In such event, you should make sure that your articles of association and your joint venture agreement identify clearly deadlock situations and a call option right mechanism to purchase your minority partner(s)' equity in case it/they is/are blocking the decision-making process.

- **Share of 50/50 of the JV's capital:** if you have the same voting rights as your Chinese partner in the JV, the new regime will not change dramatically the decision-making process as your partner's approval will still be required for passing important decisions at the 2/3 majority. As mentioned in the paragraph above, your articles of association and joint venture agreement shall foresee deadlock situations and address them clearly with a call option mechanism that still works. For example, trigger mechanism shall be reviewed as most of the deadlocks were before at the level of the board decisions whereas the law now provides that the highest authority is the shareholders' meeting.
- **Minority shareholder:** under the new law, minority shareholders in a JV will no longer have veto rights over important decisions. The need to obtain minority shareholders' approval in a JV will depend on the capital percentage held by the majority shareholder and on the number of minority shareholders involved in the JV. For example, if you hold 49% and your partner holds 51% of the JV, your approval will still be required for passing important decisions at qualified majority of 2/3 of the voting rights.



- WHICH ITEMS SHALL BE NEGOTIATED?

In order to comply with the FIL transition period deadline, foreign investors shall keep in mind that the following key points will need to be negotiated and further updated in a JV's articles of association and joint venture agreement:

Matters	Negotiation points
Agreements	A JV shall keep updated articles of association. The joint venture agreement shall further be designated as a shareholders' agreement.
Corporate structure	A JV under the nature of a limited liability company shall be in accordance with the PRC Company Law, under its articles of association and shareholders' agreement.
Highest authority	The shareholders' meeting is now the highest authority in a JV, instead of the board of directors.
Voting rights	A specific voting right mechanism can be stipulated in the articles of association. If not otherwise provided, the voting rights exercisable by shareholders at a shareholders' meeting shall be based on the ratio of capital contribution.
Power and responsibility	<p>Any resolutions made at a shareholders' meeting on the following issues shall be adopted by the shareholders representing more than two thirds of the voting rights:</p> <ol style="list-style-type: none"> (1) amendment of the company's articles of association; (2) increase or decrease of the registered capital; and (3) merger, division, dissolution, or conversion of the company. <p>No unanimous approval of all shareholders is required anymore for passing such key decisions and minority shareholders no longer have a veto right. Levels of approvals in the articles of association and shareholder's agreement of the FIE will need to be adjusted.</p>
Profit distribution	<p>Profits in JV can now be allocated in proportions different from the paid-in registered capital. For example, it means that a shareholder can pay up to 40% of the capital and may receive 60% of the profits, provided the necessary provisions have been inserted in the articles of association.</p> <p>However, according to the Draft Implementing Regulation, the shareholders can also choose to keep the current profit distribution methods agreed in the current JV contract.</p> <p>Such provision may trigger different results with regards to profit distribution if all investors in a JV do not contribute their contribution at the same pace.</p> <p>At the time of liquidation of the JV, we could also imagine that the remaining assets of the JV be distributed in accordance with the paid-in registered capital and not the registered capital ownership, if not otherwise provided in the articles of association and subject to further clarification from the legislator.</p>



Matters	Negotiation points
<p>Impact on consolidation</p>	<p>Depending on the accounting principles adopted by a company group, the basis for consolidation may be impacted by the new law.</p> <p>The JV is consolidated on the basis of control exercised by the investor (i) with a majority voting interest in the JV, or (ii) with the power of control through contractual arrangements under PRC GAAP rules, or (iii) when the investing entity has control over substantial decisions of a JV.</p> <p>Different elements can be taken into consideration by auditors to determine whether an investor has a power of control in a JV through substantial rights. Such elements may include voting rights, power on the management of the JV, call option rights, etc. and will be examined by the auditors to determine whether an investor can consolidate on the basis of control.</p> <p>The new law generates an evolution from (i) important decisions being subject to a unanimous approval of the board members to (ii) important decisions which shall be taken by a group of shareholders voting at a qualified majority of 2/3 of their voting rights. Investors shall make sure that the provisions of the articles of association and of the joint venture agreement still grant them enough control over the JV to consolidate.</p>
<p>Number of directors</p>	<p>One single executive director can be nominated instead of a board of directors, subject to negotiations among shareholders of the JV and size of the JV.</p>
<p>Term of office for director(s)</p>	<p>No more than 3 years.</p>
<p>Quorum</p>	<p>No quorum is set forth by the PRC Company Law for passing shareholders decisions. Definition of a quorum is now left to the discretion of the shareholders of the JV.</p>
<p>Shares' transfer</p>	<p>Unless the shareholders have agreed otherwise in the articles of association, a shareholder proposing to transfer its equity interests to a non-shareholder shall obtain the consent of more than half of the other shareholders.,</p> <p>No unanimous approval of the shareholders is required anymore for transferring shares to a third-party.</p>



- WHICH MATTERS STILL NEED TO BE CLARIFIED?

- **Borrowing gap calculation:** the FIL and its Draft Implementing Regulation promote equal treatment between domestic and FIE. Articles of association usually provide for a FIE's total investment and its registered capital.

The difference between the total investment and the registered capital is considered as the borrowing gap, i.e. the maximum amount of foreign debt that a FIE can incur.

The «full-bore macroprudential administration of overall cross-border financing» was introduced by the State Administration of Taxation (“SAT”) as a new method for calculation of the foreign debt capacity and does not include the notion of total investment. In a nutshell, this methodology to calculate the borrowing gap of the FIE expands the capacity of enterprises to engage in cross-border financing. Such calculation method has been used in the China (Shanghai) Pilot Free Trade Zone since 2015.

As per our consultations with the Shanghai governmental authorities, we tend to believe that FIE will still have the option to choose either formula, and that articles of association should still provide for the amount of total investment, until further clarification from the Chinese legislator or governmental authorities.

- **Transition process:** it is not clear whether the joint venture agreement and the articles of association of the existing FIE need to be revised and whether it is necessary to go through relevant approval/filing/registration process for transition.

It is foreseeable that investors will start a new round of negotiation on the organizational form and corporation structure in relevant investment agreements, including but not limited to the joint venture agreement and articles of association in order to make them in compliance with the FIL and applicable laws and regulations.

Besides, the legislator has not taken a clear position regarding the law applicable during the transition period (either the EJV Law or the PRC Company Law) when the articles of association of a JV are silent on the corporate governance of the JV. For example, as the amendment of articles of association shall be unanimously approved by the directors presented according to the current applicable EJV Law, can a shareholder argue that as the provisions of the PRC Company Law applied to the FIE since January 1st, 2020 and the directors appointed by other shareholders did not agree on the update of the articles of association, any important decision passed after this date by the board of directors is not valid? We hope that such issue will be addressed in the final version of the Draft Implementing Regulations.

On the overall, the PRC Company Law's offer more flexible corporate governance mechanisms and will leave more room for negotiations with your Chinese partner than the JV laws.

At the moment, only little guidance has been released for implementation of the FIL in practice, especially in terms of practical details and filing mechanics with the Chinese authorities (for example, whether approval from the Ministry of Commerce (“MOFCOM”) will still be required for some projects). Given the tight legislative schedule, we expect that during the first few months of 2020, broad discretion will be given to the governmental agencies for implementation of the FIL.

The Draft Implementing Regulation has now been submitted to public comments, as the FIL will be effective on January 1st, 2020, we should expect the final version of the Draft Implementing Regulation to be published in December 2019 to hopefully provide further clarifications on the implementation of the FIL.

WHO WE ARE

We are corporate lawyers based in China.
Our team is composed of 25 Chinese and internationally qualified attorneys.

Each member of our team has been trained in international law firms and is familiar with cross-border transactions. Our experience allows us to fully understand the legal implications and risks of doing business in China.

We work as a bicultural team to provide efficient solutions to navigate through the complex legal environment around the world. Our true added-value is to manage complex transactions in a changing legal and business environment.

We are entrepreneurs providing solutions that actually work. And We are in position to assist you to evaluate the level of risks and propose pragmatic solutions. We have a creative approach to solve your problems in China and are attached to a “boutique” spirit.

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