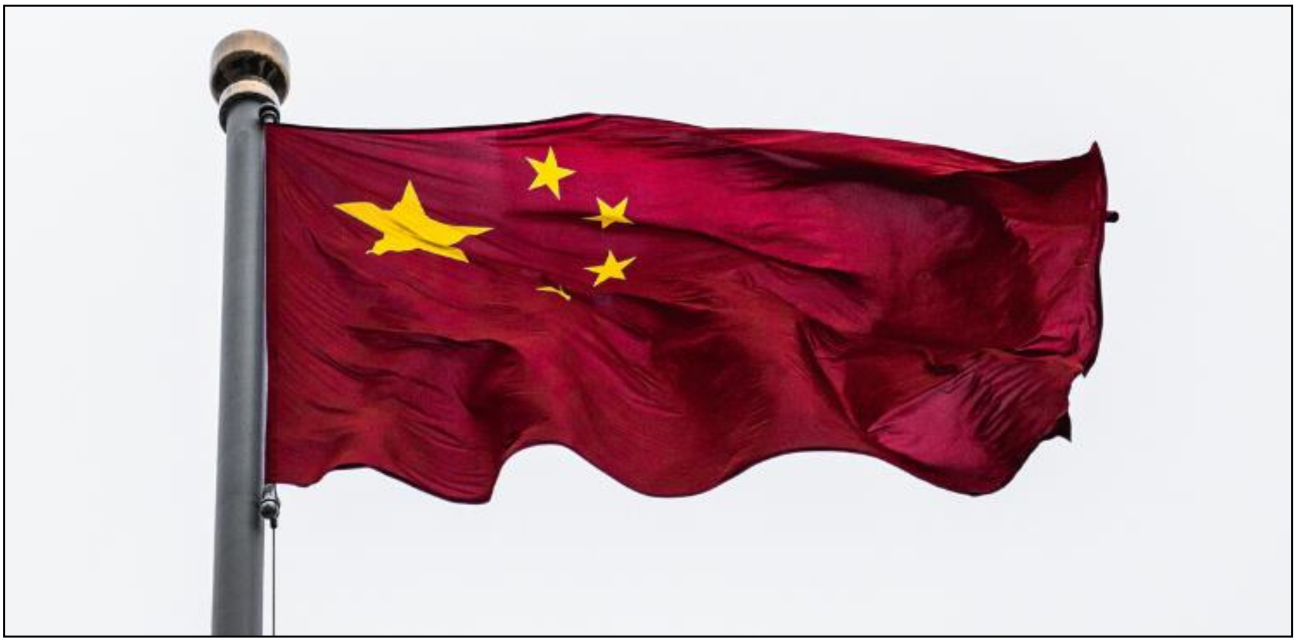
Understanding China's New Foreign Investment Law from 1 January 2020

- China.direct.biz by Noam David Stern and Daisy Du (22 October 2019)



Despite China's continued economic reform and opening-up policy since December 1978, which has given foreign investors better access to the Chinese market, China has in recent years faced repeated international criticism over its gradual opening up of its markets and alleged discrimination of foreign investors.

As a result, to further the reform process and build confidence among foreign investors, China adopted the new '**Foreign Investment Law of the PRC**' (FIL) on 15 March 2019 that will take effect on **1 January 2020**.

The new FIL will from then on regulate foreign investment under **one single unified law** and all together repeal the existing EJV Law, CJV Law and WFOE Law that have been guiding foreign investment in China for many years.

Current Law Trilogy

To direct and regulate FDI while protecting the rights and interests of foreign investors, China implemented the "Law Trilogy" consisting of the: 1) Law of the PRC on Sino-Foreign Equity Joint Ventures (EJV Law) from 1 July 1979; 2) Law of the PRC on Wholly Foreign-Owned Enterprises (WFOE Law) from 12 April 1986; and 3) Law of the PRC on Sino-Foreign Cooperative Joint Ventures (CJV Law) from 13 April 1988.

The three laws and related implementing rules have been revised regularly over the years and have gradually aligned themselves (partly) with the 'Company Law of the PRC' that regulates the organization form, structure and operating rules of all companies in China.

New Foreign Investment Law

To further the reform process and (re)build confidence among foreign investors, China adopted the new 'Foreign Investment Law of the PRC' on 15 March 2019 that will take effect on **1 January 2020**.

The new FIL will from then on regulate foreign investment in China under one single unified law and all together replace the existing Law Trilogy: EJV Law, CJV Law and WFOE Law. However, a five year transition period will apply for existing companies.

Key Provisions of the FIL

The FIL functions as an overall framework law outlining the general intentions and principles rather than a detailed set of enforceable rules. It consists of six chapters and 42 articles that establish the basic rules for the promotion, protection and management of foreign investment in China.

The first draft of the Implementing Regulations of the FIL for public comments was announced on 1 November 2019 but is still pending final approval and publication.

The FIL stresses the principles of National Treatment outside the Negative List and equal protection of foreign investment while banning forced technology transfers, improving IPR protection and streamlining the administrative implementation and enforcement nationwide.

Main Differences Between Law Trilogy and FI Law (Company Law)

According to the new FIL, foreign-invested enterprises established under the Law Trilogy can keep their original organizational forms for five (5) years after the FIL has come into force (2020-2024).

Whereas the current Law Trilogy covers greenfield investments, the new FIL covers both greenfield, M&A and project investments.

For existing WFOEs, the impact of the new FIL will be limited as most already adhere to the 'Company Law of the PRC' while the partners of existing JVs need to prepare for the required changes, including but not limited to the following matters:

<u>Highest Authority</u>

Under the EJV Law and CJV Law, the Board of Directors is the highest authority while under the Company Law it is the Board of Shareholders whereby a number of duties and powers need to be reallocated.

This requires a reallocation of duties and powers such as decisions regarding investment plans, election/ removal of directors and supervisors, approval of annual budgets, profit distribution, changes in registered capital, amendments of articles of association and resolutions on mergers, division, dissolution, liquidation or change of company structure.

Board of Directors

According to the CJV Law, the term of office for a Director shall be four (4) years whereas both the EJV Law, WFOE Law and Company Law state that the term of office is maximum three (3) years.

As to the Quorum, the EJV Law and CJV Law stipulate that a minimum of 2/3 of the directors need to be present while the Company Law has no prescribed limits.

Voting Mechanism for Important Matters

Under the EJV Law and CJV Law, important matters such as amending the Articles of Association, increase/decrease of the registered capital, and merger, division, dissolution or change of the JV structure requires the unanimous approval by the directors present at the Board Meeting while Company Law only requires the approval of 2/3 or more of the voting rights of the shareholders.

Distribution of Profits/Losses

According to the EJV Law and WFOE Law, the distribution of profits/losses shall be according to registered capital contribution of each partner while in the CJV Law it can be agreed otherwise. Under the Company Law, the distribution of profits/losses shall be based on the ratio of capital contribution, but in the event of an increase in the registered capital, the distribution can be agreed otherwise by the shareholders.

Transfer of Equity Interests

Under the EJV Law and CJV Law, the transfer of shares requires the unanimous approval by the other JV partners while the Company Law only requires the approval by more than half of the other shareholders, unless the Articles of Association state otherwise.

Ensure Compliance with the FIL

It is important to emphasize that when the FIL takes effect on 1 January 2020, all foreign-invested enterprises established under the old Law Trilogy are covered by the new FIL but must within five (5) years make the required changes to fully comply.

It is therefore recommended that the parties to an existing EJV or CJV involve a lawyer to review, offer advice and make the required amendments to both the JV Contract (shareholder agreement) and Articles of Association, and the JV parties take measures to implement the changes accordingly.

This is also a good opportunity for the JV parties to evaluate and adjust the originally agreed terms and conditions of the JV Contract.

For many existing WFOEs, the effect will be more limited as their organizational form and structure have been governed by the Company Law since 24 April 2006.

National Treatment and Protection

With the introduction of the new FIL, China has finally set a new course that aims to give foreign investors more transparency and clarity based on the principle of national treatment and protection.

JVs and WFOEs will no longer be guided by separate laws but follow a single unified Foreign Investment Law directly linked to the Company Law that regulates the organization form, structure and operating rules of all Chinese and foreign companies in China.

As with most laws in China, the finer details related to the interpretation and actual execution of the FIL depends on the pending implementing rules of the FIL.

At China-direct.biz we have the required legal expertise and experience in dealing with the effects of the FIL and ensure compliance with the FIL.

As a member of DCBF, you can get a **link to a video recording** of my webinar "Understanding China's New Foreign Investment Law from 1 January 2020 and its Impact on Existing WFOEs and JVs" that took place on 29 October 2019.

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