Chapter 1

SECTORAL CONTROL OF FOREIGN INVESTMENT

INDUSTRIAL SECTORAL CONTROL

2007 Industrial catalogue

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2011 Industrial Catalogue

2015 Industrial Catalogue

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REGIONAL SECTORAL CONTROL

INDUSTRIAL SECTORAL CONTROL

¶1-005 Governing legislation

(1) *Regulations on Foreign Investment Guidelines* (《指导外商投资方向规定》), enacted by the State Planning Commission and effective as of 1 April 2002;

(2) *Catalogue on Industry Guidelines for Foreign Investment* (《外商投资产业指导目录》), enacted by the State Development and Reform Commission and the Ministry of Commerce ("MOFCOM") and effective as of 1 December 2007 (the "2007 Industrial Catalogue") revised again in 2011 December (the "2011 Industrial Catalogue"), and further revised in March 2015 and effective as of 10 April 2015 (the "2015 Industrial Catalogue");

(3) *Law of the People's Republic of China on Sino-foreign Equity Joint Ventures* (《中华人民共和国中外合资经营企业法》), effective as of 1 July 1979 and revised on 15 March 2001 (the "EJV Law");

(4) *Regulations for the Implementation of the Law of the People's Republic of China on Sino-foreign Equity Joint Ventures* (《中华人民共和国中外合资经营企业法实施条例》), enacted by the State Council and effective as of 20 September 1983 and revised on 22 July 2001, further revised on 19 February 2014 (the "EJV Regulations");

(5) *Law of the People's Republic of China on Sino-foreign Co-operative Joint Ventures* (《中华人民共和国中外合作经营企业法》), effective as of 13 April 1988 and revised on 31 October 2000 (the "CJV Law");

(6) *Implementation Regulations for the Law of the People's Republic of China on Sino-foreign Cooperative Joint Ventures* (《中华人民共和国中外合作经营企业法实施细则》), issued by the Ministry of Foreign Trade and Economic Cooperation and effective as of 4 September 1995, further revised on 19 February 2014 (the "CJV Regulations");

(7) *Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (《中华人民共和国外资企业法》), effective as of 12 April 1986 and revised on 31 October 2000 (the "WFOE Law");

(8) *Detailed Rules for the Implementation of the Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (《中华人民共和国外资企业法实施细则》), issued by the Ministry of Foreign Trade and Economic Cooperation, effective as of 12 December 1990 and revised on 12 April 2001, further revised on 19 February 2014 (the "WFOE Regulations"); and

(9) *Catalogue of Priority Industries for Foreign Investment in Central and Western Region* (《中西部地区外商投资优势产业目录》), jointly issued by the National Development and Reform Commission ("NDRC") and the MOFCOM and effective as of 10 June 2013.

¶1-010 History of control

For the first 30 years following the founding of the People's Republic of China ("PRC" or "China"), China prohibited any participation by foreign capitalists in its economic development. The first cracks in this wall were planted in the Second Session of the Fifth National People's Congress in 1979. This meeting marked the start of China's opening up to the world.

The magnitude of the changes wrought by this plenary meeting can be seen by the figures. In the span of 37 years, China has gone from a no man's land for investment into the world's number one foreign direct investment ("FDI") destination.

Year	Foreign reserves	Export	Import	Foreign investment
1978	USD1.67 billion	USD97.5 billion	USD108.9 billion	USD17.7 billion
2015	USD3.33 trillion	USD 2.28 trillion	USD1.68 trillion	USD126.27 billion

Although these figures defy an outsider's expectations the differences within the country are more pronounced still. In the span of half a generation China has developed a sophisticated legal system and moved from wariness towards foreign investment to active encouragement.

Despite these changes China's open-door policy has always retained a door and sometimes this door is slammed shut on certain industries or activities. Although, it has opened up in a way that not even the most ardent Sinophile would have anticipated in 1979, China still maintains specific restrictions on the inflow of foreign capital into the country.

Foreign investors should also bear in mind that almost every step in the establishment process for a foreign investment enterprise ("FIEs") and its resulting operation in China requires approvals from a wide

range of Government authorities. In the main this is not onerous control, indeed in many cases the authorities play more the role of a cheerleader than an umpire.

¶1-030 Pre-2001 industrial sector control

For many years, China did not have a specific piece of legislation which set out the restrictions or encouragement to be granted to specific types of foreign investment. The approval authorities would generally base their decisions on vaguely worded legislation contained in laws or regulations regulating joint ventures ("JVs", including equity joint ventures or EJVs, and contractual joint ventures or CJVs) and wholly foreign-owned enterprises ("WFOEs") or upon "internal policies", which were not published, not available to the general public and indeed often thought to be non-existent.

EJV and WFOE legislation

The *EJV Regulations* (prior to the 22 July 2001 amendment) and *WFOE Regulations* (prior to the 12 April 2001 amendment) provided only the very broadest of brushstrokes as to what was allowed.

The *EJV Regulations* proposed a vague list of permitted JV projects (ie energy development, building materials, chemicals, metallurgical industries, machine manufacturing, instrument and meter assembly industries and offshore oil exploitation equipment, manufacturing, electronics & computer industries and communication equipment manufacturing, light industry, textile, foodstuffs, medicine, medical apparatus and packaging industries, agriculture, animal husbandry and aquaculture, and tourism and service industries).

This vague list was largely ignored and EJVs were established in a wide range of industries.

The lack of specific regulations was probably due to a mix of the authorities not sure as to what they were doing and fear of the consequences of allowing the door to be too wide open. Foreign investors also were unsure of how to invest in China and had an opposite fear from that of the Chinese authorities who feared their entry into China. The foreign investor's major concern was whether they would be allowed out again.

However, as both sides gained in experience the regulations outlining the means by which investments may be made were being improved. The provisions of the *WFOE Regulations* represented a better approach than the *EJV Regulations* in that they sought to list prohibited and restricted sectors and not all permitted sectors.

The *WFOE Regulations* were in many ways a forerunner of the *Industrial Catalogue* (discussed below) which sets out whether a particular type of business is open to foreign investment and whether certain encouragements or restrictions exist.

¶1-060 *Regulations on Foreign Investment Guidelines* and *Catalogue on Industry Guidelines for Foreign Investment*

China began to issue the *Regulations on Foreign Investment Guidelines* (《指导外商投资方向规定》) and its accompanying *Catalogue on Industry Guidelines for Foreign Investment* (《外商投资产业指导目录》, the "Industrial Catalogue") in 1995. This gave foreign investors a far clearer picture regarding the Chinese Government policies and "internal guidelines" in respect of their planned foreign investment.

This first-ever *Industrial Catalogue* clarified that some industrial sectors, many of which were regarded as being lucrative, were barred from having foreign investment.

In essence, the *Regulations on Foreign Investment Guidelines* divide foreign investment into four categories:

(1) encouraged;

(2) permitted;

(3) restricted; and

(4) prohibited.

The "encouraged", "restricted" and "prohibited" categories are listed in the accompanying *Industrial Catalogue* (the latest version came into effect on 10 April 2015; more detail in ¶1-240). Any sector not listed in the *Industrial Catalogue* is deemed to fall within the "permitted" category.

The *Regulations on Foreign Investment Guidelines* also provide a general description and different treatment for a project depending upon its category. As part of China's efforts to implement its WTO obligations, the *Regulations on Foreign Investment Guidelines* were also revised to take into account China's undertakings under such treaty.

Importance of the *Industrial Catalogue*

As the primary legislation determining whether a specific foreign invested project will be allowed, restricted or encouraged, the

Regulations on Foreign Investment Guidelines and the *Industrial Catalogue* are the initial regulations to be considered by any potential foreign investor.

In some cases a proposed project will be "prohibited" (eg news agencies, TV, satellite uplinking stations, microwave stations etc).

In other cases the proposed project may be restricted (eg animal husbandry, cotton (raw cotton) processing, certain types of mining, gold exploration etc) whereas other projects may be encouraged (eg storage and processing of vegetables, production of new anti-cancer medication, manufacturing of mine trolleys for mining etc), and such classification will be a major criteria in determining whether the project will benefit from Customs duty and related VAT exemption (further details to be discussed in **Taxation and Customs duties** from ¶28-005 to ¶28-080).

Since its inception the *Industrial Catalogue* has undergone a number of revisions, including 1995, 1997, 2002, 2004, 2007 and 2015.

2007 Industrial catalogue

¶1-110 General introduction

At the end of 2007, the NDRC and the MOFCOM jointly issued the latest version of the *Industrial Catalogue*. This revised version replaced the *2004 Industrial Catalogue* and became effective as of 1 December 2007. As always the changes in the *2007 Industrial Catalogue* reflected shifts in China's economic and industrial policies.

In 2007 China's foreign direct investment policy changed from export led growth to quality investment supporting domestic led growth. As Mr. Ma Kai, the then Minister of NDRC stated, "the focus is on strength, not scale". The general economic policy was set by the 11th Five-Year Plan which set a course away from projects that:

(1) rely upon cheap Chinese raw materials or energy;

(2) are wasteful or lead to high level of pollution;

(3) manufacture export-orientated products; or

(4) manufacture low-tech products with little value added.

On the other hand "green is the new black" when it comes to the projects that are being encouraged. Encouraged projects included:

(1) energy-saving;

(2) environmental protection;

(3) transportation infrastructure development;

(4) Hi-tech manufacturing;

(5) logistics;

(6) business outsourcing; and

(7) improvements in agricultural technology.

A quick glance at the *2007 Industrial Catalogue* shows the affect that the *11th Five-Year Plan* had. For example "real estate" and "products directly exported" were deleted from the encouraged category. This made sense for China's economic situation in 2007 before the global economic crisis began to bite. In 2007, China was facing enormous international pressure in respect of its currency. China's encouragement to its export-orientated industries and the massive current account surplus was adding further pressure on the authorities for a RMB appreciation. In addition China was facing bottlenecks in respect of resources and energy. There were concerns that China was in effect importing pollution by being the world's factory.

Another strategic concern of the PRC authorities was to stem the inflow of international "hot" money into China. Due to expectations of an appreciation in RMB there had been a rush by foreign investors to bring money into China, particularly into the overheating real estate sector. The PRC authorities had major concerns that this would further contribute to building further asset bubbles within China.

Just as the move away from export and real estate industries signalled deeper policy concerns, such concerns could also be seen in the areas that were upgraded to encouraged status. The list of encouraged sectors included services and higher value added services such as "leasing and commercial services", "bank and telecommunications back office service, software development and related contracting business"; "culture, sports and entertainment", "management and operation of public show facilities, sport centres, and training facilities, as well as related intermediary services" have been added to the encouraged category.

These changes showed China's intended move in 2007 from a "quantity economy" to a "quality economy" and concern for the environment with reference to a "green GDP".

¶1-130 Encouraged category

The *2007 Industrial Catalogue* substantially followed the categorisation methodology used in the *2002* and *2004 Industrial Catalogues*. Although the industrial sectors under the *2007 Industrial Catalogue* remained

very much the same (reduced from 13 to 12), the total number of items under the "encouraged" category and the contents had significantly changed. The total number of encouraged sectors was significantly increased from 246 to 351, with the following allocation:

- agriculture, forestry, animal husbandry and fishery (12 items);
- mining (9 items);
- manufacturing (282 items);
- generation and supply of electricity, gas and water (7 items);
- transportation, storage, and post (14 items);
- wholesale and retail (2 items);
- leasing and commercial services (3 items);
- scientific research, technological services and geological survey (14 items);
- water resources, environmental and public facility management (4 items);
- education (1 item);
- health, social security and social welfare (1 item); and
- culture, sports and entertainment (2 items).

Details as to the additions and deletions are as follows:

(1) under the heading of "generation and supply of electricity, gas and water"
   - added: "sea water utilisation, industrial waste water disposal and utilisation";
   - deleted: "construction and operation of thermal power plants with a single generator capacity of more than 300 megawatts", and "construction and operation of natural gas power plants";

(2) under the heading of "transportation, storage, and post"
   - added: "comprehensive maintenance of infrastructural facilities for high speed railways, railway cargo transportation lines, and inter-city railway lines";
   - deleted: "construction and operation of petroleum docks".

(3) under the heading of "wholesale and retail"
   - added: "modern logistics"

(4) under the heading of "scientific research, technological services and geological survey"
   - added: "biology energy development technology" and "ocean chemical energy comprehensive utilisation technology".

(5) More significant changes have occurred under the "mining" headings
   - five items added, including "mine gas utilisation" and "exploration and development of ocean bottom inflammable ice".
   - five "traditional mining" items deleted, including "exploration and development of coal and its associated resources", "exploration and extraction of low grade and hard-to-extract gold mines", "exploration and development of copper, lead and zinc" and "exploration and development of alumina".

Since the "manufacturing" heading contains more than half of the total items under the encouraged category, it is worthwhile to further discuss this heading, which consists of the following subheadings:

- agricultural and non-staple food processing (3 items);
- food manufacturing (3 items);
- beverage processing (1 item);
- tobacco product processing (3 items);
- leather and fur products (3 items);
- wood processing and bamboo, cane, palm and straw manufacturing (1 item);
- paper making and paper products (1 item);
- petroleum processing and coking industry (1 item);
- chemical feedstock and chemical product manufacturing (26 items);
- medicine (16 items);
- chemical fibre manufacturing (6 items);
- plastics products (3 items);
- non-metal mineral products (20 items);
- non-ferrous metal smelting and rolling processing (2 items);
- metal products (3 items);

- ordinary machinery manufacturing (19 items);
- specialised equipment manufacturing (71 items);
- transportation equipment manufacturing (26 items);
- electric machinery and equipment manufacturing (13 items);
- electronics and communications equipment manufacturing (35 items);
- apparatus, instruments, and cultural and office appliance manufacturing (18 items); and
- other manufacturing industries (3 items).

Significant increase in the total number of sectors falling within the encouraged category resulted from significant increase in more sectors within "manufacturing" being considered as encouraged. Specifically, notable changes occurred in the following areas:

(1) under the headings of "agricultural and non-staple food processing", "food manufacturing" and "beverage processing"
   - five items added: "development and production of plant beverage", "development, production and processing of forest food", and "production of natural food ingredients".
   - four deleted: including "storage and processing of grain products" and "production of dairy products".

(2) under the heading of "textiles"
   - three items added: "processing of special natural fibre products that meet ecological, energy utilisation and environmental protection requirements", "clothing manufacturing using computerised manufacturing systems", and "production of high-grade carpet and related products".

(3) under the heading of "leather and fur products"
   - added: "leather and fur cleaning process" and "high-grade leather (sofa leather and auto sea leather) processing";
   - deleted: "new technological processing of swine, cattle and lamb wet skins".

(4) under the heading of "petroleum processing and coking industry"
   - deleted: "asphalt production for heavy transportation roads".

(5) under the heading of "chemical feedstock and chemical product manufacturing"
   - ten items added: including "processing of ethylene downstream by-products", "environmental friendly printing inks production", and "water auto coating and related water resin production";
   - six items deleted: including "textile and fibre dyeing material production" and "auto emission cleaning catalytic agent production"; and
   - 11 items modified.

Additions and deletions also occurred in the following headings: "medicine", "chemical fibre manufacturing", "plastics products", "non-metal mineral products", "non-ferrous metal smelting and rolling processing", and "metal products".

The most significant changes (additions), however, occurred under the following headings:

(1) ordinary machinery manufacturing:
   - 14 items added, and
   - two items deleted;

(2) specialised equipment manufacturing:
   - an impressive total of 42 items added: including "colour coating equipment production", "solar energy battery production equipment manufacturing", "pollution prevention equipment production and development", "metropolitan garbage disposal equipment manufacturing", and "used plastic and battery recovery, disposal, reuse equipment manufacturing"; and
   - 13 items deleted.

(3) transportation equipment manufacturing;

(4) electric machinery and equipment manufacturing;

(5) electronics and communications equipment manufacturing; and

(6) apparatus, instruments, and cultural and office appliance manufacturing.

¶1-160 Restricted category

There were a total of 87 items classified under the restricted category under the *2007 Industrial Catalogue*. Comparing with 78 items in the

2004 Industrial Catalogue, the numerical change was not significant. Nevertheless, there were still some important changes. Notable additions to this category include the following:

(1) Aluminum fluoride production;

(2) Strontium salt production;

(3) Manufacturing of multi-vitamin dose and oral calcium dose;

(4) Repair, design and manufacturing of general vessels (including sections; controlling stake to be held by Chinese party);

(5) Construction and operation of electricity grids (controlling stake to be held by Chinese party);

(6) Creditworthiness investigation and rating services;

(7) Photography services (including stunt photography such as aerial photography, but excluding mapping aerial photography, only in the form of EJVs);

(8) Performance agency (controlling stake to be held by Chinese party) and operation of entertainment venues (only in the form of EJVs or CJVs);

(9) Currency brokerage companies and futures companies (controlling stake to be held by Chinese party); and

(10) Real estate second-tier market transactions and real estate intermediaries or agencies.

Equally important are the following deletions from the restricted category:

(1) Resin production for fibre and non-fibre use with a production capacity of less than 400 tonnes per day;

(2) Commodity trading, sales agent type commercial companies;

(3) Wholesale and retail of books, newspapers and periodicals;

(4) Goods leasing companies;

(5) Foreign trade companies; and

(6) Construction and operation of golf courses.

It should be noted that not all items listed in the restricted category signal a tightening. In some cases there, a move to the restricted category from the prohibited category. One example is the addition of "construction and operation of electricity grids" and "future trading companies" to the restricted category. Both had previously been off limits to foreign investment. Further, there are also some

modifications within the category. For example, "accounting and auditing" was limited to JVs; "high school education" had been modified to "ordinary high school education".

¶1-190 Prohibited category

There were a total of 38 items classified in the prohibited category in the *2007 Industrial Catalogue* which was a slight increase compared to the 35 items listed in the *2004 Industrial Catalogue*. Notable changes include the following additions:

- Exploration and development of tungsten, molybdenum, tin, antimony and fluorite;
- Development and application of human dry cell and genetic treatment technology;
- Ocean survey, administrative division survey and mapping;
- Internet news portal, internet audio and video programme services; and
- Construction and operation of golf courses (which was in fact moved from the restricted category in the *2004 Industrial Catalogue*).

As mentioned above, "futures companies" and "construction and operation of electricity grids" had been moved from prohibited to restricted categories.

In summary, a review of the *2007 Industrial Catalogue* compared to its predecessor – the *2004 Industrial Catalogue* – shows that the *2007 Industrial Catalogue* sought to encourage control of resources, environmental protection and energy utilisation, and sought to move the economy away from mass produced exports, to greener, higher value products and services.

Pre-2011 industrial sector control

¶1-210 *Several Opinions on the Further Utilisation of Foreign Capital*

Faced with the global economic crisis China showed signs of backtracking in respect of its lofty goals set in 2007. Low-value manufacturers such as toy manufacturers were seeing increased VAT rebates in respect of their exports. The previous policy stressed a move from the high-labour projects to high-tech projects. Given the spate of

¶10-560 Investment bankers

Investment bankers are mostly involved in transactions on capital markets or financial driven deals. They are generally not involved in industrial JV projects. The services investment bankers typically provide include identifying targets for mergers and acquisition deals, conducting financial analysis, assisting in structuring the deals, advising on pricing, assisting in obtaining financing, etc.

Chapter 4

SETTING UP PROCEDURES AND DOCUMENTATION

SETTING UP FOREIGN INVESTMENT ENTERPRISES

Joint Venture documentation

Joint venture contract

SETTING UP FOREIGN INVESTMENT ENTERPRISES

¶15-005 Governing legislation

(1) *Regulations on Foreign Investment Guidelines* (《指导外商投资方向规定》), enacted by the State Planning Commission and effective as of 1 April 2002;

(2) *Catalogue on Industry Guidelines for Foreign Investment* (《外商投资产业指导目录》), enacted by the State Development and Reform Commission and the Ministry of Commerce and effective as of 1 December 2007, revised on 10 March 2015;

(3) *Law of the People's Republic of China on Sino-foreign Equity Joint Ventures*(《中华人民共和国中外合资经营企业法》), revised on 15 March 2001 (the "*EJV Law*");

(4) *Regulations for the Implementation of the Law of the People's Republic of China on Sino–foreign Equity Joint Ventures* (《中华人民共和国中外合资经营企业法实施条例》), enacted by the

State Council and revised on 22 July 2001, revised again on 19 February 2014 (the "*EJV Regulations*");

(5) *Law of the People's Republic of China on Sino–foreign Co-operative Enterprises* (《中华人民共和国中外合作经营企业法》), revised on 31 October 2000 (the "*CJV Law*");

(6) *Detailed Rules for the Implementation of the Law of the People's Republic of China on Sino–foreign Cooperative Enterprises* (《中华人民共和国中外合作经营企业法实施细则》), issued by the MOFTEC and effective as of 4 September 1995, revised on 19 February 2014 (the "*CJV Regulations*");

(7) *Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (《中华人民共和国外资企业法》), revised on 31 October 2000 (the "*WFOE Law*");

(8) *Detailed Rules for the Implementation of the Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (《中华人民共和国外资企业法实施细则》), issued by the MOFTEC and revised on 12 April 2001, revised again on 19 February 2014 (the "*WFOE Regulations*");

(9) *Opinions on Further Encouraging Foreign Investment* (《关于当前进一步鼓励外商投资的意见》), issued by the MOFTEC and a number of other Ministries under the State Council and effective as of 3 August 1999;

(10) *Notice on Several Questions regarding the Approval of Foreign Investment Enterprises within the Encouraged Category by Local Authorities and Submission of such Approvals to MOFTEC for Record* (《对外贸易经济合作部关于地方自行审批鼓励类外商投资企业报外经贸部备案有关问题的通知》), issued by the MOFTEC and effective as of 15 October 1999;

(11) *Company Law of the People's Republic of China* (《中华人民共和国公司法》), revised and effective as of 1 January 2006, revised again on 28 December 2013 (the "*Company Law*");

(12) *Contract Law of the People's Republic of China* (《中华人民共和国合同法》), effective as of 1 October 1999 ;

(13) *Provisional Regulations of the State Administration for Industry and Commerce on the Ratio between the Registered Capital and Total Investment of Sino–foreign Joint Equity Enterprises* (《国家工商行政管理局关于中外合资经营企业注册资本与投资总额比例的暂行规定》), effective as of 1 March 1987;

(14) *Certain Regulations on the Subscription of Capital by the Parties to Sino–foreign Joint Equity Enterprises* (《中外合资经营企业合营各方出资的若干规定》), issued by the MOFTEC and the SAIC, has been invalidated by the *Decision of the State Council on Repealing and Amending Some Administrative Regulations* on 19 February 2014

(15) *Notice on Issues relating to Strengthening Administration of Approval, Registration, Foreign Exchange and Tax Collection for Foreign Investment Enterprises* (《关于加强外商投资企业审批、登记、外汇及税收管理有关问题的通知》), issued jointly by the MOFTEC and the SAIC on 30 December 2002, effective as 1 January 2003;

(16) *Notice on Certain Issues concerning the Delegation of Power of Registration and Approval of Foreign Investment Enterprises and Further Simplification of Examination Procedures* (《商务部关于下放外商投资企业备案和批准证书发放管理权限进一步简化审批程序等有关问题的公告》), issued by the MOFCOM on 14 November 2005;

(17) *Administrative Regulations of the People's Republic of China on Company Registration* (《中华人民共和国公司登记管理条例》), issued on 18 December 2005, revised on 19 February 2014, revised on 6 February 2016;

(18) *Administrative Regulations on Registration of Company Registered Capital* (《公司注册资本登记管理规定》), issued by the SAIC on 27 December 2005, revised on 20 February 2014;

(19) *Implementation Opinion on Issues relating to Application of Law for Administration of Examination and Approval and Registration of Foreign-invested Companies* (《关于外商投资的公司审批登记管理法律适用若干问题的执行意见》), issued by the SAIC on 24 April 2006;

(20) *Notice of the Ministry of Commerce on Delegation of Approval Power relating to the Alteration and Examination Items of Foreign-invested Joint Stock Companies and Enterprises* (《商务部关于下放外商投资股份公司、企业变更、审批事项的通知》), issued by the MOFCOM on 5 August 2008;

(21) *Notice of Ministry of Commerce on Further Improving Examination and Approval of Foreign Investments* (《商务部关于进一步改进外商投资审批工作的通知》), issued by the MOFCOM on 5 March 2009; and

(22) *Administrative Measures on Registration of Capital Contribution in Equity Form* (《股权出资登记管理办法》), issued by the SAIC on 14 January 2009 and has been repealed.

¶15-030 Overview

After a foreign investor has determined to establish an entity in China (whether an equity joint venture, contractual joint venture or a WFOE), the foreign investor will need to prepare the necessary documentation for establishment and proceed with both an approval and a registration procedure This section deals with the documentation required and provides a simple overview of the approval/registration process.

Joint venture documentation

¶15-070 Letter of intent

For most foreign investors intending to set up a joint venture ("JV") in China the first document encountered is the "letter of intent". This document sets out the parameters and general structure of the project between the foreign investor and the Chinese party, exclusivity, confidentiality of information exchanged and further actions to be carried out by the parties. The reason for a letter of intent is that it is easier to negotiate three or four pages than 45–60 pages of a JV Contract. In most cases, a letter of intent is only an expression of commercial intent and has no legal binding effect on the parties.

Although not binding the letter of intent should not be taken lightly. Promises made in letters of intent will be difficult to move away from during negotiations. Ideally the letter of intent should give the foreign investor confidence that the parties will be able to agree upon the main issues of a project and that the foreign investor will obtain due diligence access to relevant business and assets of the Chinese party.

In complex or large projects it is common to have a series of letters of intent. These subsequent documents may be named "memorandum of understanding", "heads of agreement", "meeting minutes", "protocol" etc. Although the names change the underlying purpose remains – these documents should move the parties closer to signing off on the JV Contract.

¶15-075 Sample letter of intent

LETTER OF INTENT

For Reference Only

This Letter of Intent ("LOI") is made on [date], by and between:

[Foreign investor] ("Foreign Investor"), a limited liability company incorporated under the laws of the [home country] with its address at [address].

and

[Chinese party] ("Chinese party"), a limited liability company established under the laws of the Republic of China with its address at [X].

Foreign Investor and Chinese party may be collectively referred to as "Parties" or separately as "Party".

Preamble

Whereas, Foreign Investor is a world-leading company in [type of product]. It possesses advanced and sophisticated technology in the field of [products].

Whereas, Chinese party is a company involved in [type of product].

Whereas, the Parties contemplate [intention].

Therefore after friendly discussions the Parties have reached the following understandings and intend to negotiate the establishment of an equity joint venture company based on the principles set forth below.

1. Formation of the Joint Venture

The Parties intend to jointly invest in and set up a new equity Joint Venture in [location], China. Foreign Investor shall hold [XX%] shares of the Joint Venture while Chinese party shall hold [XX%] of the shares.

The expected total investment shall be in the range of [RMBXXXX].

2. Transaction Documentation

The Parties expect that the transaction as contemplated herein (the "Transaction") will at least require the following documentation ("Transaction Documentation") to be entered simultaneously into by the Parties:

(a) Joint Venture Contract;

(b) Articles of Association of the Joint Venture;

(c) Long term supply agreement between the Joint Venture and Chinese party;

(d) Technology Licence and Technical Assistance Agreement between Foreign Investor and the Joint Venture;

(e) Trademark agreement between the Joint Venture and Foreign Investor;

(f) Non-competition agreement;

(g) Other agreements as required after the negotiations have been completed.

The Parties agree that the Transaction Documentation shall be prepared by Foreign Investor.

3. Business Terms of the Joint Venture

Subject to the approval of the relevant authorities, the business scope of the Joint Venture shall primarily be [insert business scope].

The territory of the Joint Venture shall be solely the People's Republic of China (excluding for these purposes Taiwan, Macau and Hong Kong) ("Territory").

4. Board of Directors and Management

(a) The board of directors of the Joint Venture shall consist of [X] directors. Chinese party shall appoint [X] directors. Foreign Investor shall have the right to appoint the [X] directors. The [Foreign/Chinese] party shall appoint the chairman of the board of directors.

(b) [Foreign/Chinese] party shall be entitled to nominate the general manager of the Joint Venture. [Foreign/Chinese] party shall be entitled to nominate the deputy general manager of the Joint Venture. [Foreign/Chinese] party shall be entitled to nominate the CFO of the Joint Venture.

5. Operational Term of the Joint Venture, call option for Foreign Investor

(a) The initial operational term of the Joint Venture shall be [x] years starting from the issuance of the business licence upon closing of the Transaction. Such term may be renewed upon expiration, subject to mutual agreement between all shareholders and approval from relevant Chinese Government authorities.

(b) The Parties shall both have the right to terminate the Joint Venture after the expiration of five (5) years in case certain

financial figures of the Joint Venture (for example sales, earnings etc.) according to the mutually agreed business plan of the Joint Venture are not reached.

(c) In case the Joint Venture shall be terminated out of whatever reason, Foreign Investor shall have a call option for the outstanding shares of Chinese party in order to continue the business of the Joint Venture.

6. Non-competition

[Will depend upon details of the transaction]

7. Confidentiality

The existence and the content of this LOI are to be confidential between the Parties hereto and their advisors. The Parties will treat any and all disclosed information of confidential nature confidential, except for

(a) disclosure to advisors as reasonably necessary in connection with the transactions contemplated by this LOI,

(b) disclosure as necessary to complete and submit any filings and other submissions necessary to consummate the transactions anticipated by this LOI, and

(c) disclosure compelled by order of court or governmental agency.

The Parties agree that the obligation to keep information confidential which has been disclosed during further negotiations shall be legally binding for two (2) years after the termination of the negotiations in case no cooperation as stipulated in this LOI has been achieved.

8. Exclusivity

Chinese party for itself and on behalf of its affiliates and subsidiaries undertake that they will not for a period of six (6) months from the date of execution of this LOI, or until notified by Foreign Investor that it no longer wishes to proceed with the Transaction (whichever is earlier):

(a) Discuss or negotiate with alternative potential buyers or third parties for projects similar to the Transaction or proposed cooperation involving the establishment of or the participation in a company similar to the contemplated Joint Venture or involving the acquisition of any equity shares, business or assets of Chinese party; or

(b) Disclose any information about the establishment of the Joint Venture to any third party that wishes to enter into negotiations for a project similar to the Transaction.

9. Expiration

The Parties obligate themselves to enter into good faith negotiations immediately upon signing of this LOI with the aim to reach a formal agreement on any and all major issues of the contemplated Transaction. This LOI is regarded as basis for moving forward in the negotiation and drafting of the Transaction Documentation.

This LOI shall expire [X] months after the date of its execution or unless definitive, binding agreements settling the Transaction as contemplated herein are executed by the Parties.

10. No legal obligation

Except for [relevant articles] this LOI does not create any legally binding rights or obligations on the parties hereto hereof. Unless otherwise agreed upon in this LOI each party shall be responsible for its own costs and expenses incurred in connection with the intended Transaction.

If, regardless of the reason, Foreign Investor' intention to participate in the Joint Venture and/or to discuss or conclude any of the agreements in connection with the Transaction should fail, none of the Parties shall be entitled to any claim – regardless of the legal grounds – eg compensation or indemnification, against the other Parties.

11. Miscellaneous

This LOI is executed in two (2) original copies with each Party holding one (1) copy. Each original copy shall contain both English and Chinese versions. Both languages shall be equally valid.

No public announcement or other disclosure concerning the Transaction contemplated hereunder shall be made without the prior written approval of all Parties with the exception of any disclosure vis-à-vis any public authority.

This LOI, its interpretation and all questions arising of, or in connection with this LOI shall be governed by the laws of the People's Republic of China.

In witness thereof, the parties hereto have caused their duly authorised representatives to execute this Letter of Intent on the date first set forth above:

Chinese party: _____

Foreign party: _____

Apart from the letter of intent, the following are documents that are generally required for a JV project.

¶15-090 Project proposal

A project proposal is simply an outline and summary of the JV project. Usual contents include proposed name of the project, particulars of the investors, purpose of the project, size of the project, proposed activities, internal organisation and financial projections.

¶15-095 Sample project proposal

PROJECT PROPOSAL FOR THE ESTABLISHMENT OF [X]

For Reference Only

I. Preliminary statement

In accordance with the *Law of the People's Republic of China on Wholly Foreign-owned Enterprises* and other relevant laws and regulations of the PRC, [X] (hereinafter "the Investor") intends to establish a wholly foreign-owned enterprise (hereinafter "Company") in [location], so as to transfer the Investor's world-class technology in production and assembly of [X] to China, to greatly improve the standard of [X] available in China and to provide the Investor with a satisfactory profit while contributing to the reform and opening up of [location].

II. Brief Introduction to the Investor

The Investor is a public company established and existing under the laws of [X] and registered [X]. The Investor's address is [X].

The Investor is a world-leading producer of [X] and has a history of many years. The Investor currently employs [X] people worldwide and in [X] it had an annual turnover of over [X].

The Investor has been doing business in China since [X].

The Investor is active in the [X] field.

The legal representatives of the Investor are [X].

III. Brief introduction to the project

(1) *Name*

The proposed name of the Company shall be "[X]" in English and "[X]" in Chinese.

(2) *Organisation Form*

The nature of the Company shall be a wholly foreign-owned enterprise and the organisation of the Company shall be a limited liability company.

(5) *Administrative Measures on Urban Real Estate Mortgages* (《城市房地产抵押管理办法》), issued by the Ministry of Construction and effective as of 1 June 1997;

(6) *Several Provisions on Changes in Equity Interest of Investors in Foreign-invested Enterprises* (《外商投资企业投资者股权变更的若干规定》), issued jointly by MOFTEC and SAIC and effective as of 28 May 1997 ("*Equity Change Provisions*");

(7) *Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the Security Law* (《最高人民法院关于适用<中华人民共和国担保法>若干问题的解释》), issued by the Supreme People's Court and effective as of 13 December 2000 ("*Security Law Interpretation*");

(8) *Provisional Measures on Administration of Foreign Debt* (《外债管理暂行办法》), issued by the State Development and Planning Commission, the Ministry of Finance and SAFE and effective as of 1 March 2003; and

(9) *Detailed Rules for the Implementation of the Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (《中华人民共和国外资企业法实施细则》), enacted by the State Council and revised as of 19 February 2014("*WFOE Law*").

¶27-010 Overview

A related issue to the financing of FIEs is the granting of security, without which financing may become difficult, if not impossible. The rules governing granting of security in China by FIEs will be discussed in this section. Depending on the financing transaction, the granting of security by a FIE may be in favour of Chinese lenders or foreign lenders, each of which is governed by different legal regimes. Accordingly, the discussions in this section will be divided into two separate parts as follows.

Foreign-related security

¶27-030 Forms of foreign-related security

The most common forms of security available or offered by FIEs include a charge, guarantee, letter of undertaking, pledge, assignment of contractual rights and set-off rights, not all of which are clearly recognised by the security law regime in China. As a matter of fact, the *Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions* (《境内机构对外担保管理办法》, "*Security Measures*") and

the Detailed Rules for the Implementation of the Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions (《境内机构对外担保管理办法实施细则》, "*Security Implementing Rules*") only provide legal basis for charges, guarantees and pledges in respect of the security in favour of foreign entities. The *Security Measures* (Art 2) specifically provides that "foreign-related security" will mean security interests provided by "domestic institutions" to "foreign entities" in the following forms (whereby the security provider or guarantor will be responsible for the debt secured should the debtor default):

(1) Guarantees in the form of a letter of guarantee, standby letters of credit, promissory notes and bills of exchange;

(2) Charges on properties within the meaning of Art 34 of the *Security Law*; and

(3) Pledges of movable property or rights within the meaning of Art 75 of the *Security Law*.

The term "domestic institutions" is not defined, but Art 2 expressly excludes foreign financial institutions in China from the scope of such term. On the other hand, Art 2 expressly includes "foreign financial institutions in China" as part of "foreign entities".

Therefore, in deciding whether a security interest falls within the scope of "foreign-related security", one has to look at two factors: the identities of the security providers and beneficiaries of such security interests as well as the form of the security interests. In other words, as a general rule, as long as the security interest is in a form permitted under the *Security Measures* and is provided by a domestic institution in favour of a foreign party, it is a "foreign-related security" and is governed by the *Security Measures* accordingly.

Charges

¶27-060 A charge or mortgage – is there a difference?

It is interesting to note that a "Diya" under Ch 3 of the *Security Law* is commonly translated or referred to as a mortgage. Such translation and reference neither seem to be accurate nor appear to be supported by other provisions of the *Security Law*. Under common law, the essential features of a mortgage include the transfer of the ownership of the collateral from the mortgagor to the mortgagee (with the mortgagor retaining a right of redemption) and the mortgagee's rights to foreclose. Such features are not

present in a "Diya" under Ch 3. Before any default by the debtor, the title to the collateral is clearly not transferred to the creditor. Even upon default of the debtor, the creditor, pursuant to Art 33, has priority to be paid from the proceeds of the collateral; the title cannot be transferred to the creditor. As a matter of fact, the *Security Law* expressly prohibits the transfer of the title from the debtor to the creditor. According to Art 40, a "Diya" contract should not stipulate that the right of ownership to the collateral is transferred to the creditor upon a default by the debtor of repaying the debt. Therefore, notwithstanding the common use of the term "mortgage" for a "Diya", a "Diya" under Ch 3 is simply a charge with a right to sell, and not a mortgage.

It can therefore be concluded here that a common law mortgage does not enjoy any legal protection under the current PRC legal framework.

¶27-080 Definition and chargeable properties

The primary legal basis for a charge over assets under the *Security Law* is Art 33 (under Ch 3), which provides that a charge refers to a situation whereby a debtor or a third party offers the assets listed in Art 34 thereof as security for the debt without transferring the possession of such assets. Upon the default by the debtor of repaying the debt, the creditor has the prior right to use for the payment of the debt the proceeds of the collateral exchanged for value (supposedly taken by the chargee for an amount agreed to by the debtor), auctioned or sold.

According to Art 34 of the *Security Law*, charges can be created over the following assets:

(1) buildings and structures over land;

(2) machinery, mode of transportation and other movable assets;

(3) land use rights; and

(4) other legally chargeable properties.

As mentioned above, where the charge is "foreign-related" (ie provided by domestic institutions, including FIEs, in favour of foreign entities), it will also be governed by the *Security Measures* and the *Security Implementing Rules*.

¶27-100 Approval requirements

Article 12 of the *Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions* (《境内机构对外担保管理办法》,

issued in 1996, the "*Security Measures*") provided that a security provider could only grant foreign-related security after the approval from the relevant SAFE agent at the local level had been obtained. In the absence of such an approval, a foreign-related security contract would be void.

The approval requirement had once caused some concerns after the issuance of the *Security Measures*, particularly where such requirement was compared with that under the predecessor legislation, the *Administrative Measures concerning Domestic Institutions Providing Foreign Exchange Guarantees to Foreign Parties* (《境内机构对外提供外汇担保管理办法》, issued in 1991 and replealed in 1996, the "*Forex Guarantee Procedures*"). Under the *Forex Guarantee Procedures*, the approval requirements applied only to a guarantee of foreign exchange debts provided by a PRC domestic institution in favour of foreign creditors. However, the approval requirements under the *Security Measures* seemed to apply not only to foreign exchange guarantees, but also to guarantees of Renminbi ("RMB") obligations, charges over immovable and/or movable and pledges of movable and/or rights as long as they are provided by domestic institutions in favour of foreign parties; the decisive criteria appeared to be the identity of the parties to a security agreement. In other words, as a general rule, so long as the permitted foreign-related security is provided by a domestic institution in favour of a foreign party, the approval requirements would seem to apply.

It was not difficult to understand China's intention to control its foreign debt and related exposure. Accordingly, it is not unreasonable to require that all foreign-related guarantees and asset-backed security provided by a third party (other than the debtor itself) be approved by the SAFE. However, without making a distinction between asset-backed securities (ie charges and pledges) provided by a third party ("three-party transactions") and charges and pledges provided by the debtor itself ("two-party transactions"), the *Security Measures* (including the approval requirements) would be applicable to two-party transactions as well. Such application (particularly where the borrower is a FIE) could have created an anomaly. If these requirements were strictly applied, the irony would be that while the borrowing of international commercial loans by FIEs does not require any Government (including SAFE's) approval, the provision of asset-backed security by such FIEs themselves for the borrowing would require SAFE's approval. The number of such transactions requiring approvals could be significant as in general commercial practice, charges and pledges are usually provided by the debtor instead of a third party.

It is fortunate that the concerns over FIEs associated two-party transactions did not last for too long, as the MOFTEC and the SAFE jointly issued *Circular on Matters concerning Foreign Investment Enterprises Providing Foreign-related Security for Securing their Own Debts* (《关于外商投资企业对外担保有关事宜的通知》, the "MOFTEC/SAFE Circular 320") on 20 January 1997. The *MOFTEC/SAFE Circular 320* provided that FIEs in using their own assets to secure their debts, ie two-party transactions, will not be required to obtain any prior approval from SAFE; but if they are providing guarantees or security as a third party for debts of others, then prior approval will be required. Although the *MOFTEC/SAFE Circular 320* brought about good news for FIEs, it could not be regarded as a logical interpretation of the *Security Measures*; rather it should be treated as a special exemption granted to FIEs. This is because purely domestic enterprises (meaning non-FIEs) were still covered and the *Security Measures* did not lay down any legal basis for the distinction between security provided by FIEs and purely domestic enterprises.

This situation has now been finally clarified by the *Detailed Rules for the Implementation of the Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions* (《境内机构对外担保管理办法实施细则》, the "*Security Implementing Rules*"). Article 27 of the Security Implementing Rules expressly provides that prior approval from SAFE is not required where a chargor uses its assets to secure its own debts (ie two-party transactions). Article 27 also states that where the chargor is a purely domestic enterprise, evidence of SAFE's approval regarding the international borrowing must be provided. In accordance with Art 27 (supplemented by Art 35 regarding pledges), it is clear that an asset-backed security provided by a debtor for its own debt in favour of foreign parties does not require SAFE's approval; instead, the SAFE's control lies in the approval of the underlying international borrowing. Hence, as long as the underlying international borrowing is approved or does not require prior approval (as in the case of FIEs being the borrower), the asset-backed security provided by the debtor for its own debt can be legally granted without any approval.

The promulgation of Art 27 and 35 of the *Security Implementing Rules* is indeed welcomed news for all parties involved in international financing, in particular for purely domestic enterprises. These provisions effectively make the legal regime in this particular area less complicated and significantly relax the once-regarded restrictive effect of the *Security Measures*. However, from the jurisprudential point of view, the issuance of Art 27 and 35 may potentially be a cause of concern. Being implementing rules to the *Security Measures* and

being issued by a lower level authority (by the SAFE as opposed to the People's Bank of China), the *Security Implementing Rules* are supposed to supplement and provide detailed procedures/explanations for the implementation of the *Security Measures*, but not to amend the primary legislation (the *Security Measures*). The distinction between two-party and three-party asset-backed security transactions, as well as the exemption granted by Art 27 and 35, does not seem to have any legal basis in the *Security Measures*. On the contrary, the provisions of the *Security Measures* seem rather firm, ie all foreign-related securities require SAFE's prior approval. Therefore, Art 27 and 35 may be regarded as arbitrary interpretation of the *Security Measures* on the basis of necessity rather than logic. It is hoped that with China's getting more experienced in drafting legislation, this type of inconsistency will be avoided (or become infrequent) in the future.

The *Security Implementing Rules*, for the first time, also clearly provide that WFOEs do not require SAFE's approval in providing foreign-related security (Art 8), although the wording of that provision could be greatly improved. While the first sentence clearly states that WFOEs can provide foreign-related security on their own volition, the second sentence states that SAFE's approval is not required for each such provision of security (implying that a certain type of overall or initial approval is required instead of a case-by-case approval). By reading Art 8 in its entirety, it would seem that this Act is more likely a result of poor drafting instead of a reflection of the legal draftsmen's actual intention. However, where the security is a charge over WOFEs' assets, one has to keep in mind Art 23 of the *WFOE Regulations*, which provides that such a charge requires the approval of the MOFTEC or its entrusted authority.

The promulgation of the *Security Measures* has the effect of expanding the jurisdiction of the SAFE. It had been questioned whether, as the Government department specifically responsible for the administration of the country's foreign exchange system, the SAFE should be involved in regulating matters such as guarantees of RMB obligations and asset-backed security. On the other hand, it had also been argued that any domestic obligations to foreign parties upon realisation would translate into a demand for foreign exchange conversion. The fact that SAFE's approval is required for such conversion may form the basis for SAFE's expanded jurisdiction. This latter argument has now been confirmed by the *Security Implementing Rules* in Art 42 and 49, which expressly provide that non-compliance with the rules (eg without the necessary approval or registration) will result in SAFE's refusal to approve any request for conversion of RMB into foreign exchange.

¶27-120 Approval procedures, level of authority and criteria

With the two-party asset-backed security expressly exempted from SAFE's approval, the number of such approvals would be significantly reduced because three-party asset-backed security transactions are exceptions rather than norms in commercial practice. Specifically, the approval procedures, criteria and the division of approval powers are laid down in the *Security Measures* and *Security Implementing Rules*.

The *Security Measures* (Art 11) and *Security Implementing Rules* (Art 9) specify the documents required to be submitted to the Approval Authority, which include:

(1) an application for approval;

(2) feasibility study and other related approvals of the underlying project for which the security is requested;

(3) audited financial statements of the security provider;

(4) audited financial statements of the debtor;

(5) letter of intent regarding the security contract;

(6) contract or letter of intent for the underlying debt;

(7) other documents required by the SAFE agent at the local level;

(8) ownership and valuation documents for the collateral; and

(9) evidence that the foreign investor has provided security proportional to its percentage interests in the JV in a case where the debtor is a JV.

Although no specific criteria are laid down as guidelines for SAFE's approval, the legislation does provide that certain essential requirements must be complied with, which will be discussed in more detail in the section regarding 'guarantees' below.

The division of approval authorities between the central and provincial level SAFEs is based on the status of the security provider, the identity of the debtor and the term of the security contract. First of all, if the security provider is a Chinese financial institution based in Beijing, a domestic enterprise directly under the central government or a FIE whose business licence is issued by the SAIC (central government level) directly, the foreign-related security in question must be approved by the SAFE; the identity of the debtor and the term of the security contract do not seem to matter. Secondly, if the debtor is a purely domestic enterprise or a FIE and the security

term is one year or less, the foreign-related security concerned can be approved by the provincial level SAFE agent provided that the security provider does not fall within the above-mentioned category. Finally, if the debtor is a non-Chinese entity (mainly Chinese-owned foreign subsidiaries) or a FIE and the security term is more than one year, the application must be submitted to the provincial level SAFE for preliminary approval and then to the central SAFE for final approval.

It is interesting to note that Art 10 of the *Security Measures* and Ar 8 of the *Security Implementing Rules* provide a slightly different scope when referring to the provincial level SAFEs. While the former includes SAFEs of all provinces, autonomous regions, directly governed municipalities, municipalities under separate State planning and Special Economic Zones ("SEZs") as "provincial level" SAFEs, the latter does not refer to SAFEs of the SEZs and municipalities under separate State planning. It is unclear whether such discrepancy is a result of inadvertent omission or deliberate effort. In theory, it is the *Security Measures* (being the primary legislation) that will prevail in case of conflict.

¶27-140 Registration requirements

According to Art 41 of the *Security Law*, an agreement regarding a charge over assets only comes into effect upon its registration with the relevant Government departments. Accordingly, registration in China not only preserves the chargee's priority over other creditors but is also essential to the effectiveness of the charge agreement. In addition, all foreign-related security must also be registered with the relevant level SAFE (Art 14 of the *Security Measures*). Non-compliance with this latter registration requirement does not seem to affect the validity of the security agreement concerned. Article 17 of the *Security Measures* only provides penalties in the form of warnings and suspension of its security-providing business. Non-compliance may nevertheless have significant effects upon realisation of the security concerned, as Art 42 of the *Security Implementing Rules* expressly provides that non-registration will result in SAFE's refusal to approve any purchase and remittance of foreign exchange outside China under the security agreement.

¶27-160 Registration procedures

Depending on the types of assets to be charged, different registration procedures would apply, although all "foreign-related security" is required to be registered with the SAFE agent at the local level.

¶27-180 Charges over movable properties

Specifically, a charge over movable properties such as machinery/equipment will have to be registered in accordance with the *Measures on Registration of Mortgage of Movable Property* (《动产抵押登记办法》). The *Movable Property Security Registration Measures* provide that SAIC is the Government department responsible for registration of movable property offered as collateral (Art 2); "movable properties", however, exclude means of transportation such as aircrafts, ships and vehicles (Art 3) which are registered with other Government departments such as the Civil Aviation Administration of China ("CAAC"). Application for registration should be submitted to SAIC jointly by the parties, together with copies of the following documents:

(1) primary contract (ie the loan agreement) and the security agreement,

(2) ownership or user's right certificates of the collateral,

(3) information concerning the location of the collateral,

(4) business licence of the parties,

(5) identities of the parties' representatives and their scope of authority, and

(6) other required documents (Art 4).

Within five days of receiving all documents submitted, SAIC will decide whether the application is acceptable for registration. If the application is accepted for registration, a Collateral Registration Certificate for Movable Properties Owned by Enterprises will be issued to the parties.

A sample Collateral Registration Certificate for Movable Properties Owned by Enterprises is set out in ¶27-700.

¶27-200 Charges over real properties

Where a charge is created over real property (ie buildings or structures together with the land use rights thereunder), registration procedures will have to be carried out in accordance with the *Administrative Measures on Urban Real Estate Mortgages* (《城市房地产抵押管理办法》). Article 30 requires that the charges over real property shall be registered with the local real property administration department within 30 days after the agreement is signed and the charge agreement becomes effective only upon registration (Art 31).

Specifically, Art 32 provides that the following documents shall be submitted for registration:

(1) chargor's identity document or documents evidencing its legal person status;

(2) application for registration;

(3) agreement setting up the charge;

(4) land use certificate, building ownership certificate or real property ownership certificate;

(5) documents evidencing the chargor's rights to charge the property;

(6) documents evidencing the value of the charged property; and

(7) other documents required by the registration authorities.

The registration authorities, upon receiving all the documents required, shall make a decision within 15 days thereafter whether to accept the submitted registration (Art 33). Where the property charged is a building with its ownership certificate issued, the registration authorities will make notes regarding "Other Rights Registration" on the building ownership certificate and issue a Building Other Rights Certificate to the chargee (Art 34).

¶27-220 Charges over bare land use rights

Where the assets charged are land use rights (without any buildings or structures thereon), the charge agreement has to be registered with the local land administration department that issued the relevant land use certificate in the first place. Furthermore, the specific registration requirements contained in the *Notice on the Registration of Charges over Land Use Rights* (《国家土地管理局关于土地使用权抵押登记有关问题的通知》, the "*Land Use Rights Charge Registration Notice*") will also have to be complied with.

Specifically, the registration procedures should be jointly carried out by both contracting parties within 15 days after the execution of the charge agreement. If one party is unable to attend to the registration, then written authorisation for the other party to do so on its behalf should be presented.

The following documents should be submitted for registration:

(1) relevant land use certificate;

(2) charge agreement;

(3) valuation reports for the land use rights; and

(4) both parties' identification documents.

It is interesting to note that the *Land Use Rights Charge Registration Notice* expressly provides that the only legal evidence of charges over land use rights is "Other Rights Certificate concerning Land". Contrary to common perception, deposit of land use certificates with the creditor does not create any charge over the land use rights concerned. The *Land Use Rights Charge Registration Notice* goes further to state that should the creditor take the land use certificate, the holder can apply for a nullification of the said land use certificate and issuance of a new certificate.

¶27-240 Foreign-related security registration

As mentioned above, the foreign-related security registration procedures must also be complied with. According to the *Security Measures* (Art 16) and the *Security Implementing Rules* (Art 39), in respect of non-financial institution security providers (such as FIEs), each provision of foreign-related security must be registered with the relevant SAFE agent at the local level within 15 days after signing the security agreement, whilst financial institution security providers are required to register with the relevant SAFE agent at the local level once a month. Upon registration, a "Foreign-Related Security Registration Form" must be filled out and the relevant SAFE agent at the local level will then issue a "Foreign-Related Security Registration Certificate".

A sample "Foreign-Related Security Registration Certificate" is set out in ¶27-702.

¶27-260 Timing of registration

As mentioned above, the relevant law and regulations provide statutory periods within which the charges have to be registered. The timing is, in general, not an issue.

However, where the security interest is provided for the purpose of a structured export financing into China, the timing of the security registration often turns out to be a crucial issue. In theory, there exists a chicken-and-egg problem. The equipment exporter, in general, wants to be paid by the borrower (with the loan proceeds) prior to shipping the equipment to China, whilst the lender, in general, insists that the registration of the charge over the equipment is a condition precedent to the disbursement of the loan, which can only be done

after the equipment has been shipped to China. It is indeed fortunate that in practice, most of the exporters are usually accommodating and that this issue could, in general, be satisfactorily resolved among the parties involved.

¶27-280 Remedies available

As far as the creditor's remedies are concerned, it was mentioned earlier that the *Security Law* simply gives the creditor a right to sue the debtor upon the debtor's default and grants the creditor a priority to be paid from the proceeds of the collateral realised. These methods of realisation seem to be limited to the exchange for value (ie the collateral to be taken by the creditor for an amount agreed to by the debtor), auction and sale. Right to foreclose, right of entry, possession, receivership and other forms of common law remedies do not seem to be available. Furthermore, default by the debtor also only refers to the default of payment by the debtor; other events of default such as breach of representations/warranties, in general, recognised in international financing are not provided for in the *Security Law*.

Guarantees

¶27-300 Definition and types of guarantees

Article 6 of the *Security Law* defines "guarantees" as acts whereby a guarantor and a creditor agree that upon the debtor's default in paying its debts, the guarantor shall pay such debts or assume liabilities as agreed. Clearly, a guarantee under the *Security Law* is very much a guarantee of payment, and not a guarantee of performance.

When two or more guarantors guarantee the same debt obligation, the proportion guaranteed by each shall be clearly stipulated; without such stipulation, these guarantors are presumed to guarantee the debt jointly and severally (Art 12).

Guarantees are divided into two types: general guarantee and joint/several liability guarantee. Where parties to a guarantee agree that the guarantor's liability arises when the debtor fails to pay its debts, the guarantee is a "general guarantee". The guarantor's liability under a general guarantee is secondary only. The guarantor can, subject to certain exceptions, refuse to assume its guarantee liability prior to the disputes over the principal debt contract having been adjudicated or arbitrated and the execution proceedings against the debtor's property having been instituted but unsuccessful in discharging the debts (Art 17). In other words, the creditor's recourse

against the guarantor in a general guarantee is unavailable until it has exhausted all legal remedies against the debtor. The exceptions to the above are:

(1) The change in the debtor's residence has caused difficulties for the creditor in demanding repayment;

(2) The people's court suspends the enforcement proceedings while hearing the bankruptcy case of the debtor; and

(3) The guarantor gives up the above protection in writing.

In contrast, a guarantee will be classified as a joint/several liability guarantee where the parties to the guarantee agree that the guarantor and the debtor are jointly and severally liable for the debt. When the debtor fails to pay its debt when due, the creditor can, under a joint/several liability guarantee, demand payment of the debt by either the debtor or the guarantor within the scope of the guarantee (Art 18). The guarantor's liability is primary in nature. The only condition to the creditor's recourse against the guarantor is the fact that the debt is unpaid when due; no exhaustion of legal remedies is required.

From the creditors' point of view, it is clear that a joint/several liability guarantee is much more beneficial and useful than a general guarantee. In practice, general guarantees may simply be the exception rather than the norm; they may only occur where the creditor is in a relatively weak bargaining position (which of course is unlikely). The *Security Law* seems to have recognised this by requiring that a general guarantee be expressly stated. Article 19 provides that where the guarantee has no stipulation or is unclear as to the type of guarantees, the guarantee is deemed to be a joint/several liability guarantee.

Even a joint/several liability guarantee seems to be different from a first demand guarantee in common law. With a first demand guarantee, the guarantor's liability is triggered (at least theoretically) by a demand of the creditor; a guarantor's liability under a joint/several liability guarantee can only be triggered by the failure of the debtor to repay the debt when due (Art 18), which in practice may simply be one of the many events of default commonly referred to in international financing.

It is also interesting to note that the *Security Law* stipulates the time limit within which the creditor may demand the performance of guarantee obligations by the guarantor. Article 25 provides that the limitation period for a general guarantee is six months, starting from the maturity of the principal debt unless the guarantor and the creditor otherwise agree. Article 26 provides that unless the parties

otherwise agree, the limitation period for a joint/several liability guarantee is also six months. In the event when the creditor fails to sue or institute an arbitration proceeding against the debtor (in case of a general guarantee) or demand payment by the guarantor (in the case of a joint/several liability guarantee) within an agreed period or the above stated period, the guarantor will no longer be liable (Art 25 and 26).

Additionally, a guarantor is exempt from any civil liability under either of the following circumstances:

(1) The guarantor was induced to provide a guarantee as a result of a conspiracy between the parties to the principal debt agreement; or

(2) The guarantor involuntarily provides a guarantee due to the use of improper means by the creditor such as deception or threat.

Article 22 provides that any assignment by the creditor of its interests will not affect the liability of the guarantor unless the guarantee provides otherwise. However, any assignment by the debtor of its obligations or any amendment to the principal contract (unless the guarantee otherwise provides) will require the prior consent of the guarantor. Otherwise, the guarantor will no longer be liable.

¶27-320 Approval requirements

Similar to a charge discussed above, a guarantee is also a recognised security device under the *Security Measures*. As such, the provisions of the *Security Measures* (including the approval requirements) apply as long as the guarantee is a foreign-related guarantee, ie a guarantee provided by a PRC entity (including a FIE) in favour of a foreign party. No exemptions or exceptions are therefore available as a guarantee by its nature is a three-party transaction. Due to the unequivocal application of the approval requirements, foreign-related guarantees, though being one of the most useful forms of security, are virtually unavailable in China. Even under the *Administrative Measures concerning Domestic Institutions Providing Foreign Exchange Guarantees to Foreign Parties* (《境内机构对外提供外汇担保管理办法》, issued in 1991 and replealed in 1996, the "*Forex Guarantee Procedures*"),, guarantees were highly controlled before the promulgation of the *Security Measures*. Under the *Forex Guarantee Procedures*, all forex guarantees were subject to the approval of SAFE. The only substantial difference between the two regimes appears to be that theoretically a guarantee of RMB obligations or a guarantee

of obligations in RMB, whilst caught by the approval requirements of the *Security Measures*, did not require any SAFE approval under the *Forex Guarantee Procedures*. However, one has to appreciate that in practice it did not make too much of a difference. Since China's RMB is still not fully convertible as far as capital account items are concerned, any guarantee in RMB, if not accompanied by SAFE's approval for conversion into hard currencies, will not be of much use to most international lenders. This is particularly so during the regime of the *Forex Guarantee Procedures* when China's control over foreign exchange was stricter.

¶27-340 Qualification of guarantors and related approval criteria

The lack of availability or non-availability of foreign-related guarantees in China results not only from SAFE's tight control in the form of approval, but is also caused by various related approval criteria (including the qualifications of guarantors), which are sometimes very difficult for a potential guarantor (including a FIE) to meet. Some of the more important criteria include the following described under Scope of potential guarantors at ¶27-360.

¶27-360 Scope of potential guarantors

Article 7 of the *Security Law* provides that any legal persons, other organisations or individuals that have the ability to pay debts on behalf of others can act as guarantors.

Article 8 prohibits public institutions and social organisations with mandates to promote public welfare (including schools, kindergartens and hospitals) from acting as guarantors.

Article 10 prohibits a branch organisation or a functional department of an enterprise legal person from acting as a guarantor, except in connection with a guarantee provided by such a branch organisation that is expressly authorised in writing by the enterprise legal person concerned. Similarly, a Government department is prohibited from being a guarantor except where the guarantee is provided for the purpose of using loans from foreign governments or international financial organizations for on-lending and with the specific approval of the State Council (Art 8). The prohibition against Government entities being guarantors is also emphasised by the *Security Measures* (Art 4), which expand the scope of the prohibition under Art 9 of the *Security Law* to public institutions, in general, without any qualifications (eg as to their mandates).

It is worth noting that with the express exclusion of Government departments, public institutions and branches/functional departments of enterprise legal persons, it is unclear what the term "other organisations" under Art 7 of the *Security Law* would mean.

The above exclusion apparently does not affect the capacity of FIEs as potential guarantors provided other conditions could be met.

¶27-380 Qualifications for foreign-related guarantors

As the discussion in this subsection applies to all forms of foreign-related security, including charges discussed above, the term "foreign-related security providers" will be used instead of "foreign-related guarantors". This also applies to the subsection below.

The *Security Measures* provide financial tests for acting as foreign-related security providers in terms of foreign exchange funds, net assets and foreign exchange revenue. Article 5 provides that the total amount of foreign-related security a financial institution can provide (plus its own foreign debt) must not exceed 20 times of its foreign exchange funds; for non-financial institutions (including FIEs), the balance of foreign-related security it can provide must not exceed its foreign exchange revenue in the previous year or 50% of its net assets. Undoubtedly, these requirements have the effect of limiting the scope of available candidates (including FIEs) qualified to provide foreign-related security and therefore directly affecting the availability of foreign-related security.

The above criteria appear to have been brought forward from the *Forex Guarantee Procedures* without the necessary adjustments to cover foreign-related charges and pledges. While these criteria may be appropriate in a foreign exchange guarantee, their relevance is more questionable in the context of asset-backed security such as charges and pledges. The issue of security becomes important when a creditor is considering his asset's value; the foreign exchange performance tests are more relevant to a borrower's ability to pay, and not as to the provision of security.

In addition, by prohibiting a non-financial institution from providing foreign-related security in an amount exceeding its foreign exchange revenue in the previous year, Art 5 makes it extremely difficult to acquire international financing (including export-financing) for newly established enterprises, special purpose project vehicles, infrastructure projects in the construction stage and enterprises without foreign exchange revenue (at all). Even if these enterprises

have valuable assets such as land use rights and equipment that can be charged as security, they are not permitted to do so because they are technically not qualified security providers under Art 5. In practice, it appears that SAFEs have not, or could not strictly enforce these criteria because most asset-backed securities do not require SAFE's approval. However, technically speaking, the potential legal risk is that the security agreement could be void as against the PRC law if the requirement is not met. Therefore, sufficient attention should be paid in this regard to the documentation creating the security.

If the security provider is a purely domestic enterprise, the *Security Measures* go further by providing that the ratio of net assets to the total assets of a trading enterprise shall in principle be at least 15%, and 30% for non-trading enterprises (Art 6). These requirements seem to have been changed by Art 17 of the *Security Implementing Rules*, which provide that these requirements apply to situations where the debtor is an entity located outside China. Is such a change intended to exclude other situations or simply as an illustration? As will be discussed below, such a change is neither logical nor supported by jurisprudence.

¶27-400 Other prohibitions and restrictions

Other prohibitions and restrictions contained in the *Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions* (境内机构对外担保管理办法, "*Security Measures*") that are applicable to FIEs include Art 7, which provides that a security provider should not provide foreign-related security for loss-making enterprises. Two questions arise from this prohibition.

First, what exactly does "a loss-making enterprise" mean? Does it simply mean any enterprise suffering a loss in any given year? Literally, this seems to be the right interpretation. From a business point of view, this, however, does not seem to make sense. Suffering a loss is a part of business life for any enterprise. It does not necessarily mean that the enterprise will not have the prospect of making a profit in the future. A loss may be temporary or may simply be an inevitable stage of development for certain businesses. Does this mean, for example, that there can be no secured financing of an infrastructure project during its development stage (export financing on machinery/equipment is particularly essential during such stage)? The *Security Measures*, by limiting an enterprise's ability to obtain financing, may have the effect of forcing the enterprise to be out of business. This is precisely so when an enterprise suffers a loss that needs financing.

Second, does Art 7 apply to situations where a security provider (also a debtor) is providing asset-backed security for its own financing? On its face, the answer seems to be "Yes" because Art 7, like other provisions of the *Security Measures*, does not attempt to make a distinction between security provided by a third party and that provided by a debtor. Furthermore, *Circular on Matters concerning Foreign Investment Enterprises Providing Foreign-related Security for Securing their Own Debts* (《关于外商投资企业对外担保有关事宜的通知》, "*MOFTEC/SAFE Circular 320*") did not change that, as *MOFTEC/SAFE Circular 320* did no more than exempting the two-party security granted by FIEs from the approval requirement. However, this would appear to create an anomaly. A loss-making enterprise may still have valuable assets that can be used as security for financing.

Many had expected the *Detailed Rules for the Implementation of the Administrative Measures on Securities Given to Foreign Parties by Domestic Institutions* (《境内机构对外担保管理办法实施细则》, "*Security Implementing Rules*") to clarify these issues and provide some additional guidance in this regard. The *Security Implementing Rules*, however, proved to be disappointing. The *Security Implementing Rules* do not give any clarification or definition of "loss-making enterprises". To the contrary, the *Security Implementing Rules* seem to have generated more uncertainties and concerns. Article 17 provides that if the debtor is an entity situated outside China, foreign-related security should not be provided if such entity is a loss-making enterprise. It is totally unclear whether this provision is intended to be supplemental to or to act as a replacement of (or an amendment to) Art 7 of the *Security Measures*. Neither seems to be logical. If it was intended to be supplemental, it is totally unnecessary as Art 7 covers all scenarios (including those under Art 17(2) of the *Security Implementing Rules*). If it was intended to be an amendment, it appears to be against the general principle that legislation issued by a lower level authority cannot amend that issued by a higher level authority. Furthermore, since the statement in Art 7 is quite bold, any change to it should be unequivocal and express; it should not be amended by way of implication by Art 17 of the *Security Implementing Rules*.

When the drafting pattern of the *Security Implementing Rules* is closely examined, the prohibition appears only to apply where the debtor is an entity situated outside China. This is good news in practice. As far as the issue of two-party security is concerned, the *Security Implementing Rules* did no more than broadening the coverage of *MOFTEC/SAFE Circular 320* in terms of the approval requirements.

¶27-420 Registration procedures

The above discussion about the approval authorities and foreign-related security registration procedures with SAFE in the context of charges apply equally to guarantees where such guarantees are provided in favour of a foreign entity.

Pledges

¶27-500 Definition and types of pledgeable properties

"Pledges" are further divided into pledges of movable properties and pledges of rights (titles). In a pledge of movable properties, the debtor will transfer the possession of the movable properties concerned (ie collateral) to the creditor as security. Should the debtor (pledgor) default, the creditor (pledgee) will have a right to use for payment of the debt concerned the proceeds of the collateral exchanged for value (supposedly taken by the pledgee for an amount agreed to by the debtor), auctioned or sold.

As the *Security Law* does not further state what properties can be pledged, it is reasonable to assume that all movable properties can be legally pledged provided they are acceptable to the creditor.

A pledge of rights, on the other hand, refers to the transfer of the relevant title documents by the debtor to the creditor as security for debt. Similarly, if the debtor (pledgor) defaults, the creditor (pledgee) will have a right to use for payment of the debt concerned the realised values of the rights pledged.

Article 75 of the *Security Law* expressly provides that the following rights can be pledged:

(1) bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts, bills of lading;

(2) shares and shareholding rights that are legally transferable;

(3) exclusive rights to use trademarks as well as property rights contained in patent and copyrights that can be legally transferable; and

(4) other rights that can be pledged.

While pledges of movable properties/rights are a recognised form of security in China, they are not, in general, used in structured export financing due to the fact that a pledge involves the transfer of

possession of the pledged goods/rights. However, in short-term trade financing, a pledge of title of the exported goods, subject to other requirements, may be a very useful form of security, especially when the goods are in transit, eg being shipped.

¶27-520 Approval requirements and procedures

For foreign-related pledges, the approval requirements and procedures discussed above in relation to foreign-related charges will similarly apply and thus will not be repeated here. It should, however, be noted that additional approval is required where the pledge is in relation to the pledge of investment interests in a FIE.

Pursuant to the relevant provisions of the *Several Provisions on Changes in Equity Interests of Investors in Foreign-invested Enterprises* (《外商投资企业投资者股权变更的若干规定》, the "*Equity Change Provisions*"), any pledge of investment interests in a FIE by an investor (Chinese or foreign) requires the consent of the other investors and an approval of the original Approval Authority (for the establishment of a FIE).

Article 12 of the *Equity Change Provisions* provides that the following documents shall be submitted to the relevant authorities for approval:

(1) the FIE's board resolution and other investors' consent for the proposed pledge;

(2) the pledge agreement;

(3) evidence that the investor pledging the investment interest has fully paid up its registered capital contribution; and

(4) the FIE's registered capital payment verification reports.

The authorities will decide within 30 days after receiving the above documents whether to approve the application. Any pledge without such approval will not be effective.

¶27-540 Registration requirements

While all charges are required to be duly registered with the relevant Government authorities, the registration requirements for pledges are mixed. As mentioned above, pledges involve in the creation of a security over certain movable properties or rights with the transfer of possession of the relevant properties or title documents as the distinctive feature (distinguishing pledges from charges). Therefore, it is reasonable to expect that a registration is not always required for pledges because the creditors have the apparent and actual control of the collateral concerned. As a matter of fact, no registration

whatsoever is required for pledges of movable properties. The delivery of the possession of the movable properties is a critical factor that affects the validity of the pledge agreement concerned. Similarly, Art 76 of the *Security Law* provides that in the case of pledges of bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts or bills of lading, the relevant titles documents shall be delivered to the pledgee after the execution of the pledge agreement. The delivery of relevant title documents will affect the validity of the pledge in question. In other words, in the above situations, the relevant pledge only becomes effective upon the delivery of such title documents.

Where the granting of security involves the pledge of freely transferable shares, the pledge agreement shall be registered with the relevant securities registration authorities. The pledge agreement only becomes effective upon the completion of such registration. Similarly, pledges of copyrights, patents and trademarks are required to be registered with the relevant departments and have to comply with the specific registration requirement laid down in the *Copyrights Pledge Contract Registration Measures* (《著作权质押合同登记办法》), the *Interim Measures on the Registration of Patent Rights Pledge Contracts* (《专利权质押合同登记管理暂行办法》) and the *Trademark Pledge Registration Measures* (《商标专用权质押登记程序》) respectively.

The registration authority for a pledge of copyrights is the State Copyrights Bureau, which is required to decide whether to accept the application within 10 days. The parties are also required to jointly carry out the registration procedures. The relevant pledge agreement only becomes effective upon its registration and with the issuance of the *Copyrights Pledge Contract Registration Certificate*.

Article 7 of the *Copyright Pledge Contract Registration Measures* provides that the following documents shall be submitted for registration:

(1) application form for registration;

(2) both parties' identification documents;

(3) principal agreement (eg a loan agreement) and the pledge agreement;

(4) documents evidencing the copyright;

(5) licensing status of the copyright prior to the pledge;

(6) the State Council's approval where the pledge involves a pledge of computer software copyrights in favour of foreign entities; and

(7) other required documents.

For the pledges of patent rights, the registration authority is the State Patent Bureau, which is required to make a decision on the registration application within 15 days. The documents that are required to be submitted for registration will include the following:

(1) application form for registration;

(2) pledgor's identification documents;

(3) principal agreement (eg a loan agreement) and the pledge agreement;

(4) documents evidencing the validity of the patent;

(5) licensing and application status of the patent prior to the pledge;

(6) the State Council's approval or other superior Government department's approval; and

(7) other required documents.

In case of pledges of trademarks, the registration authority is SAIC. The following documents shall be submitted for registration:

(1) application form for registration,

(2) copies of the parties' business licences,

(3) pledge agreement,

(4) copy of the trademark registration certificate, and

(5) other required documents.

If the pledge involves investment interests in a FIE, the registration procedures shall be carried out with the original SAIC department that handled the registration of the FIE in the first place. Article 12 of the *Several Provisions on Changes in Equity Interest of Investors in Foreign-invested Enterprises* (《外商投资企业投资者股权变更的若干规定》) provides that such registration shall be completed within 30 days after the relevant pledge has been approved.

¶27-560 Registration procedures

The registration procedures discussed above will similarly apply to pledges in favour of foreign entities.

¶27-580 Remedies available

In case of a default by the debtor, the remedies available to the pledgees are similar to those available to the charges. In other words, the primary rights for the creditors are the rights to sell pledged goods