

# The Legal Environment and Risks for Foreign Investment in China

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Shoushuang Li

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The Legal  
Environment  
and Risks for Foreign  
Investment in China

 Springer

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## Foreword

It is my great pleasure to introduce *The Legal Environment and Risks for Foreign Investment in China* by Shoushuang Li, a star young lawyer in Beijing. Mr. Li has a wealth of experience in foreign investment law and joint ventures, which he brings to bear in his analysis of this dynamic and critical field.

China's investment climate continues to evolve. Less than thirty years after the introduction of market reforms, China has become one of the world's most attractive investment locations. The legal system has developed a good deal, although there are still plenty of pitfalls that await investors who are not sufficiently careful. Foreign observers of the legal system remain divided as to whether the proverbial glass is half full, or rather half empty—some believe that China's efforts to develop the rule of law have already born fruit while others are more skeptical.

Li's strength is to combine the specific details of the various regimes governing investment in China with a broader perspective on risk management. He begins with an introduction to general issues related to foreign investment, tax law, land use right and labor law. These are likely to be of concern to investors in a wide array of fields. He then goes on to provide a wealth of detail on particular sectors of education, water, and insurance. While these sectors each have their own particular regulatory dynamics, they are also representative of many others that face similar problems. In particular, education and water involve special issues related to the provision of public goods that were traditionally monopolized by the state. Insurance on the other hand is generally viewed as best provided by market forces. The risks in all three sectors, however, demonstrate the distinctive features of the Chinese transition currently under way. Managers need to be aware not only of the general problems of doing business in China, but also the specific characteristics of the sector in which they plan to operate.

Li's concluding section ably demonstrates how managers and lawyers can reduce the risks associated with investment in China. Any investor will want to know about the options in case the deal goes bad, and China provides an array of dispute resolution choices that need to be considered before the investment occurs. These options are themselves evolving over time. With a guide as able as Mr. Li, investors can maximize the probability of a productive investment experience in the World's most dynamic marketplace.

Tom Ginsburg

*Professor*

*Director, Program in Asian Law, Politics and Society*

*University of Illinois, College of Law*

# Preface

## Investment in China: The Opportunities Co-exist with Risks

*“The single most important thing to happen in our lifetime will be the emergence of China.”*

— John Thornton<sup>1</sup>

*The high costs of business regulation, a poor institutional framework, weak property rights and an unstable macroeconomic environment are major obstacles to doing business in transition countries.*

— The European Bank for Reconstruction and Development<sup>2</sup>

John Thornton, a former President of Goldman Sachs, once observed, “The single most important thing to happen in our lifetime will be the emergence of China.” China is the new growth frontier of the global economy, and the investment opportunities that it presents are perhaps the greatest of the 21st Century. In a country of 1.3 billion people, with annual GDP growth twice that of the US (consistently 7-9%), it is clear that there is no stopping China’s emergence as a major player. Successful investors will need to learn the nature of the opportunities that abound today so as to profit from growth tomorrow. Those who ignore the China opportunity will simply be left behind as the economy continues to excel and their competition soar to new heights.

There are of course two sides to the coin, and numerous pitfalls on the path to prosperity in China. The miraculous numbers cannot disguise the problems associated with the country’s developmental transition period. In the “transition report 2005: Business in Transition” issued by the European Bank for Reconstruction and Development (EBRD), it is observed that the world’s transition countries have made significant progress, but still lag behind mature market economies in most aspects of their business environments. The high costs of business regulation, a poor institutional framework, weak property rights and an unstable macroeco-

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<sup>1</sup> Former President of Goldman Sachs (Now a Professor at Tsinghua University).

<sup>2</sup> The European Bank for Reconstruction and Development. *Transition report 2005: Business in transition*, download from <http://www.ebrd.com/pubs/econo/6520.htm> (last visit in Nov. 2005).

conomic environment all emerge from the survey as major obstacles to doing business in these transition economies.

In addition, there is concern about problems particular to China which obstructs the progress of the economy. For example, the multiple and legally-undefined roles of state-owned enterprises often perplex foreign investors. Meanwhile, traditional Chinese mono-culture has been replaced by a diversified system of values embracing foreign elements. Thus, more and more conflicts arise between the east and west, the host country and her rich foreign guests, leading to a variety of investment risks. In general, China cannot leapfrog this special phase featuring a transition from partial to complete rule-of-law. In particular, there are a large number of potential legal risks associated with the process of incorporating and operating a Chinese-Foreign joint venture or other businesses of a similar form.<sup>3</sup>

When it comes to risk management, most foreign entrepreneurs have a wealth of experience, plentiful resources and academic studies to hand. They would like to pay more attention to risk management and control in business of running joint ventures in China, whereas the legal risk otherwise is to some extent overlooked. Though this latter issue has been explored to an extent, there is still a lack of adequate depth. Foreign investors often play games with supervisory institutions and local authorities, walking the line between legitimacy and illegality. From the outset, these investors often set out ambitious plans that involve using contacts within local and central governments, or relying on their Chinese partners. These kinds of business relationships take the form of an extension to an individual's private circle, and are more grounded on the discretion of officials or the good faith of Chinese partners than business norms and legal institutions. By its nature these arrangements are vulnerable to unpredictable political and legal risks. Even if these risks are taken into account in the course of making investment decisions, the serious scarcity of knowledge concerning this issue can not effectively make them to dodge the legal risks. There are still contradictions between various levels of laws and regulations as well as gaps. This causes some outside investors to hesitate, leading to the loss of dozens of opportunities. Other investors have paid a high price for poorly-advised investments due to misunderstanding or ignoring Chinese legal risks.

Aside from statutes, and the rules of central and local government, foreign investors inevitably come across judicial interpretations, administrative policies and counsel opinions. Equally, special Chinese environmental features such as complicated land ownership, socialist public ownership and state-owned enterprises

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<sup>3</sup> See also Research results of Geringer, Kogut, Killing. Geringer, J. M. & C. A. Frayne (1990), Human resource management and international joint venture control: A parent company perspective, *Management International Review*, 30:103-120; Kogut, B. (1989), Why joint ventures die so quickly? *Chief Executive*, May/June issue: 70-73; Killing, P. (1988), Understanding alliances: The role of task and organizational complexity, In: *Cooperative Strategies in International Business*. F. Contractor & P. Lorange (Eds), Lexington: Lexington Books.

may confuse foreign guests. Often “under-table rules” virtually govern China’s economic and social development. Defaulting on these rules will result in disqualification, forfeit, and even eviction.

According to Jack Welch “One should not be afraid of the legal risk itself, but the ignorance of it”. The Chinese legal environment itself should not be blamed for foreign investors’ losses. Rather, the legal risks hidden in the environment need to be far better understood. Whether dormant risks will become active depends on the knowledge and reflexes of foreign investors. The aim of this book is to advise on the many kinds of legal risk behind China’s prosperity and to explore legal risk mitigating and management measures to be applied within China’s unique legal environment.

Shoushuang Li

October 2006

# Acknowledgements

The book is intended to discover specific legal risks hidden in all phases through a selective introduction of China's legal environment for foreign investment. Also, my goal for this book tries to guide the foreign investors in discerning and making appropriate steps against the aforesaid risks, to avoid following the same mistakes by others and better achieve their ends.

The inspiration of this project started in mid 2005 was initially born in a conversation with Mr. Wu Hangbin, an editor in China Economic Press. Previously, I wrote this book in Chinese. However, that I finally translated it into English is far attributed to Mrs. Brigitte Reschke in Springer for her kindly publishing offer.

During the years of 2005 and 2006, I was at all times pondering on an unprecedented situation—law-booming in China. Many important commercial laws and regulations including Company Law, Securities Law, Bankruptcy Law were promulgated with totally new revisions. Accordingly, I made onerous efforts in researching, analysing, rewriting to make this book updated.

I gratefully acknowledge the significant efforts of Mr. Wang Chunyang and Mrs. Gu Huaning helping me translate parts of the book.

Earlier draft of this book was proofread in painstaking detail respectively by Daniel Russel, Tamsin Westley, Grace Wang, Diana Shu, Owen Lee. Special supports were received from Adam Guli, Li Jing, Li Yunchi and Luoling to help me find them. I will always be thankful to them, whereas any remaining errors are solely my responsibility.

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# Table of Contents

- Foreword ..... V**
- Preface..... VII**
- Acknowledgements..... XI**
- Abbreviations..... XXI**
  
- 1 Introduction: The Legal Risks of Foreign Investment in China ..... 1**
  - 1.1 Definition of Legal Risk of Foreign Investment ..... 1
    - 1.1.1 Risk and Legal Risk..... 1
    - 1.1.2 Types of Legal Risks Embedded in Chinese Legal System..... 3
    - 1.1.3 Legal Risks for Foreign Investment in China..... 4
  - 1.2 Macro-analysis of Legal Risks in Investment Institutions ..... 5
    - 1.2.1 Macro-analysis of the Legislation Regarding Foreign Investment and Its Risk ..... 5
    - 1.2.2 China’s Commercial Law and Its Legal Risks for Foreign Investment ..... 7
  - 1.3 Macro-analysis of the Risks Arising from Foreign Investors Behavior..... 23
    - 1.3.1 The Risks from the Authorities..... 24
    - 1.3.2 Risks Arising From Foreign Investors’ Behaviors ..... 25

*Part One:*

## **Legal Risks of Foreign Capital Entry**

- 2 The Legal Risks of Green Field Foreign Investment ..... 29**
  - 2.1 Case Study: Legal Risks Behind the Curtain of Carley ..... 29
  - 2.2 The Risk in Partners Choosing ..... 33
  - 2.3 Risks of Registered Capital Contribution ..... 37
    - 2.3.1 Legal Rules Regarding Registered Capital Contribution of Foreign-Invested Enterprises..... 37
    - 2.3.2 Some Special Risks with Contributions ..... 39

---

<b>3 The Legal Environment and Risks for M&amp;A by Foreign Investors in China</b> .....	<b>47</b>
3.1 Macro-Analysis of Current Legal Environment for M&A by Foreign Investors in China.....	47
3.1.1 Insight into the Macro Legal Environment for M&A by Foreign Investors from the Perspective of Legal Rules.....	47
3.1.2 Insight into Macro Legal Environment for M&A by Foreign Investors from the Perspective of Market Access .....	51
3.2 Micro-analysis of Current Legal Environment of M&A by Foreign Investors in China.....	57
3.2.1 Industrial Policies for Market Access.....	57
3.2.2 Governmental Approval Procedures.....	58
3.2.3 Asset Appraisal.....	60
3.2.4 Transaction Pricing for State Assets Transfer .....	62
3.2.5 Forms of Payment.....	63
3.2.6 Time Limits of Payment.....	64
3.2.7 Anti-trust Approval .....	65
3.2.8 Labor Issue .....	66
3.3 The Legal Risks of Foreign-Funded M&A.....	68
3.3.1 Institution Risks.....	68
3.3.2 Risks with Property Rights Transfer.....	69
3.3.3 Operational Risks .....	69
3.3.4 Risks Arising from Change of Enterprise Ownership .....	72
3.3.5 Other Risks.....	73
Appendix: Laws and Regulations Regarding M&A by Foreign Investors in China .....	74
<b>4 Modes and Risks for Foreign Investments in Restricted Industries</b> .....	<b>85</b>
4.1 Industry Entry Rules for Foreign Capital.....	85
4.1.1 Basic Regulations .....	85
4.1.2 Rules of Entry to Specific Industries by Foreign Investors .....	86
4.1.3 Other Specific Arrangements .....	91
4.2 Dancer in Shackles: Modes of Foreign Investment in Restricted Industries .....	91
4.2.1 Case Study: Shanda's Contractual Control Mode .....	91
4.2.2 Modes for Foreign Investments in Restricted Industries .....	93

4.3	The Legal Risk of the Modes for Foreign Investment in Restricted Industries .....	98
4.3.1	Risks with Effectiveness of Contracts .....	99
4.3.2	Risks in the Administration of Foreign Exchange .....	100
4.4	The Outline of Anti-risk Measures for Foreign Investment in Restricted Industries .....	103
4.4.1	Draft the Contracts to Be Perfect .....	104
4.4.2	Risk Evasion by an Offshore Company .....	104
4.4.3	Reversion Clause .....	105

*Part Two:*

## **Legal Risks in Operation of Foreign-Invested Enterprises**

<b>5</b>	<b>Changeable Government: Political Risks for Foreign Investment .....</b>	<b>109</b>
5.1	Nationalization and Expropriation .....	109
5.1.1	History of Nationalization and Expropriation .....	109
5.1.2	Nationalization .....	112
5.2	The Risk of Changes to Economic Policies .....	115
5.2.1	Huang Qiao Case .....	115
5.2.2	Types of Change in Government Policy .....	116
5.2.3	Suggestions for Combating Political Risks .....	124
5.3	The Risks Coming from Local Government .....	125
5.3.1	Localized Policy when Inviting Foreign Investment .....	125
5.3.2	The Legal Risks of Localized Policy .....	126
<b>6</b>	<b>Corporate Governance Troubles in Sino-foreign Joint Ventures .....</b>	<b>129</b>
6.1	Difficulties in Managing Legal Entities Shown in the Upsurge of Foreign-Invested Enterprises .....	129
6.2	General Situation of Corporate Governance Modes of Joint Ventures .....	132
6.2.1	Corporate Governance of Joint Ventures Review .....	132
6.2.2	Survey of Sino-foreign Joint Venture Corporate Governance .....	137
6.3	Review of Legal Risks Arising from Sino-foreign Joint Venture Corporate Governance .....	139

6.3.1	Risks of Existence Reliance: Review from the Aspect of Imbalance Between the Control Right and Residual Claim Right .....	139
6.3.2	System Risks in Contorted Sino-foreign Joint Venture Management Structure.....	143
6.4	Can Sino-foreign Joint Ventures Tend Towards Harmony?.....	145
6.4.1	Failure in Dong Feng Nissan Joint Venture and Born of the Fundamental Law of Dong Feng Nissan .....	145
6.4.2	Way for Joint Ventures to Go Toward Harmony as Shown in the Dong Feng Nissan Basic Law.....	147
6.4.3	Political Policy Being the Essential Reason for Joint Venture Governance Troubles.....	148
<b>7</b>	<b>Tax Risks Under the New Tax Law Environment.....</b>	<b>151</b>
7.1	Introduction .....	151
7.2	Cat and Mouse Game Between Tax Evasion and Anti-tax Evasion .....	151
7.2.1	Black Hole in Foreign-Invested Enterprises' Tax .....	151
7.2.2	Road Map for Tax Evasion by Foreign Investors.....	152
7.3	Anti-tax Evasion Action Upgrading in China.....	156
7.3.1	Spread of 'Anti-tax Evasion Storm' .....	156
7.3.2	APA Limits Transfer Pricing.....	157
7.3.3	Prevention of Weakening Capital Started by the Enterprise Income Tax Law (Draft) .....	159
7.4	Unification of Income Tax and Its Risks for Foreign Investment.....	160
7.4.1	Income Tax Reform Coming.....	160
7.4.2	Games on Unification of Income Tax Reform .....	160
7.4.3	Unification of Income Taxes Moving Ahead Under Debating .....	162
	Appendix I: Tax Law Applicable to Foreign-Invested Enterprises.....	163
	Appendix II: Current Chinese Foreign-Invested Enterprise Income Tax System .....	170
<b>8</b>	<b>Land Use Right Risks in Foreign Investment.....</b>	<b>175</b>
8.1	Introduction .....	175
8.2	Legal Issues in Foreign-Invested Enterprises' Use of Land .....	176
8.2.1	Policies Change .....	176
8.2.2	Ways for Foreign-Invested Enterprises' to Obtain Land Use Right.....	178

8.2.3	Fee for Land Use Right .....	180
8.2.4	Term for Land Use Rights .....	181
8.3	Land Risks in Foreign Investment .....	181
8.3.1	Legal Risks in Developing Zones' Land Transfer .....	181
8.3.2	Legal Risks in Land Requisition .....	184
8.3.3	Legal Risks in Contribution with Collectively Owned Land.....	188
8.3.4	Legal Risks in Land Offered by Local Governments for Free .....	190
8.3.5	Lack of Judicial Remedy to Land Disputes .....	191
<b>9</b>	<b>Labor Legal Risks of Foreign-Invested Enterprises .....</b>	<b>195</b>
9.1	Labor Legal Risks Shown in Trade Union Disputes.....	195
9.1.1	Widespread Foreign Enterprises' Refusal of Establishing Trade Unions .....	195
9.1.2	Risks Increasing in Refusal to Establish Trade Unions .....	196
9.1.3	Reflection of Tense Employer-Employee Relation by Refusal of Establishing Trade Unions .....	198
9.2	Overview on Foreign-Invested Enterprise Labor Law Rules.....	199
9.2.1	Foreign-Invested Enterprise Labor Legislation .....	199
9.2.2	Provisions on Labor Contracts of Foreign-Invested Enterprises .....	200
9.3	Insight into Foreign-Invested Enterprises' Labor Risks .....	203
9.3.1	Case Analysis of Foreign-Invested Enterprises' Legal Risks....	203
9.3.2	Brief of Labor Legal Risks in Foreign-Invested Enterprises .....	204
9.4	Legal Risks Arising from Controversial China's Draft Labor Contract Law .....	209
9.4.1	Highlights of the Draft.....	209
9.4.2	Implications of the Draft.....	212

*Part Three:*

**Legal Risks for Foreign Investment in Specific Industries**

<b>10</b>	<b>Modes and Legal Risks of Foreign Investment in Non- governmental Education in China .....</b>	<b>217</b>
10.1	Introduction .....	217
10.2	Foreign Investment Modes of Non-governmental Education .....	219
10.3	Summary of Legal System for Non-governmental Education .....	224

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10.4 Legal Risks for Foreign Investment in Non-governmental Education in China .....	229
10.4.1 Legal Risks Shown by Ren Jingxi's Withdrawal .....	229
10.4.2 Insight into Legal Risks for Foreign Investment in Non-governmental Education.....	230
<b>11 Legal Risks for Foreign Investment in China's Water Market .....</b>	<b>241</b>
11.1 Introduction .....	241
11.1.1 Basic Information of Foreign Investment in China's Water Market .....	241
11.1.2 Big Events in Foreign Investment in the Chinese Water Market.....	244
11.2 BOT Mode of Foreign Investment in Water Industry.....	245
11.2.1 BOT in China .....	245
11.2.2 Case Study: Chengdu Sixth Waterworks.....	247
11.3 Insight into Legal Risks for Foreign Investment in Chinese Water Market Under BOT Mode.....	249
11.3.1 Foreign Water Companies' Failures Under a Flawed BOT Legal Environment .....	249
11.3.2 Detailed Analysis on Legal Risks for Foreign Investment in the Chinese Water Market Under BOT Mode.....	251
Appendix: Laws and Regulations on Foreign Investment in China's Water Market .....	264
<b>12 Legal Risks for Foreign Investment in the Insurance Industry ...</b>	<b>267</b>
12.1 Introduction of Foreign Investment in China's Insurance Industry .....	267
12.1.1 Brief View on China's Insurance Industry .....	267
12.1.2 Brief View of Foreign Investment in China's Insurance Industry .....	269
12.2 Laws and Regulations on Foreign Investment in China's Insurance Industry .....	272
12.2.1 Participation in Insurance Companies .....	272
12.2.2 New Establishment.....	276
12.2.3 Specialties of Capital Contribution.....	278
12.3 Legal Risks for Foreign Investment in China's Insurance Industry.....	279
12.3.1 Withdrawal of Foreign Insurance Companies Signals Risks.....	279
12.3.2 Insight into Legal Risks for Foreign Investment in Insurance Industry .....	280
Appendix: List of Chinese Insurance Laws and Regulations.....	288

<b>13 An Insight into Foreign Investment Dispute Resolution in China .....</b>	<b>291</b>
13.1 Insight into Commercial Dispute Resolution in China .....	291
13.1.1 Introduction .....	291
13.1.2 Assessment of China’s Civil Justice System .....	291
13.1.3 Current Reform and Further Proposals.....	294
13.1.4 Alternative Dispute Resolution (ADR) .....	295
13.1.5 China’s Perspective on Commercial Dispute Resolution .....	296
13.1.6 Conclusion: How to Choose an Ideal Commercial Dispute Settlement Mechanism in China.....	298
13.2 Characters of a Chinese-Style Judicial Decision-Making Process.....	299
13.2.1 The Government-like Judicial System and Judicial Decision-Making .....	299
13.2.2 Decision-Making by the Judicial Committee .....	301
13.2.3 Local Governments and the Peoples’ Congress’ Influence on Decision-Making of Localized Courts.....	302
13.2.4 CPC’s Committees or Committees of Political and Legislative Affairs’ Influence on Judicial Decision-Making.....	302
13.2.5 Lobbying and Judicial Decision-Making.....	303
Appendix: A Typical Chinese Judicial Process.....	304
13.3 Insight into Chinese-Style Arbitration .....	306
13.3.1 A Crisis in China’s Arbitration History.....	306
13.3.2 Chinese Characters of Arbitration .....	307
13.3.3 The Root of Risk in Chinese Arbitration.....	309
13.4 Mediation in China .....	310
13.4.1 Mediation in the Litigation Process.....	310
13.4.2 Mediation in the Arbitration Process.....	311
13.4.3 Mediation in the Mediation Center.....	311
<b>14 Managing the Future – The Strategy for Foreign Investment Under Power-Oriented Economy .....</b>	<b>313</b>
<b>References .....</b>	<b>317</b>

# Abbreviations

<b>AIC</b>	Administration of Industry and Commerce
<b>CBRC</b>	China Banking Regulatory Commission
<b>CIRC</b>	China Insurance Regulatory Commission
<b>CJV</b>	Sino-foreign Cooperative Joint Venture
<b>CPC</b>	Community Party of China
<b>CSRC</b>	China Securities Regulatory Commission
<b>FESCO</b>	Foreign Enterprises Services Company
<b>FISC</b>	Foreign-Invested Joint Stock Limited Company
<b>EJV</b>	Sino-foreign Equity Joint Venture
<b>FIE</b>	Foreign-Invested Enterprise
<b>GAC</b>	General Administration of Customs
<b>HC</b>	Holding Company
<b>JV</b>	Joint Venture
<b>LLC</b>	Limited Liability Company
<b>M&amp;A</b>	Mergers and Acquisitions
<b>MOFCOM</b>	Ministry of Commerce
<b>MOLR</b>	Ministry of Land and Resources
<b>NDRC</b>	National Development and Reform Commission
<b>NEPC</b>	National Economic Planning Commission
<b>PBC</b>	People's Bank of China
<b>PRC</b>	People's Republic of China
<b>QFII</b>	Qualified Foreign Institutional Investor
<b>Rep Office</b>	Representative Office
<b>RMB</b>	Renminbi, the official currency of China
<b>SAEP</b>	State Administration of Environmental Protection
<b>SAFE</b>	State Administration of Foreign Exchange
<b>SAIC</b>	State Administration of Industry and Commerce
<b>SASAC</b>	State-Owned Assets Supervision and Administration Commission
<b>SAT</b>	State Administration of Taxation



<b>SETC</b>	State Economic and Trade Commission
<b>SOE</b>	State-Owned Enterprises
<b>VAT</b>	Value Added Tax
<b>WFOE</b>	Wholly Foreign-Owned Enterprises
<b>WTO</b>	World Trade Organization

# 1 Introduction: The Legal Risks of Foreign Investment in China

*“Nothing is a risk in itself; there is no risk in reality. But on the other hand, anything can be a risk; it all depends on how one analyses the danger, consider the event.”*

— François Ewald<sup>1</sup>

*“Human Beings are not born for solving universal problems, but may find out where the problems come, so limit them in an understandable range.”*

— Goethe’s talk to Eckermann<sup>2</sup>

## 1.1 Definition of Legal Risk of Foreign Investment

### 1.1.1 Risk and Legal Risk

#### *Risk*

The word “risk”, in Ewald’s study, originated from the Italian word “rischio”, which was used in early transactions in the maritime and insurance industries. This original usage of the word referred to natural disasters such as storms.<sup>3</sup> With the development of the modern insurance industry, new definitions of “risk” were introduced. In Merriam-Webster’s Dictionary of Law, the definitions of “risk” include: (a) possibility of loss or injury (b) responsibility for loss or injury.<sup>4</sup> Similar understandings of the concept of risk are found in other disciplines

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<sup>1</sup> Ewald, F. (1991), Insurance and risk, in Burchell, G. Gordon, C. and Miller, P. (eds) *The Foucault Effect: Studies in Governmentality*, Chicago University Press.

<sup>2</sup> Eckermann (2005), *the Dialogue of Goethe*.

<sup>3</sup> Id 1.

<sup>4</sup> Risk a: possibility of loss or injury; b: liability for loss or injury if it occurs <the risk of loss passes to the buyer when the goods are duly delivered to the carrier —Uniform Commercial Code> <the risk of personal injury and property damage should be placed with the manufacturer rather than the consumer —Case & Comment>. Merriam-Webster’s Dictionary of Law, Merriam-Webster, Inc (1996).

such as statistics, actuarial science and insurance, where the “risk” is defined as the chance or probability of loss or injury to the subject. This can be summarized in the equation: (R)isk = (H)arm × (P)robability. Mary Douglas and Wildawoski, two anthropologists, give their definition of “risk” as the perception of a hazard by a group, and consider this ability to discern the hazardousness of an environment as one of inherent functions of social structure. In this vein, the definition of “risk” may be divided into two levels. Firstly, the chance of a disadvantageous outcome incurred either by human behavior or environmental factors; and secondly the cognition of the “risk” by the subject. It is this later which determines human behavior.

### *Legal Risk*

In the legal field, the issue of risk is raised as a practical matter. In most cases, people’s main concern is to discern and assess legal risk and to mitigate the downside; yet no clear definition of legal risk has been generally accepted.

Basel II gives us the explanation that legal risk involves penalties, punitive damages and private settlements incurred by administrative conduct.<sup>5</sup>

According to International Bar Association publications, legal risk is a risk of loss to an institution caused primarily by: (a) a defective transaction; or (b) a claim (including a defense to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss (for example, as a result of the termination of a contract) or; (c) failing to take appropriate measures to protect assets (for example, intellectual property) owned by the institution; or (d) a change in the law.<sup>6</sup>

In China’s current legal environment, a party does not typically regard a legal channel as a potential protective measure for its own good, but sees the legal framework as an external restriction imposed upon its will. Essentially, the motivation for giving heed to legal risk is to avoid potential charges for inadvertent conduct in violation of laws and regulations. In one sense, legal risk is the risk incurred by the functions of law on the person(s) at dispute. *The Reminding Letter of Legal Risks in Civil Litigation*, issued by the Supreme People’s Court of China, also prescribed that legal risks are procedural, incurred as a result of the violation of procedural laws.

In Lovell’s 2005 publication, *Legal Risk of Top 100 Chinese Enterprises*, Legal Risk is defined as a commercial risk involving the perils or economic losses incurred by the violation of related laws and regulations, breach of contract, tort (intellectual infringement), or delay in performing corporation rights. It embraces the following categories: operational risks (income or profit loss, cost or

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<sup>5</sup> Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework.

<sup>6</sup> IBA Working Party on Legal Risk.

responsibility increase, etc.), civil claims, judgments or judicial opinions (attorney fees and settlement expenses), administrative or criminal penalties or punishment, losses of enterprises' assets, reputational damage etc. The reasons for the above injury or loss include: violation of related regulations, tortious acts to a third party, nonfeasance of legitimate rights or taking positive measures to obtain or protect legal rights.

In conclusion, we can say that legal risk can be interpreted as the assumption of possible responsibility or unfavorable results incurred by the conflicts in legal rules per se or between the subject's behavior and legal rules. Considering that the legal codes of different states contain different legal risks, the analysis in this book will confine itself to the unique legal risks embedded in Chinese legal system.

### 1.1.2 Types of Legal Risks Embedded in Chinese Legal System

In this book, the legal risks embedded in the Chinese legal system are divided into two categories: institutional risks and behavioral risks.

#### *Institutional Risks*

First and foremost, legal institutional risks are not merely the risks generated by the provisions of legal papers or specific regulations, because the occurrence of unlawful results or legal risk can be avoided if the party performs in accordance with the law and the law provides clear instructions and anticipates results. If a party acts against unambiguous regulations, there is clearly a behavioral risk.

Institutional risk implies risk due to equivocal provisions of laws and regulations, lack of specific regulation, institutional change or other legal institutional blankness. Institutional risk can be broken down as follows:

**Ambiguity in the Law.** The principal function of the law is to provide instructions as to acceptable human behavior. There may be some ambiguous provisions arising from China's imperfect legislation other than multi-vocal legal expression. These ambiguities constitute a legal risk. Furthermore, the conflict and overlapping of different legal rules, which is a characteristic of China's legal system, are problematic, as there is a lack of conflict law.

**Blankness in the Law.** In an unceasingly changing world, the written law cannot keep step in all corners of society. Theoretically, one's civil action may be justified unless it contravenes expressly prohibitive provisions in private law. Legal risk does not co-exist with the unrestrictive nature of human behavior. The case in China is different. Conduct is permitted only if there exists detailed legal provisions permitting it. To take the example of the take-over of a listed company, "*Company Law*" and "*Securities Law*" both provide general rules, but in reality a party cannot take substantial steps to realize the proposed take-over before relevant provisions regarding compulsory disclosure of information are issued. Unfortunately, China's laws

and regulations often lack the detailed rules of implementation as support. Legal risks are therefore incurred as business proceeds where there are merely general principles established, without detailed implementation rules. In addition, under some extreme circumstances, one will come across the legal risk due to the lack of both general principles and implementation rules.

**Change in the Law.** As a social measure to guard against conflict of interest, the law is required to be stable and concrete. Most international organizations take legal stability into account when assessing the level of investment risk in a country. Legal risk is maximized in a transition country like China because of the unstable legal environment.

### *Behavioral Risks*

Logic suggests that all legal risks are behavioral risks; that is to say, there is no legal risk without action. All legal risk is incurred by human behavior.

From the point of view of legal risk, human behavior can be divided into two parts: normative behavior and non-normative behavior. The latter (which does not necessarily constitute an illegal act) includes any action in violation of the law or covered under ambiguous, nonexistent or changeable laws. Based on the definition of legal risk, we can say non-normative behavior is the root of all legal risks.

### 1.1.3 Legal Risks for Foreign Investment in China

Having defined legal risk, we can extend this and say that legal risk in foreign investment is the possible liability or unfavorable results incurred by the conflicts in the foreign investment legal system per se or between the behavior of foreign investors and related legal institutions.

In addition to economic behavior, foreign investment is also a complicated legal activity. The legal risks lie dormant behind a set of legal institutions, with which foreign participants interact with in the course of investment activities.

Although China's current legal system governing foreign investment<sup>7</sup> provides a set of basic rules for investors, the underdevelopment and imperfections in this code may bring about certain legal risks. Luc Laeven and Christopher Woodruff's studies demonstrate that the quality of the legal system has a significant effect on the size of investing firms. Based on their research, a standardized one point improvement in the quality of the legal system increases the average firm size by

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<sup>7</sup> Legal institutions of foreign investment does not equal to the laws related to Three Forms of Foreign Investment Enterprises, also include all of laws and regulations concerning foreign investments, such as "*Civil Law General Principles*", "*Company Law*", "*Securities Law*", etc.

about 10-15 percent.<sup>8</sup> The low-quality of China's legal system is causing it to act, to some extent, as a legal-risk-maker.

As to the subjective behavior in foreign investments, it contains not only the foreign investor, but also the guest country and host country (also including central and local governments and their ministries), the employees of foreign firms, their partners, their executive officers and competitors in different levels. For each of subjects, its behaviors that may incur legal risks such as government's renege, improper control of join-venture partners, the counterfeits by rivals and so forth are often found in foreign investment.

## 1.2 Macro-analysis of Legal Risks in Investment Institutions

### 1.2.1 Macro-analysis of the Legislation Regarding Foreign Investment and Its Risk

Foreign investment legislation has been developing for more than 25 years since China's Open-up Policy was constituted, and has fared relatively well during this time. This framework is comprised of the *Constitution*, as its base; separate laws and regulations related to foreign investment, forming the core of the legislation; plus other economic laws. Some negative factors such as ambiguities, conflict between laws and the legal hiatus should also be taken into consideration.

First of all, because the legislation is "problem-oriented" all regulations are drafted as keys to specific problems. Hence, the coherence of the legal system is ignored, and there are frequently conflicts which not only serve to perplex people, but also debase or even negate the value of the law. This debasement has considerably obstructed the normal process of foreign investments. In identifying what constitutes a "foreign investor" for example, there are consistently two standards – the nationality of the legal entity and considerations of capital control. According to "*Company Law*" and other commercial registration procedures, foreign investment firms are supposed to be Chinese entities. Yet in contradiction to this fact, they fall under *Interim Provision on Re-investment within China by Foreign-invested Enterprises* as foreign entities while re-investments in China.

Secondly, the ambiguity of words in legislation may account for legal risks. For instance, property rights are an equivocal concept as constituted in some laws and regulations for foreign-funded mergers and acquisitions (see "*Reorganization of State-Owed Enterprises by Foreign Financing Tentative Provisions*"). These rights are effectively an economic concept rather than a legal one. So far, we have not considered whether we are discussing a proprietorship, a creditor's right, a

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<sup>8</sup> Luc Laeven and Christopher Woodruff, *The Quality of the Legal System, Firm Ownership, and Firm Size*, download on the official website of World Bank, last visit in Oct. 2005.

share ownership or only a property right owned by a legal entity, and many rule-drafters have an imperfect understanding of this issue themselves. A similar problem arises in a book titled “*The Guidance of the transfer of State-owned Property Right*” issued by the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC). It defines “state-owned property right” as “a summation of every property right owned by the State”. The transaction with regard to state-owned property right is “a transaction between two or more parties pertinent to the transfer of all or parts of property right ... or parts of property right without change of the proprietor’s title”. Here it adopts a concept of “a cluster of rights” that property right is a cluster of congregated rights, as typical definition in economics. Contrarily, in another regulation of SASAC, it provides that the state-owned property rights are the investment incomes and interests in all kinds owned by the state, state holding or state-owned companies, and other rights and interests owned by the State under law. In fact, the term is translated from the conception of “ownership” used in accounting.<sup>9</sup> Since there is lack of certain and uniform definition of property right in writing, the risks concerning property right transactions would sharply increase in practice. To be worse, most of legal drafters only have economics backgrounds rather than legal ones, which implies recent laws and regulations regarding foreign investment have been transplanted into over-abundant economic terms. Consequently, this becomes a main reason for the growing legal risks in foreign investments.<sup>10</sup>

Furthermore, the problem of legal hiatus looms large in foreign investment, even though there are plenty of related laws and regulations. The rapidly expanding, newly-enacted laws cannot meet the needs of social and economic development. On the one hand, there is still a lack of general principles and of laws at the supreme level; on the other hand, the guidance rules and regulations at the second or third level still fall short. Some have commented that “China’s laws and regulations are too simple to be used.” Unfortunately, most of the rules that govern foreign investment are administrative regulations, at a lower level than the law or code. Searching China’s law database on the Website of Peking University ([www.chinalawinfo.com](http://www.chinalawinfo.com)), there are only 20 administrative regulations but 754 administrative rules. In judicial practice, the administrative rules are deemed to be a legal resource that “could be referred to” in accordance with *Administrative Procedure Law*. Also, in “*Several Issues Concerning Application of the ‘Contract Law’ Interpretation (I)*” issued by the Supreme Court, it is provided that the court shall be entitled to invalidate a contract in accordance with the laws constituted by the National People’s Congress and its Standing Committee, and the regulations of the State Council; not under local regulations or administrative rules. By this token, there is no real foreign investment “law” in China. (in a narrow sense; in a broad sense, the law includes law, regulation and administrative rules).

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<sup>9</sup> See Article 2, Section 3 of “Tentative Provision of Transfer of Property Right”.

<sup>10</sup> Zhang Ya (2005), *The Legal Dilemma of Property Right Transaction*, *The Report of State-owned Enterprises Reforms Vol. 2*.

## 1.2.2 China's Commercial Law and Its Legal Risks for Foreign Investment

The commercial law is a set of outstanding rules regarding merchants and business organizations, guided by civil law principles in a specific historical and business context. It is equivalent to civil or criminal law which is a separate body of laws and regulations. In China, there is no uniform code as is the case in Germany or France, but a literal system consisting of commercial laws and rules such as “*Company Law*”, “*Securities Law*”, “*Insurance Law*”, “*Maritime Law*”, “*Trust Law*”, “*Investment Fund Law*”, etc. Foreign investment is by its nature a commercial activity. Thus, the quality of commercial laws is crucial to the success of foreign investments. We now examine the negative characteristics of China's commercial law in detail, so as to give a clearer picture of the legal risks involved.

### *Abnormal Characteristics of China's Commercial Law and Their Legal Risks*

**Anti-mercantilism.** Traditional commercial law originated in the middle ages in Europe. It broke the shackles of feudal law, patrician law and church law; being both convenient and flexible it greatly boosted the prosperity of Mediterranean cities during the Middle ages. By contrast, China's commercial law seems to revive the specter of the Dark Ages, with inflexible institutions and unnecessary and burdensome procedures.

In a survey of business registration procedures in 85 nations and areas in the world; LaPorta and Shleifer of Harvard University, Lopez. De. Silanes of Yale University and Djankov of the World Bank, collected data regarding registration formalities and average application days and fees. Including Chinese Taiwan, Hong Kong and Macao, China ranks similarly with Italy (mainly influenced by Mafia) where the commercial environment is hardest in the world for foreign investors.<sup>11</sup> This depressing result is mainly caused by the fact that the setting-up of a corporation in China proceeds under the registration-by-approval, rather than registration-by-recording principle prevalent in the rest of world. In addition, the Statutory Capital System (embracing Three Principles “Capital Ascertained, Capital Sustainable and Capital Unchangeable”) may be taken into account for the badness of commercial environment that was adopted in drafting the Company Law of China.<sup>12</sup> On October 27, 2005, the Chinese legislature made

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<sup>11</sup> Chen Zhiwu (2002), Who obstructs our business? New Fortune, December Issue.

<sup>12</sup> As the basic doctrine, Statutory Capital System principle has been preserved apparently and coherently along the whole process of law from legislation to adjudication. The functions of this principle are extraordinarily exaggerated up as the mythology of Capital Credit. A series of institutions deriving from it accordingly clamp down the passion of



critical adjustments to the capital system in the new Company Law, but the Statutory Capital System (with amendments) was retained. The Authorized Capital System adopted by most states was passed-over again.<sup>13</sup>

**Discrimination by Ownership.** Most commercial laws and regulations are constituted to serve state-owned enterprises centered on economic reforms. Consequently, they inevitably provide many favorable treatments and priorities for the interests of state-owned enterprises and their employees. On the other hand, non-state enterprises may be unequally scrutinized. Even though it tries to blur the legal distinction of ownership status, the continued existence of solely state-owned companies in the newly amended *Company Law* implies the ongoing differentiation of legal status and treatment by nature of ownership. This discrimination against non-state owned enterprises is often rooted between the lines of the written law.

China's tradition that one's fate is decided by class and origin has great influence on the legislation of commercial law. By the nature of ownership, enterprises are classified into the following types: state-owned, collectives, foreign-invested, and privately-owned. There are a number of biases for state-owned collective and foreign-invested enterprises. The later in particular enjoy preferential taxation (the actual rate of tax paid by foreign-invested enterprises is 10%-15%, a far cry from the 33% nominal rate; domestic enterprises pay 25%). In this classification, domestic privately-owned enterprises come in at the bottom of the pile. According to statistics collated by the Investment Institute of the State Planning Commission (predecessor of the National Development and Reform Commission), there are a large number of barriers to entry for privately-owned enterprises in nearly 30 industries. In particular: infrastructure, heavy manufacturing, financial and insurance services, telecommunications, education, culture, public sanitation and tourism

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investments and new businesses, including minimum registration capital requirement (0.1 million for limited liability corporation, 10 million for joint stock limited corporation), payment in-a-lump of registered capital, legalization of forms of capital contribution (limited in cash, intellectual property, tangible property, land use right, non-patented property), maximum of capital contribution by intangible property, prohibition of withdrawal, limitation of shareholder's reinvestments (less than 50% of new assets), prohibition of discounted offering, redemption and mortgage of shares, rigid procedures for reduction of contributions, etc. "The obsession with it becomes the shackle of the advancement and innovation of China's company law. We created it but at last were lagged by it.", said Professor Zhao Xudong, as assistant director of Drafting Team of Company Law. In any case, we are baffled with the conditions provided by ourselves.

<sup>13</sup> The newly amended Company Law made considerable adjustments such as lowering the maximum of capital contribution, allowing capital contribution in installment, extended forms of contribution and limited withdrawal and redemption of shares and canceling the limits of foreign holding shares. However, by my perspective, current commercial law circumstances are not completely changed since the belief of anti-mercantilism is still haunting in most legislators' minds.

as well as any transactions involving state-owned property. This discriminatory treatment highlights the unbalanced structure of investment in China.<sup>14</sup> Although some efforts have been made to change the situation, the newly amended Company and Securities Law still remains somewhat conservative and inexorable in some areas.

**Excessive Governmental Control.** As is the case in many transition countries, China's government would like involve itself in all aspects of society. From the very beginning, legislators set out with the principle that conduct should be prohibited unless expressly permitted by law. The system is therefore more vulnerable to a breakdown in public law than if laws were drafted to prohibit rather than permit behavior. As a typical example in "*Insurance Law*", it is provided that "[t]he basic insurance clauses and insurance premium rates for major categories of commercial insurance shall be formulated by financial supervision and administration departments." Some optimists observed that, as a part of political reform, the central government has recently begun clearing up 4159 overstepping examinations and verifications interfered by governments, 800 of which will be called off; however, the authorities in the rest ones may be of much influence to the civil life.

In contrast to Adam Smith's "invisible hand", the hand of the Chinese government is busy in its attempts to promote the social good, an endeavor in which it has ultimately proved to be ineffectual. Government involvement remains all pervasive in China, and its institutions are accustomed to acting as a broker for the distribution of foreign investment. Most participants in the market may count on official favors and judgments over economic values. The commercial law does not restrain public power from interfering in civil life, but rather sidesteps it with legal justifications. In addition, the lack of independent commerce guilds or organizations, which hurdles by governmental restriction on the right of constituting an association, may explain the fact that government can at will intervene civil society. Actually, the existed guilds or organizations at every level usually function as authoritative intermediaries or mufflers for harsh official voice. Free-will sits at the core of business, and is the origin of market forces. In this sense, an ignorance of market forces and economic freedoms will cost China dearly.

**Warlordism in Commercial Law.** A Taiwanese Scholar has expressed the view that oriental culture, especially Chinese culture, is a form of warlordism. It can be compared to the social structure in the ant world with the "queen" living on supplies from the lower-status "workers", even though the she cannot materially con-

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<sup>14</sup> By a survey, even in the city of Dongguan, Gong Dong province, where there is less than governmental regulation, only 41 areas into which private capital funds may be allowed to enter in the contrast with 81 areas open to foreign investors. In Jiang Su province, the loan for private economy just takes 5.2% of the whole bank loans in 2000. Similarly in Zhe Jiang province, the proportion of bank loans flowed to township and village enterprises is only 6.5%.

trol the “workers”. It is the same in China’s traditional political culture. The supreme authority is worshiped by its subordinates but cannot effectively govern these subjects. Subordinates come to be the material authority in their own kingdom as long as they serve their superiors well. Similarly, in commercial law, some so-called implementation rules from local authorities have trespassed into a higher level without correction mechanisms or effective conflict law. China’s governments at every level also like to constitute specific rules in the investors’ favor outside the laws prescribed by the National People’s Congress and its Standing Committee. For example, Beijing Municipal Bureau of Industry and Commerce once created some institutional innovations such as “limited partnership”, capital contribution in installments and the removal of limits on the scope of business; all contravening the “*Company Law*” of the time. All kinds of governmental rules, orders and documents form the main body of China’s commercial law; these are the warlords of the commercial law world. Since separate rules represent the interests of different departments, conflicts inevitably occur, not to mention the impact of under-the-table rules. Some local authorities have taken erratic measures such as prohibiting the set-up of limited companies held by a husband and wife. In some provisions, the majority shareholder cannot contribute more than 85% of the share capital, while the minority shall contribute more than 15% of the share capital. Again, this chaos in commercial law inevitably leads to confusion among investors.

**Blankness of Credit Legislation and Credit Crisis.** In Chinese tradition, “**Be-nevolence, Justice, Courtesy, Wisdom, Faith**” (“Ren, Yi, Li, Zhi and Xin”) are the basic doctrines for people’s behaviors. However, in modern China, there is an unprecedented credit crisis. Dwight Perkins, director of the Harvard Institute for International Development, has observed that it takes a long time to get to know a partner in China’s current legal climate, before actually getting down to business. Time is needed to ascertain who the partner is, what his goal is and whether or not he is trustworthy. The traditional Chinese method is rooted in assumptions about people’s morality, and is probably not ready to deal with complex modern challenges. It is totally different in Western developed countries, in which there is a set of advanced institutions regarding commercial credit bolstered by related laws and regulations. One of the functions of a credit record system is to reduce the cost of transaction. Credit investigation, according to research from the World Bank, decreases the default rate of big banks by 41%, and of small banks by 78%. This credit checking capability, backed up by legal institutions, allows banks to be flexible and provide loans without a mortgage, in sharp contrast with the loan operations of China’s banks. Most lines of credit are built up through personal or family connections which can prove stifling and somewhat fragile. It cannot accommodate the needs of the modern economy.

The legislation concerning commercial credit just sets off its way out in China. According to a study by Professor Justin Yifu Lin, Director of the China Economic Research Institute of Peking University, the inefficient distribution of credit

costs China 585.5 billion RMB, equal to 37% of total government revenue and representing 2 percentage points of lost GDP growth. Put plainly this credit issue has become a crucial problem in the development of China's economy. More alarmingly still, the traditional credit system is on the verge of collapsing, particularly during the transition period.

### *Commercial Law Booming and Its Legal Risks*

It is no bluff to say that there has been a great revolution in China over recent years. The commercial law in the transition of Chinese society from the mode of planned economy to the market-oriented one mostly features provisionally. Old laws act more as a roadblock for economic prosperity than a proper mechanism for advancing social welfare. Recent events illustrate a legislation boom ongoing in the field of commercial law.

**Company Law.** Company law is one of the basic legal pillars in a modern market-oriented economy. In a sense, it is the legal expression of intrinsic economic rules. A good institutional framework composed of advanced legal principles provided by company law can have a great influence on the protection of market participants, forms of capital investment, property security, and business transactions. The first "*Company Law of PRC*" was adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993, effective on July 1, 1994, and contained 11 chapters and 230 articles. It was amended for the first time at the thirteenth session of the Standing Committee of the Ninth People's Congress on December 25, 1999, adding supervisory committees for solely state-owned companies and loosening the requirements for public offerings for high-tech companies. In early 2004, the Office of Legislative Affairs of the State Council initiated a new revision process and completed the first draft for public consultation in July, 2005. At the 18th session of the Standing Committee of the Tenth National People's Congress on October 27, 2005, the new revised Company Law was adopted with a large number of amendments.

Some important amendments include: new provisions for single shareholder limited liability companies, independent boards of directors, cancellation of outward investment restrictions, the lowering of standards for public offering, reinforcement of controlling shareholders' responsibilities and loosening the restrictions on share redemption. More details are given in Table 1.1.

**Securities Law.** The first modern *Securities Law of the PRC* was born at the Sixth Session of the Ninth National People's Congress Standing Committee on 29 December 1998, effective on July 1, 1999. Before this, only related administrative regulations had existed for some 12 years. The promulgation of *Securities Law* was a reaction to the challenges of the Asian financial crisis in 1999. Thus, there are many prohibitions and privatives under stringent finance policies in such special period. Needless to say, many terms and clauses were not of a mature and deliberate

**Table 1.1.** Changes in Revised Company Law<sup>15</sup>

<b>Areas of Amendments</b>	<b>Before Revision</b>	<b>After Revision</b>
“To Pierce the Corporate Veil”	None	Article 20 Paragraph 3
Cumulative Voting System	None except for some provisions of CSRC	Article 106
Minimum Registered Capital down to 30,000 RMB in installments for Limited Liability Companies	Article 23 (separately 100,000, 300,000, 500,000 RMB for different forms of company)	Article 26
Minimum of Registered Capital down to 500 million RMB for Joint Stock Companies	Article 78 Paragraph 2 (Minimum of Registered Capital is 10 million RMB)	Article 81 Paragraph 3
Forms and Structure of Capital Contribution	Article 24 (limited to cash, industrial property rights, non-patented technology or land use rights)	Article 27 (added “non-monetary properties that may be assessed on the basis of currency and may be transferred in accordance with the law”)
Removal of the compulsory ratio of outward investment to net assets	Article 12 Paragraph 2 (cumulative sum no more than 50% of net assets)	None
Enhancing the institution of derivative litigation and shareholder’s litigation	Article 111 (“[i]f the resolutions of a meeting of shareholders or the board of directors have violated the law, administrative decrees or encroached upon the legitimate rights of shareholders, the shareholders concerned have the rights to sue at the people’s courts ...”)	Article 20 Paragraph (resolution abolishment lawsuit); Article 75 Paragraph 2 (lawsuit regarding the compensation for dissenting shareholders); Article 152, 153 (managers and board of directors liability lawsuit)
Clarification of shareholder’s rights regarding accessing to financial and account statements	Article 32	Article 34

<sup>15</sup> Particular thanks contributed to the article of Zhang Yabo regarding the amendments to Securities Law and Company Law for its very helpful references.

**Table 1.1 (continued)**

<b>Areas of Amendments</b>	<b>Before Revision</b>	<b>After Revision</b>
Right of withdrawal for minority shareholders of limited liability companies in specific circumstances	None	Article 75
Independent Board of Directors	None except for some provisions of CSRC	Article 123 (to set up an independent board of directors in listed companies; the State Council constitutes the implementation measures)
Strict regulation of related-party transactions	None except for some provisions of CSRC	Article 21, Article 125, Article 217 Item (4)
Removal of provisions for statutory reserve funds	Article 177 Paragraph 1 (“... set aside 10 percent of the profits for the company’s statutory reserve fund and 5 to 10 percent as the company’s statutory public welfare fund.”)	Article 167 (the statutory reserve fund for the welfare company employees.)
Securing independence of accounting firms	None except some provisions of Securities Regulatory Commission	Article 170, Article 171
Shareholder’s rights of application for the judicial dissolution of company under certain conditions	None	Article 183 (“[w]here any company meets any serious difficulty in its operations or management so that the interests of the shareholders will face heavy loss if it continues to exist and it cannot be solved by any other means, the shareholders who hold ten percent or more of the voting rights of all the shareholders of the company may plead the people’s court to dissolve the company”)
Emphasis of social responsibilities	None	Article 5 Paragraph 1
Equipping sole shareholder limited liability companies with risk prevention mechanisms	None	Article 58 Paragraph 2, Article 59 – Article64