

EQUITY JOINT VENTURES

Legal status

An equity joint venture is a Chinese legal person with limited liability. It is established on the basis of a joint venture contract between Chinese and foreign parties after approval by the Ministry of Commerce (“MOFCOM”), or its local counterpart, and other relevant departments.

Equity joint ventures are regulated primarily by the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures (the “Joint Venture Law”) and the Implementing Regulations for the Joint Venture Law (the “Joint Venture Regulations”). In addition, supplementary legislation covers such issues as contributions of registered capital, debt-equity ratios, registration, labor, imports and exports, foreign exchange, accounting and taxation. The Company Law of the People’s Republic of China (the “Company Law”) also includes certain provisions that apply to equity joint ventures. These pieces of legislation, however, do not cover all relevant issues.

There is a lack of regulations and precedents to provide guidance in resolving some issues of corporate organization, management and procedures. In some cases, these issues can be resolved by including appropriate provisions in the joint venture contract or articles of association. In other cases, uncertainties may be resolved by consultation with MOFCOM or its local counterpart.

Establishment

The procedure for establishing equity joint ventures (and other foreign-invested enterprises) may vary depending on the location and the ownership structure of the Chinese party.

There is a general trend placing greater importance on environmental protection specifically for manufacturing joint ventures. The project will require environment impact assessment (EIA), which is under the jurisdiction of the local environmental protection bureau.

For land which is subject to the bidding process, the approval for the construction plan and construction work will be necessary.

After or in parallel with the EIA and the land and construction related approvals, and depending on the specific case, the Chinese party, generally a state-owned entity, must receive preliminary approval for the project from its department in charge. The Chinese party must submit a project proposal and preliminary feasibility study to its superior governmental department and to the appropriate examination and approval authority (generally MOFCOM or its local counterpart).

After the Chinese party obtains initial approval from the examination and approval authorities, the parties will prepare a joint feasibility study that reflects their assessment of the economic viability of the proposed project.

The parties will proceed to negotiate and draft the joint venture contract and articles of association. When the parties have completed these documents, they must apply to the examination and approval authority by submitting an application, the joint feasibility study, the joint venture contract and articles of association, as well as other documents. Upon receipt of these documents, the authorities will need to review these documents and decide whether to approve the proposed joint venture.

In general, the establishment of an equity joint venture will have to be approved by the State Development and Reform

Commission, MOFCOM or their local government counterparts depending on the size and business nature of the proposed joint venture and other factors. The contracts and articles of association of “large” equity joint ventures will have to be approved by MOFCOM.

After approval, the joint venture must register with the local bureau of the State Administration for Industry and Commerce (“SAIC”) within one month. The joint venture will then be issued with a formal business license and be officially established.

Documentation

The Joint Venture Regulations do not set forth detailed requirements for the form or contents of documents such as the letter of intent, feasibility study, the joint venture contract and articles of association. The Chinese authorities have, however, published model forms for joint venture contracts and articles of association that are closely adhered to by the Chinese parties to joint ventures. By law, the joint feasibility study, joint venture contract and articles of association may be drafted in both Chinese and a foreign language. Under the Joint Venture Regulations the joint venture contract must be governed by Chinese law.

In addition to the above documents, the parties will often simultaneously negotiate and execute contracts related to the joint venture’s operations, such as those for technology transfer, trademark licenses, and supplies of parts or raw materials, as well as for the distribution of finished products. These related contracts may be attached to the joint venture contract as attachments.

Parties' investments

The most important concepts relating to the capitalization of an equity joint venture are “registered capital” and “total investment.” In the joint venture legislation, “registered capital” refers to the total amount of paid-in capital contributions by the parties to the joint venture. The “total investment” equals “registered capital” plus permitted financing for the joint venture. The capital of joint ventures must meet certain debt to equity ratios. For example, if the total investment is less than US\$3 million, at least 70% of the total investment must be registered capital.

Capital contributions may take several forms, including cash, buildings, equipment, technology, materials and the right to use land. If the capital contributions are in a form other than cash, the parties must agree on the appropriate value of the contributions on the basis of fairness and reasonableness or agree to have a third party make the evaluation. In addition, the valuation is subject to verification by official appraisers. The timing of capital contributions must also conform with the schedules set forth in the approved articles of association.

An equity joint venture must obtain approval from the examination and approval authorities for increases or reductions of its registered capital.

Term and scope of activities

Joint ventures in China are typically limited to a fixed term, which must be stipulated in the joint venture contract. In practice, the usual range is between 15 years and 50 years depending on the size and nature of the project, with most substantial manufacturing ventures having a term of 25 years or more. Indefinite terms are permitted subject to government

approval, but joint ventures in certain service industries, land development and real estate, natural resource exploration and exploitation projects, and other areas, which are restricted must have a fixed term. Upon the expiration of its term, an equity joint venture is to be dissolved, with the property remaining after clearance of debts to be distributed in accordance with the ratio of the parties' capital contributions except where the joint venture agreement, contract or articles of association have other stipulations.

Under the current PRC corporate law regime, all entities in China (whether domestic or foreign-invested) have definitive "business scopes" approved by the governmental authorities, which specify the range of business activities in which they are permitted to engage. The business scopes are generally brief and quite specific. They require careful drafting and are often the subject of negotiation between investors and the government authorities in the pre-establishment stage.

Foreign exchange

China's national currency, the Renminbi, is not freely convertible into other currencies. Nevertheless, China has introduced a form of current account convertibility, under which joint ventures may purchase foreign exchange for current account expenditures without the necessity of obtaining government approval. China also permits the conversion of Renminbi into foreign exchange for remittances of after-tax profits or dividends to foreign investors in equity joint ventures. Foreign exchange remittances and receipts must go through authorized banks designated to handle foreign exchange transactions. Instead of government approval for foreign exchange remittances and receipts, the designated banks examine the documentation for the underlying transaction to ensure that

the proposed payment or receipt qualifies as a current account item. Joint ventures also have access to the interbank market for the purchase and sale of foreign exchange through the designated banks.

Government approval is still required for the purchase and remittance of foreign exchange for certain capital account transactions. The general trend is to reduce government approval and some capital account transactions can be now be processed by the designated banks.

Financial administration

An equity joint venture is required to adopt accounting procedures based on a dual-entry, accrual system. All accounting records, books and statements are required to be prepared and kept in Chinese. The accounting system adopted by the joint venture must be reported, for the record, to the competent government authorities and the local financial and tax departments. Chinese legislation also requires an accountant registered in China to act as the auditor of the joint venture.

An annual profit distribution plan has to be prepared and distribution of profits among the parties should be in proportion to their respective contributions to the registered capital of the joint venture.

Equity joint ventures are required to allocate a certain percentage of after-tax profits to a reserve fund, enterprise expansion fund and incentive and welfare fund for staff and workers.