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PERSPECTIVE

Foreign Direct Investments in China— Practical Problems of Complying with China's Company Law and Laws for Foreign-Invested Enterprises

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I. INTRODUCTION**

Foreign investors in China face a legal system and legal issues that are very different from those found in the United States. This article seeks to illustrate some of the important differences in China's corporate law that govern or affect foreign investors' interests. The purpose of this article is to help foreign investors become aware of legal problems and investment risks in creating a foreign-invested enterprise in China. This article also proposes changes to existing Chinese laws that will more reasonably accommodate the legal concerns and protect the legal interests of foreign investors (as well as incidentally benefiting domestic Chinese investors).

A. Company Law

The passage of the Company Law of the People's Republic of China¹ ("Company Law") by the National People's Congress of China ("NPC") in 1993 was applauded by both the legal and business worlds as a milestone in the legal and economic history of China. The Company Law's historical significance and its legal influence on China's transformation into a market-oriented economy may not be easily disputed. The goals of the Company Law are to regulate and standardize the organization and conduct of companies, to protect the legitimate interests of companies' shareholders and creditors, and to stimulate the development of a socialist market economy.² Or, as commonly understood, the Company Law is meant to help shape China's planned economic system into a market-oriented system by shifting the control of business organizations from government to private citizens.

The Company Law is the first national legislation in China that expressly recognizes the legality of limited liability forms of business organi-

**For English versions of Chinese laws or China legal research, see Wei Luo, *How to Find the Law of the People's Republic of China: A Research Guide and Selective Annotated Bibliography*, 88 LAW LIBR. J. 402 (1996). Due to accuracy considerations, the Chinese laws cited in this article are mostly based on the author's own translations.

EDITOR'S NOTE: The Editors of the *Northwestern Journal of International Law & Business* relied on the author's translations for the following Chinese laws: the Law of the PRC on Wholly State Owned Industrial Enterprises, see *infra* notes 3, 120; the Provisional Regulation of the PRC on Private Enterprises, see *infra* notes 3, 120; the Regulation for the Registration and Administration of Enterprise Legal Persons on the PRC, see *infra* notes 26, 27, 31, 91; the Rules on Capital Contributions by the Parties of Chinese-Foreign Equity Joint Ventures, see *infra* notes 78, 102; the Contract Law of the PRC, see *infra* note 89; and the Law of Wholly Individual Owned Enterprises, see *infra* note 120.

¹See COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA (ZhongHua RenMin GongHe Guo GongSiFa) (passed on December 29, 1993 and came into effect on July 1, 1994) (PRC) [hereinafter Company Law]. For a general overview of the Company Law, see DANIEL A. LAPRES & YUEJIAN ZHANG, *BUSINESS LAW IN CHINA* (1997); Yabo Lin, *New Forms and Organizational Structures of Foreign Investment In China Under the Company Law of the PRC*, 7 TRANSNAT'L LAW 327 (1994).

²Company Law, art. 1.

zations wholly established by Chinese nationals, and also the legality of private Chinese citizens' ownership of such organizations.³ Furthermore, it is also the first national legislation in China that implicitly recognizes foreign investors' ability to participate in a Chinese Joint Stock Company, and the first national legislation that recognizes their right to establish representative offices in China.⁴

The historical significance of the Company Law is not questioned in this article. However, in the six years since the enactment of the Company Law, it has become evident that ambiguities and imperfections in the law threaten to impede its successful operation. Serious structural problems exist, and these problems, if unresolved in the near future, would substantially undermine the ultimate goal that the Company Law purports to accomplish.

Three types of companies are provided for in the Company Law: the Wholly State-Owned Company (*Guo You Du Zi Gong Si*), the Limited Liability Company (*You Xian Ze Ren Gong Si*, similar to a closely held corporation in the United States), and the Joint Stock Company Limited (*Gu Fen You Xian Gong Si*, also translated as "Company Limited By Shares"). A limited liability company is defined in the Company Law as a company organized by at least two but no more than fifty shareholders who are liable

³ NPC legislation that was passed before the Company Law mainly dealt with Wholly State Owned Enterprises. One such example is the Law of the PRC on Wholly State Owned Industrial Enterprises. LAW OF THE PRC ON WHOLLY STATE OWNED INDUSTRIAL ENTERPRISES (ZhongHua RenMin GongHeGuo QuanMin SuoYouZhi GongYe QiYe Fa) (promulgated by the NPC on April 13, 1988) (PRC). Although a 1988 interim regulation of the State Council recognized private ownership in a limited liability company, such recognition was not embodied in national legislation of the NPC until the promulgation of the Company Law. See PROVISIONAL REGULATION OF THE PRC ON PRIVATE ENTERPRISES (ZhongHua RenMin GongHe Guo SiYing QiYe ZanXing TiaoLi) (promulgated on June 25, 1988 by the State Council) arts. 2, 9 (PRC) [hereinafter "Provisional Regulation on Private Enterprises"]; Company Law, arts. 3, 4.

Only a Chinese company or other business entity may establish joint ventures with foreign investors. Laws for foreign invested enterprises do not allow Chinese individuals to participate in joint ventures with foreign investors. See LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON CHINESE-FOREIGN EQUITY JOINT VENTURES (ZhongHua RenMin GongHeGuo ZhongWai HeZuo JingYing QiYeFa) (promulgated on April 16, 1988) art. 1 (PRC) [hereinafter EJV Law]; see also LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON CHINESE-FOREIGN CONTRACTUAL JOINT VENTURES (ZhongHua RenMin GongHeGuo ZhongWai HeZuo JingYing QiYeFa) (promulgated on April 16, 1988) art. 1 (PRC) [hereinafter CJV Law].

⁴ Nowhere do the FIE laws explicitly mention the "foreign-invested joint stock company." However, article 75 of the Company Law requires that in order to incorporate a joint stock company (Company Limited By Shares), more than half of the five or more incorporators must have their domicile within the territory of China. So impliedly, some of the incorporators could be foreigners who are not domiciled in China. Company Law, art. 75

Before the passage of the Company Law, the previous regulation governing the establishment of foreign representative offices was an interim provisions promulgated by the State Council on October 30, 1980 (Interim Provisions of the PRC On the Administration of Resident Representative Offices of Foreign Enterprises). Company Law, art. 9.

for the company's debts to the extent of their capital contributions.⁵ This article will examine the existing legal and practical problems related to Limited Liability Companies ("LLC" or "LLCs") under both the Company Law and laws for Foreign-Invested Enterprises.

B. Laws for Foreign-Invested Enterprises

A brief overview of China's laws regarding Foreign-Invested Enterprises is necessary and helpful at the outset of this article.⁶ The collective concept of a Foreign-Invested Enterprise ("FIE") encompasses three types of enterprises: Equity Joint Venture ("EJV"), Contractual Joint Venture ("CJV") and Wholly Foreign-Owned Enterprise ("WFOE"). Each type of enterprise is governed by its respective laws and regulations.⁷

1. Equity Joint Venture

An EJV is a limited liability company owned by both Chinese and foreign investors in which the foreign investors' capital contributions should not be less than 25% of the total registered capital.⁸ All EJVs are legal per-

⁵ Company Law, arts. 3, 20.

⁶ For a general overview of China's FIE laws, see Lapres and Zhang, *supra* note 1; see also JAMES M. ZIMMERMAN, CHINA LAW DESKBOOK: A LEGAL GUIDE FOR FOREIGN-INVESTED ENTERPRISES 47 (1999).

⁷ The main regulations applicable to EJVs are the Law of the People's Republic of China on Chinese Foreign Equity Joint Ventures and Regulations for the Implementation of Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures. See EJV Law; REGULATIONS FOR THE IMPLEMENTATION OF LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON CHINESE-FOREIGN EQUITY JOINT VENTURES (promulgated on Sept. 20, 1983 by the State Council, amended on Jan. 15, 1986) (PRC) [hereinafter EJV Implementation].

The main regulations applicable to CJVs are the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures and Detailed Rules for the Implementation of Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures. CJV Law; DETAILED RULES FOR THE IMPLEMENTATION OF LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON CHINESE-FOREIGN CONTRACTUAL JOINT VENTURES (promulgated on Sept. 4, 1995 by Ministry of Foreign Trade and Economic Cooperation, also called MOFTEC) (PRC) [hereinafter CJV rules].

The main regulations applicable to WFOEs are the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises and Detailed Rules for the Implementation of Law of the People's Republic of China on Wholly Foreign-Owned Enterprises. LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON WHOLLY FOREIGN OWNED ENTERPRISES (*ZhongHua Ren-Min GongHeGuo WaiShang DuZi QiYeFa*) (promulgated on April 12, 1986) (PRC) [hereinafter WFOE Law]; DETAILED RULES FOR THE IMPLEMENTATION OF LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON WHOLLY FOREIGN-OWNED ENTERPRISES (promulgated on Oct. 28, 1988, by the State Council) (PRC) [hereinafter WFOE rules].

The FIE laws themselves are generally very short and skeletal. The laws generally cited and used in practice are the implementing regulations and rules that are much more extensive and practical than the FIE laws.

⁸ See EJV Law, art. 4.

sons under Chinese law.⁹ The EJV is the principal form adopted by foreign investors in China so far.

2. Contractual Joint Venture

A CJV is a company operated under a contract between Chinese and foreign enterprises.¹⁰ Although a CJV does not have to be a legal person, a CJV that satisfies the requirements of a legal person under Chinese law shall obtain such status.¹¹ A CJV differs from an EJV in that a CJV has more flexibility its rules of incorporation and profit distribution. Examples include: (1) a CJV need not meet the higher legal standard of a legal person; (2) the requirements of capital contribution are generally more lenient; (3) the contract may agree that foreign parties may recoup their investments first; and (4) recoupment of investment may occur even before the income tax of the CJV is paid.¹²

3. Wholly Foreign-Owned Enterprise

A WFOE is a business entity wholly owned by foreign investors.¹³ A WFOE shall acquire the status of a legal person if it meets the requisite conditions.¹⁴

4. Defining "Foreign Investments"

A basic question arises regarding China's FIE legal regimes: what is the legal standard of "foreign" versus "domestic"? The legal treatment for foreign investments differs significantly from that for domestic investments in terms of establishment procedures, approval standards, management structures, income tax treatment, and tariff consequences; therefore, a clear standard is necessary to ensure that the proper laws are applied. Unfortunately, no standard at all was provided by the relevant laws and implementing regulations. A practical standard generally used by the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC")¹⁵ is to examine the source of the investments. If the investment comes from outside the territory of China, it is usually characterized as a "foreign investment" even if it originates from Chinese nationals or companies. For the purpose of this characterization, Hong Kong, Macao and Taiwan are treated as being out-

⁹ See EJV Implementation, art. 2.

¹⁰ See CJV Law, art. 2.

¹¹ See *id.*

¹² See CJV Law, arts. 2, 8, 22.

¹³ See WFOE Law, art. 2.

¹⁴ See WFOE Law, art. 8.

¹⁵ Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") is a government agency with branches all over the country in charge of the examination and approval of FIEs.

side China's territory.¹⁶ An exception to this source-oriented rule applies to the use of profits from existing FIEs operating within China's territory. If such profits are used for investment in China, they are treated as "foreign investments" so as to enjoy the preferential legal treatments given to foreign investments.¹⁷

Unless otherwise provided, the term "LLC" hereinafter includes limited liability companies incorporated under both the Company Law and EJV law, and the term "FIE" includes all three types of foreign-invested enterprises.

C. Choices of Law for Incorporation

A foreign company seeking to establish a subsidiary in China has several options. It may incorporate as an equity joint venture under the EJV law, a contractual joint venture (with or without legal-person status) under the CJV law, or a wholly foreign-owned enterprise under the WFOE law. Moreover, it may also incorporate as a LLC under the Company Law¹⁸ or even a foreign-invested joint stock company under the Company Law.¹⁹ Such choices of law depend solely on investors' preferences, and a joint venture incorporated under one law will not be later recharacterized by the government for any purpose, including income tax purposes.²⁰ Further, joint ventures incorporated under one law may be reorganized by the investors into a different format under another law as long as it meets the requirements of the other law.

A FIE incorporated under one FIE law (e.g., CJV law) would not be governed by another FIE law even if it operates more like a corporate form under another FIE law (e.g., EJV law). Further, FIE law would not govern a foreign-invested LLC or joint stock company incorporated under the Company Law because the FIE laws only apply to companies that have chosen to be incorporated under them.

The reverse is not necessarily true; companies incorporated under FIE law may be governed by the Company Law in some cases. Under Article

¹⁶ PROVISIONS OF STATE COUNCIL FOR THE ENCOURAGEMENT OF FOREIGN INVESTMENT (*GuoWuYuan GuangYu GuLi WaiShang TouZi De GuiDing*) (promulgated on Oct. 11, 1986) art. 20 (PRC) [hereinafter "Provisions for the Encouragement of Foreign Investment"].

¹⁷ In addition, the FIE's may petition for a refund of income tax allocated to the profits used for reinvestment. See EJV Law, art. 7; WFOE Law, art. 17; Provisions for the Encouragement of Foreign Investment, art. 10.

¹⁸ The Company Law applies to limited liability companies with foreign investment. Company Law, art. 18.

¹⁹ Company Law, art. 75.

²⁰ In the U.S., the Internal Revenue Service may classify a foreign entity for U.S. tax purposes by applying the U.S. Internal Revenue Code rather than by applying the foreign law governing the entity. See, Norman N. Nystrom, *Entity Characterization Issues In The People's Republic of China*, 21 WM. MITCHELL L. REV. 839, 843 (1996). However, this is not the case in China.

18, the Company Law applies to "limited liability companies with foreign investment." However, the FIE laws prevail over the Company Law if the FIE laws provide otherwise. Thus, presumably, the Company Law will apply to both the foreign-invested LLCs incorporated under the Company Law and FIEs that are incorporated under the FIE laws and have limited liability (e.g., EJV).²¹

Therefore, the relationship between the Company Law and FIE laws is that of general to special laws. The legal implications of this relationship are threefold. First, where the Company Law is silent, the specialized provisions of the FIE Laws should apply. Second, where the Company law and FIE laws conflict, the latter prevails. Third, where the FIE laws are silent, the general principles of the Company Law apply. It is the third point that gives rise to some practical problems, some of which will be discussed in Part II of this article.

D. Registration by Approval

In the United States, a corporation is created when articles of incorporation are filed with the secretary of state in the state where the corporation intends to do business.²² The secretary of state has a duty to file the documents for incorporation if, on their face, the documents satisfy the requirements of the law.²³ In other words, the secretary of state has no authority to judge the substantive validity of the documents or information provided, except for the corporation's name.²⁴

In China, however, a corporation is created or registered not by right, but by approval. The MOFTEC, which is in charge of examining and approving FIEs, and the SAIC,²⁵ which is in charge of the registrations of companies and business organizations, will examine the substantive validity of all the application documents and underlying acts of incorporation. The State Administrative of Industry and Commerce ("SAIC") will not approve the application unless it is satisfied with the procedural and substantive validity of the information in the document, including but not limited to, the company name, the business purpose, the qualification of the legal repre-

²¹ Under article 4 of EJV Law, an EJV is a limited liability company. EJV Law, art. 4.

²² See REV. MODEL BUS. CORP. ACT §2.03(a) (1984); N.Y. BUS. CORP. LAW §104(e) (West 1999).

²³ See REV. MODEL BUS. CORP. ACT §1.25(a) (1984).

²⁴ See *id.*, at §§1.25(d), 4.01. However, in some states, like New York, simply making a filing does not constitute approval of the corporation name. See N.Y. BUS. CORP. LAW §104(e) (West 1999).

²⁵ The State Administrative of Industry and Commerce ("SAIC") is a government agency and has branches all over the country in charge of the registrations of all business organizations.

sentative, the qualifications of directors, and the supervisors.²⁶ Furthermore, any later changes to the registered information are only effective upon the approval of the relevant registration authorities.²⁷

E. The Difference Between the Appearance and the Reality of the Law

For foreign companies doing business in China, one thing that must be understood is that China's written laws do not necessarily reflect Chinese law in practice. The effects of this problem are twofold. First, the rights guaranteed to a person or corporation by law or by the constitution may in fact be wholly or partially invalidated or abridged by a governmental agency. For example, a corporation may be required by a local government to submit a monetary contribution (other than taxes) that is not prescribed or even expressly prohibited by law. Such an aggrieved party has no recourse from the judicial system except where the specific governmental action is the imposition of an administrative penalty defined by administrative procedure, in which case the court may invalidate the administrative penalty.²⁸ Second, the mandatory requirements of the law may sometimes be disregarded by the agency in charge of law enforcement. For example, the requirement that shareholders of a foreign-owned holding or investment corporation should contribute at least U.S. \$30 million (or its equivalent) to the corporation's registered capital is often disregarded by local governments that are eager to attract foreign investors to their territories.

Part of the explanation for this problem is the *de facto* supreme position of the Communist Party in China, a position arguably supported by the ambiguous language in the constitution.²⁹ Thus, in practice, the policies of the Communist Party of China are essentially superior to the constitution and to governmental legislation. The policies of the Communist Party change so frequently that it is not uncommon in China that some laws, though properly enacted and technically effective, can in fact be "repealed" by the policies of the Communist Party, and therefore in actuality are not

²⁶ See REGULATION FOR THE REGISTRATION AND ADMINISTRATION OF ENTERPRISE LEGAL PERSONS OF THE PRC (ZhongHua RenMin GongHeGuo QiYeFaRen DengJi GuanLi TiaoLi) (promulgated by State Council on June 6, 1988) arts. 7, 9, 15 (PRC) [hereinafter "Regulation for Legal Persons"]; REGULATION OF THE PEOPLE'S REPUBLIC OF CHINA ON ADMINISTRATION OF REGISTRATION OF COMPANIES (ZhongHua RenMin GongHeGuo GongSi DengJi GuanLi TiaoLi) (promulgated on June 24, 1994) arts. 9, 10 (PRC) [hereinafter "Regulation of Registration of Companies"].

²⁷ See Regulation for Legal Persons, art. 17; Regulation of Registration of Companies, art. 23.

²⁸ See ADMINISTRATIVE PROCEDURE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (ZhongHua RenMin GongHeGuo XingZheng SuSongFa) (adopted at the Second Session of the Seventh National People's Congress on April 4, 1989) art. 2, Cl. 11 (PRC).

²⁹ See CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA (ZhongHua RenMin GongHeGuo XianFa) (adopted at the Fifth Session of the Fifth National People's Congress in 1982, as amended) Preamble §§ 7, 10 (PRC).

enforced. Therefore, parties interested in doing business in China should be aware that some provisions of the Company Law and the FIE laws are not strictly enforced and are sometimes even totally disregarded by relevant governmental agencies; and that some governmental agencies may, without any statutory authority, impose additional requirements to the written laws and regulations.

However, one point worth emphasizing is that, despite the interference of the Communist Party, *de jure* law in China is still respected and recognized in the majority of situations, especially in the area of corporate law. In fact, in a communist country such as China, it is the Communist Party that controls the initiation and passage of legislation, therefore legislation would not possibly be passed without the consent and support of the Communist Party. Nevertheless, because the written law in China is not always the same as the actual law, consultation with a competent Chinese attorney is a necessity for foreigners contemplating an investment in China.

II. GOVERNANCE STRUCTURE

A. Structural Inconsistencies Between the Company Law and FIE Laws

Question: Is a LLC incorporated under the FIE laws also governed by the Company Law? If so, is it practically possible for the LLC to comply with both the Company Law and FIE laws?

In the United States, the same corporate law generally governs the incorporation requirements for both domestic and foreign investors.³⁰ In China, on the other hand, investors have a choice of several types of organizational structures under which to incorporate, each of which is governed by different laws with different requirements.

Generally, the Company Law regulates and standardizes the organization and conduct of “domestic enterprises,” a concept used in China to refer to companies organized by Chinese nationals or enterprise legal persons.³¹ Thus, the Company Law arguably was not intended to regulate FIEs, a special business sector in China.

Nevertheless, Article 18 of the Company Law states that the Company Law also applies to “foreign-invested limited liability companies.” But in practice, the FIE laws prevail over the Company Law in areas specifically addressed by the FIE laws. As discussed above, only where the FIE laws

³⁰ For example, New York has eliminated requirements as to citizenship and residence of incorporators. See N.Y. BUS. CORP. LAW §401 (West 1999).

³¹ An “enterprise legal person” in China means a business entity that may independently undertake its civil liability. See GENERAL PRINCIPLES OF CIVIL LAW OF THE PEOPLE’S REPUBLIC OF CHINA (ZhongHua RenMin GongHeGuo MinFa TongZe) (adopted at the Fourth Session of the Sixth National People’s Congress, promulgated by Order No. 37 of the President of the People’s Republic of China on April 12, 1986, and effective as of January 1, 1987) art. 37 (PRC) [hereinafter “Civil Law”]; Regulation for Legal Persons, art. 7.

are silent on a specific point do the general principles of the Company Law apply.

However, the structure of the Company Law differs so dramatically from that of the FIE laws that sometimes it is impractical to apply the Company Law to FIEs. Under the Company Law, the highest authority in a LLC is its "shareholders' meeting,"³² whereas under the EJV law, a board of directors is the highest authority. Shareholders' meetings are not even considered an authoritative body in companies incorporated under the FIE laws.³³ (See *infra* Part II, Heading B, discussing the powers and functions of shareholders' meeting and board of directors.) This structural disparity makes it impractical to apply the Company Law to FIEs.

For example, Article 52 of the Company Law requires that all LLCs establish a board of supervisors or a sole supervisor. The board of supervisors should consist of representatives appointed or elected by both shareholders and employees (See *infra* Part II, Heading C, discussing the power and functions of the board of supervisors.) Since the FIE laws are silent on this matter, theoretically Article 52 should also apply to FIEs. Thus, the FIEs should also establish a board of supervisors or a sole supervisor. The problem, however, is to determine the procedure by which the shareholders of an EJV appoint the supervisors. Since the shareholders' meeting is not a decision-making body in an EJV, the EJV law does not provide convocation and voting procedures for shareholders. Although the board of directors is the highest authority in an EJV, it is arguably inappropriate for it to appoint the supervisors who, in turn, would be responsible for supervising them.

Another example is the transfer of shares in a LLC. Under the EJV law, the transfer of a shareholder's capital contribution in an EJV's registered capital requires the unanimous consent of all attending directors³⁴ and also the consent of the non-transferring shareholders.³⁵ But the EJV law fails to provide guidance if, for example, an attending director abstains from voting, one or more directors simply fail or refuse to attend the proposed board meeting causing the meeting to fall short of the quorum requirement (see *infra* Part IV, discussing deadlock), or a shareholder fails or refuses to respond to another shareholder's proposed transfer of shares.

Detailed provisions are very important in China because they are the only guidelines for Chinese companies and judges. In China—essentially a civil law country—the only sources of law are statutes (promulgated by the NPC), and the rules and regulations promulgated by the administrative branches of the central and local governments in accordance with those

³² Company Law, art. 37.

³³ See EJV Law, art. 6; EJV Implementation, art. 33.

³⁴ See EJV Implementation, art. 36.

³⁵ See EJV Implementation, art. 23.

statutes. The role of the courts is limited to applying the law, and in doing so, a court must not deviate from the literal language of the law. Courts and judges in China have no authority to make law, either by making inferences from the law or by applying equitable remedies.

In contemplation of the foregoing situations, the Company Law provides that a shareholder who does not agree to the transfer of shares of another shareholder must purchase the shares in question. A failure to purchase the shares is considered a consent to the transfer.³⁶ Due to the structural inconsistency between the Company Law and the FIE law, however, this provision of the Company Law only partially solves the problem, and some of the foregoing situations are still left unresolved.

The Company Law may resolve the situation where shareholders in an EJV fail or refuse to respond to a proposal to transfer shares. However, it does not address what course should be taken if the board of directors, whose consent is necessary to transfer shares in an EJV, fails or refuses to consent to a share transfer. It is obviously improper to require the non-cooperating directors, as officers of the company, to purchase the shares in question. Neither is it appropriate to require the shareholders who appointed the non-cooperating directors to purchase the shares since the directors are supposed to act independently of shareholders.

In light of these dilemmas, it is no surprise that as a practical matter, the SAIC and MOFTEC do not apply the Company Law to FIEs at all. Some attorneys in China argue that the Company Law is not intended to govern the FIEs because the term "foreign-invested limited liability companies" in Article 12 of the Company Law should be distinctive from the LLC concept under the FIE laws. Under their view, the former is a narrow concept and includes only LLCs organized under the specialized requirements of the Company Law, whereas the latter is a general legal concept covering all companies with a limited liability feature. This view, however, is not supported by the ambiguous language of the Company law and is contradicted by the clear language of the EJV law, which states that "[a]n EJV shall take the form of a limited liability company."³⁷

Suggestion: Either the Company Law or FIE laws should be amended to remedy the structural inconsistencies that cause these confusions and problems.

³⁶ Unfortunately, the Company Law fails to define what constitutes a "failure" and whether a mere lapse of time could constitute such "failure." Company Law, art. 35

³⁷ Company Law, art. 18 (This law applies to limited liability companies with foreign investment.); EJV Law, art. 4.

B. A "Mandatorily Sterilized" Board of Directors Under the Company Law

Question: Should the board of directors or the shareholders' meeting be responsible for the centralized management of a foreign-owned LLC incorporated under the Company Law?

Generally in the United States, all corporate power is exercised and managed by a board of directors.³⁸ Shareholders may only vote on resolutions already passed by the board.³⁹ The structures of China's FIE laws generally follow this format.⁴⁰ By contrast, a U.S. corporation with 50 or fewer shareholders may dispense with or limit the authorities of a board of directors by describing in its articles of incorporation who will perform some or all of the duties of a board of directors—a situation referred to as a "sterilized board."⁴¹

In China, under the current structure of the Company Law, a sterilized board of directors is mandatory for all LLCs (and also all Joint Stock Companies Limited). Under Article 37 of the Company Law, the shareholders' meeting is the LLCs' highest authority. The shareholders' meeting is granted the power to decide the company's investment plan and approve the company's budget and profit distribution. Also, the shareholders' meeting makes resolutions with regard to the increase or decrease of a company's registered capital, the issuance of bonds, the amendment of articles of incorporation, and the merger, division, and dissolution of the company.⁴²

These shareholder powers and functions are generally performed by boards of directors in the United States, and by the boards of directors of FIEs in China. It is doubtful that shareholders, who are sometimes outside the centralized management of the company, possess the requisite knowledge and familiarity with the company's operations to perform these detailed functions. This is especially true when the corporation is a large-scale LLC or public Joint Stock Company Limited (Company Limited By Shares).

While the Company Law takes away most of the authority that the directors of a LLC traditionally possess and vests it in the shareholders' meeting, the Company Law also grants the board of directors some of the powers that managers normally possess. For example, in addition to the directors' traditional power to appoint officers and make bylaws, the board of

³⁸ See REV. MODEL BUS. CORP. ACT §8.01 (1984); N.Y. BUS. CORP. LAW §701 (McKinney 2000).

³⁹ See Anna M. Han, *China's Company Law: Practicing Capitalism In a Transitional Economy*, 5 PAC. RIM L. & POL'Y J. 457, 478 (1996).

⁴⁰ The Board of Directors determines all the major issues of the equity joint venture. EJV Law, art.6. The Board of Directors is the highest organ of authority of the EJV. EJV Implementation, art. 33.

⁴¹ For the use of term "sterilized board", see, e.g., William A. Musgrove, *Business and Corporate Law*, 30 U. RICH. L. REV. 1219, 1244 (1996).

⁴² See Company Law, art. 38.

directors of a LLC also drafts the company's budget plan and profit distribution plan (to submit to the shareholders' meeting for approval),⁴³ tasks normally performed by the general manager and leading financial officer. In practice, however, it is difficult for directors to perform such detailed functions when none of the directors are, at the same time, managers or other officers of the company.

The legislative intent behind this structure was never officially published in China. The state may be trying to maintain control over the LLCs, especially those in which the state participates.⁴⁴ A second reason may be the legislators' belief that China so far lacks sufficient numbers of professional managers. China has been a market economy for only twenty years, so a large group of professional managers has yet to emerge. This situation, together with the insufficiency of ethical standards for managers to observe, may create in the legislators' minds a general distrust toward the directors and managers of currently existing companies.

This "mandatorily sterilized" board structure has produced ironic results in practice. In shareholders' meetings, the voting power of shareholders is exercised by so-called "shareholders' representatives." The representatives of the controlling or majority shareholders are usually one or more of the directors. Thus, when the board of directors signs its resolution and submits it to the shareholders' meeting for approval, the resolution essentially has already been approved by the shareholders' meeting since the controlling shareholders' representatives have already signed the resolution.

Nevertheless, a shareholders' meeting—an often lengthy but in fact useless exercise—must be held according to the Company Law. A separate document called "Resolution of Shareholders' Meeting" has to be signed again by one or more of the directors in their capacities as shareholders' representatives. This "double resolution" or "double signature" also results when an executive director, as a substitute of a board of directors, is established under Article 51 of the Company Law. This redundant practice has drawn increasing criticism from the practicing bar.

Suggestion: The Company Law should be amended to provide that incorporators of a company (especially a foreign-owned LLC) should have the right to select in the articles of incorporation either a board of directors or the shareholders' meeting as the highest authority of the company.

⁴³ See Company Law, art. 46.

⁴⁴ See Han, *supra* note 39, at 478.

C. Board of Supervisors Under the Company Law: Merely Window
Dressing

Question: Can the board of supervisors of a LLC incorporated under the Company Law effectively supervise the conduct of directors and managers under the current structure of the Company Law?

The concept of a "board of supervisors" is not found in U.S. corporate law. Such a notion, however, exists in other countries such as Germany.⁴⁵ In China, a LLC incorporated under the Company Law with "large-scale" business operations is required to establish a board of supervisors that consists of no fewer than three supervisors. A LLC with a small number of shareholders or a "small scale" of business may instead establish a board with one or two supervisors.⁴⁶

The board of supervisors should contain both shareholders' representatives and employees' elected representatives, the ratio of which should be stated in the LLC's articles of incorporation.⁴⁷ The Company Law provides the board of supervisors with broad powers. The board may examine the company's accounting records, and it may supervise the conduct of the directors or managers to prevent them from committing violations of law, violations of the company's articles of incorporation, or engaging in conduct impairing the company's interest.⁴⁸ Further, the board has the power to call provisional shareholders' meeting and to attend meetings of the board of directors.⁴⁹

Several problems arise in practice with respect to the concept of a board of supervisors. First, no statutory definition or meaningful guidance was ever given by the government with regard to what constitutes a "large-scale" or "small-scale" corporation, which leaves the determination solely to the LLCs itself. Many LLCs prefer to have a sole supervisor, permitted for small-scale businesses, because it allows LLCs to dispense with the complicated employee election process.

Second, the Company Law provides no procedure by which the employees of a LLC elect their representatives to the board of supervisors. An election is a very complicated, time-consuming, and expensive process. A detailed procedure is necessary but so far deficient. As a consequence, neither the State Council Securities Commission ("SCSC") nor the China Securities Regulatory Committee ("CSRC") takes the enforcement of this provision seriously in the context of Joint Stock Company Limited (Com-

⁴⁵ For more discussion in this regard, see also Herbert Wiedemann, *Codetermination By Workers In German Enterprises*, 28 AM. J. COMP. L. 79 (1980).

⁴⁶ See Company Law, art. 52.

⁴⁷ See *id.*

⁴⁸ See Company Law, art. 54.

⁴⁹ See *id.*

pany Limited by Shares).⁵⁰ Typically, corporations comply with this provision of the Company Law by electing members to the board of supervisors at the shareholders' meeting. The CSRC allows this as long as one of the supervisors is an employee other than a director, manager or officer in charge of financial affairs.⁵¹

The most critical problem is that the Company Law does not provide for a board of supervisors that will necessarily be an effective check on the activities of the directors and managers. Under the Company Law, the board of supervisors possesses broad powers to monitor the conduct of directors and managers. However, as addressed above, the board of supervisors is elected by the shareholders' meeting, which is run by a group of controlling shareholders. Since the board of directors is also elected and appointed by the same controlling shareholders, both the board of directors and the board of supervisors may perceive themselves to be representatives of the controlling shareholders. Thus, the supervisors may not be sufficiently critical in their supervision of the activities of the directors and managers. This lack of independence, together with the lack of operating standards for fiduciary duties (see *infra* Part III, Heading B), makes the board of supervisors merely a figurehead, and not a monitor in real sense.

Suggestion: Since the board of supervisors may not effectively perform an oversight function under the current structure of the law, it should be eliminated from the Company Law and replaced by provisions that better protect minority shareholders' interests.

III. FIDUCIARY DUTY AND THE PROTECTION OF MINORITY INTERESTS

A. Protection of Minority Shareholder Interests in the Company Law

Example: Upon the proposal of a majority shareholder controlling 80% of the registered capital, the shareholders' meeting of a LLC incorporated under the Company Law makes a resolution to merge with another company that was also controlled by the same majority shareholder. The 20% minority shareholder strongly disagrees with the merger. Does the minority shareholder have the legal right to stop the merger, or at least recover the fair market value of its investment in the company? The answers to both questions are negative.

⁵⁰ The State Council Securities Commission ("SCSC") and its administrative entity, China Securities Regulatory Committee ("CSRC"), are responsible for regulating and supervising China's Securities market.

⁵¹ Article 52 of the Company Law provides that directors, managers or other personnel in charge of financial affairs may not serve as supervisors at the same time that they hold these offices. Company Law, art. 52.

This is only one illustration of how the Company Law lacks mechanisms to protect minority shareholders' interests. In the U.S., minority shareholders of LLCs have various means to protect their interests, such as cumulative voting.⁵² A minority shareholder has the right to demand the payment of a fair market value of its shares if it dissents from a decision to merge, an exchange of shares, or an amendment to the articles of incorporation or bylaws.⁵³ A minority shareholder also may bring a derivative law suit on behalf of the corporation under certain circumstances.⁵⁴ Moreover, U.S. law recognizes the fiduciary duty of controlling shareholders to minority shareholders upon certain transactions.⁵⁵

China's Company Law provides no effective measures to protect minority shareholder interests. The FIE laws, however, do a better job in this regard. Under Article 33 of the EJV Implementation, the board of directors (rather than the shareholders' meeting) is the highest authority of an EJV. Directors are appointed by the investing parties in accordance with their ratio of registered capital contributions.⁵⁶ In the board meeting, the directors vote by head (each has a single vote), not by the number of shares they represent (which is the case in a LLC's shareholders' meeting under the Company Law). The common practice is that minority shareholders are generally allowed to appoint at least one member of the board, even though the voting right of this director could possibly exceed the minority shareholders' corresponding investment ratio.

Furthermore, under the EJV law, minority shareholders have veto power over certain important matters. According to Article 36 of EJV law, the following matters require the unanimous consent of all attending directors (providing that the meeting meets the two-third quorum requirement): (1) modifications to an EJV's articles of incorporation, (2) termination or dissolution of an EJV, (3) the increase or transfer of an EJV's registered capital, and (4) mergers with other business organizations. This veto power is crucial to protect the interests of minority shareholders.

By contrast, the Company Law gives no say at all to minority shareholders. Under the Company Law, the shareholders' meeting is the highest authority in a LLC and makes the final decisions about most important

⁵² See REV. MODEL BUS. CORP. ACT §7.28(b) (1984); N.Y. BUS. CORP. LAW §618 (McKinney 2000).

⁵³ See REV. MODEL BUS. CORP. ACT §13.02(a)(1-4) (1984); N.Y. BUS. CORP. LAW §910 (West 1999).

⁵⁴ See REV. Model Bus. Corp. Act §7.40 (1984); N.Y. BUS. CORP. LAW §626 (West 1999).

⁵⁵ The typical cases involving controlling shareholders' fiduciary duty to minority shareholders include *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (De. 1971), *Perlman v. Feldmann*, 219 F.2d 173 (2nd Cir. 1955), and *Weinberger v. UOP, Inc.*, 457 A.2d 701 (De. 1983).

⁵⁶ See EJV Implementation, art. 34.

matters.⁵⁷ For example, all the matters listed above as being determined by the board of directors in an EJV are determined by the shareholders' meeting in a LLC.⁵⁸ Moreover, shareholders in LLCs vote by the number of shares they own.⁵⁹ As a consequence, the majority shareholders would presumably exercise control over such matters as appointing the members of board of directors and most of the board of supervisors, determining the company's business policy and investment plan, and deciding the company's budget and profit distribution.⁶⁰

It is notable that the exercise of these powers by the shareholders' meeting is mandatory, not optional, which means that even though the majority shareholders are willing to give up certain controls, they may not legally do so. Furthermore, the Company Law does not recognize cumulative voting as it exists in the United States, nor does the Company Law require that minority shareholders have a minimum number of representatives on the board of directors or board of supervisors.

Though Article 43 of the Company Law provides that shareholders representing one-quarter of the voting rights in a corporation may initiate a provisional shareholders' meeting, the lack of voting power these shareholders possess makes this provision useless. The supervisory board does not provide real protection for minority interests because, as discussed above, the board functions merely as a figurehead. The directors' lack of independence in their decision-making and the lack of standards of fiduciary duty for directors make the protection of minority interests even harder.

Moreover, in contrast to U.S. laws, China has never recognized the fiduciary duty of controlling shareholders to minority shareholders. No provision in the Company Law or FIE laws restricts the controlling shareholders' abilities to self-deal or engage in conflicting transactions (which is in fact prevalent in China). Voting trusts and voting agreements⁶¹ are not recognized and are unenforceable in China. Minority shareholders cannot initiate derivative proceedings because such actions have never been recognized either in law or in practice. The concept of dissenter's rights or appraisal rights, recognized in U.S. law,⁶² is unknown to most Chinese judges. This lack of protections for minority shareholders has led many companies in China to adopt a formal policy of never investing in minority positions.

⁵⁷ Company Law, arts. 37, 38. This is also true in the context of Joint Stock Companies Limited (Companies limited by shares). See Company Law, art. 102.

⁵⁸ See Company Law, art. 38.

⁵⁹ See Company Law, art. 41.

⁶⁰ See Company Law, art. 38.

⁶¹ See REV. MODEL BUS. CORP. ACT §§7.30, 7.31 (1984); N.Y. BUS. CORP. LAW §621 (West 1999).

⁶² See generally REV. MODEL BUS. CORP. ACT §§13.01-13.31(1984) (Chapter 13 discusses dissenters' rights).

Suggestion: The Company Law should be amended to give more voting power to minority shareholders in shareholders' meetings and guarantee minority shareholders a minimum number of seats on the board of directors. Dissenters' rights, the right to initiate derivative lawsuits, and the fiduciary duties of the controlling shareholders to minority shareholders should be recognized in both the Company Law and FIE laws.

B. Lack of Operating Standard for Fiduciary Duties

Example: The board of directors of an EJV engaged in the beer brewing business is convening to discuss the feasibility of entering the local soft-drink market (which is highly profitable and less competitive) by merging with a promising soft-drink company. While he realizes that such a plan is in the best interests of the EJV, one of the directors objects to the merger plan in the fear that the merger would impair his personal soft-drink business, which is a major competitor of the target company. The merger plan is suspended due to the veto. May a shareholder sue the vetoing director for breach of fiduciary duty? The answer is that it would be very difficult to prevail in such a suit.

U.S. law generally recognizes directors' and officers' fiduciary duties to the corporation and shareholders. In observing their fiduciary duties, the directors and shareholders must comply with the "business judgment rule," i.e., they must act in good faith, with the care an ordinary prudent person in a like position would exercise under similar situations, and in a manner they reasonably believe to be in the best interests of the corporation.⁶³ China's Company Law also imposes fiduciary duties on directors, supervisors and managers of LLCs in Articles 59 through 63.⁶⁴ Generally, these provisions may be divided into two categories.

The first category seems simply to reiterate provisions of the criminal law. Article 59 prohibits directors, supervisors, and managers from accepting bribes. Article 60 prohibits directors, supervisors, and managers from embezzling company funds. Article 62 prohibits directors, supervisors, and managers from disclosing a company's commercial secrets without proper authorization. These provisions were absolutely necessary at the time the Company Law was enacted because of an obvious loophole in China's criminal law. At that time, the provisions of criminal law forbidding bribery and embezzlement only applied to state employees,⁶⁵ i.e., the employees of the government, state-owned enterprises and collectively-

⁶³ See REV. MODEL BUS. CORP. ACT §8.42(a)(1-3) (1984); N.Y. BUS. CORP. LAW §§717, 715(h) (West 1999).

⁶⁴ Similar provisions exist in context of Joint Stock Company limited.

⁶⁵ See CRIMINAL LAW OF THE PEOPLE'S REPUBLIC OF CHINA (1979) (ZhongHua RenMin GongHeGuo XingFa (1979)) arts. 126, 155, 185 (PRC) [hereinafter "1979 Criminal Law"].

owned enterprises, but not employees in the private business sector.⁶⁶ The above provisions in the Company Law are apparently intended to close this loophole.

The second category concerns fiduciary duties in the real sense. Article 59 requires that directors, supervisors, and managers abide by the company's articles of incorporation, protect the company's interests, and perform their duties with loyalty and honesty. Article 59 further prohibits such officers from exploiting their positions in the company to advance their personal interests. Article 60 prohibits directors, supervisors, and managers from providing personal guaranties with the company's assets. Article 61 states that directors, supervisors, and managers may not, on their behalf or on behalf of others, engage in the same line of business as the company, and may not conduct transactions with the company unless the company's articles provide otherwise or the shareholders' meeting approves the transaction. Article 63 requires directors, supervisors, and managers to compensate the company for damages caused by any conduct they engage in that violates the laws or articles of the company. Moreover, under Article 40 of the EJV Implementation, general managers and vice general managers may not take the same positions in other business organizations, and may not participate in commercial competition with the company on behalf of other organizations.

These provisions reflect the well-intended efforts of China to establish fiduciary duties for company officers. Nonetheless, a serious problem exists regarding the practicability of these provisions. Like all Chinese laws, these provisions are too skeletal and lack operating standards. For example, Article 59 provides that "directors, supervisors, and managers should perform their duties with loyalty and honesty." But what is the standard of "loyalty" or "honesty"? The law provided no operating standards. Directors, supervisors, and managers in China, unlike their U.S. counterparts, have no "business judgment rule" on which to rely or with which to protect themselves.

Furthermore, a lot of murky areas have been left unilluminated by the Company Law. For example, Article 63 of the Company Law requires directors, supervisors, and managers to compensate the company for damages caused by action undertaken in violation of the laws or articles of incorporation of the company. But the law fails to set out the responsibilities of those officers, or establish any penalties for an officer who acts in bad faith, or fails to act in the best interest of the company without violating the letter of the company's laws or articles of incorporation.

⁶⁶This loophole was resolved by the promulgation of new NPC legislation in 1995 and 1997. See CRIMINAL LAW OF THE PEOPLE'S REPUBLIC OF CHINA (1997) (ZhongHua RenMin GongHeGuo XingFa (1997)) (promulgated on Oct. 1, 1997) arts. 271, 272 (PRC) [hereinafter "1997 Criminal Law"]. (The 1979 Criminal Law was replaced by the 1997 Criminal Law. The 1997 Criminal Law is the current Law of China).

The direct consequence of lack of operating standards is that directors, supervisors, and managers can only act based on their own subjective judgment, or at the direction of the shareholders who appoint them. In fact, directors, supervisors, and managers in China tend to perceive themselves as representatives of the shareholders who appoint them and thus act in the best interest of such shareholders, rather than in the best interest of the company.

For majority shareholders, the only practical remedy when an officer disobeys their orders is to replace the delinquent officer because of the lack of standards for their conduct. Without definitive standards, initiating suits against the delinquent officers is likely to be protracted and unpromising. For minority shareholders, there is no remedy at all because, as discussed earlier, they have no say in the company's management.

Notwithstanding the letter of the law, the SAIC does not strictly enforce the provisions regarding the fiduciary duties of company officers. It is very common in China for an officer to engage in the same line business as the company for which he acts as an officer, and conduct transactions with the company without the approval of either the articles of incorporation or the shareholders' meeting. It is also common for the general managers or vice general managers of EJV's to hold the same positions in more than one company and sometimes even compete with their company on behalf of other companies.

Suggestion: A clear standard of fiduciary duties for directors, managers, and supervisors should be set forth in the Company Law and FIE laws.

IV. RESOLVING DEADLOCK

Example: X company, an EJV in China, has two shareholders: Mr. Li, who holds 60% of the registered capital and has the right to appoint three members to the board of directors, and Mr. Kwan, who holds 40% of the registered capital and has the right to appoint two members to the board. Mr. Kwan instructed his appointed directors not to attend the annual board meeting in retaliation for Mr. Li's refusal to give Mr. Kwan a say in the management and because Mr. Li's refused to approve Mr. Kwan's plan to transfer his shareholdings to a third party last year. Consequentially, X company's board meeting could not be legally held because it failed to meet the two-thirds quorum requirement, and therefore X company could not obtain loans to maintain its operation without the board's resolution (required by all banks in China). Could Mr. Li unilaterally petition to dissolve the company under this situation? Answer: Such a petition is very unlikely to be successful.

U.S. law confers on shareholders the right to petition for a judicial dissolution of a corporation under certain circumstances, such as when the management of the corporation is deadlocked; if the directors act in a ille-

gal, oppressive, or fraudulent manner; or if the corporate assets are being misapplied or wasted.⁶⁷ By contrast, insufficient mechanisms are provided in China's Company Law and FIE laws to resolve potential deadlocks and shareholders' oppressions. Such deadlocks frequently occur when shareholders fail to or refuse to cooperate with other shareholders, making the operation of a LLC or EJV impossible, or when one shareholder would like to transfer its shares and other shareholders block the transfer.

A. Shareholders' Failure or Refusal to Cooperate

Failure or refusal by some shareholders to cooperate in some important matters of a LLC or EJV is prevalent in China. This is especially true in LLCs when the controlling shareholder controls the management and operation of the company and refuses to give the minority shareholders a say. For example, under Article 43 of the Company Law, minority shareholders representing one-quarter of the voting rights in a company may propose a provisional shareholders' meeting. This meeting should be called by the board of directors upon receiving notice from the minority shareholders.⁶⁸

If the board, probably dominated by the controlling shareholder, expressly refuses to call the meeting, the minority shareholders may enforce their statutory rights in court. But if the board of directors simply fails to respond to the minority shareholders' notice, or after agreeing to call the meeting delays in providing notice of the date and venue of the meeting, the minority shareholders would likely have a difficult time enforcing their rights in court. Generally, courts in China are reluctant to hear cases like this where no clear statutory rights are violated.

Another typical situation arises from the special provision of EJV law. Under Article 35 of the EJV Implementation, a board of directors meeting (both annual and provisional) may be held only if two-thirds of the directors attend. A problem arises when some directors fail or refuse to attend the meeting and their absence causes the meeting fail to satisfy the two-thirds quorum requirement. Since the board of directors is the highest authority of an EJV and makes all the major decisions about the operation of the EJV, the inability of board to convene would seriously disable the company, and sometimes even render the EJV "dead." The EJV law provides no remedy for an aggrieved party in this situation.

B. Deadlock in the Context of Share Transfers

Under Article 23 of the EJV Implementation, if one party of an EJV would like to transfer all or part of its capital contribution to a third party

⁶⁷ See REV. MODEL BUS. CORP. ACT §14.30 (1984); N.Y. BUS. CORP. LAW §1104 (West 1999).

⁶⁸ See Company Law, art. 43 (Where a limited liability company established the board of directors, the shareholders' meetings shall be called by the board of directors....)

(other than current shareholders of the EJV), the unanimous consent of all attending directors and all shareholders is required.⁶⁸ If one party objects to the transfer, then presumably the transfer should fail. The EJV law fails to contemplate the situation in which, instead of objecting, the non-transferring party simply fails to respond to the transferring party's notice. Should the transferring party wait indefinitely for the consent? Bear in mind that under the structure of EJV law, the board of directors is the highest authority,⁷⁰ and neither the shareholders nor the shareholders' meeting qualifies as an organ of the EJV. Thus, a shareholder has no means to require or compel another party to respond to its notice under the EJV law.

Possibly contemplating this situation, the Company Law addresses the transfer of shareholders' shares in more detail. Under the Company Law, shareholders may transfer to each other all or some of their shares without the consent of the shareholders' meeting or of other shareholders.⁷¹ If a shareholder would like to transfer its shares to an outsider, the consent of a majority of shareholders is required.⁷² If such majority consent cannot be obtained, the shareholders who did not consent to the transfer must purchase the shares in question.⁷³

Still, several problems arise with regard to the practicality of this provision. First, under what price and conditions should the dissenting shareholders purchase the shares in question? What if the dissenting shareholders agree to purchase the shares, but only at a lower price? The Company Law is silent about whether the dissenting shareholders should purchase the shares at the same price and conditions as those given by the outside purchaser, which is the requirement for shareholders to exert their preemptive right.⁷⁴ Consequently, the dilemma for the transferring shareholders could be either selling their shares to an insider in a lower price, or keeping them.

The second problem is that the Company Law fails to address a situation in which more than one shareholder dissents. How many shares should each dissenter purchase in this situation? Should they purchase the shares in equal portions, or pro rata, i.e., in the same ratio as their capital contributions? What if the dissenting shareholders fail to agree on how many shares each should purchase? Is it fair for the transferring party to wait indefinitely for them to negotiate and reach agreements?

⁶⁹ The EJV Law is silent with regard to whether such consents are still required if the transfer is made to one of the parties of the EJV. In practice, the SAIC imposes the same requirements (i.e. consents of all non-transacting parties) on such transfers as those to a third party. See EJV Implementation, art. 33.

⁷⁰ See EJV Implementation, art. 33.

⁷¹ Company Law, art. 35.

⁷² See *id.*

⁷³ See *id.*

⁷⁴ See *id.*; EJV Implementation, art. 23.

C. Shareholders' Right of Dissolution

May an aggrieved party, under the deadlock situations discussed above, petition for a unilateral dissolution before the relevant administrative or judicial branch? In this situation, courts in China would likely dismiss the case by simply saying that no clear statutory right is violated and that there is no statutory provision for courts to enforce. The right of involuntary dissolution in China may only be asserted by creditors of a company.⁷⁵

Under limited circumstances, an EJV (not a shareholder) may petition the dissolution of itself before the MOFTEC. Those circumstances include: (1) when the term of an EJV expires, (2) when an EJV incurs heavy losses and is unable to continue its operation, (3) when a party to an EJV agreement, contract, or articles of incorporation fails to perform its obligations, making it impossible for the EJV to continue its operations, (4) when an EJV incurs heavy losses due to an act of god (such as a natural disaster or war) and is unable to continue its operation, (5) when an EJV fails to accomplish its operating goal and has no future for further developments, and (6) when other reasons for dissolution provided in the EJV contracts or articles of incorporation arise.⁷⁶

However, all of these situations except the expiration of EJV terms require that the board of directors of the EJV submit a resolution of dissolution to MOFTEC.⁷⁷ If, as discussed above, deadlock has occurred and convening the board of directors is impossible, a "dissolution resolution" may not be legally submitted in the name of the board of directors.

A shareholder's right to petition a unilateral dissolution upon a deadlock is not generally recognized in either the Company Law or FIE laws. However, according to a rule jointly promulgated by the SAIC and MOFTEC, there is one limited exception to the rule. That is, if one party of an EJV fails to fully contribute the registered capital required under the EJV contracts and is unable to do so within one month after the observing party's admonition, the observing party may unilaterally petition the dissolution of the EJV.⁷⁸ Obviously, this unilateral dissolution can occur only in very limited situations and cannot apply to deadlocks occurring after parties have fully contributed their shares in registered capital.

Suggestion: Detailed provisions regarding how to resolve deadlocks should be set forth in the Company Law and FIE laws, and a shareholder's

⁷⁵ See CIVIL PROCEDURE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (ZhongHua RenMin GongHeGuo MinShi SuSongFa) (promulgated on Apr. 9, 1991) art. 199 (PRC).

⁷⁶ See EJV Implementation, art. 102.

⁷⁷ See *id.*

⁷⁸ See RULES ON CAPITAL CONTRIBUTIONS BY THE PARTIES OF CHINESE-FOREIGN EQUITY JOINT VENTURES (GuanYu ZhongWai HeZi JingYing QiYe TouZi GeFang ChuZi De GuiDing) (Promulgated jointly by MOFTEC and SAIC on Jan. 1, 1988) art. 7 (PRC) [hereinafter "Rules on Capital Contributions"].

right to petition a unilateral judicial or administrative dissolution of the company should be recognized in both the Company Law and FIE laws.

V. INFLEXIBLE RESTRICTIONS

A. Limited Business Purpose: A Mandatory Requirement for Incorporation

Example: X company is an EJV in China with a registered business purpose of manufacturing and selling beer. Since the soft drink market is more profitable and X company may utilize its current equipment to produce soft drinks, the shareholders and board of directors issued a resolution to enter the soft drink market, and amended its articles of incorporation accordingly. However, it failed to change its registered business purpose in the filings of the SAIC and MOFTEC. Can X company produce and sell soft drinks? Answer: Not yet.

Once a company or FIE is incorporated in China, it may only engage in the activities set forth in its business license and articles of incorporation.⁷⁹ This is also the case in the United States.⁸⁰ There are, however, sharp differences between the U.S. and Chinese laws. In the U.S., a selected business purpose is not a mandatory requirement for incorporation and a company may engage in "any lawful business," unless a more limited purpose is set forth in the articles of incorporation.⁸¹ In China, a limited business purpose (the literal translation is "scope of business") must be selected at the time of incorporation. A broad statement intended to include all lawful business is not allowed as a matter of fact, although it is not expressly prohibited as a matter of law.

As a consequence of this mandatory requirement, a company or FIE is considered legally incompetent or unqualified to conduct activities outside its business purpose. All contracts and transactions that go beyond the scope of a company's business purpose are void per se.⁸³ Courts in China, however, have often found it difficult to determine whether the content of a contract is within or beyond the scope of a company's business purpose.

This mandatory limited business purpose requirement is one of the indications of the major transition that China's laws are undergoing. No legitimate justification except the residue of the planned economic system could explain this requirement. In the planned economic period, a factory

⁷⁹ See Civil Law, art. 42; See Company Law, art. 11.

⁸⁰ See REV. MODEL BUS. CORP. ACT §3.01 (1984); N.Y. BUS. CORP. LAW §201(a) (West 1999).

⁸¹ See REV. MODEL BUS. CORP. ACT §§2.02(b), 3.01 (1984); N.Y. BUS. CORP. LAW §§ 201(a), 202(16) (West 1999).

⁸³ However, in recent years, courts in China have been reluctant to invalidate contracts merely because the contracts go beyond the business purpose of one of the contracting parties. But thus far, there has been no substantive change in the law regarding this matter.

or company only functioned as a unit of a bigger system, and therefore only specialized in a very narrow area. A company was required to play its assigned role in the system rather than to pursue profits. But in a market-oriented economic system, this rigid requirement not only produces enormous uncertainty in business transactions and impedes companies' autonomy of contracts, it also affects a company's ability to pursue the goal of maximum profits.

If the business purpose of a company or FIE is "direct investment," or in other words if the prospective company is intended to be incorporated as an "investment company" or "holding company," some special rules apply. Otherwise, the cumulative direct investments of a non-investment company may not exceed 50% of its "net assets" (equity).⁸⁴ However, in practice, there is no effective mechanism for the government to monitor the investment activities of LLCs so as to ensure compliance with this requirement of the Company Law.

Suggestion: All relevant legal provisions regarding the mandatory limited business purpose ought to be abolished, or the requirement should become optional at the time of incorporation.

B. Legal Representative: An Unjustified Statutory Authorization

Example: An EJV is near the closing of a deal to purchase expensive equipment. However, the president of the EJV's board, as its legal representative, disagreed with the rest of the board of directors with regard to both the quality and the price of the equipment. In spite of his dissent, the board of directors made a resolution to purchase the equipment and authorize the vice president to close the deal on behalf of the EJV. Assuming the convening of the meeting and the resolution of the board of directors meets the requirements of the law, can the vice president legally represent the EJV with the authorization of the board? Answer: The vice-president cannot do so without the authorization of the legal representative.

In the United States, any duly authorized director or officer of a corporation may act on behalf of the corporation.⁸⁵ Such authority may be ex-

⁸⁴ Those detailed rules include the approval of State Council for domestic companies (no foreign investment involved) and approval of MOFTEC if foreign investments are involved. See Company Law, art. 12; PROVISIONAL REGULATIONS OF THE PRC ON INVESTMENT COMPANIES ESTABLISHED BY FOREIGN INVESTORS (GuanYu WaiShang TouZi JuBan TouZiXing GongSi De ZanXing GuiDing) art. 3 (PRC) [hereinafter "Provisional Regulations of the PRC on Investment Companies"]. Also, for a FIE investment company, the registered capital should be more than U.S.\$30 million or its equivalent. See Provisional Regulations of the PRC on Investment Companies, art. 2. Moreover, the foreign party must meet some other requirements, such as possessing certain amount of assets. See *id.*

⁸⁵ See REV. MODEL BUS. CORP. ACT §8.41 (1984); N.Y. BUS. CORP. : LAW §715(g) (West 1999).

press, implied, or apparent.⁸⁶ In China, only the "legal representative" of a business may act on behalf of the business.

The "legal representative" in China is a civil-law concept with Chinese characteristics. In China, a legal representative is a natural person authorized by the law (not by the board of directors or shareholders' meeting) to act on behalf of and bind the company.⁸⁷ The legal representative of a LLC or FIE is the president of the board of directors, and in a small-scale LLC choosing not to have a board, it is the executive director.⁸⁸

The legal implications of this unique concept are twofold. First, the statutory authorization of a legal representative is absolute and not subject to the power of the shareholders' meetings or board of directors. In order to be a legal representative, a person must first be elected or appointed as president of the board of directors, and then be approved by the SAIC, which registers and prints that person's name on the company's business license. Once these requirements are met, the legal representative would bind the company by any transaction he or she conducts on behalf of the LLC without the need of any further authorization.

The power of the legal representative is absolute in the sense that such power is authorized by the law and the power to bind the company is not subject to any limitation set by the articles of incorporation, resolutions of shareholders' meetings, or board of directors.⁸⁹ For example, if the shareholders and board of directors pass a resolution prohibiting the legal representative from conducting certain transactions and the legal representative proceeds regardless of such resolution, the company is still bound by the transaction (although the shareholders may have a cause of action against the legal representative personally).⁹⁰ Thus, the only way for shareholders to abridge a legal representative's absolute statutory authority is to deprive him or her of the status of legal representative by changing the registration at the SAIC.⁹¹

The second legal implication is that a legal representative's statutory authorization is exclusive. The legal representative is the only person who may represent the company in conducting business activities, and all activities conducted by other officers without the authorization of the legal repre-

⁸⁶ See LARRY D. SODERQUIST ET AL., CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 267 (4th ed. 1997).

⁸⁷ See Civil Law, arts. 38, 43.

⁸⁸ See Company Law, art. 45; EJV Implementation, art. 37.

⁸⁹ See Civil Law, art. 43; A company may be bound even if the legal representative acts without proper authorization. See CONTRACT LAW OF THE PRC (ZhongHua RenMin Gong-HeGuo HeTongFa) (promulgated on March 16, 1999) art. 50 (PRC).

⁹⁰ See Civil Law, art. 49.

⁹¹ See Regulation for Legal Persons, art. 7; Civil Law, art. 38.

sentative are presumably void.⁹² In other words, the legal representative is the only officer of a company with the "inherent authority" to act for the company. All business must be carried out through the legal representative or his or her authorized agents, even if it concerns a matter requiring the resolution of shareholders' meeting or board of directors under the articles of incorporation.⁹³ The flip side of this legal implication is that officers other than the legal representative, even those ranking as high as a director or general manager, and even if they have been authorized by the directors or shareholders, may not conduct business on behalf of the company without authorization from the legal representative.

This absolute and exclusive authorization of legal representative is unjustified under the basic principles of the Company Law. China recognizes "equal share, equal right" as the basic principle regarding the exercise and distribution of shareholders' power.⁹⁴ However, the absolute and exclusive power of a legal representative gives a huge advantage to the shareholder who has the ability to control the election or appointment of the legal representative. Such an advantage, as a practical matter, potentially gives one shareholder superior rights to another regardless of the number of shares she or he holds.

A look at recent history might make it more understandable why such a concept is embedded in the modern company law of China. The legal representative under the Company Law may trace its origins to the concept of the wholly State-Owned Enterprise ("SOE"), a structure that has no problem with unequal shareholders' rights because the state is the sole owner. In a traditional SOE (without the mechanism of the shareholders' meeting or board of directors),⁹⁵ the state is the highest authority in the enterprise. However, because the state has no ability to conduct the day-to-day management of the business, a legal representative is appointed and vested with both authorities and liabilities.

In the context of SOEs, the legal representative system does play some positive roles, both in the management of the SOEs and the preservation of state assets. However, such roles are very doubtful when the authority in a company changes from the state, which has no ability to conduct day-to-day

⁹² See Civil Law, art. 38 ("...[T]he responsible person who acts on behalf of the legal person in exercising its functions and powers shall be its legal representative"). However, the authorization need not necessarily be express. It may be inferred from the course of dealing or course of performance. For example, periodical office supply contracts conducted by lower officers of a company could be legally recognized.

⁹³ See *id.*

⁹⁴ See *infra* note 108.

⁹⁵ This is still the typical situation for the majority of SOEs. A traditional SOE may be standardized into a wholly state-owned company ("WSOC") under the Company Law. However, no legal significance was added by such standardization. The SOE is already, as a practical matter, a limited liability company prior to the standardization.

management, to a board of directors, whose function purports to be just that.

While enjoying absolute and exclusive powers, the legal representative does bear greater risks than other directors and officers of a LLC. The legal representative may be subject to administrative penalties or even criminal prosecution if the company engages in business beyond its authorized business purpose, conceals material facts from registration or tax authorities, or hides properties in order to evade debts, regardless of whether the legal representative has personally participated or authorized such activities.⁹⁶

Moreover, a person may be disqualified from being a legal representative in other organizations if he or she is the legal representative of a company whose business license has been revoked within the past three years and the legal representative was held personally liable for the conduct causing the license to be revoked.⁹⁷ No enlightening definition is found in the Company Law about what constitutes "personal liability." Also, it is doubtful that the legal representative of a LLC under the Company Law, who possibly lacks a say in the shareholders' meetings and in decisions about important company matters, should fairly bear such a responsibility.

However formidable these provisions, the SAIC has not been serious in enforcing them and does not trace the records of legal representatives or other high-level company officers. Also, the legislative trend in China is to dilute the concept of legal representative, and in recent legislation, it has been replaced by terms such as "responsible person" or "directly responsible person."⁹⁸

Suggestion: The legal-representative system ought to be abolished in China. Any duly authorized officer should be able to represent a company legally.

C. Registered Capital: A Misleading Illusion

Example: Two LLCs, A and B, engaged in the same line of business and newly incorporated under the Company Law, have registered capital of 10 million and 1 million cash, respectively. Is Company A more credit-worthy than Company B for a 1 million dollar purchase of equipment? Answer: Not necessarily.

Registered capital is a mandatory requirement for the registration of a LLC under both the Company Law and FIE laws.⁹⁹ The shareholders are liable for the LLC's debts only to the extent of their agreed capital contri-

⁹⁶ See Civil Law, art. 49.

⁹⁷ See Company Law, art. 57.

⁹⁸ See Company Law, arts. 212, 213.

⁹⁹ Company Law, art. 22; EJV Implementation, arts. 12, 14, 16. See also Company Law, art. 23 (setting forth minimum requirements of registered capital for LLCs engaged in different lines of business).

butions in the registered capital.¹⁰⁰ For a LLC under the Company Law, the registered capital must be actually and fully contributed to the account of the LLC before the SAIC issues the requisite registration.¹⁰¹ This requirement distinguishes China's "registered capital" from "stated capital" under U.S. law, which is not required to be actually paid by shareholders to the corporation at the time of registration.

Under the EJV law, the contribution requirement of registered capital is more liberal. The parties have six months to contribute their registered capital and may have an additional one month to do so after the six months expires without substantially affecting their rights under the EJV contracts.¹⁰² Although the SAIC exercises close supervision to make sure that LLCs have genuinely contributed their registered capital, a large number of companies still successfully circumvent the law, which sometimes makes the registered capital only an illusion to creditors.

One way to circumvent the law is to obtain a false "Certificate of Capital Contribution Examination." Under both Company Law and EJV law, a company must submit to the SAIC a "Certificate of Capital Contribution Examination" (the "certificate") to verify its actual capital contribution. The certificate should be issued by a qualified accounting institution.¹⁰³ However, due to relaxed professional discipline and government oversight, some accounting institutions issue certificates for a fee without actually examining the clients' bank records. As a result, a certificate may be obtained even if an investor does not have a penny in its account.

The second way to circumvent the law is to withdraw the registered capital after obtaining a certificate. In spite of the prohibition that the shareholders of a LLC may not withdraw their capital contributions after the registration of the company,¹⁰⁴ it is a common practice in China that investors withdraw their investments and leave the company to rely on loans or other sources. Some investors even withdraw their capital contributions prior to the registration soon after they acquire a certificate from an accounting institution. Even though the withdrawing shareholders are still legally liable to the creditors of the company, the typical situation is that such shareholder is insolvent, or acquires his or her own registration by the very same practice.¹⁰⁵ Therefore, the creditors may suffer losses from relying on the illusory registered capital.

¹⁰⁰ See Company Law, art. 3; EJV Law, art. 4.

¹⁰¹ See Company Law, art. 27.

¹⁰² See Rules on Capital Contributions, art. 24.

¹⁰³ Company Law, art. 26.

¹⁰⁴ Company Law, art. 34.

¹⁰⁵ Generally, the shareholders conducting this kind of practice would not be subject to criminal fraud prosecution. Currently, more and more Chinese companies and creditors choose to conduct only secured transactions.

To make this situation worse, the SAIC does not seriously enforce the administrative and criminal penalties related to withdrawal of the registered capital or false representations about the registered capital. In fact, some state employees in local branches of the SAIC engage in the lucrative "business" of helping investors to obtain false certificates. All the foregoing situations leave innocent creditors unprotected and to some extent affect the creditability and reputation of China's LLCs as a whole.

Suggestion: Strict enforcement of relevant laws regarding the registered capital should be stressed. Another alternative is to eliminate from both the Company Law and FIE laws the "actual contribution" requirement regarding registered capital.

D. Limitation on Shareholders' Right to Distribute Profits

Example: X Company, a LLC incorporated under the Company Law, made a substantial profit in its first year of operation by manufacturing and selling beer. After paying all the taxes required by law, the shareholders' meeting made a resolution distributing all the after-tax profit to shareholders. Can X Company do this? Answer: Not yet.

Under both the Company Law and FIE laws, profits may not be distributed until all previous losses have been paid up by the company.¹⁰⁶ In other words, the distribution of profits is allowed only if the company has "accumulated retained earnings." This is essentially an "earned surplus test" similar to § 45 of the U.S. Model Business Corporation Act (1969). "Capital surplus" may not be distributed to shareholders as dividends.¹⁰⁷ The basic principle regarding the profit distribution is that "equal shares receive equal profits,"¹⁰⁸ and the distribution of profits is made in accordance with the percentage of shareholders' capital distribution in the registered

¹⁰⁶ Company Law, art. 177; EJV Implementation, art. 88.

¹⁰⁷ See Company Law, arts. 178, 179.

¹⁰⁸ This is thus a Joint Stock Company Limited (Company Limited by Shares). Company Law, art. 130.

The provisions regarding LLCs are silent on this matter. However, it is a practical principle for LLCs. One misunderstanding regarding this provision is that in China, the "percentage of capital contributions" is thought to be a different concept from the "percentage of shareholdings." But in fact, they are virtually the same, providing that all shareholders actually and fully contribute their shares in registered capital. As a matter of law, for Companies Limited by Shares and as a matter of fact for LLCs, all shares must be sold at the same price at the time of issuance. Company Law, art. 133. Therefore, a party contributing the same capital contribution will receive the same number of shares as any other parties contributing the same capital contribution. After the registration of a company, a premium may be paid by a purchaser to a shareholder to purchase their existing shares in the company. However, for this latter situation, the company will recognize that the number of shares that the purchaser bought is the same as the number of shares that the seller sold, even though the purchaser may have paid a higher price for the same shares.

capital (assuming that all shareholders have actually and fully contributed their shares in the registered capital).¹⁰⁹

The Company Law is silent as to whether a company may issue different classes of stocks with different voting and dividend rights. Presumably, this is not allowed because the Company law provides that in the context of Joint Stock Company Limited (Companies Limited by Shares), the company must issue stocks under the principles of "equal share, equal right," "equal share, equal profit," and "equal share, equal price."¹¹⁰

Although the Company Law essentially adopted an "earned surplus" test, subtle differences exist between China's law and U.S. law. In the United States, all profits satisfying this "test" may be distributed in any manner the corporation wishes. In China, however, company is required to allocate a certain percentage of its after-tax profits into certain mandatory funds before distributing profits.

Under the Company Law, a company must place ten percent of its after-tax profits into a "mandatory accumulated fund," and five to ten percent into a "mandatory public welfare fund." These two funds are commonly referred to as the "double funds requirement."¹¹¹ Under EJV law, allocations must be made to a "reservation fund," an "employee bonus and welfare fund," and an "enterprise development fund" (with their percentages decided by the board of directors).¹¹²

The "mandatory accumulated fund" may be used to pay the company's losses or increase the company's production, or may be converted into registered capital.¹¹³ A company may suspend the allocation of this fund if the total accumulated funds equals 50% of the company's registered capital. The "mandatory public welfare fund" should be used to promote the collective welfare of the company's employees.¹¹⁴

The so-called "double funds" originates from similar concepts in state-owned enterprises. In state-owned enterprises, the state employees and the state-appointed managers directly in charge of the enterprise tend to engage in short-term practices that are beneficial to their personal promotion but are not in the long-term interest of the enterprise and its employees. To remedy this problem, the state, by law, required state-owned enterprises to contribute to the mandatory double funds.

Although the double funds may play a positive role in state-owned enterprises, this concept is surely out of date in the context of the modern LLC. Here, the ownership of a company is clear and unambiguous; only

¹⁰⁹ See Company Law, arts. 33, 177.

¹¹⁰ See Company Law, art. 130.

¹¹¹ See Company Law, art. 177.

¹¹² See EJV Implementation, art. 87.

¹¹³ See Company Law, art. 179.

¹¹⁴ See Company Law, art. 180.

the owners (shareholders) and its representatives (board of directors) have a say in deciding what is in the best interest of the company. The mandatory double funds interfere with shareholders' autonomy regarding profit distribution, reinvestment, and repatriation of their investment. As a consequence, a company's shareholders have to leave their profits (amounting to up to 50% of the registered capital) in the company, even though the business is unpromising and not worth additional investment. The company has to contribute to the "mandatory public welfare fund" every year it has profits, even if it had already provided competitive wages and benefits to its employees.¹¹⁵

Suggestion: The double-funds requirement should be abolished from both the Company Law and FIE laws.

E. Restrictions on FIEs' Ability to Establish Wholly-Owned LLCs

Example: X company is a wholly foreign-owned enterprise ("WFOE") in China with a limited-liability feature incorporated by a multi-national corporation several years ago. Due to its increasing business, X company would like to incorporate subsidiaries in all major cities in China, and would like the subsidiaries to maintain the limited-liability feature. Moreover, X company wants to incorporate all the subsidiaries using its own funds (which is also the policy of the multi-national corporation) so that it need not deal with other shareholders. Can X company do carry out this plan? The answer is no; X company must find at least one other investor in order to incorporate a LLC.

Chinese laws treat Chinese and foreigners unequally, or more accurately, treat Chinese nationals and legal persons, including those established by foreign investors, less favorably in terms of the establishment of enterprises and income taxes than foreign investors coming directly from abroad. If the justification for the preferential tax treatment is to attract more foreign investment to China, it is hard to conceive of any legitimate reason not to grant Chinese nationals and legal persons the same rights as to the establishment of enterprises. This is because foreign investments may not necessarily benefit from, or may even be harmed by, such discrimination against Chinese nationals and legal persons.

According to Article 2 of the WFOE law, a foreign investor directly coming from a foreign country may establish a wholly-owned foreign enterprise in China as a sole shareholder, and this enterprise may be granted the status of legal person.¹¹⁶ The term "investor" includes both legal and

¹¹⁵ The Company Law is silent regarding how to dispose this fund upon a company's dissolution.

¹¹⁶ See WFOE Law, art. 8.

natural persons.¹¹⁷ Moreover, investors from Hong Kong, Macao, and Taiwan are also treated as "foreigners" for the purpose of FIE laws.¹¹⁸

For a Chinese national or enterprise to establish a subsidiary enterprise with a legal-person status (so as to enjoy the advantage of limited-liability), however, at least two shareholders are required, even though another shareholder's shareholdings may be negligible.¹¹⁹ This is even true when an FIE would like to further incorporate subsidiaries in China. Otherwise, the sole investor of a "private enterprise" has unlimited personal liability with respect to the debts of the enterprise.¹²⁰

No official legislative explanation has ever been disclosed for this unequal treatment. One speculation in legal circles is that the NPC suspects that Chinese nationals or companies might misuse the limited liability feature to commit fraud. For a short time after China implemented its open door policy, "Co." and "Ltd." were used by some unscrupulous Chinese business owners to commit fraud because in the planned economic period, companies designated "Co." and "Ltd." were all owned by the State and were therefore symbols of trustworthiness. But this is surely no longer the case since China began implementing an open-door policy. However, more preventive measures in the law and more stringent law enforcement would be more effective than this unjustified bright-line prohibition in terms of the deterrence of fraud.

On the other hand, if the NPC believed that one-person companies are inherently untrustworthy, there is no reason to limit this rule to Chinese nationals or companies, since no evidence indicates that foreign investors are more creditworthy than Chinese investors, or that all investors coming from foreign countries are more trustworthy than subsidiaries established by foreign investors in China. In fact, investment fraud committed by small investors from Hong Kong, Macao, and Taiwan became so prevalent in China in the 1980s that some leading party members became hostile toward small

¹¹⁷ See WFOE Law, art. 1.

¹¹⁸ See *REGULATIONS OF STATE COUNCIL FOR ENCOURAGING FOREIGN INVESTMENTS* (1986) art. 39 (PRC).

¹¹⁹ The Company Law fails to specify the minimum percentage of minority shareholders' capital contribution in the registered capital. The practical standard adopted by some SAIC local offices is 2%. Company Law, art. 20.

¹²⁰ See Provisional Regulation On Private Enterprises, arts. 7, 9 (The limited liability companies shall have more than two but no more than 30 investors). The legal distinction between the private enterprise and the sole proprietorship is whether eight or more employees are employed. See Provisional Regulation On Private Enterprises, art. 2. If eight or more are employed, then it is a private enterprise; otherwise, it is a sole proprietorship. Different laws with regard to application procedures, capital requirements and tax consequences apply for private enterprises and sole proprietorships. There is no privately-owned one-shareholder corporation with LLC status in China. See *LAW OF WHOLLY INDIVIDUAL OWNED ENTERPRISES OF THE PRC* (ZhongHua RenMin GongHeGuo GeRen DuZi QiYeFa) (passed on August 30, 1999, effective Jan. 1, 2000) art. 2 (PRC); Company Law, art. 13 (A company is responsible for the civil liability of its branch company).

investors from these areas. Typical frauds committed by these foreign investors included withdrawing or delaying capital investment in EJVs while sharing the profit as though the foreign investors had fully contributed the registered capital, or using the EJVs or WFOEs as tax shelters (in order to enjoy the tax holiday) by transfer pricing arrangements between the EJVs or WFOEs and the foreign investors' overseas subsidiaries.¹²¹

Suggestion: The company law should be amended to allow Chinese nationals and companies, including FIEs incorporated by foreign investors in China, to incorporate wholly owned enterprises with limited liability protection.

VI. CONCLUSION

The problems discussed in this article require amendments to the current Company Law and FIE laws. However, foreign legal practitioners and investors should not be too discouraged by the slow pace of China's legislative action. Due to their communist education and backgrounds, some if not most of the leading Communist Party members and national legislators are conservative, and even suspicious of the market economy and capitalism.¹²² A transition period is necessary and inescapable. The important thing is that China is continuing its progress, both economically and legally, from a planned economy to a market economy. China's entry into the World Trade Organization will certainly accelerate such transformations.

¹²¹ Small investments from Hong Kong, Macao and Taiwan are not wholly-heartedly welcome in China at the present time for several reasons. One such reason is the fact that they are labor-intensive and cannot bring in the modern technologies currently in high demand in China. Moreover, very often they have been found to be in breach of the labor law with regard to the minimum wages or maximum working hour restrictions, or to be in breach of the fire-prevention law by failing to provide sufficient fire exits or blocking such exits in their manufacturing facilities.

After fully enjoying the income tax holidays and tariff exemptions for their manufacturing machinery, some investors liquidated their EJVs and WFOEs at the end of their fifth year and reopened as new companies so as to once again enjoy the preferential tax and tariff treatments.

¹²² Indeed, though such social problems as high unemployment rates and inequitable and unbalanced enrichment may have already existed before the open door policy, they did not become apparent until after China implemented the policy.