FENWICK & WEST LLP

Guide to Establishing a Subsidiary in China

BY JIE CHEN

As China's strength in the global economy continues to grow, businesses need to consider the prospect of establishing operations within its borders. In order to successfully transact business in China or with Chinese enterprises, foreign investors, including financial investors and entrepreneurs, should consider setting up a subsidiary in China. This article provides general information on establishing a subsidiary by foreign investors, to help provide guidance and demystify the process.

Purpose of Establishing a Subsidiary in China

Establishing a subsidiary in China should be considered by those who have long-term business objectives in China. Although foreign companies can enter into some commercial contracts with Chinese enterprises, such as sales contracts, license agreements, and distribution agreements, they cannot do business directly in China without an approved business license. Doing business in China through a subsidiary is at least advantageous—and sometimes a necessity—in overcoming certain legal and business restrictions on foreign companies.

Some foreign companies may already have a resident representative office in China. Such representative offices function as internal liaisons for their parent company. However, they may not do business in China directly. Because resident representatives are not recognized as independent legal persons under Chinese law, they may not assume independent civil liabilities to a third party, which prevents significant commercial activities such as signing commercial contracts with a third party. Nor may they directly hire local Chinese employees. There are limited exceptions, however, such as a lease contract for office space.

Companies that desire to invest directly in China, hire local people, conduct research and development, manufacture products, and market their products or services directly to the Chinese market, should consider establishing a subsidiary in China.

Incorporation Forms of Subsidiaries

"Subsidiaries in China" as used herein means entities where at least one of the shareholders is a foreign entity or individual ("foreign investor") incorporated or with citizenship outside of China. A subsidiary is often called "Foreign Invested Enterprise" (FIE) in China. The percentage of equity shares held by foreign investors in an FIE must be no less than 25%[1].

If all of the shareholders of a company are Chinese registered companies or Chinese citizens, the company should be a domestic company, not an FIE. Although FIEs and domestic companies are both governed by the Company Law of China, FIEs are also governed by specific FIE-related laws that subject them to additional or different rules and regulations in many respects.

In some business areas restricted to foreign investors, such as telecommunication services and online content providers, even if an FIE is allowed it is restricted by such thresholds as maximum equity ownership by foreign investors (which means that the foreign investor must joint venture with a Chinese partner), additional requirements on the qualification of its investors, and/or a lengthy approval process for its establishment. Under these circumstances, it is not unusual for a foreign investor to have affiliated Chinese persons or entities establish a pure domestic company, instead of an FIE or simultaneously with an FIE in an allowed industry. This structure enables contractual arrangements to be set up between the foreign investor, its non-restricted FIE in China and the domestic company. Such arrangements with affiliated domestic companies can provide flexibility that may help foreign investors reach their business objectives more quickly and efficiently. See the

[1] *An enterprise whose foreign investor(s) holds less than 25% is hard to approve. Even if approved or allowed by some specific regulations, generally it is not qualified to enjoy the preferential treatment as granted to FIEs having more than 25% shares.*

article *Investment and Operation in Restricted Industries in China* at http://www.fenwick.com/publications/6.3.0.asp for additional information if your company operates within a restricted industry.

There are four possible incorporation forms that are allowed for FIEs:

1. Wholly foreign-owned enterprise (WFOE);
2. Sino-foreign equity joint venture (EJV);
3. Sino-foreign contractual joint ventures (CJV)[2]; and
4. Sino-foreign joint stock company limited.

The first three enterprises are called limited liabilities companies in China, although liabilities of shareholders in joint stock companies are also limited by their subscribed shares. Joint stock limited companies, in which foreign investors hold more than 25% of the shares, are not as commonly used by foreign investors as the first three.

The main reasons are that an FIE joint stock company limited must be approved by the Ministry of Commerce at the central government level. The approval time is significantly longer and a higher minimum investment amount is required. Further, the promoters' shares in a joint stock limited may not be transferred until three years after its establishment. Therefore, unless the Chinese subsidiary itself intends to go public on the Chinese stock market in the near future, most foreign investors will select a WFOE, CJV or EJV.

Foreign investors should consider their own business model and circumstances to decide between WFOE and a JV, unless the industry the FIE is in restricts it from being a WFOE. Currently, if they operate in an industry that permits WFOEs, more foreign investors are choosing WFOEs. If a foreign investor has to rely heavily on local support, such as land, factories, equipment, or access to local sales and market channels, the JV structure may also be considered if the foreign investor's Chinese partner can assist the JV with these items. Nonetheless, since many foreign investors are now more familiar with China's markets and business environment, a WFOE is acceptable for foreign investors if they can find local support on their own by hiring capable local people. Additionally, many Chinese governmental authorities are becoming more accustomed to direct communication with foreign companies. For these reasons, a WFOE is not necessarily disadvantageous for FIEs that rely heavily on local resources and channels. In addition, the parent company of a WFOE generally has more flexibility in controlling the management of an FIE, controlling its IP issues, making contractual arrangements with the WFOE and exiting from an FIE.

Instead of setting up a new FIE at the outset, the foreign investor could also set up a subsidiary by acquiring an existing FIE or a domestic company and the acquired enterprise would become a WFOE or JV.

Who Sets Up a Subsidiary and Where to Locate It

From the perspective of Chinese law, the foreign investor's country of origin does not impact the approval procedure or treatment of its FIE in China. No matter where the foreign investor is incorporated—in the Cayman Islands or in the U.S.—the FIE follows the same approval procedure, the same regulations and receives the same treatment. Foreign investors from special regions such as Hong Kong, Taiwan, and Macao are also treated as foreign investors for the purpose of FIEs. Of course, different countries will have different tax implications for foreign investors, based on whether there is a bilateral taxation agreement between China and the investor's country. Also, the investor should consider its future plan to exit the FIE, as well as tax planning from the perspective of other applicable jurisdictions, when deciding who is to set up the subsidiary and where it is to be located.

A qualified employee pool is one of the main factors for deciding where to locate a subsidiary. A location with universities and colleges nearby helps to provide qualified R&D staff for high-tech subsidiaries. It is not surprising that many high-tech companies are located in Beijing and Shanghai, the two biggest cities in China. Cities in many other developed regions such as Jiangsu, Zhejiang, Sichuan and Guangdong Provinces also provide large quantities of high-tech personnel. Investors of a manufacturing subsidiary would likewise want to establish plants and distribution facilities in areas where the available labor pool can support manufacturing work.

A good relationship ("Guanxi") with local Chinese government officials and enterprises is also crucial. Many investors will seek a location where they can have frequent and close contacts with local governments and local businesses. Or they may prefer to select a location

[2] *There are some differences between EJV and CJV, both of which require the foreign investor to partner with a local Chinese partner to organize the company together. EJV shareholders' obligations and rights should be assigned pursuant to their equity percentage, while shareholders to a CJV are allowed to organize the company in a more flexible way.*

where they can engage capable managerial personnel with established local relationships. A good Guanxi, which today emphasizes communications rather than deals under the table, generally helps the subsidiary start its business more quickly and smoothly.

Many cities and regions have established industrial and high-tech parks to attract investors to invest within the park by providing various benefits. Tax benefits, basically those on income tax and taxes on importation, depend on the nature of the park and its FIEs. Except for some local taxes and charges, major FIE taxes are generally regulated at the national level. Investors should make sure that the park they select is officially recognized by the state. As for which city to choose, FIEs need to consider many other important factors, such as employment pools, local support, Guanxi, transportation and infrastructure.

The Incorporation Process and Approximate Cost

FIEs must be approved by the Ministry of Commerce or its equivalent authorities at the provincial level or city level (collectively, "approval authorities"). The ability of a local authority to approve an FIE depends on the amount of total investment and nature of the industry in which the FIE desires to engage. Approval by the central approval authority generally takes much longer and many investors prefer to have the subsidiary approved by the local authority. Currently most FIEs may be approved at the city or provincial level. If all the required documents are completed and are submitted directly to the local approval authority, many FIEs not subject to specific legal restrictions can be approved and registered within one month.

Once approved, an FIE must register with the State Administration for Industry and Commerce or its counterparts at the provincial or city level (collectively, "registration authority"). The registration authority issues the FIE its business license, at which time the FIE is considered legally established and incorporated.

Chinese law divides industries into four categories for foreign investment: 1) encouraged; 2) allowed; 3) restricted; or, 4) prohibited. In the post-WTO age, China is less restrictive on the number of industries that may receive foreign investment.

The costs for establishing an FIE are mainly the registration fee, announcement fee and registered capital. The registration fee and announcement fee are collected by the registration authority based on the amount of registered capital. These two fees generally will be around US$1,000 to US$3,000. For FIEs with greater investment, the fees can be higher, but are still generally less than US$8,000.

The biggest cost factor for foreign investors generally is "registered capital" (which also determines the amount of the government-collected registered fee and announcement fee). Chinese law requires shareholders to put real money (cash or in kind) into the enterprise. All shareholders of an FIE must subscribe the registered capital to the invested company according to their respective ownership percentage, which must be paid fully by them within a specified time period after the FIE is set up, as described in the incorporation documents. The first contribution to registered capital must be no less than 15% of the registered capital and must be made within 90 days after the issuance of the business license.

Local governments have different policies on the minimum registered capital of FIEs. For example, in Shanghai, US $200,000 for manufacturing FIEs and US$ 140,000 for services FIEs are generally required; in Beijing, the foreign exchange equivalent to RMB 500,000 (a bit more than US $60,000) may be acceptable. Nevertheless, since the registered capital is paid within the time schedule described in the incorporation documents, it still provides some flexibility for investors to contribute capital at their own pace. Investors of WFOEs are required to pay all their registered capital to WFOEs within three years after they are established.

Hiring Local Service Providers

There are some authorized agencies that specifically help foreign investors set up FIEs. They can prepare the incorporation documents and communicate with the approval and registration authorities. With their help, the incorporation process can be accelerated. However, since many local governments are very willing to attract foreign investment, the approval of a typical FIE is quite routine. Many investors find that they can handle the approval process without agency assistance.

Lawyers may also help their client to secure approval and registration from governmental authorities. Sometimes lawyers work with authorized agents, which can be more cost efficient for the client: the agent facilitates routine work with the authorities, while the lawyer ensures all the legal documents and approval procedures are properly done.

For financial reasons, many start-ups prefer to deal with all aspects of the FIE establishment without legal assistance. However, hiring a lawyer or a service agent is not necessarily costly and obtaining a Chinese lawyer's advice on the

most advantageous legal structure can facilitate future negotiations and funding—especially if the investors intend to make special contractual arrangements for the FIE or have specific requirements on the FIE.

Controlling a Subsidiary

Unlike general domestic limited liability companies, whose highest power authority is the shareholders' meeting, an FIE's highest power authority is the board of directors, which decides all material matters of the JV. This has always been true until 2006 when several local approval or registration authorities started requiring FIEs, including WFOEs who may only have one shareholder, to set up a shareholders meeting according to the Company Law. The directors are appointed by the shareholders. Depending on the situation, how to regulate and balance power between the board of directors and management can be flexibly arranged in the incorporation documents. WFOEs have more flexibility in setting up and regulating the allocation of power and the management team.

In addition to control by the board of directors, some arrangements between the parent and its subsidiary can also be established to control the subsidiary. It is not unusual for the parent company to own the critical IP and license it to the subsidiary. Another common arrangement is that products of the subsidiary may only be marketed, distributed and sold through the parent company. In other cases, the investor controls the operation of the subsidiary, to some extent, under covenants in a loan agreement.

Operational Implications

Each enterprise in China, including a domestic company or FIE, must conduct its business within the business scope specified on its business license. Generally, domestic enterprises are approved for a much broader business scope than FIEs. Domestic enterprises may be granted carte blanche "to conduct any business as allowed by law, except those required to be specially permitted by law must be conducted only upon obtaining the special permit." Currently, this kind of catch-all business scope may not be granted to FIEs, which are required to be set up for a specific business. Since each industry is categorized as encouraged, allowed, restricted or prohibited for foreign investment, each FIE is expected to do some specific business. For example, an FIE approved to manufacture semiconductor products generally would not be granted a business scope to produce chemical products; a non-retail or wholesale FIE should not sell a third party's products (since a retail or wholesale FIE is subject to specific legal requirements), although the FIE could sell products it "manufactures" itself. Under some circumstances, it may be unclear at what point the FIE is operating beyond its approved business scope. The registration authority has the flexibility to determine whether the business conducted by the FIE is beyond the approved business scope, which sometimes makes implementation ambiguous.

In addition, some business activities, even within the business scope, still may only be conducted upon the grant of a special permit. For example, a basic telecommunication business or value-added telecommunication business can only be conducted under a permit issued by Ministry of Information Technology (MII) or its local offices.

During its daily operation, an FIE can transact business with other domestic or foreign entities, including signing commercial contracts, licensing, borrowing loans from banks and engaging a distributor, as long as these transactions are in compliance with Chinese law. An FIE, as a limited liability company, is an independent legal person and independently assumes the liabilities to any third party with which it made a deal. An FIE's liability to a third party is limited to its assets. Shareholders' liabilities are limited by their contribution to the FIE. Shareholders are not liable to third parties with which an FIE transacts, except that they must pay fully the registered capital subscribed to the FIE.

Intellectual Property

Intellectual property can be protected administratively and judicially in China. The relevant administrative governmental authority could impose an administrative penalty for infringement within its authority, while the holder of intellectual property rights can also claim its rights before the court in China. China is a member of the major IP international conventions, including Berne Convention (for copyright protection), Universal Copyright Convention, Paris Convention (for patent protection), Patent Cooperation Treaty, and Madrid Protocol (for trademark protection). Trade secrets are protected mainly by unfair competition law and contract law. Confidentiality agreements and non-competition agreements can also be valid and enforceable in China. IP rights can even be the equity investment in an FIE, but the percentage of IP rights should not be more than 20% of the registered capital (for advanced technology, this percentage can be up to 30%).

With respect to the judicial enforcement of infringement of intellectual property rights, courts may issue injunctive orders, require infringers to pay monetary damages and make public apologies. Although monetary damages may

include reasonable expenses, actual damages and sometimes constructive damages, generally speaking, the monetary damages confirmed by courts are not big enough to frighten off infringers. Nonetheless, the trend now is toward bigger damage awards. Further, for their serious infringement of intellectual property rights, infringers may be jailed subject to the criminal laws which now are enforced more strictly.

Foreign Exchange

China does not allow foreign currency to be freely circulated within its borders. Except for the allowed maximum amount for foreign exchange reserved in its bank account, an FIE's revenue in foreign exchange must be converted into RMB (Renminbi, Chinese lawful currency). On the other hand, lawful payments made outside of China are allowed to be converted into foreign currency. Banks authorized to conduct relevant foreign exchange business will examine the required documents for each remittance. Shareholders' dividends, license fees, and purchase prices for imported equipment and materials may be remitted out of China if the completed documents and verifications are submitted to the bank, and the proper withholding taxes have been deducted. Under some circumstances, an approval from State Administration for Foreign Exchange (SAFE) or its local offices may be required.

Employment and Stock Options

An FIEs' employment matters are subject to Chinese Labor Law and related regulations. Social insurance benefits such as medical insurance, pension, unemployment insurance, and housing funds are legally required. Employers can require non-disclosure agreements, non-competition agreements and intellectual property ownership agreements, as long as the provisions in such agreements are in compliance with the relevant laws and regulations.

The granting of stock options is also more acceptable for Chinese employees nowadays. However, there is no fixed method for employees to exercise their stock options. In practice, some Chinese employees will exercise the option by funds (or funds of their family members or relatives) deposited outside of China. Since most Chinese employees do not have bank accounts outside China, they may arrange a cashless exercise with the employer. See the article *Overview of Stock Option Grants in China* at http://www.fenwick.com/publications/6.3.0.asp for additional information.

Exits and Liquidity

Foreign investors can exit subsidiaries by selling their shares in the FIE or transferring their shares in the parent company. A transfer of shares in an FIE must be approved by the original approval authority, although this kind of approval generally is routine. If the share transfer is made from foreign investors to a Chinese investor, who then converts the FIE into a domestic company, the later-formed domestic company should satisfy the requirements for establishing a domestic company under Company Law, rather than under FIE law.

In some cases, when an acquirer chooses to purchase the assets and business of an FIE, the seller may be requested to enter into liquidation and dissolution. After the liquidated FIE pays off its salaries, taxes and debts owed to third parties, in that order, the remaining assets may be distributed to the shareholders according to their equity percentage. This kind of acquisition will help the acquirer avoid assuming the seller's liabilities to third parties.

Investors may also elect to have the parent company, or its subsidiary, registered in a foreign country and taken public, so their shares can be sold on the open market.

Conclusion

Companies accustomed to business in the United States will find the Chinese legal system and its operational environment are quite different. Investors and entrepreneurs who seek to establish a subsidiary in China should consider their market needs and the long-term strategy of the subsidiary. Subject to the approval of the original approval authority, investors may wind up an FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assests distributed to them outside China.

A well-designed subsidiary in China, together with other carefully designed arrangements, can prevent unnecessary economic costs and eliminate surprises when the subsidiary seeks future funding. Armed with a thorough understanding of the business constraints—as well as the opportunities—in China, investors can make business decisions that will help them successfully establish, operate, and exit from their subsidiaries.

Jie Chen is a visiting lawyer in the Corporate Group of Fenwick & West. Ms. Chen is a partner at Jun He Law Offices in Beijing, China, where she has represented multinational companies, high-tech companies, investment banks and Chinese state-owned enterprises. She may be reached at 650.335.7147 or jchen@fenwick.com.