

JV Compliance Issues during the Transition Period under the new FIL

By Yuhua Yang

On 1 January 2020, the *Foreign Investment Law of the People's Republic of China* ("FIL") came into force, at the same time, the four-decades old *Sino-foreign Equity Joint Venture Law of the People's Republic of China* ("EJV Law") and the three-decades-plus old *Sino-foreign Co-operative Joint Venture Law of the People's Republic of China* ("CJV Law") and their relevant regulations were simultaneously repealed. With respect to the existing c. 125,000 joint ventures already established in accordance with the previous EJV Law or CJV Law and their regulations, the new FIL and its Implementation Regulations provided a 5-year transition period ("Transition Period") for them to make the necessary adjustments and conversion to ensure compliance by the end of 2024.

During the Transition Period, EJV and CJV, as long established types of entity in China, will quickly fade out of people's sight. For those existing EJVs and CJVs which have already adopted limited liability company ("LTD") form, the *Company Law of the People's Republic of China* ("Company Law") shall universally govern them in the same way as it does domestic Chinese companies; for non-legal person CJV entities, it is necessary to conduct a legal form conversion, i.e.

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reincorporation as an LTD or restructuring into a limited partnership or general partnership both of which are governed by the *Partnership Enterprise Law of the People's Republic of China* ("**Partnership Law**").

In order to help the existing JVs and their investors better understand the impact of the new FIL and its relevant regulations, we hereby set out the main compliance issues to be attended to in the Transition Period, mainly in respect of the corporate governance, foreign exchange and foreign investment reporting obligations etc.

Note: Given that EJVs account for the majority of the existing JVs, we focus on the EJV situation in this article.

1. Corporate Governance

In order to quickly identify the to-be-complied issues, we have conducted an examination of all the corporate governance aspects under the old EJV Law regime and the new FIL regime. Accordingly we have prepared the below detailed table which sets out the main issues.

Issue	Old EJV Law	New FIL
Legal basis for the establishment and operation of the EJVs	EJV Law, its relevant implementation regulations, rules, orders, measures, notices and circulars etc.	FIL and its relevant implementation regulations, rules, measures, notices and circulars etc. which are currently under rapid development to substantiate in practical terms the new FIL regime. Upon the repeal of the EJV Law, the Company Law shall govern all the corporate issues of EJVs.
Articles of Associations	The articles of association of an EJV shall state the following: (1) name and legal address; (2) purpose , business scope and term ; (3) name, country of incorporation, legal address, legal representative (name, title and nationality) of the joint venture partners; (4) total investment and registered capital of the JV; each party's contribution amount, percentage, cash or in-kind, paid-in schedule, as well as the equity transfer, profit distribution and loss sharing ; (5) composition, powers, rules of procedure of the Board of Directors;	The articles of association of a company shall state the following: (1) name and address; (2) business scope; (3) registered capital; (4) names of the shareholders; (5) method, amount and timing of capital contribution; (6) organizational authorities, composition, duties and powers, and rules of procedure; (7) legal representative of the company; and (8) other matters resolved by the shareholders' meeting to be stipulated in the articles.

	term of directors; duties and powers of the Chairman and deputy Chairman of the Board; (6) management structure and rules; duties and powers as well as appointment/removal of the general manager, deputy general manager and other senior manager personnel; (7) principles of financial affairs, accounting and audit; (8) dissolution and liquidation; and (9) procedures of amending the articles of association.	
Highest authority	The Board of Directors is the highest authority and decides on all major matters of the JV. (without the shareholders' meeting)	The shareholders' meeting is the highest authority of the company.
Power of the highest authority	All major matters of the JV, such as - the amendment of the articles of association, - increase or reduction of the registered capital, - a merger/acquisition/division, - a dissolution and so on are decided by the Board of Directors.	The Company Law includes more detailed provisions on the power and authority of shareholders' meeting: (1) determining the company's business strategies and investment plans; (2) appointing and changing directors and supervisors of the company and deciding on their remuneration; (3) approving the reports of the Board of directors (or the executive director); (4) approving the reports of the Board of supervisors (or the supervisor); (5) approving the annual financial budgets and final accounts; (6) approving the profit distribution and loss recovery; (7) resolving on the increase or reduction of the registered capital and/or the total investment (if applicable); (8) resolving on the issuance of any corporate bonds; (9) resolving on any merger, division, dissolution, liquidation of the company or any change of organizational form; and

		(10) amending the articles of association of the company.
Voting rights on major matters	The following major corporate matters are subject to the unanimous consent of all the directors attending the Board meeting : (1) amendment of the articles of association; (2) increase or reduction of the registered capital; (3) merger/acquisition/division; and (4) termination/dissolution.	The following major corporate matters require approval of shareholders representing 2/3 or more of the voting rights : (1) amendment of the articles of association; (2) increase or reduction of the registered capital; (3) merger/division/dissolution; and (4) any change to the organizational form.
Directors	Directors are appointed /removed by the respective JV parties .	Directors are elected and removed by the shareholders' meeting .
Board seat allocation	No less than three seats are allocated roughly proportionately as agreed by the JV parties.	The number of Board seats (3 - 13) to be agreed between/among shareholders; Directors to be elected by the shareholders meeting.
Chairman and Deputy Chairman of the Board	Where the Chairman is appointed by one party, the Deputy Chairman shall be appointed by the other party.	The appointment of Chairman and Deputy Chairman shall be stipulated by the articles of association of the company.
Term of the Directors	Four (4) years.	The term is stipulated by the articles of association but shall not exceed three (3) years.
Convening the Board meeting	The Board meeting shall be held at least once a year, which is convened and presided over by the Chairman. When the Chairman is unable to do so, he/she shall entrust the Deputy Chairman or other director to convene and preside over the Board meeting. Proposed by 1/3 directors or more, the Chairman may convene an interim meeting.	Though the Company Law has no specific requirement on the frequency of the Board meeting, once a year remains the minimum to discharge Board's duties. The Board meeting shall be convened and presided over by the Chairman. When the Chairman is unable to do so, the Deputy Chairman shall step in. When the Deputy Chairman is also unable to discharge such duty, a director elected by half or more of the directors shall convene and preside over the meeting. No specific requirement about who can call an interim Board meeting.
Quorum of the	At least 2/3 of the directors.	This may be determined by the

Board meeting		shareholders themselves (as stipulated in the articles of association).
Legal representative	Chairman of the Board	Chairman of the Board (or the sole Executive Director as the case maybe) or General Manager (head of the management), as stipulated in the articles of association
Management	The general manager and deputy general manager shall be respectively held by the JV parties ¹ . In the last three to four decades, it has been common practice for a lot of JVs that Chinese and foreign JV parties send their own personnel to fill the senior management positions of the JV.	The Company Law has adopted a modern corporate governance structure, under which the management is appointed by the Board and is responsible to the Board.
Supervisor(s)	NO requirement for establishing a Board of Supervisors or a sole Supervisor, though in recent years, in order to align with the Company Law, there have been measures to encourage then require JVs to appoint a Supervisor or to set up a Board of Supervisors.	Mandatory requirement under the Company Law that a Board of Supervisors, consisting of at least three (3) supervisors OR 1-2 supervisors have to be in place.
Post-tax profit reserve	A JV shall, upon payment of income tax on its profits pursuant to the relevant tax law, make apportionment to its reserve fund, employees' bonus and welfare fund, and enterprise development funds (a.k.a. "FIE three funds"). The percentage of apportionment shall be determined by the Board of Directors. As a matter of fact, in practice, the "FIE three funds" rule has already been widely relaxed in recent years and a lot of JVs have stopped providing after-tax funds into the FIE three funds.	Under the new FIL, the relevant provisions of the Company Law shall govern the reserve fund issue. A company shall contribute 10% of the post-tax profits into its statutory reserve which may be capped at 50% of its registered capital. Apart from the statutory reserve, any other reserve, provident fund(s) as well as retained earnings are subject to company's own discretion. The relevant outdated and obsolete provisions in relation to the "FIE three funds" contained in the articles of association shall be amended.

¹ From the appointment procedure point of view, the general manager and deputy general manager shall be appointed by the Board according to the EJV Law implementation regulations.

Liquidation	Generally the members of the liquidation committee shall be elected from the directors of the JV. When a director is unable or unfit to be a liquidation committee member, the JV may engage Chinese certified public accountant(s) and lawyer(s) instead.	The liquidation committee of a limited liability company shall be formed by the shareholders according to the law. The relevant provisions in the articles of association shall be amended to give the shareholder(s) the right to constitute the liquidation committee. If a JV considers liquidation during the Transition Period, the liquidation shall comply with the Company Law.
Profit distribution	Strictly proportionate according to the ratio of the registered capital	It may be determined by the shareholders (as stipulated in the articles of association), i.e. disproportionate distribution is feasible.
Equity transfer	Any equity/share transfer, the other shareholder (JV partner)'s consent is required.	The Company Law has provided a more flexible equity transfer mechanism: (1) If the transfer is internal, i.e. between the shareholders, no other shareholder's consent is required (3+ shareholders scenario); (2) If the share is to be transferred to any third party, consent of more than half of the other shareholders is required. The transferor shareholder shall notify the other shareholders of the contemplated transfer in writing and seek their consent. Failure to reply within 30 days from receipt of the written notice shall be deemed as consent to the contemplated transfer. Where more than half of the other shareholders do not consent, the dissenting shareholders shall acquire those shares to be transferred, failing which they shall be deemed to have consented.

2. Joint Venture Contract and Articles of Association

For all existing JVs, the Joint Venture Contract ("**JVC**") and Articles of Association ("**AoA**") are the two most important legal documents. The JVC is actually a shareholders' agreement and AoA is a corporate constitution for a JV. On the one hand, it is inevitable that the AoA is amended to achieve the adjustment

and updating of the corporate governance of a JV to ensure compliance within the Transition Period; on the other hand, a critical question would be how to ensure the existing JVC remains legally binding and enforceable governing the Chinese and foreign parties' relationship; the key issues concerned mainly include equity transfer procedures, profit distribution and loss sharing, liquidation distribution etc.

The *Implementation Regulations for the FIL* explicitly provide that during the Transition Period, existing JVs can choose to make the adjustment to their organizational form and structure and file with the relevant company registry; or they can choose to keep everything the same. **After** making the necessary adjustments to the organizational form and structure² of the JV, the existing provisions in respect of equity transfer, profit distribution and liquidation distribution etc., agreed by the Chinese and foreign parties in the JVC may continue to be binding and enforceable.

Such arrangements during the Transition Period aim to reconcile the conflict between existing provisions in the JVC and the Company Law. The State Administration of Market Regulation ("**SAMR**", company registry authority in China) also illustrated its approach in its notice to local offices about *Registration of Foreign Invested Companies Following the Implementation of Foreign Investment Law* ("**Notice**"): Article 12 of the Notice allows existing decision-making mechanisms to be used before or when a JV applies to make an FIL conversion; and Article 13 specifically addresses that existing JVC provisions about equity transfer can still be used, which aligns with the *Implementation Regulation for the FIL*. With such rules in place, the key interests and intentions of investors can be maintained to the maximum extent during the Transition Period, and sufficient time has been reserved for a gradual conversion.

3. Foreign Debt Management

Under China's foreign exchange regulatory regime, the foreign debt management system involving the total investment ("投资总额") and the stipulated gap between the registered capital and the total investment ("投注差") have been in place for many years. A JV is allowed, not obliged, to take out loans and incur foreign debt within such a gap. In 2017, the *Notice of the People's Bank of China on Full-coverage Macro-prudent Management of Cross-border Financing* specified a new alternative foreign debt management system.

Technically speaking, the total investment and the gap between the registered capital and the total investment are no longer mentioned in either the new FIL or the Company Law. However, the competent authorities have not yet promulgated new regulations formally repealing the old foreign debt management system, i.e. the old and new foreign debt management systems co-exist for the time being. Practically

² The "organizational form" refers to the legal form of an entity, i.e. an LTD or a partnership. As all the EJVs have adopted mandatorily required LTD form since being established, there is no need to adjust "organizational form" any more. It is only necessary for those non-legal person CJVs, i.e. reincorporation as an LTD or restructuring into a limited partnership or general partnership both of which are governed by the Partnership Law.

The "organizational structure" ultimately refers to the corporate governance structure. Necessary adjustments have to be made to ensure complying with the new FIL as set out in the table in section 1 of this article.

speaking, the total investment provisions in the articles of association may not need any immediate change where a JV prefers at present not to switch to the new system.

There has recently been some kind of transitional regulatory practice. For example, pursuant to a notice issued by SAFE³ Beijing Bureau in March 2020, non-financial enterprises/companies in Beijing may choose to change their current foreign debt regime where the gap between the registered capital and the total investment is essential, to the more flexible Macro-prudent Management of Cross-border Financing System⁴ which may offer an easier approval/registration process and a higher amount of foreign debt to be raised. It is advisable to pay continuous close attention to the subsequent updates of regulations in this regard.

4. Foreign Investment Report

Since 2016, while the “restricted” foreign investment within the scope of the relevant negative lists continues to be subject to approval of the relevant authorities, “encouraged” and “permitted” foreign investment has been subject to filing requirements.

Effective from 1 January 2020, the *Measures on Reporting of Foreign Investment Information* (“**Reporting Measures**”) established a new foreign investment information reporting system, under which the JVs shall submit investment information reports (incl. initial report, change report, deregistration report, annual report, etc.) through the online Enterprise Registration System and the Enterprise Credit Information Publicity System.

Pursuant to the Reporting Measures, where there is a registerable change such as the name, address, legal representative, shareholder(s), scope of business, registered capital etc., a JV shall report the same via the Enterprise Registration System at the same time of processing the relevant change(s) registration. Where the change does not involve a registerable item but is subject to the relevant filing requirement, a JV shall report the same via the Enterprise Registration System within twenty (20) working days from the occurrence of the changed matter (e.g. the date of the related resolutions).

The annual report for the preceding year should be submitted before **30 June** annually through the National Enterprise Credit Information Publicity System, which may include the JV’s basic corporate information, the investors/JV partners and their actual controllers, business conditions, assets and liabilities, etc. Please note that in accordance with the Company Law, a company shall have its annual financial statements audited; however for the time being the reporting obligation might not explicitly require the audited financial statements to be uploaded via the reporting system.

5. Timing Considerations

It is worth noting that

³ State Administration for Foreign Exchange

⁴ <http://www.safe.gov.cn/beijing/2020/0310/1194.html>

- (1) the FIL is new and Chinese authorities are still in the process of ramping up the necessary implementing rules and measures, practice needs to be time tested;
- (2) although the 5-year Transition Period seems to be plenty of time, a timely compliance conversion has been encouraged by the Chinese authorities;
- (3) 31 December 2024 is a hard deadline; from 1 January 2025 if a JV has not fully complied with the new FIL, the registration window will be closed, thus jeopardizing the foreign investor's investment in that JV and a public notice listing the incompliant companies will be issued.

Undoubtedly with due care penalties for the delay should be avoided.

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