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The Foreign Invested Partnership—A New Vehicle for Foreign Invested Enterprises in China

On November 25, 2009, the State Council of the People's Republic of China (the "PRC") promulgated the *Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals* (the "FIP Measures") which will take effect on March 1, 2010. Beginning on that date many foreign investors will be eligible to use the foreign invested partnership ("FIP") structure for their investments in China.

Legislation Background

In 1997, the Standing Committee of the National People's Congress promulgated the first *Partnership Enterprise Law of the PRC* (the "Partnership Law") and the *Administrative Measures on the Registration of Partnership Enterprises* (the "Registration Measures"). The Partnership Law and the Registration Measures were revised in 2006 and 2007, respectively. Both the Partnership Law and the Registration Measures cover only domestic partnership enterprises. However, Article 108 of the Partnership Law states that "the administrative measures on the establishment of partnership enterprises in China by foreign enterprises or individuals shall be formulated by the State Council." So, the FIP Measures are a supplement to the Partnership Law and fulfill the commitment made in Article 108 to make partnerships available to foreign investors as vehicles for investment in China. The FIP Measures build on the existing Partnership Law, so it should not be surprising that many of the principle rules contained in the Partnership Law also apply to FIPs.

Partnerships in China

General Partnership and Limited Partnership. According to the Partnership Law, there are two types of partnerships in China—general partnerships and limited partnerships. A general partnership is formed by one or more general partners, and each partner is jointly and severally liable without limit for the debts and other obligations of the partnership. A limited partnership is formed by one or more general partners, and one or more limited partners, and each general partner is jointly and severally liable without limit for the debts and other obligations of the partnership while each limited partner is liable for the debts and other obligations of the partnership up to the amount of its/their subscribed capital contribution. The total number of partners in a limited partnership may not be less than two nor more than fifty, and at least one of them must be a general partner.

Partnership Agreement. A written partnership agreement concluded unanimously by all partners needs to be filed with the relevant Industry and Commerce Administration Bureau in order to obtain a business license for the partnership. Partners must not engage in partnership business in the name of the partnership before the date of issuance of the partnership business license. The partnership agreement is the most important document governing the partnership. The following matters must be covered by the partnership agreement: the name and principal business premises of the partnership, actual business scope of the partnership, name and address of each partner, the method, amount, and period of capital contribution of each partner, profit and loss distribution method, the management of partnership affairs, admission and withdrawal, dispute resolution method, dissolution and liquidation of the partnership, and liabilities for default under the partnership agreement. In addition to the above mentioned matters that must be covered by both general partnership agreements and limited partnership agreements, a limited partnership agreement must also set forth the following: the names and addresses of general partners and limited partners; the qualifications and selection procedures for managing partners; the scope of authority for managing partners and the procedures for handling defaults; the criteria for the removal of managing

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partners and the replacement procedures; the criteria for admission and withdrawal of limited partners; the relevant liabilities of general and limited partners; and the procedures for conversion of limited partners to general partners and vice versa.

Distribution of Profits and Losses. Distribution of profits and losses of a partnership must be made pursuant to provisions in the partnership agreement. Where the partnership agreement does not provide for the distribution of profits and losses of a partnership clearly, the partners must decide on the distribution of profits and losses by negotiation. Where negotiation is unsuccessful, the profits and losses must be distributed according to the ratio of actual capital contribution. Where the ratio of capital contribution cannot be determined, the profits and losses must be divided among the partners equally. However, a general partnership agreement may not provide that all profits are to be distributed to only some partners or that all losses are to be born by only some partners (but there is no guidance as to whether this prohibition applies to less than all profits or losses).

How to Establish an FIP

According to the FIP Measures, an FIP can be established in China among any of the following three groups of entities or individuals:

- Two or more foreign corporations or individuals setting up an FIP among themselves;
- One or more foreign corporations or individuals setting up the FIP with one or more Chinese corporations or individuals; or
- One or more foreign corporations or individuals being admitted as a new partner in an exiting partnership.

Registration. At present, there are primarily three forms of foreign invested enterprises in China—a China-Foreign Equity Joint Ventures, a Chinese-Foreign Contractual Joint Ventures, and a Wholly-Foreign-Owned Enterprises. Collectively, they are referred to as a Foreign Invested Enterprises ("FIE"). To establish, amend, or dissolve an FIE, approval by the Ministry of Commerce ("MOFCOM") or its local counterpart is required. However, the FIP Measures simplify this administrative procedure by allowing FIPs to register directly with the appropriate local bureaus of the State Administration on Industry and Commerce ("SAIC") without prior approval by the local counterpart of MOFCOM. The mechanics of the registration process, although somewhat simplified compared to the process for registering other FIEs, is beyond the scope of this article.

Documents Required. According to the FIP Measures, an FIP must comply with the same foreign investment industry guidance applicable to other FIEs (which is issued by MOFCOM from time to time and lists foreign investment industries in catalogues according to encouraged, restricted, and prohibited categories), and submit to the appropriate local bureau of SAIC in writing confirmation of compliance with the guidance as well as other documents required by the Partnership Law for registration of the FIP. A detailed discussion of such documentation is also beyond the scope of this article.

How the FIP Measures May Be Useful to Foreign Investors

Simplified Registration Procedure. As described above, an FIP needs to file with only the SAIC or its local counterpart for its establishment (as well as amendment or termination) without prior approval by MOFCOM or its local counterparts as long as its business scope falls into the permitted or encouraged categories in the foreign investment industry guidance. This will save foreign investors the time of also filing with MOFCOM or its local counterpart.

Flexibility in Capital Contribution. In both the Partnership Law and the FIP Measures, there is no requirement as to the minimum amount of the capital contribution to form a partnership. And, although the FIP Measures do not mention the permitted forms of capital contribution, we can still assume that the forms of capital contribution for domestic partnerships shall apply to FIPs since the FIP Measures are contained in the regulatory framework set forth by the Partnership Law. That means cash, tangible properties, land-use rights, intellectual property rights, other property rights, or even services to be provided by one or more of the general partners are valid forms of capital contribution to an FIP.

Tax Consideration. Partnerships are not subject to the business income tax (to which companies are). Only the corporate partners or the individual partners of the partnership are liable for corporate income tax or individual income tax obligations, respectively. Moreover, if tax circular *Caishui [2000] No.91* which was issued jointly by the Ministry of Finance and the State Administration of Taxation in 2008, applies to FIPs, the taxable loss allocated to a foreign partner can be carried forward to set off against the allocated taxable income from that partnership in the immediately following five years.

Many Important Issues Remain Open

Article 14 of the FIP Measures provides that certain issues relating to partnerships in the investment business have intentionally been left open, subject to adoption of further detailed regulations. However, there are many more important issues that

remain open subject to further guidance in the form of additional implementation rules or other interpretations applicable to all partnerships. To name a few:

- Whether and how many of the general rules applicable to other FIEs will also be applicable to FIPs, such as provisions relating to minimum capital contribution, maximum percentage of non-cash capital contributions and other capital-related matters;
- Confirmation that the regulations on tax treatments for domestic partnership will be equally applicable to FIPs;
- How to calculate the income tax of a foreign corporate partner of an FIP who may also have other investments in China and whether there is another layer of tax upon repatriation of the allocated taxable income from the FIP after tax at the foreign partner's level; and
- Whether an FIP is responsible for withholding the payable income tax from income obtained from the FIP's business by its foreign corporate partner.

Conclusion

Although the FIP Measures do offer a new option for foreign investors that want to do business in China, it is too early to tell whether an FIP is a good choice in general or for any particular prospective investor. As is the case with any new law in China (or elsewhere for that matter), the devil will be in the details—in this case in the detailed implementation regulations that will be forthcoming (probably both before and after the March 1, 2010, effective date) to clarify unsolved issues. We will monitor future developments, and update *China Insights* readership from time to time.

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China's Anti-Monopoly Law—A Look Back

After 14 years of discussion and drafting, China's landmark Anti-Monopoly Law (the "AML") came into force on August 1, 2008 with a stated purpose of preventing and restraining monopolistic conduct, protecting fair competition, enhancing economic efficiency and safeguarding the interests of consumers and public interests. Now, after 18 months under the AML's regulatory regime, we thought it appropriate to review the implementation of the law and its impact on commerce in China.

The AML concentrates primarily on the control of the following activities: (1) monopolistic agreements; (2) abuse of market dominance; (3) uncompetitive business combinations; and (4) abuse of administrative power to eliminate or restrict competition. The AML is basically in line with international antitrust practices; however, as Joerg Wuttke, the president of the European Chamber in China, stated at the time of the AML's implementation, "[t]he impact of the new law can only be fully assessed once the implementing guidelines are issued and will depend largely on how the implementing authorities will perform their roles."

The AML Only Sets Up Principles

As is the case with many laws in China, the AML itself only establishes principles. Approximately 40 planned implementation rules were supposed to be in place before the effective date of the AML, but, to date, only a handful of regulations have been published and only a few actually adopted. One of those is the Regulation Regarding the Threshold of Declaration for the Concentration of Operators (the "Threshold Regulation"), which was issued on August 4, 2008.

Article 3 of the Threshold Regulation stipulates that, except in certain specialized industries such as banking and insurance, when a business combination reaches one of the following thresholds, a notice must be filed in advance with the relevant commercial authority under the State Council: (1) The total global turnover for the last fiscal year of all the operators that take part in the combination exceeds RMB10 billion, *and* at least two businesses involved each have revenue in China during the prior fiscal year in excess of RMB 400 million; or (2) The total turnover in China for the last fiscal year of all the operators that take part in the combination exceeds RMB 2 billion, *and* there are at least two operators, each of whose turnover in China for the last fiscal year exceeds RMB 400 million. The Threshold Regulation was received with a certain amount of relief by observers who had speculated that the thresholds might be very low and present an obstacle to many M&A transactions in China.

One of the biggest questions for foreign investors is whether there will be differences in the application and enforcement of the law between foreign companies and local companies, particularly state-owned enterprises. The AML seems to generally provide a fair platform for both foreign and local companies, but with a state security exception. Article 31 of the AML provides that if state security is implicated in an acquisition of a domestic enterprise by a foreign buyer, an examination of the possible national security impact of the transaction shall be conducted. The provision resembles similar state security exemptions in other countries; however, observers are still worried about the risks in the implementation of this tenet of the AML.

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AML Enforcement Authorities

The AML does not specify which government bodies are responsible for its enforcement, but it does call for the formation of the Anti-Monopoly Commission, which was established by the State Council and is in charge of organizing, coordinating and guiding China's anti-monopoly efforts. However, the commission was not given enforcement powers, and its functions are mainly drafting policies, issuing guidelines and coordinating administrative law enforcement.

The actual enforcement of the AML is carried out by three authorities: (1) the Ministry of Commerce ("MOFCOM"); (2) the State Administration of Industry and Commerce (the "SAIC"); and (3) the National Development and Reform Commission (the "NDRC"). MOFCOM, the ministry primarily responsible for overseeing international trade and investment issues, is the sole authority overseeing merger control. The SAIC, which issues business licenses and administers various commercial laws, enforces AML prohibitions against monopoly agreements and abuses of market dominance. The NDRC, which investigates price fixing among other things, prosecutes price-related violations of the AML. These central authorities can also authorize local authorities to enforce the AML.

It remains to be seen whether the division of the enforcement authority among multiple government agencies will prove to be a workable model. Many commentators and anti-trust experts remain concerned about inefficiency and inconsistency in interpretation and enforcement of the law.

"It remains to be seen whether the division of the enforcement authority among multiple government agencies will prove to be a workable model."

Implementing Regulations

To date, the various regulating bodies have circulated ten draft regulations for the AML. Five of those regulations, including the Threshold Regulation, have come into effect.

In January 2009, the Anti-Monopoly Bureau of MOFCOM circulated five draft implementation regulations for the AML for comment, among which the Measures Regarding the Declaration for the Concentration of Operators (the "Declaration Measures") and Measures Regarding the Investigation for the Concentration of Operators (the "Investigation Measures") went into effect January 1, 2010. Those measures clarify several questions regarding the enforcement of the AML such as how to calculate "turnover" (or sales revenue) of the parties in interest, which is now defined by the Declaration Measures. Moreover, the Declaration Measures stipulates that in the case of an acquisition of a portion of a business, the thresholds in the AML will measure the turnover of the targeted portion of the business, not the entire business. Significantly, these measures also make clear that even transactions that do not meet the notification thresholds under the AML are still subject to the AML and MOFCOM may investigate any such transactions that threaten to eliminate or restrain competition.

In April 2009, the SAIC issued two draft implementation rules for comment: Regulations for Prohibiting Monopoly Agreements and Regulations for Prohibiting Abuses of Dominant Market Positions. The former focuses on the types of agreements that can be found to "monopolistic" and the latter provides additional information on the definition of a "dominant market position" and the factors the government will look at to determine the existence of a dominant market position. However, these draft regulations have not yet become effective.

In May 2009, the SAIC issued two regulations that went into effect on July 1, 2009. The regulations confirm that the SAIC will investigate monopolistic agreements and abuse of market dominance, detail investigation procedures, limit the ability of SAIC to abuse its administrative power to restrict competition, and confirms that SAIC will not be responsible for price related issues. One of the regulations, the Procedure Rules for the Administration of Industry and Commerce Department on Investigating Cases of Monopoly Agreement and Abuse of Dominant Status in Market, empowers any individual or entity to inform the government of monopolistic behavior.

Despite the adoption of certain implementing regulations, there are still many questions pertaining to China's AML regime that need to be resolved in practice. It is apparent that the AML will continue to evolve and be explained through additional detailed implementation rules, as well as through the application of those rules in various cases.

The First Major Test of the AML: Coca Cola - Huiyuan

Coca-Cola triggered one of the first major tests of the AML by offering USD2.4 billion to buy the Chinese juice producer Huiyuan, which has about 42 percent of the fruit juice market in China. After its initial review of the proposed transaction, MOFCOM decided to attach restrictions to the acquisition. When Coca-Cola and the Chinese government were unable to agree on the scope of the restrictions,

MOFCOM prohibited the deal from going through.

The Coca-Cola—Huiyuan case presented many challenges for the new AML and the Chinese government. Since the AML only set up principles for anti-monopoly decisions, it was unclear how the government would judge whether the acquisition would hurt competition. For example, an important question raised by the proposed deal was how to define the "market," which could have been limited to the fruit juice market or defined as the whole beverage market in China. The government also had to decide what level of market dominance would be deemed unacceptable. None of these questions had been clarified by implementing regulations at the time of the deal.

In its decision, MOFCOM cited concerns that Coca-Cola could use its dominance in the soft drink market to hurt competition in the juice market by bundling products, setting up exclusive terms, restricting consumer choice and raising prices. MOFCOM also cited concerns that the strength of the Coca-Cola and Huiyuan brands would prevent other companies from competing effectively. However, the nationalistic opposition the deal encountered raised questions as to whether the Chinese government used the AML for protectionist purposes. While MOFCOM contends that the decision was motivated solely by anti-monopoly concerns, the decision highlights the Chinese government's reluctance to let foreign companies acquire majority interests in large successful Chinese companies.

While the Coca-Cola—Huiyuan deal was ultimately blocked, the government did adhere to the six-month timetable for review set out in the AML. The timely review of the Coca-Cola offer contrasts sharply with the experience of the U.S. private equity firm Carlyle Group which abandoned its attempt to buy a stake in the Xugong Group, a leading Chinese construction equipment manufacturer, after three years of waiting for regulatory approval.

Through October of 2009, MOFCOM had accepted 93 transactions for review under the AML, of which 69 transactions have been consummated. Of the transactions that were closed, 63 were approved without any conditions, five were approved with conditions, and only one, the Coca-Cola—Huiyuan deal, was blocked.

We will continue to monitor developments pertaining to the AML and its implementation, and will provide further updates in subsequent issues of *China Insights*.

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Will Broer, a senior at Claremont-McKenna College, who recently interned in Benesch's Shanghai office, contributed to the research and writing of this article.

Events

Yanping Wang and **Robert Spira** authored "Non-Vessel Operating Common Carrier Regulations in China," which appeared in the February 2010 International Transportation Committee Newsletter which was published by the American Bar Assocation—Section of International Law.

Peter Shelton spoke at the Great Lakes Higher Education Law Symposium on Operating in China.
February 2, 2010 | Cleveland, OH

Yanping Wang will be speaking on China-related subjects at the 2010 Transportation Lawyers Association Conference.
April 29–May 1, 2010 | Hilton Head Island, SC

New Offices

We are pleased to announce the opening, earlier this year, of a new office in White Plains, New York, with three transactional and regulatory health care lawyers, further expanding Benesch's existing national health care practice—and, effective March 1, in Indianapolis, the merger with an Indianapolis firm, Dann Pecar Newman & Kleiman, bringing added strength in five of Benesch's core areas: real estate, litigation, business reorganization, transportation and construction. Cleveland will remain the headquarters for the merged firm.

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We help U.S. companies as they: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally related legal issues in China; (5) source components or products from China and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We also help Chinese companies with respect to U.S. legal and business considerations as they: (1) establish U.S.-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish subsidiaries and other business operations in the U.S.; and (3) acquire the shares or assets of U.S. companies.

We help clients as they structure, negotiate and document China-related transactions; and consult with clients with respect to capital structure, operating control, governance, due diligence and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and government officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers (including Chinese licensed lawyers with whom we work when our clients' needs require) enables us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost-effective manner.

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