

Business Withdrawals and Deferral of Capital Contributions - Considerations for Foreign Invested Enterprises in China During International Economic Crisis

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Challenging Times

The past several months have been tremendously challenging for businesses almost everywhere, and China has been no exception. Indeed, 2008 was not an easy year for many foreign invested enterprises in China. Both the Labor Contract Law of the People's Republic of China (the "Labor Contract Law") and the Law on Enterprise Income Tax of the People's Republic of China (the "Enterprise Income Tax Law") became effective in that year resulting in generally increased labor costs and higher tax obligations. Many export-oriented businesses were further hurt by significant reductions in the amount of VAT refunds on their products. Those factors were compounded by heightened consumer safety concerns and, of course, the global economic crisis that started in the fall of 2008.

As a result, a large number of foreign investors have elected to cancel or delay investment projects and, in some instances, to withdraw their investment from China, as evidenced by the Ministry of Commerce's ("MOFCOM") recent announcement that direct foreign investment in China dropped 15.81% in February from a year earlier, the fifth-straight month of declining investment. The situation is further evidenced by a recent U.S. Chamber of Commerce survey which found that 39% of respondents are postponing or have canceled planned investments this year, while 21% of respondents expect to shrink their China work force.

China's initial reactions to these challenging times has included both a carrot and a stick approach.

Abnormal Withdrawals - The Stick

A foreign invested enterprise cannot just shut down its investment and pull out of China without complying with applicable procedures unless it is prepared to take on significant additional risk. Generally speaking, a "normal" withdrawal entails going through the procedure of liquidation or bankruptcy. If, for example, a foreign invested company intends to liquidate before the expiration of its business term, its liquidation needs to be approved by the local economic and trade bureau or other applicable authority. The company also needs to form a liquidation committee, publish a liquidation notice and properly notify creditors, and only then can it begin to sell off its assets, terminate contracts, and fulfill the applicable procedures of deregistration with the local

administration of industry and commerce, customs, the tax bureau and other relevant authorities. As the procedures are complex, legal counsel and accounting advisers are typically involved.

As a result of the costs involved in following the legal procedures for withdrawal, some foreign invested enterprises have chosen to withdraw illegally-abandoning their China operations without a formal liquidation and deregistration. Those illegal withdrawals have caused serious problems. For example, it is difficult for unpaid workers to obtain compensation, and it is also hard for the counter party to a contract to recover damages caused by a wrongful termination. In order to protect domestic parties, four central ministries of China jointly issued the Working Guidelines on Cross-border Pursuit of Liability and Initiation of Legal Action by Relevant Interested Parties in Connection with Abnormal Withdrawal from China of Foreign Investors (the "Guidelines") in November 2008, which recently have again received widespread attention.

The Guidelines do not provide domestic parties with new ways to protect themselves, but they demonstrate the central government's strong public views relating to abnormal withdrawals. Moreover, the Guidelines remind domestic parties of their rights to pursue appropriate remedies and take legal action when they suffer damages as a result of an abnormal withdrawal.

Articles 3, 4 and 6 of the Guidelines caution foreign investors that they may assume the following risks if they illegally withdraw from China:

(1) If the company does not go through legal liquidation procedures, the shareholders of a limited liability company and the controlling shareholders, directors and the controller of a joint stock limited company assume joint liability for the debts of the said company despite its limited liability nature.

(2) Domestic parties may take legal action in China and obtain compensation from the abandoned assets which are located in China; and they also may seek to enforce judgments of Chinese courts in the investor's home country under applicable treaties.

(3) In the case of investors who flee China leaving significant debts or unpaid taxes, the Chinese government reserves the right to take action through diplomatic channels (for example, attempted extradition) in order to pursue recovery from the investor.

Also, because local administrations of industry and commerce maintain foreign invested records of shareholders, directors, supervisors and some senior management of a company and, accordingly, if the investor withdraws illegally without liquidation and deregistration, it may be difficult for them to engage in any business in China in the future.

There has been relatively little experience with enforcement of the remedies and sanctions described in the Guidelines to date. We will remain alert for information respecting any enforcement activities and keep our clients and friends informed.

Deferred Capital Contributions - The Carrot

It is important to note that China's response to the slowdown in investment and increase in business closures has also included some enhanced incentives. For example, the VAT export rebate rate on certain products has been raised as many as five times since the beginning of 2008. Moreover, on February 26 of this year, six ministries jointly issued the Notice regarding Jointly Annual Inspection to Foreign Invested Enterprises in 2009 (the "Notice"), which permits foreign invested enterprises that have a registered capital contribution due after July 1, 2008 to apply for an extension of their

capital contribution to the end of 2009. Seven days later, on March 5, MOFCOM issued another notice to devolve some authority for approving more foreign investment projects to local authorities. In addition, many local authorities have also taken measures to help foreign invested enterprises in their area to weather the crisis by improving services and attempting to solve various administrative difficulties encountered by foreign invested enterprises.

It is unclear how the remainder of 2009 will unfold for the global economy and foreign direct investment in China. We will remain alert to additional "carrots" and "sticks" that may surface, and provide additional information as warranted.