About the PRC Foreign Investment Law – Things Foreign Investors Should Know

On March 15th, 2019, several months after the launch of soliciting public opinion on the draft PRC Foreign Investment Law[1], the National People's Congress of the PRC (the "**NPC**") approved *the PRC Foreign Investment Law* (the "**Foreign Investment Law**"), which will come into force on January 1st, 2020, repealing simultaneously the present foreign investment legal framework formed by *the PRC Sino-Foreign Equity Joint Ventures Law* (the "**EJV Law**"), *the PRC Sino-Foreign Contractual Joint Ventures Law* (the "**CJV Law**") and *the PRC Wholly Foreign Owned Enterprises Law* (the "**WFOE Law**") and unifying the PRC foreign investment legal regime.

The highlights of the Foreign Investment Law are as follows:

1. The Scope of Foreign Investment

According to Article 2 of the Foreign Investment Law, foreign investment means those investment activity directly or indirectly carried out by foreign natural persons, entities or other organizations, including:

(i) the incorporation of foreign invested entity in the PRC, individually or collectively with other investors;

(ii) the acquisition of a PRC entity's shares, equities, property shares or other similar rights and interests;

(iii) the investment in a new project, individually or collectively with other investors; and

(iv) other methods of investment regulated by the laws, regulations or provisions of the State Council.

[1] See our commentary on the MOFCOM 2015 Draft at https://www.garrigues.com/en_GB/new/draft-foreign-investment-law-chinas-reform-regime-foreign-investment-0 and our commentary on the draft for public opinion version dated on December 26, 2018 at https://www.garrigues.com/cn/en_GB/new/china-publishes-new-draft-foreign-investment-law.

Issues to be further clarified under the definition of foreign investment include the definition or example of the "indirect foreign investment activity", "investment in any new project" and whether the investors from HK S.A.R., Macau S.A.R. and Taiwan region shall be classified as foreign investors.

(i) Indirect Foreign Investment Activity

Without the definition or example of the "Indirect Foreign Investment", whether it intends to regulate the down-stream entities invested by second-tier foreign invested entities, or whether it refers to the investment with VIE structure, variable interest entity, remains uncertain.

(ii) Investment in a New Project

It is subject to further clarification whether the project refers to those Sino-foreign contractual projects regulated by the CJV Law, such as the Sino-foreign cooperative agreements on the exploitation of petroleum resources, as well as its intention to focus on new project only.

(iii) Classification of Investors from HK S.A.R., Macau S.A.R. and Taiwan Region

The investors from HK S.A.R., Macau S.A.R. and Taiwan Region are not in the scope of foreign investor set by the Foreign Investment Law, and the law keeps silent on whether the investment by the investors from HK S.A.R., Macau S.A.R. and Taiwan Region are regulated with reference to the Foreign Investment Law.
However, on March 15th's press conference, when this question was raised by Phoenix Media, Premier Li Keqiang replied that the investment from HK S.A.R., Macau S.A.R. and Taiwan Region could be administrated with reference to the Foreign Investment Law. We expect the State Council to further clarify this issue in writing.

2. <u>Management System of Pre-establishment National Treatment and Negative List</u>

It is the first time the adoption of management system of pre-establishment national treatment and negative list to foreign investment has been officially stipulated in law-level legislation. The State will give national treatment to foreign investment outside of the negative list released by or upon approval by the State Council.

The negative list indicates the industries with restrictions or prohibition on foreign investment, which shall be subject to special administrative measures for access of foreign investment. The latest 2018 national negative list was released on June 28th, 2018.

The Foreign Investment Law also empowers the State to establish special economy zone or implement pilot policies and measures for foreign investment, when necessary. Currently, foreign investment in the Pilot Free Trade Zones ("**FTZ**") is subject to the FTZ negative list, which may adopt more flexible policies to the foreign investment within the FTZ on a trial basis. For instance, the Pilot Free Trade Zone Negative List released on June 30th, 2018 removes the foreign investment in performance brokerage institutions from the FTZ Negative List and allows foreign investors to invest in cultural and artistic performance groups, provided the group is controlled by a Chinese party.

3. <u>Protection of the Intellectual Property of Foreign Investors and Foreign Invested Enterprises</u>

The Foreign Investment Law further emphasizes the protection of the intellectual property of foreign investors and foreign-invested enterprises and stipulates that the administrative organ and its staff are not allowed to force the transfer of any technology by administrative means.

Furthermore, shortly after the publicity of the Foreign Investment Law, *Decision of the State Council on Modification of Certain Regulations* ("**Decision No. 709**") was released on March 18th, 2019, which deletes following restrictions to the technology import contract set by *Regulations for the Implementation of the PRC Sino-Foreign Equity Joint Ventures Law* ("**Implementation Regulation of EJV Law**") and *Regulations on Technology Import and Export Administration of the PRC*:

(i) The term of a technology transfer agreement is generally no longer than ten years;

(ii) After the expiry of a technology transfer agreement, the technology importing party shall have the right to use the technology continuously;

(iii) Where an infringement of third party's legal rights and interests occurs when an assignee of a technology import contract is using technology provided by the assignor in accordance with the provisions of the contract, the assignor shall bear the responsibility;

(iv) During the period of validity of the technology import contract, the right over any improvements in the technology shall be vested with the party which has made the improvements;

(v) A technology import contract shall not contain the following restrictive clauses:

(1) requiring the assignee to accept incidental provisions that are not essential to the importing of the technology, including the purchase of unnecessary technology, raw materials, products, equipment or services;

(2) requiring the assignee to pay fees for the usage of or bear related obligations for technology where the patent rights have expired or have been declared invalid;

(3) restricting the assignee from improving the technology provided by the assignor or using the improved technology;

(4) restricting the assignee from obtaining the technology similar to or competing with the technology provided by the assignor from other sources;

(5) unreasonably restricting the channels or sources that the assignee may procure raw materials, parts, products or equipment from;

(6) unreasonably restricting the quantity, type or sale price of assignee's products; and

(7) unreasonably restricting the assignee's export channels for products produced by using the imported technology.

Decision No. 709 came into effect on March 18th, 2019, so does it mean the above deleted rules shall no longer apply to the technical transfer contracts between the foreign assignors and domestic assignees? The answer may not be so certain.

For the technical contract governed by the PRC laws, it shall also be governed by the *PRC Contract Law* and the *Interpretation of the Supreme People's Court on Issues relating to Applicable Laws for Trial of Dispute Cases involving Technical Contracts*.

Regarding item (i) "the term of a technology transfer agreement" and item (ii) "right to use the technology continuously after the expiry of term", since there is no restrictive provisions set by the PRC laws and regulations on said matter, the parties could freely negotiate the corresponding term.

Regarding item (iii), *the PRC Contract Law*[2] allows the parties to negotiate the liability allocation of the infringement caused by the performance of the technology contract.

Regarding item (iv) "the ownership of the right over improvement of technology", the parties could agree on the ownership of the right over any improvements in the technology. If there is no such agreement or such agreement is not clear, the party made the improvement shall be the right owner[3]. In addition, under the scenario the technology contract is recognized as void and the parties are unable to reach an agreement on the ownership of the right over the improvements in the technology, the court may rule that the party made the improvement shall own the right over said improvement[4].

Regarding item (v) "the restrictive clauses", although they have been deleted from the *Regulations on Technology Import and Export Administration of the*

[2] The PRC Contract Law, Article 353

[3] The PRC Contract Law, Article 354

[4] Interpretation of the Supreme People's Court on Issues relating to Applicable Laws for Trial of Dispute Cases involving Technical Contracts, Article 11

PRC, those restrictions are still applied to the technology contracts in accordance with *the PRC Contract Law*, which stipulates that a technology contract with restrictions (1) to (7) will be regarded as illegally monopolizing technology and impeding technological progress, and shall cause the technology contract be void[5]. Same as we elaborated above regarding item (iv), when the contract is regarded as invalid, it will bring uncertainty to the ownership of the improvement of the technology.

To those foreign assignors seeking less restriction to the technology transfer, selecting laws in favor of the foreign assignor might be an alternative. Furthermore, the foreign assignors may persuade the assignees to agree to resolve the dispute through an overseas arbitration institution in the territory of any signatory of the *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*. However, the enforceability of said option is an open question and it is subject to further interpretation to the law by the law makers, the Supreme People's Court and opinions made by the judges.

4. Organization and Activities of the Company

After the effective date of the Foreign Investment Law, i.e. January 1st, 2020, the newly incorporated foreign invested companies shall comply with the PRC Company Law (the "**Company Law**") or the PRC Partnership Enterprise Law. The Foreign Investment Law grants the foreign invested companies established in accordance with the EJV Law, CJV Law and WFOE Law to keep their original organization forms within a five-year transitional period commencing from January 1st, 2020.

In consideration that most of the foreign invested entities are limited liability companies, our discussion hereinafter will focus on the main changes of limited liability companies set by the Company Law against the sino-foreign equity joint venture companies ("**EJV**"):

(i) Organization

[5] Interpretation of the Supreme People's Court on Issues relating to Applicable Laws for Trial of Dispute Cases involving Technical Contracts, Article 10, and the PRC Contract Law, Article 344

The launch of the Foreign Investment Law will also change the corporate governance structure of foreign-invested entities from board-centrism to shareholder-centrism. According to the Company Law, the shareholders' meeting is the authority of the company therefore the power to decide the major issues of the company shall be shifted from the board of directors (executive director) to the shareholders' meeting (shareholder). Resolutions on (1) amendment to the articles of association of the company; (2) increase or reduction of registered capital; and (3) company merger, division, dissolution or change of company structure shall be passed by shareholders holding two-thirds or more of the voting rights on a shareholders' meeting, replacing the previous requirement of the unanimous approval of all directors present at a duly convened board meeting.

The voting rights exercisable by shareholders on a shareholders' meeting shall be based on the ratio of capital contribution, but the Company Law allows the shareholders to reach agreement on the allocation of the voting rights in the articles of association of the company.

(ii) Board of Directors

Under the Company Law, board of directors (executive director) is a management and executive organ of a company, not the highest organizational organ provided by the EJV Law.

The non-employee's representative directors shall be elected or dismissed by the shareholders on the shareholders' meeting, instead of being appointed or removed by the shareholders.

(iii) Subscription of Incremental Capital

Other than the subscription of incremental capital on pro rata basis, the shareholders could agree on the ratio of future incremental capital subscription in the articles of association.

(iv) Transfer of the Equity Interest

Instead of obtaining consent from the other shareholder(s), the Company Law only requires the shareholder(s) proposing to transfer its equity interest to a non-shareholder to obtain the consent of more than half of the non-proposing shareholder(s), the transfer of equity interest between shareholder(s) is not subject to any prior consent.

In addition, if shareholders reach agreement on the transfer of equity interest in the articles of association of the company, such provisions shall prevail.

(v) Profit Distribution

It is compulsory for the companies governed by the Company Law to contribute 10% after-tax profits into their statutory surplus before profit distribution till the aggregate sum of the statutory surplus reserve is more than 50% of its registered capital, while the EJV Law allows the board of directors to determine the contribution percentage of the reserve funds.

The Company Law not only allows the company to distribute profit in proportion to the ratio of each shareholder's respective actual contributions to the registered capital but also allows the shareholders to freely determine the profit distribution proportion, provided the agreement is reached by all of the shareholders.

5. Others

Other than the above commented main changes, the Foreign Investment Law reiterates the encouragement and protection to the foreign investment, upgrades the foreign investment information reporting system and security review system for foreign investment as the basic system set by law, grants the power to take actions against any discriminatory prohibitive or restrictive measures made by other nations or regions, and specially carves out the financial industry and financial market, where the provisions stipulated by the State shall prevail.

The Foreign Investment Law grants the foreign investors a five-year transitional period to convert the present foreign invested entities to the unified corporation forms under the Company Law (or the PRC Partnership Enterprise Law as the case may be). It takes time for the foreign investors, especially those investing in EJVs or a Sino-foreign contractual joint ventures ("**CJV**"), to digest the rights and obligations set by laws, the changes and new formalities requirements, to discuss internally and externally with their advisors regarding the challenges and strategies, to renegotiate the terms of shareholders agreement and its ancillary contracts, usually including the technology transfer arrangements, and the articles of association. Due to the flexibility set by the CJV Law, e.g., co-operative conditions, different forms of corporation, either in a legal person or a non-legal -person form, profit distribution, etc., the foreign investors of CJVs face more challenges and obstacles on such conversion.

The launch of the Foreign Investment Law has led to some uncertainty in fields of commercial registration, foreign investment filing, foreign exchange and preferential tax treatment, among others. Further legislation providing clarification to these unsettled questions is expected to be issued. In this regard, we will continue to follow and report the regulatory developments.