

pay for equal work." Admittedly foreign investors found it embarrassing to argue that foreigners were worth more and should be paid more than Chinese individuals working at their side and in similar positions. Nevertheless, the reality was that foreign technicians and managers would not come to China in the early years unless they were paid considerably more than what they would be paid at home and therefore many times more than what the average Chinese individual was paid then and now.

One response to this request was to pay the foreign expatriate managers the same amount as a Chinese state-owned enterprise manager. All amounts above this limited salary would be paid to the manager by his or her foreign employer (the foreign investor) in the foreign country. This arrangement was less than satisfactory since such costs were substantial and not borne evenly by the partners in the joint venture. It also raised a question as to which number, the salary paid by the China joint venture or the salary paid by both employers, was used when declaring income for the Individual Income Tax Law. Eventually this problem was solved by service contracts discussed below in Chapter 16.

The argument for a differential in wages became somewhat easier when it was learned that the individual worker did not in fact receive the money, but instead was forced to turn in the difference between his or her salary in the state-owned enterprise and what would be earned in the new factory. These funds normally went straight to the Chinese partner, but on some occasions were donated to the worker welfare and bonus fund in the state enterprise holding company or used to fund state subsidies and pension plans for workers. When it became clear that this demand for equal pay for equal work was not motivated by sentiments of equality and apparently did not directly benefit the overpaid manager, the argument faded into the background. On occasion, however, Chinese negotiators will ask that the articles or the feasibility study contain a statement that Chinese managers will be paid some specified percentage of what foreign managers are paid.

In recent years, the salary and benefits for trained Chinese managers have risen greatly as foreign companies continue to invest and have had to find able managers. Because of the heavy demand, the ease with which managers may change jobs, and salary inflation, the demand of equal pay for equal work is no longer common.

Chapter 5

Cooperative Joint Venture Contracts

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§ 5:1 Cooperative joint ventures

Unless specifically referenced, the discussion to this point has related solely to Equity Joint Ventures. There are two reasons for this discrimination against the Cooperative Joint Venture: first, the Equity Joint Venture Law came first and is the model on which all joint ventures are based; and second, the Cooperative Joint Venture Law basically adopts the structure of the Equity Joint Venture Law, but in certain areas introduces additional flexibility. This chapter will therefore focus on the Cooperative Joint Venture Law by comparing it to the Equity Joint Venture Law and pointing out where those additional areas of flexibility lie.

§ 5:2 Legislative history

The Cooperative Joint Venture Law was adopted in 1988.¹ During the nine years from the date of the Equity Joint Venture Law

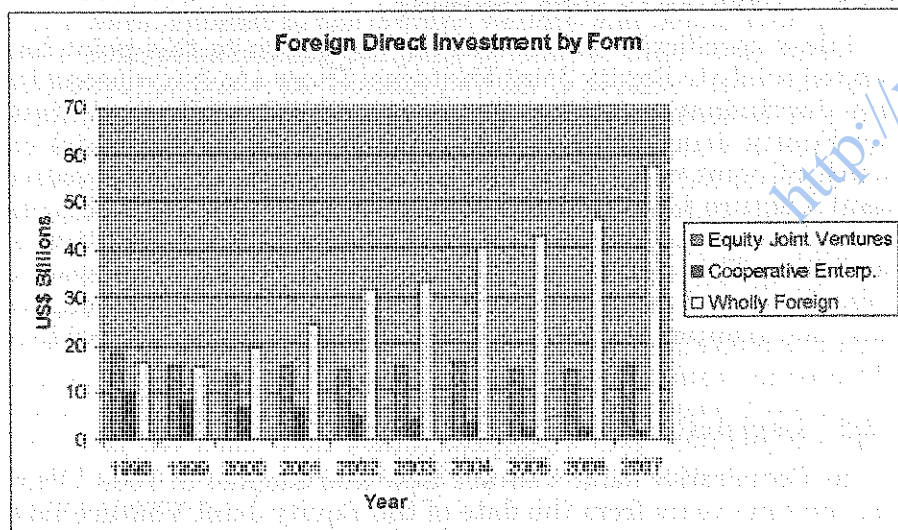
[Section 5:2]

¹Law of the People's Republic of China on Sino-foreign Cooperative Enterprises (中华人民共和国中外合作经营企业法) (National People's Congress, April 13, 1988 and revised by the Standing Committee of the National People's Congress on Oct. 31, 2000) (herein the "Cooperative Joint Venture Law").

to the publication of the Cooperative Joint Venture Law, cooperative joint ventures were actually more popular than they would be after a law was passed sanctioning their existence. The reason for this strange result was that cooperatives were referred to as "contractual" joint ventures and the only prohibition was whatever one could not get approved. The procedure followed was for the foreign investor to follow the equity joint venture format up until the point where a problem with the equity joint venture rules was encountered. At that point, the venture would become a cooperative and take the form of a "contractual" joint venture with the troubling point of the Equity Joint Venture Law simply ignored. Common examples of this phenomenon involved the nature of one party's contribution; for example, the Chinese side frequently wanted to supply labor, but was prevented from doing so by the capital contribution rules and the foreign side frequently wanted to contribute a customer list or distribution rights, but again was prevented from doing so by the capital contribution rules applicable to equity joint ventures. The solution to this and similar problems was to change the name of the agreement to a Contractual Joint Venture and submit the nonconforming document to the approval authority to see whether it would be approved. Most were.

Figure 5.1

Source: Statistical Yearbooks of China 1998 - 2008



When the Cooperative Joint Venture Law was adopted in 1988 much of the flexibility disappeared. The ability to contribute labor services, for example, was not listed as one of the forms of acceptable investment, nor was the value of customers or distribution rights recognized.² Moreover, the flexibility that local approval authorities had felt in approving projects that strayed from the Equity Joint Venture Law was now missing, since the new law, even if not clear, was a law and "higher authorities" might consider it to be clearer than the actual words on the page would indicate. Therefore, the very wide ranging flexibility permitted by the "contractual joint venture" was replaced by a cooperative enterprise law that no one understood and were afraid to implement since an approval authority's guess as to meaning might be criticized at the Central Government level. The result of the 1988 legislation was to cause a steady decline in the number of cooperative joint ventures.

§ 5:3 Organizational form

A cooperative joint venture may be (and generally is) a Chinese limited liability company with legal personality, although this is not required under the law. Article 2 provides, in rather confusing fashion:

Any cooperative venture, which complies with the provisions of Chinese law for a legal person, shall acquire the status of a legal person.¹

Prior to the adoption of the implementing rules in 1995, when limited liability was desired, a clause had to be inserted in the conditions of cooperation (that is, the Joint Venture Contract) stipulating that the company was to be formed as a limited liability company. When registering with the Administration of Industry and Commerce, the limited liability nature of the enterprise was disclosed and the registration would indicate that the company was a "limited company." If these procedures were followed, the investors have no liability for the debts and liabilities of the company. After 1995, the implementing regulation clarified the issue and made clear that all "legal person" cooperative enterprises enjoyed limited liability.²

There are, however, two distinct types of cooperative joint

²Cooperative Joint Venture Law, Art. 8.

[Section 5:3]

¹Cooperative Joint Venture Law, Art. 2.

²The Detailed Rules for the Implementation of the Law of the People's Republic of China on Sino-foreign Cooperative Enterprises (中华人民共和国中外合作经营企业法实施细则) (State Council, Aug. 7, 1995; promulgated by the Ministry of Foreign Trade and Economic Cooperation, Sept. 4, 1995) (herein the "Detailed Rules"), Art. 14.

ventures. The first type, as described in the previous paragraph, is very much like a joint venture formed under the Equity Joint Venture Law in that a legal entity similar to a limited liability company is created. This type of cooperative enterprise is managed by a board of directors and only certain major matters are referred to the investors for their decision.

In the second type of cooperative, no legal entity is created and aspects of business relations between the parties are stipulated in the joint venture contract. This "nonlegal" person form of joint venture derived from the "contractual joint venture" and a number of significant joint ventures had been created using this form. When the Cooperative Joint Venture Law was adopted in 1988, there were already 5,200 enterprises formed as "contractual joint ventures", some of which were not registered legal persons. This second form of cooperative enterprise—the nonlegal person venture—began to disappear after 1988, as government authorities would generally no longer approve such cooperative enterprises. Such cooperative enterprises are now most often limited to offshore oil exploration, major mining projects, and large infrastructure endeavors, where a lengthy concession contract serves as a law unto itself. Given that nonlegal person cooperative enterprises are not expressly precluded by the Cooperative Joint Venture Law,³ it may be possible to obtain approval for cooperative enterprise that is essentially a partnership. Nevertheless, the current Chinese policy is not to approve cooperative enterprises that have not been established as separate legal persons, unless the negotiating position of the foreign investor is sufficiently strong to alter otherwise applicable policy.

Although the Cooperative Joint Venture Law was vague on the question of whether a cooperative enterprise enjoys limited liability, this issue was clarified by the Detailed Rules,⁴ which make clear that a legal person cooperative enjoys limited liability, while a nonlegal person cooperative enterprise does not. Where a cooperative joint venture returns capital to the foreign investor prior to the termination of the cooperative enterprise, such capital distributions may be recalled should the venture subsequently require funds. While technically this right of recall of distributed capital does not reverse or eliminate the limitation on liability, foreign investors, if required to put back money into an enterprise that is failing, will be hard pressed to tell the difference. Thus,

³As quoted above, Article 2 only provides that those entities that qualify as legal persons shall be registered as legal persons. Thus, the nonlegal person format technically continues. As such, however, it is a form of partnership and China now has a partnership law and foreigners are now permitted to form such partnerships in China as one form of foreign investment vehicle. It is also worth noting that the amended Partnership Law now allows limited liability partnerships, which in turn may constitute a new form of joint venture vehicle.

⁴Detailed Rules, Art. 14.

an early return of capital does not mean that an investor has truly received a return of capital, since the investor may be required to re-insert the cash removed. Because the registered capital and the investor's obligation to contribute it cannot be reduced during the term of the venture without special permission,⁵ investors—even those that have been repaid their capital—remain potentially liable for the venture company's debts.

The Detailed Rules also make clear that the few nonlegal person cooperatives are general partnerships in the sense that the partners to the cooperative are civilly liable for the obligations of the enterprise.⁶ As a corollary to this principle, the assets contributed to the enterprise's use are owned by the investors, not the enterprise—although their management and use is completely controlled by the board of management.⁷ Since there is a general policy disposition to ensure that the investment of a foreign investor is completely under the control of Chinese law, the ownership of assets in China by the foreign investor, even though dedicated to the business of the nonlegal person enterprise, is probably one of the principal reasons that approval authorities so seldom approve this particular type of foreign investment enterprise.

As China now has a partnership law, it is unclear whether there is any continuing role for the nonlegal person cooperative joint venture. To date, however, it has proven difficult for foreign investors to invest through use of the partnership form, so that at some point foreign investors may take another look at the nonlegal person cooperative as a way of accomplishing partnership objectives.

§ 5:4 Principal differences with equity joint ventures; profit divisions

The primary difference, from a business point of view, between a cooperative joint venture and an equity joint venture is that, in a cooperative, the parties may agree to split profits and responsibilities in any proportion that may be negotiated, rather than based on their respective equity contributions to registered capital.¹ This provision was originally used by Chinese parties to obtain a greater share of the profits than their capital contribu-

⁵Detailed Rules, Art. 16.

⁶Detailed Rules, Art. 50.

⁷Detailed Rules, Art. 52.

[Section 5:4]

¹The Cooperative Joint Venture Law, Art. 2, refers to the right of the parties to "distribute earnings or products". Article 21 makes it even clearer that "The Chinese and foreign partners shall distribute earnings or products and bear risks and losses in accordance with the stipulations contained in the coop-

tion would justify on the basis that, as the local host, the Chinese party was opening the Chinese market for the foreign investor. The same argument has been used in reverse by foreign investors that argue that since they will be selling the products of the cooperative in foreign countries, they deserve to receive a greater share of the net profit for providing the export market to the venture.

In addition, if the parties agree that the Chinese party is to be given all the fixed assets of the cooperative joint venture at the end of its term, the parties may further agree to permit the foreign party to recoup its investment before the termination of the enterprise, which is not possible under the Equity Joint Venture Law.² The two most common ways to accomplish this objective are to agree to a fixed rate of return for the foreign investor for a period of years, followed by a lesser return in later years. The other method is to agree in the Cooperative Joint Venture contract that net profits will be shared in accordance with the parties' contribution ratios, but the foreign investor will receive as an additional dividend excess cash flow arising from depreciation and other noncash items on the profit and loss statement. If the recoupment is to be made out of pre-tax profits, the local tax and finance authorities must approve the arrangement.³

One other rather common form of profit division in a cooperative enterprise is the fixed or guaranteed return. Originally these provisions were used as a way of gaining the cooperation of a local business or government unit to permit the foreign investor to have a relatively free hand in managing the new enterprise. For example, some of the earliest restaurants and clubs with international names like Planet Hollywood, TGIF, and Hard Rock Café would agree to pay a fixed return to a land or building owner and the land or building owner would contribute its land or space in the building as its investment in the cooperative enterprise. The fixed return was actually rental, but described as a method to share profits.

At some point these arrangements were converted into the opposite arrangement whereby a local government would guarantee the fixed return of the investor. This guarantee was given either by agreeing to assign the local partner's profit share until the foreign side had reached the agreed return, or in some cases,

erative venture contract." The Detailed Rules apparently limits this ability to change the profit sharing ratio to cases where the Chinese party receives the assets of the venture on termination (see Detailed Rules, Art. 44); however, in practice, the parties are still free to agree on the sharing ratio regardless of the parties' respective capital contributions.

²Cooperative Joint Venture Law, Art. 21; Detailed Rules, Art. 44.

³Detailed Rules, Art. 44.

actually guaranteeing the profit after tax of the foreign side. Such guarantees were used in infrastructure projects by local governments to encourage foreign investors to invest, because local governments did not have the power to borrow money on their own and therefore had to disguise the loan as an investment. During the Asian financial crisis of 1997–1998, however, China began to see these "fixed return" contracts as a way of borrowing money without an approval from the State Administration of Foreign Exchange and therefore a potentially destabilizing factor that allowed foreigners to speculate in Chinese currency. In 1998, the State Council ordered that all such contracts in China be reviewed and data compiled on their purpose and cost.⁴ After much consideration, such contracts were found to violate the general principle that the investors should share the risks in a foreign investment and therefore have now been banned.⁵

§ 5:5 Principal differences with equity joint ventures; profit divisions—Management arrangements

A cooperative joint venture may have either a board of directors, similar to equity joint ventures, or a board of management,¹ which is not very commonly used. The most significant feature of the board is that, since the parties are free to decide upon the sharing ratio of profits, they are also free to decide upon the sharing of management responsibilities. Thus, even though a foreign investor may only contribute 30% of the company's capital, it could appoint a majority of the directors.

The parties may agree on whether the Chinese or foreign party is to nominate the chairman of the board of directors or the director of the joint management committee; the other party will then nominate the deputy.²

There is no role for the shareholders in management and no shareholders' meeting is required, although the investors have more freedom in the case of a cooperative enterprise than in the case of an equity joint venture to allocate management responsibilities to one investor. The only exception to this rule appears in the Cooperative Joint Venture Law which requires that major

⁴Circular on Strengthening the Administration of Foreign Exchange and External Debt and Launching Inspection of Foreign Exchange and External Debt (国务院关于加强外汇外债管理开展外汇外债检查的通知) (State Council, Guo Fa [1998] No 31, Sept. 14, 1998).

⁵Circular on Issues Related to the Proper Disposal of Existing Projects with Guaranteed Fixed Returns for Foreign Investors (关于妥善处理现有有保证外方投资固定回报项目有关问题的通知), Art. 1 (General Office of the State Council, Sept. 10, 2002).

[Section 5:5]

¹Cooperative Joint Venture Law, Art. 12.

²Cooperative Joint Venture Law, Art. 12; Detailed Rules, Art. 26.