those just mentioned. (We will explore the tax issues in detail in Chapter 7.) A share transfer might not be subject to China taxes at all if the share transfer can be accomplished entirely offshore. As we noted in Chapter 2, many FIEs have a holding company structure in which the holding company is located in a tax haven country, such as the British Virgin Islands. In such a case, a share transfer that occurs entirely in the British Virgin Islands, with a capital gains tax rate of zero,[40] could result in substantial tax savings. To review these tax avoidance strategies, see Chapter 2 at pp. 103-06. Note, however, that most domestic Chinese companies do not have overseas holding companies.

Although an asset transfer might be more costly, it still might be the better course of action if the seller has incurred significant liabilities. The risk of exposure to these liabilities might outweigh the additional tax costs of an asset transfer. To complete an asset purchase, the foreign investor needs to set up an FIE to acquire the desired assets of a target (either to inject the assets into the FIE as part of the capital contribution of the foreign investor or to use the FIE to buy the assets directly from the target). The target's creditors must then be notified of the sale by direct notice and an announcement must be published in a national or provincial newspaper prior to completion. After the purchase, the target's assets will belong to the FIE.

In a case where a seller has not incurred significant liabilities, then a share transfer deal might be more efficient and less costly. The foreign investor can purchase the shares from the seller and step into the shoes of the seller so long as the seller has not incurred significant liabilities. The share transfer deal may have the advantage of avoiding the tax consequences of an asset transfer, but the transfer of shares may be subject to some special restrictions depending on the nature of shares that will limit the transferability of the shares so that the foreign investor will have no other choice than to proceed by way of asset transfer. We introduce these issues in this section so that you can see why both share and asset transfer deals are used; we return to an examination of these issues in greater detail below. The ultimate decision on whether to pursue an asset or share transfer will depend upon a detailed analysis of the issues that we have briefly identified here.

PROBLEM 3-5

Giant Foods is considering the purchase of several food processing factories owned by Long Life Goods Group, a conglomerate of business entities in China. The factories have high technology production lines and a good location, within distribution channels to major urban areas with dense populations. In doing its due diligence, Giant Foods has discovered that in 2009,

[40] *See* Chapter 2 at p.105.

several of the factories were accused of selling tainted dairy food products in China and are faced with some irate consumers. Some of the products also reached the United States in the form of tainted pet foods. Several of the factories were also involved in dumping garbage and wastes into a river causing contamination and making the water unfit for consumption. Advise Giant Foods whether an acquisition is advisable and, if so, what method it should use to acquire the factories from Long Life.

PROBLEM 3-6

Luxor Homes, a real estate developer based in New York, wishes to build a luxury apartment house in Shanghai. Luxor is considering a site that is currently occupied by a Hong Kong owned tourist hotel in the central business district. The hotel can, with some major renovations, serve as a high end apartment house for ex-patriates working in Shanghai. Due to Shanghai's development, the land use rights to the site have appreciated significantly. In fact, the market value for the land is now at least twenty times the stated value of the land when it was acquired by the Hong Kong hotel. The general manager of the hotel has told Luxor that any purchase and sale agreement must include a clause under which Luxor will pay any taxes incurred by the seller. What type of transactions would you recommend to Luxor under these circumstances?

II. REORGANIZATION AND CONVERSION OF AN EQUITY JOINT VENTURE INTO A WHOLLY FOREIGN-OWNED ENTERPRISE

In Chapter 2, we examined the business vehicles available for foreign investors who wish to make a foreign direct investment in China: the equity joint venture, the cooperative joint venture, and the wholly foreign-owned enterprise. In this section, we examine how an equity joint venture can be reorganized and converted into an WFOE. This transaction is considered to be an M&A transaction and is depicted in scenarios 3-2a and 3-2b, above in Problem 3-2. The M&A transaction is subject to the 1997 Provisions because the target of the M&A transaction, the equity joint venture, is an FIE. We use this transaction as an illustration of the issues involved in restructuring and reorganization of FIEs in China. Of course, there are many other types of M&A transactions targeting an FIE, but due to the constraints of time and space, we cannot review all of them in detail. Rather, we have chosen to focus on the reorganization of a joint venture into an WFOE because it involves the two most popular forms of FIEs in China and is illustrative of the basic issues involved in any FIE restructuring. In addition, by examining the reorganization of a joint venture into a WFOE, we also gain some insights into the advantages and shortcomings of the most popular types of foreign investment vehicles.

A. CONSIDERATIONS LEADING TO AN FIE RESTRUCTURING

When China first opened its doors to international trade and business and created the joint venture as a vehicle for foreign investment, many foreign investors considered the joint venture to be the business vehicle of choice. During the first wave of FDI in the 1980s and 1990s, many foreign investors did not feel confident about being able to do business in the China market without a local partner. China's own plans for the joint venture were that it would eventually terminate and that the foreign investor would depart the scene, allowing the local partner to continue to run the company as a purely domestic concern. However, many joint venture partners found that long before the planned termination of the joint venture, problems arose that led the parties to its early termination. Often the conflicts that arose between the partners did not mean that the joint venture itself and its business were not profitable, but that the business relationship had soured for various reasons and that the joint venture could not therefore continue.

What are the types of problems that arose that would jeopardize the business relationship between the parties? Even in the best of partnerships, there is an inherent loss of flexibility and an added layer of bureaucracy in having to deal with a partner. Most partnerships endure if the advantages of the cooperation outweigh these disadvantages. In the case of a joint venture in China, however, many foreign investors are able to replicate many of the advantages initially brought to the relationship by the local partner. The value of the contributions brought to the joint venture by the local partner in the form of local connections, influence, knowledge, and experience tend to diminish over time. Almost immediately, the MNC will begin to narrow the knowledge and experience gap by installing its own ex-patriate managers on the ground in China and by hiring and training local employees for the joint venture. Some MNCs are able to develop connections of their own with important government bodies through frequent contacts, the use of public relations firms, and by hiring former government officials to work for them. On the other hand, the local partner is often unable to compensate by finding ways to make valuable, continuing contributions to the joint venture, as the local partner is usually unable to contribute in the areas of research and development of products or with advanced managerial skills. An instance where the local partner continues to add value to the joint venture may be where the Chinese entity has a dominant market position, is in a specialized industry where there are few competitors, or has relationships with other business entities that create a continuing market for the joint venture's goods and services. For example, some state-owned enterprises in a heavy industry sector, such as steel and transportation, may dominate these

industries to the extent that operating in that sector alone or without a partnership with the right local player creates a significant disadvantage for the MNC. The local partner might also possess some usually valuable skills in negotiating with Chinese authorities and in navigating China's complex bureaucracies or may be especially skilled in understanding the needs of the Chinese consumer. In addition, foreign investors may be required by law to use a joint venture in certain industries.

Other than in these special cases, the MNC finds that as the joint venture becomes more successful, the local partner's value to the MNC may diminish over time. Where the joint venture is successful, the foreign partner is likely to discover that while the value of the local partner's contribution tends to diminish over time, the amount of return on the local partner's investment tends to increase over time as the joint venture must pay a percentage of profits to the local partner in proportion to its ownership interest in the joint venture. The foreign investor naturally begins to wonder whether the payments to the local partner are justified by the local partner's diminishing contributions to the joint venture.

Another set of concerns are issues that can divide the MNC and the local partner. The local partner and the foreign investor often bring different expectations to the joint venture. The MNC often has a longer time horizon and wants to reinvest profits while the local partner has a shorter term horizon and wants an immediate payout.

These differences can lead to myriad conflicts in the workplace—frustration on the part of the parties concerning underlying differences in expectations can be manifested in the form of disagreements on other seemingly unrelated issues, such as the need for a new cafeteria, or whether a new deputy manager should be hired from the MNC or the local partner. For example, a frustrated local Chinese partner who is not receiving profits might refuse to go along with the foreign investor on an unrelated business matter as a form of retaliation. Another issue that is a cause for frustration is that the local partner often sees the joint venture as a deep pocket and will subject the company to an seemingly endless list of charges. For example, in providing electricity and water to the joint venture, the local partner will charge the company an "administrative fee" of up to 15 percent on top of the cost of the utilities. If the joint venture uses roads over land owned by the local partner for ingress and egress, the local partner might charge a road maintenance fee. In some cases, the MNC begins to believe that it is being bilked and exploited at every opportunity by the local partner. This can create frustration and tension between the parties.

One of the most serious problems occurs when the MNC finds that the local partner has begun to compete with the joint venture. This scena-

rio arises with some frequency: the local partner has acquired advanced technology from the MNC for use in the joint venture but then applies the new knowledge to improve its own operations to compete with the joint venture itself. The joint venture agreement should have a clause to address this issue, but even if such a clause exists there is little or nothing to prevent a local partner from making such use of the technology that it acquires. In fact, many local partners truly do not understand why using the technology acquired from the MNC to improve its own operations, even if contrary to the language of the joint venture agreement, should be a problem. After all, isn't the whole point of establishing a joint venture to learn from the MNC and to acquire advanced technology for China? From the perspective of the MNC, however, these actions are often viewed as a fundamental breach of trust and unethical, if not illegal. When faced with an unrepentant partner who continues to appropriate technology for its own operations, the MNC often decides that it is impossible to continue the business relationship. The issue then becomes what to do with the joint venture. Even outside of the technology field, this type of competition can occur. In the early hotel joint ventures, it was often the case that managers trained by the joint venture were reassigned back to the Chinese entity and ended up working at a new hotel, wholly owned and operated by the Chinese entity and often within a few blocks of the original joint venture hotel.

One alternative is to simply terminate the joint venture (see Joint Venture Agreement, Art. 20 in Chapter 2 at p. 132), but this may not be the best alternative if the joint venture business is a profitable one. The other alternative is for one of the parties to buy out the other and to continue the company on its own. The most efficient method to achieve this objective would be for one joint venture partner to buy out the equity interests of the other and to reorganize the joint venture into a wholly foreign-owned enterprise or a domestic Chinese company. In this book, we will assume that Ultra Bright will buy the equity interests of Beijing Panda and continue to run the company.

Early on during the first two decades of FDI in China, it was unclear whether it was possible to reorganize a joint venture into an WFOE. Some experts believed that it would be necessary to first terminate the joint venture, liquidate, and distribute its assets, and then apply to the approval authorities to establish a new wholly foreign-owned enterprise. Of course, this two-step process would be much more time consuming, costly, and disruptive than a conversion and reorganization of a joint venture into an WFOE, which would not interfere with the continuing operation of the business. Fortunately, in 1997, MOFCOM and the State Administration of Industry and Commerce jointly passed regulations that allow for a direct conversion. We examine how this process occurs in this section and the myriad issues that may arise.

A reorganization and conversion of the joint venture into a WFOE usually signals the end of the working relationship between the foreign investor and the local partner. As it is usually a premature termination of the joint venture, it is likely not to be an entirely happy event; to the contrary, there may be disappointment and acrimony between the two parties who were once partners but who may now be direct competitors or adversaries. This situation suggests that there are a number of risks involved in this process. The problems below explore some of these issues.

B. A SAMPLE FIE EQUITY TRANSFER AND REORGANIZATION CONTRACT

In the problems below, we revisit the joint venture formed by Ultra Bright, the MNC and foreign investor, and Beijing Panda, the local Chinese partner, which we examined at length in Chapter 2 on FDI. Assume that the parties have agreed to allow Ultra Bright to buy out the equity interests of Beijing Panda in a share transfer agreement. What issues might arise?

PROBLEM 3-7

In the Equity Transfer Agreement below, Ultra Bright, the MNC, is buying out Beijing Panda, the local partner. Ultra Bright will be the new and sole owner of the company reorganized as a WFOE. Under the agreement, Ultra Bright will make a payment to Beijng Panda, which then departs the scene. Ultra Bright will continue the company as a WFOE. Of the two parties, one bears a much higher risk. Which one? How should these risks be managed? What can be done to anticipate or discover all of these risks? Is it important to draft the Equity Transfer Agreement to anticipate these risks before the buyout is consummated?

PROBLEM 3-8

Ultra Bright, the MNC foreign investor, decides that it wishes to reorganize and convert a successful joint venture that it established with local partner Beijing Panda, into a WFOE. Ultra Bright's registered capital in the joint venture is $48 million and Panda's registered capital is $12 million.

(1) The conversion and reorganization requires an equity transfer agreement. What is the purpose of this agreement? *See* Changes in Equity Interest Provisions (EIP), art. 2 below.

(2) What represents Panda's equity interest in the joint venture? *See* Equity Transfer Agreement, art. 2.2.

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type of proceeding to initiate or where the case is brought. For example, in a case where a joint venture or wholly foreign-owned enterprise's products are being counterfeited, the foreign investor or MNC usually has no choice but to go to the area where the suspected counterfeiting occurs and engage the local authorities. Where an MNC's products cause injury to a consumer or the MNC is accused by a third party of a business tort, the MNC might find itself as a defendant in a court where the tort occurred, which may be in a remote location not of its choosing. It is important to recognize that the types of business disputes discussed in this chapter are those that can be anticipated by the parties and can be the subject of a prior agreement regarding conditions for resolution.

A. CONCILIATION AND MEDIATION IN CHINA

This chapter is divided into two main parts: arbitration and litigation. Before we discuss either of these methods, however, we begin with conciliation and mediation, the informal methods of dispute resolution that are often used in China in conjunction with both arbitration and litigation.

Chinese parties have traditionally sought to avoid resolving disputes in a confrontational manner. Court based litigation is adversarial and may lead to damage to the existing business relationship between the parties. Arbitration, while more flexible than litigation, is still adversarial in nature with two opposing parties seeking to persuade a neutral body of arbitrators of the merits of contending positions. By contrast, conciliation refers to direct negotiations between the disputing parties without the presence of a third party. This method may be more amicable than any formal method of dispute resolution. Conciliation is expressly encouraged by the Contract Law, the Cooperative Joint Venture Law, and the Equity Joint Venture Law. Conciliation is often the last step before adversarial proceedings are initiated, but it may continue even after formal proceedings have begun. Both conciliation and mediation, discussed below, are consistent with Confucian traditions that seek to preserve social harmony and avoid confrontation. Both methods also allow parties to save face because they are less accusatory and provide greater opportunities to avoid criticizing or impugning an opponent as might occur with greater frequency in litigation or arbitration.

While conciliation involves only the parties to the dispute, mediation involves the use of a third party who serves as the mediator. Mediation is encouraged by the PRC government, which has established more than 950,000 People's Mediation Committees that resolve over 7 million disputes annually. The China Council for the Promotion of International Trade (CCPIT), a recognized dispute resolution center, has established more than 40 mediation centers in China. Each mediation center maintains a roster from which mediators can be chosen, although the parties are also allowed to choose a mediator who is not listed on the roster. In 2004, the CCPIT also established the U.S. China Business Mediation Center, which is intended specifically to mediate business disputes between U.S. and Chinese entities.

Note that in all mediations in China (and in the United States) the mediator lacks any power to bind the parties, so all resolutions must be voluntarily accepted by the parties. Many MNCs find this to be a disadvantage and consider it a waste of time to use mediation alone and not in conjunction with litigation and arbitration, as further discussed below.

B. DIFFERENCES WITH THE UNITED STATES

A distinct difference between mediation in the United States and in China is that mediation in the United States is often an independent process that the parties enter into prior to litigation or arbitration. If the mediation proves to be unsuccessful, the parties will then proceed to litigation or arbitration. In China, both conciliation and mediation are informal processes that are not necessarily a discrete phase of the dispute resolution process but can occur concurrently with litigation or arbitration. In fact, in some cases, a judge presiding over a pending litigation in China may also serve as a mediator for the litigants. It would not be unusual for a judge to ask the parties whether they would consider mediation, with the judge serving as the mediator, after he has heard oral presentation by the parties. If the parties come to an agreement under the judge's mediation, then the court enters a settlement instead of a judgment. Some judges prefer this result because appeals from settlements are not allowed and the judge does not risk a reversal or remand by a higher court. Since both parties have agreed to the result this could be a face saving measure for the parties and for the judge. The role of a judge as mediator, however, raises concerns about the neutrality of the decision maker and about conflicts of interest.

Such practices in China differ from those in the United States where judges cannot serve as mediators at the same time that they are presiding over litigation pending between the parties. The parties would naturally feel under pressure if a presiding judge suggests mediation and offers to serve as the mediator, and the judge may have a conflict of interest if the judge has an incentive to have the case resolved by mediation in order to avoid a trial and the risk of a reversal on appeal.

An arbitrator can also serve as a mediator in China, but in mediations under the rules of the CCPIT, a mediator cannot be an arbitrator for the same dispute unless the parties expressly waive this prohibition.

The PRC expressly encourages conciliation and mediation during both arbitration and litigation, and many disputes are resolved informally or settled after litigation or arbitration has already formally begun.

II. ARBITRATION

Since China began to attract foreign direct investment in the 1980s, arbitration has been the preferred method of dispute resolution among MNCs and foreign investors. Arbitration has several advantages over both of the informal methods of conciliation and mediation and court-based litigation. Unlike conciliation and mediation, arbitration is binding on the parties and awards can be enforced using the court system in China and overseas under applicable international treaties. Arbitration also has numerous advantages over court-based litigation:

- *Language*: The parties can choose to have English as the language used in arbitration. All court-based litigation in China must proceed in Chinese.
- *Expertise*: The parties are allowed to choose arbitrators, including arbitrators of foreign nationality, who have special expertise relevant to the dispute. Access to expertise can be a great advantage in complex business cases in China because some judges may lack the expertise in business matters as well as the application of foreign law, which may be involved in the dispute.
- *Neutrality*: Some courts in China may be subject to local protectionism and political influence (further discussed below). The parties may wish to select arbitrators who are more neutral than some local judges and less susceptible to external influence.
- *Saving Time and Money*: Each case in arbitration stands on its own, so there is no delay due to a backlog of cases on a court's docket. In addition, an appeal from an award is possible only on narrow grounds, so the entire process is relatively quick.
- *Confidentiality*: Litigation will expose the dispute to public scrutiny in China, but arbitration can be kept confidential. No records of arbitration need ever be made public (except in cases where courts are asked to enforce arbitral awards).
- *Enforceability*: Arbitral awards are entitled to enforcement in China using the court system and in over 130 countries abroad under the New York Arbitration Convention (further discussed below).
- *Mitigation of Hostilities*: Arbitration is usually more conducive to preserving the business relationship between the parties than litigation, which is often confrontational and hostile.

Arbitration must be chosen in writing by the parties. The best time to plan for arbitration is before a dispute erupts. Many foreign investors to a joint venture include dispute resolution clauses selecting arbitration in the joint venture contract and the articles of association. Both parties usually find it much easier to agree on dispute resolution clauses in the glow of the good will that often accompanies the expectations of entering into a new business venture. Once a dispute has already erupted, the relationship may become frayed and both parties might become contentious in a way that impedes reaching a common agreement on dispute resolution. If the parties' relationship has become strained to the point where agreement cannot be reached, then the default of litigation may become the only possibility.

A. CIETAC AND OTHER ARBITRAL TRIBUNALS

Arbitration in China is governed by the Arbitration Law (1994), but each arbitration commission has its own set of rules that sets forth its own procedures. China has both arbitration commissions that deal with domestic matters (domestic commissions) and special tribunals designed for foreign related disputes. Although domestic commissions are now also empowered to hear arbitration cases that involve foreign related disputes, domestic commissions have two distinct disadvantages: Chinese must be the official language of the proceedings and the parties are not allowed to choose the arbitrators. Moreover, domestic commissions are less likely to be familiar with the complex commercial disputes involving foreign investors.

The commissions that hear most foreign related arbitrations in China are the China International Economic and Trade Arbitration Commission (CIETAC) and the China Maritime Arbitration Commission (CMAC). CIETAC is generally regarded within China as a highly prestigious and powerful body. CIETAC maintains its headquarters in Beijing and maintains sub-commissions in Tianjin (north of Beijing), Shanghai, Shenzhen (southern China adjacent to Hong Kong), and Chongqing (southwestern China). CMAC specializes in maritime disputes, which usually involve the carriage of goods by sea in ships, still the dominant mode for the transport of goods in modern international trade. CIETAC and CMAC have issued their own sets of rules of procedure, see CIETAC Rules (promulgated 1995, amended 1998, 2000 and 2005) and CMAC Rules (promulgated 1995, amended 2000, 2004). CIETAC Rules are subject to

modification by the parties for the purposes of managing the proceedings, choosing arbitrators, and evidentiary issues, so long as the changes do not violate applicable Chinese laws.

CIETAC and its predecessor institutions have long been the traditional vehicles for arbitration of foreign related claims. CIETAC was first established in 1954 as the Foreign Trade and Arbitration Commission and renamed the Foreign Economic Trade Arbitration Commission in 1980. The original purpose of these institutions was to resolve disputes arising from contracts involving foreign trade between Chinese and foreign parties. In 1989, the Commission was renamed CIETAC. Since the 1990s, CIETAC's workload has grown every year, increasing from over 200 disputes per year to over 1300 in 2009, making CIETAC one of the busiest arbitration centers in the world. By contrast, the International Chamber of Commerce, located in Paris and long regarded as one of the world's leading arbitration centers, handles approximately 350 cases per year. CIETAC is now considered to be a world class arbitration center.

Parties to CIETAC arbitration are permitted to select arbitrators from a Register, which now includes a large number of foreign nationals, including people from the United States, Hong Kong, Australia, and a number of European countries. Prior to 1989, all CIETAC arbitrators were Chinese nationals. At present, about one-third of all persons on the Register of Arbitrators are foreign nationals. Parties are still required to choose a CIETAC-approved arbitrator from the Register; however, the parties are also permitted to choose an arbitrator from outside of the Register provided that the parties consent and CIETAC approves the arbitrator. The ability to choose a non-CIETAC approved arbitrator can be a significant advantage for MNCs since they can then freely select persons who have the expertise and experience to deal with the dispute at hand and are not restricted to a list of people who might be unsuitable for the particular dispute. Chinese is the official language of CIETAC, but the Commission also permits the parties to choose another language, such as English, as the official language of the proceeding and to ask for translation support for hearings and any documentation. Most U.S.-based MNCs choose English as the language of the arbitration. The ability to select the language of the proceeding and to rely on foreign experts as arbitrators are two of the main features that make CIETAC arbitration attractive to foreign investors and MNCs in China. For this reason, the majority of foreign parties prefer CIETAC (or CMAC) arbitration to any other forum now currently available in China.

CIETAC arbitration panels can consist of one arbitrator or a tribunal of three arbitrators. If the parties decide to appoint a tribunal of three arbitrators, the usual procedure is for the claimant to appoint one arbitrator, the respondent to appoint the second arbitrator, and for both parties to jointly appoint the third arbitrator who serves as the presiding arbitrator, or the arbitrator-in-chief. If either of the parties is unable to appoint any of the arbitrators within a prescribed period of time, CIETAC is authorized to make the appointment.

Although foreign parties have traditionally appointed their own foreign counsel to represent them in arbitration hearings and CIETAC rules do not prohibit this practice, several regulations adopted by the Ministry of Justice in 2002 appear to limit the roles that foreign lawyers can serve in an arbitration proceeding. *See, e.g.*, Foreign Law Firm Implementing Regulations (2002). The Regulations appear to allow an advisory role by the foreign lawyer but Chinese lawyers must be appointed to handle matters relating to the applicability of Chinese law or to render opinions on Chinese law during the arbitration. While this is not a total ban on foreign attorney participation in Chinese arbitration, it is severely limiting and seems to be inconsistent with the fundamental principle that arbitration is a strictly private method of dispute resolution and that the parties have the right to choose their own representatives and agents. The position of the MOJ and the State Council also appears to be inconsistent with Article 29 of the Arbitration Law and Article 16 of the CIETAC Rules, which expressly allow parties to appoint their own lawyers. Unfortunately, the ability of parties to appoint foreign lawyers to serve as lead counsel in CIETAC arbitrations remains unclear.

Unlike the United States and many other countries, China does not permit ad hoc arbitration. Parties are not allowed to form their own arbitration panels outside of an established commission in China and select a set of rules, such as the United Nations Commission on International Trade Arbitral Rules. All arbitration in China must proceed through officially recognized commissions, such as CIETAC.

The following is an example of a model CIETAC arbitration clause:

> Any dispute arising from or in connection with this Contract shall be submitted to the Beijing branch of the China International Economic and Trade Arbitration Commission (CIETAC) for final and binding arbitration, which shall be conducted in accordance with the Commission's arbitration rules then in effect. Each party shall appoint one arbitrator (either from or outside of the CIETAC roster) within 30 days from the filing of the arbitration proceedings. If a party fails to appoint an arbitrator within 30 days, then the CIETAC president shall appoint such arbitrator to serve. The two appointed arbitrators shall jointly select a third arbitrator from the CIETAC roster within 30 days. The third arbitrator shall serve as the arbitrator-in-chief. If the two arbitrators fail to appoint the