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## Investing in Hospitality Operations in the People's Republic of China: The Legal Framework

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## **Abstract**

In the late 1970s, the People's Republic of China announced its "Open Door Policy." After being closed to the outside world for decades, the Western world was not certain what to make of this turnaround. The author looks at a number of questions: Was China sincere in its statements that it wanted foreign investment on its soil? Was it willing to provide the economic and legal framework within which foreign investors could feel secure about placing their investment dollars? What concerns or issues still remain with regard to such investment decisions today?

## **Keywords**

Bruce Urdang, Asia

# Investing in Hospitality Operations in the People's Republic of China: The Legal Framework

by  
Bruce S. Urdang

*In the late 1970s, the People's Republic of China announced its "Open Door Policy." After being closed to the outside world for decades, the Western world was not certain what to make of this turnaround. The author looks at a number of questions: Was China sincere in its statements that it wanted foreign investment on its soil? Was it willing to provide the economic and legal framework within which foreign investors could feel secure about placing their investment dollars? What concerns or issues still remain with regard to such investment decisions today?*

In 1979, the Chinese government took the first step toward creating the legal structure necessary to attract foreign investment with the promulgation of the Joint Venture Law. The JV Law meant that for the first time the Chinese government had codified its allowance of joint ventures owned at least in part by foreigners. The ventures contemplated by the JV Law were to be those designed to promote the development of China's economy and the raising of scientific and technical levels. Only certain broad categories of industry were to be permitted, however. The classic manufacturing and high technology industries that China so badly needed were included. Also included were tourism and service trades. Thus, the hospitality industry was welcomed.

The JV Law, in addition to enabling the existence of joint ventures, did provide some guidelines to foreign investors in detailing how such organizations were to be formed and managed. For example, joint ventures must obtain government approval to operate. China, long renowned for its large and cumbersome bureaucracy, has not created any type of streamlined procedure for securing such approval. Thus, the process is time consuming and confusing. The partners must convince the government that the venture will be good for the country by providing the government with a project proposal and a feasibility study. If approval is granted, the next step involves the preparation of the joint venture agreement and articles of association.

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Once validly formed, the law provides that the venture will be considered a legal entity in China and that the entity will enjoy limited liability. The western equivalent is that of a corporation wherein the shareholders are not individually liable for the debts and obligations of the corporate entity.

Capitalization of the venture is also controlled. The Joint Venture Law provides that at least 25 percent of the venture's capital must come from the foreign partner. The capital may take any one (or more) of several forms. Cash, tangible assets and even intangible assets such as expertise in areas such as management or finance are permitted. In fact, such "capital" is widely sought after in China. It is one effective way to increase the skills of both local management and labor. The Chinese partner will more often than not contribute the land upon which the venture is to operate. Ownership of the land remains with the state; therefore, the land contribution takes the form of use, rather than ownership.

Profit distribution is likewise controlled. The JV Law states that profits will be distributed in proportion to each partner's capital contribution, after the payment of income tax. The tax structure in China, though, is set up to provide some very attractive benefits. For example, certain areas of the country have been set aside by the government as Special Economic Zones. These are located mostly in the southern part of the country, with the city of Shanghai as the most prominent example.

Before the communists took over in 1949, Shanghai served as the commercial heart of Western colonialism on the Asian continent. The waterfront, known as the Bund, once housed the banks and trading firms that earned Shanghai the nickname "Paris of the East." Those buildings still exist today and the Chinese government has been seeking buyers, or tenants, to be more precise. The price tags have been quite high, though. However, with some quite significant tax incentives, the revitalization of Shanghai as a major player in the Asian economic scheme could occur. According to "Shanghai's Foreign Economic Rules and Regulation 1982-1990," foreign investments in the development zones enjoy preferential treatment. No local income tax will be assessed. That tax waiver is set to expire at the end of 1995, although it might very well be extended. No real estate tax is levied against businesses in the Special Economic Zones for five years, beginning with the month they begin operations. Enterprises involved in the construction of infrastructure also will receive preferential treatment, including similar tax breaks along with favorable land use treatment.

The JV Law goes on to address other specifics of the venture's operations. A bank approved by the government must be used. First priority must be given to sourcing material from within the country. End products are strongly encouraged to be exported rather than sold domestically. This is obviously required so that China may acquire the foreign currency it desperately needs.

Despite the somewhat onerous government regulation of the joint venture, the economic opportunity presented has lured substantial foreign investment. In 1992, foreign investment was estimated to be approximately \$3.4 billion, more than the previous 12 years combined. In 1993, this number more than doubled, reaching the \$7 billion mark. The first quarter of 1994 was also strong at \$2 billion.

### **Drawbacks Do Exist to Investing in China**

In 1983, the "bare bones" of the 1979 JV Law were supplemented by a set of regulations designed to give greater substance to the Law. In 1990, actual amendments to the JV Law were adopted. Despite what appears to be the government's good faith attempts to alleviate western fears about investing substantial dollars in the PRC, some significant, and, for some investors, insurmountable problems remain.

Probably the greatest fear any foreign investor will have is the possibility that some day the Chinese government will nationalize his/her business. The taking of private property by government for a public purpose is not a concept foreign to western law. In the United States, the Fifth Amendment to the Constitution prohibits the taking of private property by the government without "just" compensation. Therefore, even a purely domestic enterprise in the United States is subjected to the possibility that someday it might be forced by the government to give up its business. However, at least the U.S. business or property owner is guaranteed "just" compensation.

Whether or not the same, or a substantially similar, safeguard exists as to the foreign partner's investment in a Chinese joint venture is questionable. The 1990 JV Law amendments attempted to alleviate that fear. These amendments included a provision wherein the Chinese government agreed not to "nationalize" any joint venture without a "public purpose." They further stated that, should such nationalization occur, the owner would be entitled to "appropriate compensation." Exactly what the phrase "appropriate compensation" means is unclear. In the United States, the term "just" compensation has been held to mean the owner will be entitled to the fair market value of the property taken by the government. This concept is often litigated, most often in the context of eminent domain proceedings (often referred to as "condemnation" proceedings) in which the government is taking private property for a public purpose (a roadway). The litigation most often concerns not whether the government has the right to "take" the property, but how much compensation is "just." Normally, expert appraisal evidence is admitted and a jury is asked to determine, based upon the testimony, how much the owner could have gotten in an arm's length transaction.

Whether the use of the term "appropriate" compensation as used in the 1990 amendments to the JV Law is the equivalent of the term "just" compensation is doubtful. The term "appropriate" implies a subjective standard which does not include the notion of "fair market value." It seems to give the Chinese government a license to decide

what is appropriate without reference to any outside criteria. Had the 1990 amendments to the JV Law instead used the term "adequate" or "just" compensation, it would have implied western notions of fair market value and put the investing public more at ease.

As it stands now, the nationalization provisions of the 1990 amendments were at least an attempt to put such fears of western investors to rest. That purpose has been only partially achieved. The concept which should probably make foreign investors least fearful of nationalization of their investments without fair compensation is the reality that the Chinese government must know that, should a foreign investor be unfairly compensated if his/her investment is taken, the chilling effect that would have on future foreign investment would be substantial. Perhaps that is also why, at present, it is not clearly known how the PRC would compensate a foreign investor; it has not yet occurred.

### **Term Limits Exist in China**

The length of time that a foreign joint venture may remain on Chinese soil has been a problem in the past and remains so today. Western notions of corporate existence almost uniformly include perpetual existence. The articles of incorporation of almost any domestic corporation include a provision that the existence of the corporation shall be perpetual. Continuity of existence is one of the hallmarks of corporate existence. In fact, a major reason why one might wish to incorporate one's business is that it continues beyond one's own mortal existence.

Pursuant to the 1979 JV Law, the term of the joint venture had to be specifically set forth in the articles of association. Typically, term limits were 10 to 15 years, perhaps longer, depending upon the scope of the project. Any extension of the term had to be approved by the government.

The amendments to the JV Law did help. The partners were given the right to determine the term of the venture. Most importantly, however, no longer did the law set maximum term limits. The effect was to create the possibility that the venture could remain in China indefinitely. That possibility remains just that, however, a mere possibility. The government can still decide which ventures will be permitted to remain in perpetuity, and it could change its mind as it sees fit. If the government behaves as it traditionally has, those ventures which engage in those industries that China most needs will be the ones that stay. The others will be terminated. The amendments attempt to allay investors' fears, but do so only to a limited extent.

### **Dispute Resolution Methods Are Also Different**

Western notions of dispute resolution are not favored in the PRC. Traditionally, and one should not underestimate the influence of tradition in Chinese culture, only "face-saving" methods would be acceptable. That is, China favors dispute resolution methods which do not have, at their conclusion, a "winner" and a "loser." Thus, the 1979 JV

Law encouraged the resolution of disputes through mediation or conciliation. Resort to litigation was not provided for.

The 1983 Regulations did attempt to accommodate more western dispute resolution options. These stipulated that only after mediation or conciliation had failed could litigation be commenced. Although resort to the courts was provided for, just as the Chinese government's attempts to assuage western investors' concerns with regard to nationalization and the length of a JV's term failed to go far enough, so did this attempt.

The defect was in which forums were made available. Only resort to Chinese courts was permitted. Such a restriction has caused significant concern with foreign investors. Probably the greatest concern is the one which strikes fear into the heart of every litigator and every litigant, the fear of bias by the court in favor of its own citizens, in legal jargon, the fear of being "hometowned." That fear exists even with regard to purely domestic disputes on both an interstate and intrastate level. In the United States, if a dispute exists between citizens of different states, a federal court will have the jurisdiction to hear that case. If the litigants in that same case happen to be from the same state, the federal court could not hear that case. That rule, referred to as diversity of citizenship jurisdiction, developed to allow the judge with no hometown/state affiliation, the federal judge, to hear the case so that the loser could not claim that he lost because the judge was biased in favor of the litigant from the judge's home state. If the foreign JV partner has no choice but to litigate before a Chinese court, that fear becomes a reality.

A second effect of being forced to litigate in China is the removal from the parties to the JV agreement of a significant aspect of freedom of contract. The right of the parties to select the forum of any future dispute along with the body of law which would govern is taken away. In the United States, most contracts will contain choice of law and choice of forum provisions. The agreed upon contract terms are generally respected by the courts and are enforced as written. In fact, such provisions can often be extremely important. Since laws vary significantly from state to state, the body of law applied can often determine the outcome of the case. Removing that right to choose from the parties is significant.

Finally, the Chinese judicial system is not nearly as well developed or established as western judicial systems. Procedures for accessing the system and provisions for enforcement of judgments obtained are weak and, for the most part, inadequate. In short, for the foreign investor, resolution to the courts of the PRC is not very comforting.

### **Foreign Exchange Problems Exist**

Before investing in a Chinese joint venture, the foreign JV partner, and any investors, must be assured that any profits earned by the operations in China can be transferred out of the PRC into the hands of the investors as returns on their investment. Absent such assurances, the incentive to invest is lacking.

There is no prohibition against the foreign partner remitting earned foreign exchange outside the PRC. However, because Chinese currency (called "Renminbi") is not freely convertible into foreign currency, while foreign currency can be converted to Renminbi, practical problems are created.

Transferring the currency itself is obviously of no use for it cannot be converted to other currency and therefore cannot be used. The only way to remove profits from the PRC is if those profits are already in a foreign currency. While much of the JV's earnings may be in non-Chinese currency because the product is exported, as strongly encouraged by the JV Law, much of the earnings will be in Renminbi. Some fairly creative solutions have been resorted to with varying degrees of success.

One strategy has been to attempt to manufacture those goods which the PRC normally imports. If a partially foreign-owned joint venture could sell its product to another Chinese enterprise that otherwise would have had to import that item, the JV has a ready customer. The Chinese government would not object because that buyer no longer needs to import the item, which would require sending valuable foreign currency out of the PRC. In addition, even though the transaction will not result in the JV earning foreign currency, which it could then send out of the country to its investors, it could use the Renminbi earned to purchase its needs locally, thereby obviating the need to purchase those same items with foreign currency.

Another strategy has been to enter into agreements with other Chinese entities using barter, or like-kind exchanges, instead of currency. The result is that the JV need not use its foreign currency to pay other Chinese ventures. To those entities without foreign partners, it does not matter that it is not going to receive its consideration in the form of currency readily exchangeable on the world market. Conversely, it is extremely important to the foreign JV partner that all of its foreign currency be available for distribution outside the country.

Investing in the People's Republic of China is by no means a simple or risk-free proposition. Despite the Chinese government's good faith efforts to "westernize" the investing climate, significant problems remain. One cannot overstate the need for experienced legal advice when considering such a venture. The rules are not the same, yet it is fair to say that, at the very least, there are rules in the People's Republic of China today.

## References

<sup>1</sup>Charles Burrell, "A New China May Reopen Shanghai's Bund to Foreigners," *San Francisco Chronicle* (May 18, 1994).

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