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Dissolution and Liquidation of Foreign Invested Enterprises in China

The recent economic slowdown has had a significant negative effect on economies worldwide, including emerging economies, which economists had previously thought to be relatively insulated from declining global growth. China's economy has not been immune to this trend, and like other countries, the Chinese government has already implemented an economic stimulus plan with the purpose of maintaining economic growth and increasing consumption.

As a result of the global economic slowdown, many enterprises have decided or are being forced to reduce or restructure their business operations. In China, the dissolution and liquidation of foreign-invested enterprises ("FIEs") has also increased, either because the enterprises are seeing the current slowdown and the changes in Chinese law as opportunities to evaluate their businesses and management structures in order to achieve greater efficiency, or because they have decided to leave the Chinese market.

Historically, the dissolution and liquidation process of FIEs in China has been full of cumbersome hurdles and requirements. In an effort to simplify and consolidate the liquidation and dissolution requirements applicable to FIEs and domestic entities, the Procedures for Liquidation of Foreign Invested Enterprises (the "Procedures") were abolished by the State Council of the People's Republic of China (the "PRC") on January 15, 2008. Currently, for the dissolution and liquidation of FIEs, the new PRC Company Law (the "Company Law"), effective January 1, 2006, the Provisions of the Supreme People's Court for Issues Applicable to the Company Law of the People's Republic of China (II) ("Judicial Interpretation II"), promulgated May 12, 2008 and effective May 19, 2008, the Guide Opinions of the General Office of the Ministry of Commerce for Handling Dissolution and Liquidation of Foreign Invested Enterprises (the "Guide Opinions"), promulgated and effective May 5, 2008, the Notice of the State Administration for Commerce and Industry and the Ministry of Commerce for Relevant Issues Regarding Administration on Dissolution and Liquidation of Foreign Invested Enterprises (the "Notice"), promulgated and effective October 20, 2008, and other relevant provisions regarding dissolution and liquidation of FIEs, shall apply.

The Guide Opinions state that the dissolution or liquidation of an FIE must comply with the Company Law, but it also provides that matters that are not fully covered in the Company Law shall be subject to foreign investment laws and certain regulations. The Notice clarifies the procedural requirements to a certain extent, but the details of such requirements are not completely clear to governmental agencies. The Judicial Interpretation II expands on the topic of dissolution and liquidation of FIEs through court procedures. The following provides a general framework for the dissolution of FIEs in China and includes the recent developments described above.

I. Removal of Significant Hurdles in Dissolution and Liquidation

The dissolution and liquidation of an FIE may be either friendly (where equity holders of an FIE fully cooperate, allowing a smooth dissolution and liquidation process) or adversarial (when the shareholders of an FIE do not cooperate, thereby adversely impacting the dissolution and liquidation process). In an adversarial proceeding, a foreign investor often finds himself in the embarrassing situation where the uncooperative relationship among the equity holders results in losses to both the FIE and the foreign investor.

Prior to the adoption of the Guide Opinions and the Judicial Interpretation II, an adversarial relationship would have prevented a fragile FIE from completing the dissolution and liquidation process. The uncooperative party would have, by itself or through its appointed director, hindered the dissolution and liquidation of the FIE using any of the following means: (1) by refusing to apply to the Ministry of Commerce (the "MOC") or its counterparts at the local level, the Commission of Foreign Trade and Economic Cooperation (the "COFTEC"), for the required approval for the FIE's dissolution; (2) by disagreeing to the formation of the liquidation committee of the FIE; or (3) by refusing to execute the liquidation report of the FIE.

Fortunately, recent legal developments have improved this situation, providing alternatives to equity holders who find themselves in an adversarial liquidation or dissolution process. Under the current legal framework, for example, if a party refuses to apply to the MOC or COFTEC for the FIE's dissolution of a joint venture (the "JV"), the other party in interest has two methods to force the JV's dissolution: (1) it can file a lawsuit or an arbitration against the party refusing the dissolution of the JV, claiming that the JV is unable to continue its business due to the breach of the joint venture contract by the breaching party, and, with a valid judgment or arbitral award, the MOC or COFTEC shall be able to approve a unilateral application for dissolution of the JV; or (2) if such party holds 10% or more of the voting rights of the JV, such party can apply to a court of competent jurisdiction to dissolve the JV because the JV's business operation and management have encountered serious difficulties and as a result, the continued existence of the JV would cause the shareholders to suffer material losses, leaving dissolution of the JV as the only option (the Judicial Interpretation II further sets forth the requirements of the facts that must be proved[1]).

It is important to note that, for a wholly foreign-owned enterprise ("WFOE") where two or more foreign investors are involved, the first method described above would not be available, making the second option the only one available to the equity holders of a WFOE trying to dissolve such entity under an adversarial situation.

Once the dissolution of the FIE is approved by the MOC or COFTEC, or adjudicated by the court, and the liquidation committee is formed, the process of liquidation commences. However, if a party disagrees with the formation or composition of the liquidation committee, the other party is generally entitled to request that the court intervene with the appointment or formation of the liquidation committee.

Under the current legal framework, the FIE needs to complete the liquidation process within a reasonable period of time, although the existing laws do not currently detail a specific period of time. If the liquidation committee is formed by the court and the court leads the liquidation process, there is a time limit of six months from the formation of the liquidation committee to the completion of the liquidation process. Any extension must be approved by the court.

Although the Guide Opinions and the Judicial Interpretation II have made it easier for an FIE under an adversarial situation to go ahead with a liquidation and dissolution proceeding, the process for the

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[1] According to Article 1 of the Judicial Interpretation II, the specified facts include: (a) the company has failed to call a meeting of shareholders or a general meeting of shareholders for two or more consecutive years and the operation and management of the company is in great difficulty; (b) due to the fact that a statutory quorum or a quorum specified in the articles of association of the company cannot be present at the time of voting by shareholders, a meeting of shareholders or a general meeting of shareholders has not been able to adopt any valid resolution for two or more consecutive years, and the operation and management of the company is in great difficulty; (c) disagreement among directors of the company remain for an extended period of time and cannot be settled through meetings of shareholders or general meetings of shareholders and the operation and management of the company is in great difficulty.

preparation and adoption of the liquidation report is still unclear. The Guide Opinions require the liquidation report to be confirmed in a shareholder meeting or a meeting of the board of directors of the FIE before the liquidation report is submitted to the MOC or COFTEC. There is no regulation stating the vote required for the board of directors meeting to approve the liquidation report made by the liquidation committee, but generally such approval requires a unanimous vote from the directors. Disagreement among the shareholders or the directors, who represent different shareholders, may also impact the approval of the liquidation report and interfere with the liquidation process. Nonetheless, Article 189 of the Company Law and Article 4 of the Notice may offer a solution by allowing the court to confirm the liquidation report, in replacement of the shareholder meeting or the meeting of the board of directors of the FIE.[2]

II. Major Issues in Preparation for and Process of Dissolution and Liquidation

In addition to the issues discussed above, there are several issues in the preparation for, and the process of, the dissolution and liquidation of an FIE, which may either delay or facilitate the liquidation process.

1. Disposal of Machinery and Equipment ("M&E")

It should be noted that there are differences between the disposal of bonded M&E that was imported on the basis of exemption of duty and value-added tax ("VAT") ("Bonded M&E") and the disposal of non-Bonded M&E. For the Bonded M&E, an FIE is required to dispose of the M&E in any of the following manners: (a) direct removal of the Bonded M&E outside China to the investor of the FIE; (b) sale of the Bonded M&E to a foreign entity and physically exported outside China;[3] (c) making up the proportioned duty and VAT associated with the M&E[4] and then selling the Bonded M&E to a domestic enterprise; or (d) discarding the Bonded M&E with a designated "disposal warehouse" if previously approved by the customs office.[5] For the non-Bonded M&E, it can be sold to any other party or be directly distributed to any of the shareholders during the liquidation process.

2. Employee Settlement

In order to expedite the liquidation process an FIE should have a thorough plan for the employee settlement (*i.e.*, transfer, termination and/or severance pay of employees). In practice, the authorities usually require the FIE to submit a report regarding the employee settlement. The relevant PRC labor laws and regulations provide specifically for the calculation of severance pay, notice requirement and labor union consultation procedures.

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[2] In practice, it seems that, unfortunately, the local COFTEC is reluctant to accept the court's confirmation of the liquidation report. Perhaps in time, an increasing number of similar circumstances may change the attitudes of the COFTEC.

[3] In order for the FIE to receive the payment of the sold M&E, it must provide documents to demonstrate that the M&E has been physically exported outside China.

[4] For the purpose of calculating the duty and VAT, the net book value will be used to determine the price of the M&E and the current duty and import VAT rate (rather than the rate applicable at the time when the M&E was imported into China) will apply.

[5] If the FIE decides to discard the Bonded M&E, the FIE is not required to make up the import duty and VAT from which it was previously exempt but is required to ship the M&E to the "disposal warehouse" at its own expense and pay disassembly and/or fusing fees.

3. Repayment of Enterprise Income Tax ("EIT") and Financial Subsidy

Prior to 2008, if the FIE was a manufacturing entity with a business term of more than ten years, it was entitled to a five-year tax holiday (which means that the entity is exempt from EIT for two years commencing on the first profitable year and is entitled to a 50% reduction of the EIT due for the three years thereafter). However, if the actual number of years of operation of an FIE is fewer than ten years, the FIE must disgorge the EIT five-year tax holiday benefit. Following January 1, 2008, newly-established FIEs can no longer enjoy such preferential treatment. Nonetheless, those FIEs previously granted the five-year tax holiday may face the issue of the repayment of EIT if they are dissolved before the end of the 10-year business term.

Similarly, an FIE that previously received financial subsidy or incentive from local government may also be required to disgorge the financial subsidy or incentive when it is dissolved within ten years of operation. There may be exceptions, however. For example, in the Pudong New Area of Shanghai, if a dissolved FIE is restructured out of existence, but has transferred its business and employees to its affiliate that is also registered in Pudong, the dissolved FIE would not be required to disgorge financial subsidies or incentives previously granted.

4. Remittance of Dividends Following Liquidation

Principally, the foreign exchange authority decides the amount of the dividends following the liquidation, based on the amount of the net assets written in the liquidation audit report issued by a qualified auditor. However, there is a gap between the date of issuance of such liquidation audit report and the date of remittance of the dividends. During this gap period, interest income may be earned and the actual payment of the costs and expenses for the liquidation process may be more or less than the accrued costs and expenses estimated in the liquidation audit report. Both the interest income and the difference between the actual and estimated payment of the costs and expenses for the process can result in changes to the dividends of the FIE following the liquidation.

In practice, for the interest income, the foreign exchange authority generally approves the remittance. However, the foreign exchange authority may not agree to the remittance of the additional amount resulting from the difference between the actual and estimated liquidation costs and expenses.

5. EITs or Individual Income Taxes ("IITs") Levied on Liquidation Distribution

Generally speaking, liquidation distribution in excess of the capital contribution is subject to a 10% withholding tax.

Although there are no significant legal impediments to dissolution and liquidation of FIEs, in practice, the process can easily take one year or longer. Careful planning and meticulous execution are key to successful completion of the dissolution and liquidation process.

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