

## LEGAL REFORM IN CHINA: LEGISLATION ON BUSINESS ENTITIES

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For the past 28 years, China has implemented various legal reforms, including the re-establishment of the Ministry of Justice, the re-opening of the courts, the revival of legal education and the passage of numerous pieces of legislation. Although the restoration of legal institutions is a major constituent of legal reform in China, this article focuses on legislation. Moreover, since it is impossible to provide an exhaustive review of China's legislative enactments and amendments in almost three decades, legislation on business entities is chosen as an illustration. Toward this aim, the following discussion first introduces legal norms in China. It then provides an overview of the legislation on business entities and highlights most recent statutory amendments. Finally, it draws conclusions in the broader context of China's legal reform.

### I LEGAL NORMS IN CHINA

Legislation in China is multi-layered. First and foremost, the Chinese Constitution, the supreme law of the land, is passed and amended by the National People's Congress ('NPC'), the highest legislative body as well as the highest organ of State power.<sup>1</sup> Below the Constitution are basic laws passed by the NPC and its Standing Committee.<sup>2</sup> The State Council, the highest organ of State administration, is empowered to enact administrative regulations to implement basic laws as well as regulations on matters falling within its administrative power.<sup>3</sup> Indeed, the NPC and its Standing Committee may authorise the State Council to enact administrative regulations on certain matters for which laws have not yet been passed.<sup>4</sup>

Under the State Council, there are various ministries and commissions, which may enact ministerial and departmental rules on matters falling within their

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1 The Constitution of the People's Republic of China, adopted by the Fifth Session of the Fifth National People's Congress on 4 December 1982 and amended on 12 April 1988, 29 March 1993, 15 March 1999, and 14 March 2004 respectively ('Constitution'): Preamble and arts 5, 57-58; the Legislation Law of the People's Republic of China, adopted by the Third Session of the Ninth National People's Congress on 15 March 2000 ('Legislation Law'), art 7.

2 Constitution, arts 62 and 67; Legislation Law, art 7.

3 Constitution, arts 85 and 89; Legislation Law, art 56.

4 Legislation Law, art 9.

respective administrative powers in order to implement laws as well as the State Council's administrative regulations and decrees.<sup>5</sup> Similarly, the people's governments of provinces, autonomous regions, municipalities directly under the Central Government and larger cities may enact local government rules to implement basic laws, administrative regulations and local regulations and to handle concrete administrative matters within their respective administrative districts.<sup>6</sup> In this article, these two types of rules are collectively referred to as 'government rules'.

Although China has a unitary system, people's congresses and their standing committees of provinces and municipalities directly under the Central Government may enact local regulations in light of the actual circumstances and practical needs of their respective administrative districts.<sup>7</sup> Likewise, the people's congresses of ethnic autonomous areas may enact self-governing or specific regulations in light of local political, economic, and cultural characteristics.<sup>8</sup>

In sum, the Constitution is at the top of the hierarchy of legal norms. Basic laws take precedence over administrative regulations, local regulations and government rules, while administrative regulations take precedence over local regulations and government rules.

## II LEGISLATION ON BUSINESS ENTITIES

Prior to economic reforms, under a command economy, there were only two major types of business entities in China – State-owned Enterprises ('SOEs') and collectively-owned enterprises. SOEs were those whose means of production (ie property) belonged to the State. Collectively owned enterprises were those whose property belonged to the working people and in which the principles of 'joint labour' and 'distribution in accordance with work' were implemented.<sup>9</sup> In 1979, China opened its door to the outside world. To attract foreign investment, technology, and management expertise, China enacted the Law on Sino-Foreign Equity Joint Ventures.<sup>10</sup> Thereafter, there were the Provisional Regulations on the Administration of the Resident Representative Offices of Foreign Enterprises,<sup>11</sup> the Law on Sino-Foreign Cooperative Joint Ventures,<sup>12</sup> and the Law on Wholly Foreign-Owned Enterprises.<sup>13</sup> In the following years, detailed

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5 Constitution, art 90; Legislation Law, art 71.

6 Legislation Law, art 73.

7 Constitution, art 100; Legislation Law, arts 63-64.

8 Constitution, art 116; Legislation Law, art 66.

9 The Regulations of the People's Republic of China on Collectively Owned Enterprises in Cities and Towns, adopted by the State Council on 21 June 1991, art 4.

10 The Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, adopted by the Second Session of the Fifth National People's Congress on 1 July 1979.

11 The Provisional Regulations on the Administration of the Resident Representative Offices of Foreign Enterprises, promulgated by the State Council on 30 October 1980.

12 The Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures, adopted by the First Session of the Seventh National People's Congress on 13 April 1988.

13 The Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, adopted by the Fourth Session of the Sixth National People's Congress on 12 April 1986.

implementation regulations for equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises were also promulgated.<sup>14</sup>

Subsequently, the three statutes on foreign investment enterprises – equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises – had only minor revisions. For example, the Law on Sino-Foreign Equity Joint Ventures was amended in 1990 and 2001; the Law on Sino-Foreign Cooperative Joint Ventures was amended in 2000; and the Law on Wholly Foreign-Owned Enterprises was amended in 2000. Nevertheless, the Provisional Rules on Several Issues Concerning the Establishment of Foreign Companies Limited by Shares<sup>15</sup> were promulgated in 1995 to provide foreign investors with another investment vehicle because joint ventures and wholly foreign-owned enterprises had, in most cases, been limited liability companies.

On the domestic side, China first allowed individual industrial or commercial households, which permitted individuals to engage in certain types of business activities with the assistance of mostly household members. Then, in 1988, China passed the Law on Industrial Enterprises Owned by the Whole People, which adopted the principle of separation of ownership and management,<sup>16</sup> and the Provisional Regulations on Private Enterprises,<sup>17</sup> which was designed to promote the further development of private businesses. In fact, the Law on Bankruptcy of Enterprises (for Trial Implementation) was also passed in 1986 but only became effective in 1988, three months after the Law on Industrial Enterprises Owned by the Whole People was implemented, to allow SOEs to file for bankruptcy procedures.<sup>18</sup>

During the 1990s, as economic reforms intensified and China's experience with business and the market economy increased, China enacted three significant pieces of legislation. In 1993, the Company Law was enacted.<sup>19</sup> In 1997, the Partnership Law was passed.<sup>20</sup> In 1999, the Sole Proprietorship Law was promulgated.<sup>21</sup> Consequently, the four major forms of business in China in the

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14 The Implementation Regulations for the Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, promulgated by the State Council on 20 September 1983; the Implementation Regulations for the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, promulgated by the Ministry of Foreign Trade and Economic Cooperation on 28 October 1990; the Implementation Regulations for the Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures, promulgated by the Ministry of Foreign Trade and Economic Cooperation on 4 September 1995.

15 The Provisional Rules on Several Issues Concerning the Establishment of Foreign Companies Limited by Shares, promulgated by the Ministry of Foreign Trade and Economic Cooperation on 10 January 1995.

16 The Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People, adopted by the First Session of the Seventh National People's Congress on 13 April 1988, art 2.

17 The Provisional Regulations of the People's Republic of China on Private Enterprises, promulgated by the State Council on 25 June 1988.

18 The Law of the People's Republic of China on Bankruptcy of Enterprises (for Trial Implementation), adopted by the Eighteenth Session of the Standing Committee of the Sixth National People's Congress on 2 December 1986.

19 The Company Law of the People's Republic of China, adopted by the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993 ('1993 Company Law').

20 The Partnership Law of the People's Republic of China, adopted by the 24th Session of the Standing Committee of the Eighth National People's Congress on 2 February 1997 ('1997 Partnership Law').

21 The Sole Proprietorship Law of the People's Republic of China, adopted by the Eleventh Session of the Standing Committee of the Ninth National People's Congress on 30 August 1999.

1990s and early 2000s were the limited liability company, company limited by shares, partnership and sole proprietorship. Subsequently, the Company Law was amended twice (in 1999 and 2004), though only with minor revisions.

Since 2005, China has had four major legislative amendments or enactments relating to business entities. In 2005, the Company Law was substantially revised.<sup>22</sup> In 2006, the Partnership Law was substantially overhauled,<sup>23</sup> and the Law on Bankruptcy of Enterprises was passed (twenty years after the trial implementation was promulgated).<sup>24</sup> In 2007, the Enterprise Income Tax Law was passed, repealing the Law on Income Tax of Foreign Investment Enterprises and Foreign Enterprises (1991) and the Provisional Regulations on Enterprise Income Tax (1993).<sup>25</sup> To illustrate how the regulatory framework of business entities has changed, the following will highlight the major revisions in both the Company and Partnership Laws.

From 1993 to 2005, there were two major types of companies in China: the limited liability company with two to fifty shareholders (similar to proprietary companies in Australia) and the company limited by shares (similar to public companies in Australia). The minimum registered capital for a limited liability company depended on the nature of the business, for example, RMB 500,000 for manufacturing businesses and RMB 300,000 for retailing businesses.<sup>26</sup> The minimum registered capital for a company limited by shares was RMB 10,000,000 and the amount for a listed company was RMB 50,000,000.<sup>27</sup> Corporate governance in large limited liability companies and companies limited by shares was comprised of the board of directors and the board of supervisors.<sup>28</sup>

From January 2006, a business could be a limited liability company with fifty or fewer shareholders, a company limited by shares or a one-person limited liability company.<sup>29</sup> The minimum registered capital for a limited liability company is RMB 30,000,<sup>30</sup> while those for companies limited by shares and one-person limited liability companies are RMB 5,000,000 and RMB 100,000 respectively.<sup>31</sup> In a limited liability company, capital contributions can be made

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22 The Company Law of the People's Republic of China, amended by the Eighteenth Session of the Standing Committee of the Tenth National People's Congress on 27 October 2005 ('2005 Company Law').

23 The Partnership Law of the People's Republic of China, amended by the 23rd Session of the Standing Committee of the Tenth National People's Congress on 27 August 2006 ('2006 Partnership Law').

24 The Law of the People's Republic of China on Bankruptcy of Enterprises, adopted by the 23rd Session of the Standing Committee of the Tenth National People's Congress on 27 August 2006.

25 The Enterprise Income Tax Law of the People's Republic of China, adopted by the Fifth Session of the Tenth National People's Congress on 16 March 2007, art 60. However, the Enterprise Income Tax Law does not apply to the sole proprietorship and partnership. Enterprise Income Tax Law, art 1.

26 1993 Company Law, art 23.

27 1993 Company Law, arts 78 and 152.

28 1993 Company Law, arts 45-49, 52-54, and 102-28.

29 2005 Company Law, arts 23-36, 58-64, 77-98. The main features of a one-person limited liability company include: the shareholder can be a natural person or a legal person; annual financial statements audited by an accounting firm are required; and a natural person can establish only one one-person limited liability company, which, in turn, cannot establish another one-person limited liability company: 2005 Company Law, arts 58, 59, 63.

30 2005 Company Law, art 26.

31 2005 Company Law, arts 59, 81.

in the forms of cash, in-kind, intellectual property, land use rights etc; however, contributions of all shareholders in the form of cash cannot be lower than 30 per cent of registered capital.<sup>32</sup>

Moreover, the original Company Law has been criticised for various deficiencies, especially in terms of corporate governance. The revised Company Law has the following improvements with respect to corporate governance: greater protection of shareholders by allowing shareholder derivative suits;<sup>33</sup> shareholders' dissolution of the company by petitioning the court;<sup>34</sup> protection of minority shareholders in limited liability companies;<sup>35</sup> cumulative voting by shareholders in a company limited by shares;<sup>36</sup> introduction of independent directors;<sup>37</sup> maintaining independence of auditors;<sup>38</sup> and piercing the corporate veil.<sup>39</sup>

Similar to the Company Law, the Partnership Law was substantially revised in 2006. From 1997 to May 2007, there was only one type of partnership in China: the general partnership. Partners were natural persons who had full civil capacity and the partnership was to pay taxes.<sup>40</sup> Since 1 June 2007, there are three types of partnerships in China: general partnerships, special-general partnerships and limited partnerships.

In a general partnership, partners bear joint and several unlimited liability (similar to general partnership in Australia).<sup>41</sup> The partners in a general

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32 2005 Company Law, art 27.

33 When a director, supervisor, or senior manager has caused losses to the company as a result of contravening the law or the articles of association, and the board of directors, executive directors, board of supervisors, or supervisors refuse to lodge a lawsuit, or where irreparable harm will result if a lawsuit is not filed immediately, the shareholder(s) of a limited liability company, or the shareholder(s) of a joint stock limited company, holding one per cent or more of the total shares for a period of 180 consecutive days, may file a lawsuit directly in the people's court: 2005 Company Law, arts 150, 152.

34 If the company experiences serious difficulty in operation and the continuance of the company will cause significant harm to the shareholders, but the problem cannot be solved by other means, the shareholder(s) who hold(s) 10 per cent or more of the voting rights may petition the court to dissolve the company: 2005 Company Law, art 183.

35 If a limited liability company has made profits for five consecutive years but has not distributed dividends even though the distribution requirements are met, where the company is to be merged or divided or to have its major assets transferred, or where the shareholders' meeting decides to amend the articles of association so as to continue the existence of the company despite its expiry or dissolution, the shareholders who vote against such a resolution may ask the company to buy their shares at a reasonable price. If no agreement is reached over the purchase within 60 days of the resolution of the shareholders' meeting, the shareholders may file a lawsuit with the court: 2005 Company law, art 75.

36 In a company limited by shares, the shareholders may use cumulative voting to elect directors or supervisors: 2005 Company Law, art 106.

37 A listed company is to establish independent (external) directors: 2005 Company Law, art 123.

38 To ensure the independence of auditors, the hiring and dismissal of accounting firms for auditing purposes is to be deliberated in the shareholders' meeting or the meeting of the board of directors: 2005 Company Law, art 170.

39 If a shareholder abuses the independent existence of the company and his or her limited liability to evade debts, which causes serious losses to the creditors of the company, the shareholder will bear joint and several liability: 2005 Company Law, art 20. In a one-person limited liability company, if the shareholder cannot prove that his or her personal property is independent from that of the company, he or she will bear joint and several liability for the debts of the company: 2005 Company Law, art 64.

40 1997 Partnership Law, arts 2, 9, 61.

41 2006 Partnership Law, art 2.

partnership can be natural persons, legal persons, or other organisations.<sup>42</sup> A special-general partnership, however, must be a professional profit-making entity.<sup>43</sup> In a special-general partnership, a partner who, in executing the partnership affairs, deliberately or through gross negligence causes the partnership to incur debts will bear unlimited liability, while the other partner(s) will bear liability to the extent of its (their) share of partnership property.<sup>44</sup> Even so, all partners bear joint and several unlimited liability for debts incurred not as a result of deliberate or gross negligence of any partners or for other partnership debts.<sup>45</sup>

In a limited partnership, which is similar to a limited partnership in Australia, there must be two to fifty partners, one of which must be a general partner.<sup>46</sup> The partners in a limited partnership can be natural persons, legal persons, or other organisations.<sup>47</sup> General partner(s) bear(s) joint and several unlimited liability for the debts of the partnership, while limited partner(s) bear(s) liability for the debts of the partnership to the extent of its (their) capital contribution(s).<sup>48</sup> A limited partner cannot execute partnership affairs, except for deciding the admission or withdrawal of a general partner, obtaining the audited financial and accounting reports, providing guarantee for the partnership etc.<sup>49</sup> Nevertheless, a limited partner may do business with the partnership or even operate a competitive business, unless otherwise provided in the partnership agreement.<sup>50</sup>

Furthermore, partners are to pay income taxes respectively for partnership gains allocated to them,<sup>51</sup> which can avoid the problem of double taxation. As regards partnerships established by foreign enterprises or individuals, the State Council is to devise the regulatory scheme.<sup>52</sup> Accordingly, the regulatory frameworks for both companies and partnerships have improved considerably. The protection of creditors and private property is enhanced through the passage of the Law on Bankruptcy of Enterprises and the newly enacted Property Law.<sup>53</sup> The effectiveness of statutory reforms, however, remains to be seen. In any event, legislation on business entities vividly exemplifies the gradualist approach used by China in lawmaking. Thus, it appositely provides a succinct account of this gradualist approach.

When China has limited experience in a certain matter, but the rapid developments of the country do not allow it to take time to pass a fully-fledged statute, it usually promulgates a provisional administrative regulation or a

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42 2006 Partnership Law, art 2.

43 2006 Partnership Law, art 55.

44 2006 Partnership Law, art 57.

45 2006 Partnership Law, art 57.

46 2006 Partnership Law, art 61.

47 2006 Partnership Law, art 2.

48 2006 Partnership Law, art 2.

49 2006 Partnership Law, art 68.

50 2006 Partnership Law, arts 70-71.

51 2006 Partnership Law, art 6.

52 2006 Partnership Law, art 108.

53 The Property Law of the People's Republic of China, adopted by the Fifth Session of the Tenth National People's Congress on 16 March 2007.

government rule (sometimes referred to as ‘measures’) to deal with issues relating to that matter. After implementing the provisional regulation or the government rule for several years, either the NPC or the State Council will enact a basic law or an administrative regulation based on the accumulated experience. After several years, China will revise the basic law or administrative regulation substantially to refine the regulatory framework or to meet the country’s changing economic or social conditions. Alternatively, where a matter must be dealt with by a basic law, China may enact a basic law which has much room for improvement or simply pass a basic law designated for trial implementation. After a number of years of implementation, the basic law will be substantially revised, or the law for trial implementation will be re-drafted into a more permanent, comprehensive one.

As discussed above, China first legislated to separate the ownership and management of SOEs, to facilitate the closing down of failing SOEs and to promote the establishment of private enterprises. Thereafter, China passed its three major statutes on business entities – the Company Law in 1993, the Partnership Law in 1997, and the Sole Proprietorship Law in 1999 – to provide different vehicles to conduct business. As its economic reforms intensified in the 2000s, China substantially revised the Company Law and Partnership Law, as well as promulgating the Law on Bankruptcy of Enterprises, the Enterprise Income Tax Law and the Property Law.

The gradualist approach exemplified in the field of business-entity law is generally characteristic of the legislative patterns in other areas of law. There are several reasons for China to adopt an incremental approach. First, China has limited experience with a market economy and law as an institution. With only 28 years of experience in economic and legal reforms, China is a minor compared to other well-established legal systems and market economies. Second, China’s national circumstances – socio-economic, political-economic and historical – are very different from those of other countries. It does not want to transplant the laws of other well-established legal systems indiscriminately. Third, China wants to ensure that a policy measure is feasible and beneficial before implementing it more permanently and nationwide. Social stability, which is of paramount importance to the Chinese leadership, warrants a more cautious approach to lawmaking. Fourth, since China is a socialist country, various ideological issues have arisen as a result of developing a market economy. The protection of private property is a very good example. In other words, law must be made based on Chinese characteristics.

Notwithstanding the gradualist approach, lawmaking in China is both reactive and proactive. For instance, the new provisions on corporate governance are designed to eliminate (or at least reduce) embezzlement and fraud, which has been rampant in China. In addition, the one-person limited liability company and the general-specific partnership are designed to meet the anticipated needs arising from a growing market economy. As a matter of fact, one can often tell what has been happening in China by examining the new additions to or deletions from existing laws and regulations or the recently promulgated laws, regulations, and rules.

### III LEGAL REFORM IN CHINA

Since the implementation of economic and legal reforms in China, the Communist Party has focused on formulating policies and guidelines at the macro level, namely, setting directions for the country. Nowadays, party law has been applied mainly to Communist Party members and for the purpose of self-discipline. In other words, the Communist Party has taken a back seat and let the legislature perform its designated functions.

For many years, the NPC has been dubbed the 'rubber stamp'. Considering the developments of the NPC in recent years, one can no longer argue that it is a mere 'rubber stamp'. For example, in March of 2007, delegates to the NPC expressed their dissatisfaction with the previous year's work of both the judiciary and the procuratorate by an opposition vote of twelve per cent and an abstention vote of four per cent.<sup>54</sup> Moreover, in drafting a major piece of legislation, such as the recent Labour Contract Law, the Chinese Government often solicits opinions from legal academics, interested groups and even the general public. Therefore, efforts have been made to achieve 'democratic lawmaking' and to advance future compliance with the law.

Regardless of whether China is a rule of law or rule by law country, law has been playing an increasingly significant role in its economic development and social ordering. Legislation in China does serve its normative function by standardising or regulating commercial, social, and government behaviour. Enforcement is still a problem. Consequently, increased efforts must be put into restoring and building the necessary legal infrastructure, raising the legal consciousness of both officials and ordinary citizens and fighting corruption.

As China's national circumstances change, the characterisation of the Chinese legal system has become controversial. In the past, the Chinese imperial codes were primarily penal in nature and incorporated various Confucian tenets. Prior to China's economic and legal reforms, the Chinese legal system was viewed as 'socialist', especially in light of such features as the coexistence of state law and party law, denunciation of private property, and the delegation of governmental functions to mass organisations (such as the All-China Federation of Trade Unions).

Based on the recent developments in China, one can also argue that China now is a civil law country, especially in view of the facts that legislation is the main source of law, judges are to apply the law, and there are no case precedents. Nonetheless, China has also drawn eclectically on both civil and common law countries to draft its laws and regulations and to train its legal professionals. Taking into account China's development of a socialist market economy, its official recognition of private property, its participation in world trade and its

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54 'Property Law Passed by 97 Percent High Votes: NPC Held Its Breath to See the Results; Applause upon the Completion of Votes Counting' (in Chinese), *Mingpao* (Hong Kong), 17 March 2007; available at <<http://www.mingpaonews.com>> at 17 March 2007. There were 2,889 delegates attending the Congress. For the report of the Supreme People's Court, 359 votes were oppositions and 127 votes were abstentions. For the report of the Supreme People's Procuratorate, 342 votes were oppositions and 128 votes were abstentions.



recent promotion of the rule of virtue, it is possible that the Chinese legal system may develop into a *sui generis* legal tradition.