



JÖNKÖPING INTERNATIONAL BUSINESS SCHOOL  
JÖNKÖPING UNIVERSITY

# Corporate establishment in China

A comparative study of establishment options available for an Aktiebolag when entering the Chinese market

Master Thesis in International Company Law

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## Sammanfattning

Många svenska företag är aktiva på ett eller annat sätt på den kinesiska marknaden och efter Kinas medlemskap i WTO år 2001 har Kina blivit än intressantare för företag. Kinas medlemskap innebär inte bara att det blivit lättare för svenska företag att nå den kinesiska marknaden, det finns också en ökad möjlighet för kinesiska företag att ta sig in på den svenska marknaden. Som det är nu står kinesiska företag för en väldigt liten del av den andel utländska företag aktiva i Sverige, däremot finns de flesta stora svenska företag representerade i Kina tillsammans med en rad mindre svenska företag.

Den kinesiska lagstiftningen för de olika bolagsformerna är omfattande. Precis som i Sverige bygger Kinas juridiska system på stiftad lag och har en skriven författning. Kina är en kommunistisk en-parti stat som styrs av det Kommunistiska Partiet medan Sverige är demokratiskt med flera partier. Detta reflekteras i den kinesiska lagstiftning där det finns flera uttryck för det kommunistiska arvet. Det finns också fler typer av bolagsformer i den kinesiska lagstiftning som kan attrahera utländska investerare medan det i den svenska bolagsrätten bara finns en typ av bolagsform som är en juridisk person med begränsat ansvar. Båda länderna ger utländska företagare möjligheten att öppna ett representant kontor, vilket dock inte får bedriva näringsverksamhet i landet. Annars så är möjligheterna goda i båda länderna för utländska investerare att starta ett företag med få juridiska hinder. I den svenska lagstiftning finns endast ett krav på bosättning inom EES medan det stora hindret i Kina mer verkar vara byråkrati som av många svenska företag anses som tidsödande och krånglig.

För utländska företag är det viktigt att ta hänsyn till kulturen i det främmande landet. Speciellt i Kina finns det kulturella koncept som skiljer sig från de i väst, det är *guanxi* samt *mianzi* som kan vara viktiga att känna till. *Guanxi* kan liknas vid att ha ett starkt nätverk men i Kina kan detta nätverk uträtta mirakel, medan *mianzi* bäst liknas vid att ha ett gott rykte, något som är ytterst viktigt att ha i Kina.

# Master's Thesis in International Company Law

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## Summary

There are many Swedish companies active on the Chinese market, since China's accession to the WTO the year 2001 China has gotten even more interesting. China's WTO accession does not only make it easier for Swedish companies to be present in China, it also provides Chinese companies an increased opportunity to access the Swedish market. Currently Chinese companies active in Sweden only counts for a small share of the total amount of the foreign companies present in Sweden, while there are several Swedish companies present in China.

The Chinese legislation for the various entities is extensive. Just as in Sweden, China applies a civil law system with a written constitution. While China is a communistic one-party state Sweden is democratic nation with several parties. The communistic legacy is reflected in the Chinese legislation. There are several types of entities that appeals to a foreign investor in the Chinese legislation while there in the Swedish legislation only exist one kind of entity that counts as a legal person with limited liability. In both nations there exists the possibility of establishing a Representative Office however it is not allowed to conduct any kind of profit making business. There is in neither state any severe obstacles from establishing a company, there is only a demand for residency within the EEA in the Swedish legislation. According to many Swedish companies present in China it seems that bureaucracy in China is the major difficulty, it is perceived as complicated and time-consuming

For foreign companies it is important to respect the culture in the foreign country. The Chinese culture is different from the western and there are some concepts that are valuable to be familiar with. *Guanxi* can be compared to having a powerful network which may perform miracle with the time-consuming Chinese bureaucracy and *mianzi* which is more than just having a good reputation. How the company is perceived is highly important in China.

## List of abbreviations

- AB** Aktiebolag (Swedish company with limited liability)
- ABL** Aktiebolagslagen (The law governing Aktiebolag)
- AG** Aktiengesellschaft (German public company with limited liability)
- BL** Lag om Handelsbolag och Enkla bolag (The law governing Handelsbolag and Enkla bolag)
- CEO** Chief Executive Officer
- Ch** Chapter
- CJV** Cooperative Joint Venture
- CNY** Chinese Yuan
- CPC** the Communist Party of China
- EEA** European Economic Area
- EJV** Equity Joint Ventures
- EU** European Union
- FDI** Foreign Direct Investment
- FIE** Foreign Investment Enterprises
- GATT** General Agreement on Tariffs and Trade
- GATS** General Agreement on Trade in Services
- GmbH** Gesellschaft mit beschränkter Haftung (German company with limited liability)
- GPCL** General Principle of Civil Law
- HB** Handelsbolag (trading partnership)
- ITPS** Institutet för Tillväxtpolitiska Studier (the Swedish institute for growth policy studies)
- KB** Kommanditbolag (limited partnership)
- LoU** Lagen om offentlig upphandling (The law governing public procurement)
- NPC** National People's Congress
- p** page
- RF** Regeringsformen (Swedish constitution)
- RB** Rättegångsbalken (the Swedish code of judicial procedure)
- SAIC** State Administration for Industry and Commerce
- SCB** Statistiska Central Byrån (Statistics Sweden)
- SCCC** Swedish Chamber of Commerce in China

**SEK** Swedish kronor

**SOE** State Owned Enterprises

**TRIPs** Agreement on Trade-Related Aspects of Intellectual Property Rights

**WTO** World Trade Organization

**WFOE** Wholly Foreign Owned Enterprise

# Table of Contents

<b>1</b>	<b>Introduction.....</b>	<b>1</b>
1.1	Background .....	1
1.2	Purpose .....	2
1.3	Delimitations.....	2
1.4	Method .....	3
1.5	Outline .....	4
<b>2</b>	<b>The legal systems in Sweden and China .....</b>	<b>5</b>
2.1	Introduction.....	5
2.2	Constitution .....	5
2.3	Judicial system .....	6
2.4	China in transition.....	7
2.5	Concluding remarks.....	8
<b>3</b>	<b>World Trade Organization (WTO).....</b>	<b>9</b>
3.1	Introduction.....	9
3.2	Facts.....	9
3.3	China's Accession to the World Trade Organization .....	10
3.4	Consequences for Swedish companies.....	12
3.5	Concluding remarks.....	14
<b>4</b>	<b>Chinese trading culture.....</b>	<b>15</b>
4.1	Introduction.....	15
4.2	Culture.....	15
4.2.1	Face - <i>mianzi</i> .....	16
4.2.2	<i>Guanxi</i> .....	16
4.3	Concluding remarks.....	18
<b>5</b>	<b>Swedish entities.....</b>	<b>19</b>
5.1	Introduction.....	19
5.2	Aktiebolag (AB) .....	19
5.3	Foreign establishment in Sweden .....	21
5.4	Concluding remarks.....	22
<b>6</b>	<b>Chinese entities .....</b>	<b>23</b>
6.1	Introduction.....	23
6.2	Chinese company law .....	23
6.3	State Owned Enterprises (SOE).....	25
6.4	Representative Office .....	26
6.5	Equity joint ventures (EJV) <i>Hezi Jingying Qiye</i> .....	26
6.5.1	Advantages and disadvantages with an EJV .....	28
6.6	Cooperative Joint Venture (CJV) <i>Hezuo Jingying Qiye</i> .....	29
6.6.1	Advantages and disadvantages with CJV .....	30
6.7	EJV vs. CJV comparison .....	31
6.8	Wholly Foreign Owned Enterprises (WFOE) <i>Waishang Touzi Jingying Qiye</i> .....	32
6.8.1	Advantages and disadvantages of WFOE.....	35

6.9	Concluding remarks.....	36
<b>7</b>	<b>Final analysis and comparison.....</b>	<b>39</b>
7.1	Introduction.....	39
7.2	Consequences of China's WTO accession .....	39
7.3	Entities.....	40
7.3.1	Representative Offices .....	40
7.3.2	Aktiebolag.....	41
7.3.3	Wholly Foreign Owned Enterprise.....	42
7.3.4	Equity Joint Venture/Cooperative Joint Venture.....	42
7.4	Culture.....	44
7.5	Concluding remarks.....	45
<b>8</b>	<b>Conclusions .....</b>	<b>46</b>
	<b>References .....</b>	<b>49</b>

# 1 Introduction

China's accession to the World Trade Organization (WTO) have given more companies the opportunity of becoming established in the Chinese market therefore this master thesis will be discussing the forms of entities in China that may be of interest for foreign investor. Parallels will be drawn to the Swedish Aktiebolag, which is an entity with legal person status and limited liability. To provide a deeper understanding this thesis also contains a chapter where some concepts of Chinese culture are discussed.

## 1.1 Background

China has proved to be an important actor on the global market; the Chinese market has grown tremendously over the last years.<sup>1</sup> An increasing number of foreign companies are investing in China, not only to gain access to the Chinese market but also to place their was production in China. The importance of China as a trading partner was increased by the recent Chinese accession to the WTO. For many Swedish companies it is essential to do business with or in China.

The Swedish export to China has grown every year since 1995, and the growth rate for Swedish export to China is higher than for many other nations. China has become Sweden's largest trading partner in Asia and the 12<sup>th</sup> largest on a global scale. 2 per cent of Sweden's total export is being shipped to China and Sweden receives close to 3 per cent of the total import from China. The total value of the import is growing steadily while the export is slowly declining.<sup>2</sup> A survey made by the Swedish Embassy in Beijing in cooperation with the Swedish Chamber of Commerce in China (SCCC) showed that Swedish investors had until 2004 invested a total of 2.8 billion USD. in China and an estimated 33 000 persons are employed by Swedish companies in China. The survey was

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<sup>1</sup> BBC. *China's growth hits six year high* Retrieved 2005-12-06, from <http://news.bbc.co.uk/2/hi/business/3412069.stm>

<sup>2</sup> SCB *Export och Import fördelade på länder* Retrieved 2005-11-14 from [http://www.scb.se/templates/tableOrChart\\_\\_\\_\\_142265.asp](http://www.scb.se/templates/tableOrChart____142265.asp); Widman, E (2005). *Sveriges handel med Kina – fortsatta framgångar*. Retrieved 2005-11-14 from <http://www.swedenabroad.com/SelectImage/20800/Handel.pdf>

answered by 93 companies which represent four fifths of the Swedish companies currently active in China. The total revenue was estimated to 7.5 billion USD.<sup>3</sup>

The World Bank estimates that if China's international economical co-operation will proceed as planned, China will have a share of world trade up to 10% in 2020 second only to the US which will have an estimated share of 12%.<sup>4</sup>

This thesis will primarily focus on Swedish companies establishing in China since most of the China related business is conducted in China. In Sweden there was in 2004 only 17 companies with a total of 231 employees that was fully owned by Chinese investors.<sup>5</sup> Therefore this thesis will only deal with one form of Swedish entities but more Chinese entities.

## 1.2 Purpose

The purpose of this thesis is to examine the legal forms of entities in China that are available for a Swedish company looking for an investment vehicle in the Chinese market. What options are there for a Swedish company when establishing in China and are there any particular legal issues to take into consideration as a Swedish investor?

## 1.3 Delimitations

Due to the extent of the legislation concerning the two nations various forms of entities, the focus is on the basic structure of the different entities. In order to fully establish a company in a new market many areas of law such as tax law and labour legislation needs to be discussed, this thesis will be limited to mainly the field of company law. No other Chinese entities will be discussed but the ones available for foreign investors; the only exception is the State Owned Enterprises which is mentioned due to the fact that it is a governmentally owned company in a socialist state. It is likely that it may take part in a joint venture and it is also a good example of the communist legacy that still exists in China. The

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<sup>3</sup> Widman, E. *China business climate report 2005: Swedish business in China expands but two thirds continue to face barriers to trade and investment* p.1. Retrieved 2005-11-14 from [http://www.swedenabroad.com/SelectImage/20800/climate\\_report\\_2005.pdf](http://www.swedenabroad.com/SelectImage/20800/climate_report_2005.pdf)

<sup>4</sup> Panitchpakdi, S., & Clifford, M.L. *China and the WTO – changing China, Changing World Trade*. p.33-34.

<sup>5</sup> ITPS. *Utlandsägda företag*. 2004. S2005:006 Retrieved 2005-11-14 from [http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Statistik/S2005/S2005\\_006.pdf](http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Statistik/S2005/S2005_006.pdf).17

only Swedish entity that will be dealt with is the Aktiebolag since that is most likely the form of companies that will take part in the business in China. Aktiebolag is also probably the most interesting option for Chinese companies to use when seeking an opportunity in the Swedish market. According to statistics, the Aktiebolag is the Swedish form of entity that is generally responsible for the highest turnover<sup>6</sup> and since it is a form of entity with limited liability it has the advantage of lessening the risks that are related to conducting business abroad.

## 1.4 Method

In order to fulfil the purpose of this thesis various sources must be used. The findings will, where possible, be based on primary legal sources such as Swedish and Chinese legislation.

When writing a legal thesis it is always advantageous to use a source that is as close to its original as possible. When discussing Swedish legislation, the original source has been used and thereby there have been no risk of anything being lost in translation. The problem of translation has arisen when discussing the Chinese legislation, since translated sources have been used. If anything should differ from the original source it will hold precedence over any translation. Throughout the work with this thesis there have been a constant strive to use recognized translated sources; which was to be found from the Chinese Ministry of Commerce website as well as from The Lehman, Lee & Xu law library which holds one of the most complete electronic collections of Chinese laws and regulations available.<sup>7</sup>

Due to the problem of finding translated Chinese law this thesis also relies on the information to be found in literature written by reliable authors, such as Kui Hua Wang, a Chinese scholar who has taught Chinese law at the School of Law at Deakin University for many years.

Various internet sites have been the source of information concerning statistics and facts. The sites that have been used are in large extent the official sites of the organisations that are discussed or sites from other official organisations that are involved in the topic mentioned. There is also information taken from a yearly survey conducted by the Swedish

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<sup>6</sup> SCB. *Företagens ekonomi för industri- bygg och tjänsteföretag*. Retrieved 2005-11-25 from [http://www.scb.se/templates/Publikation\\_\\_\\_\\_139436.asp](http://www.scb.se/templates/Publikation____139436.asp)

<sup>7</sup> The Lehman, Lee & Xu law library. Retrieved 2005-11-24 from <http://www.chinalaw.cc/lib/lib/default.htm> ;Ministry of Commerce of the PRC. Retrieved 2005-11-24 from <http://english.mofcom.gov.cn/>

Chamber of Commerce in China. This survey provides a valuable overview over the performance of Swedish companies active in China and how they perceive the climate as foreign investors.

## **1.5 Outline**

In order to answer the questions of this thesis different issues have to be examined. The thesis will begin by giving a brief introduction to the basics of the legal systems in China and Sweden with the focus on China, to make the reader understand what kind of legal environment China offers. This is followed by a discussion of the Chinese accession to the WTO. The reader is provided with WTO facts as well as a discussion how the Chinese accession will affect Chinese company law and China's business climate. In order to make it easier to understand the Chinese way of reasoning when looking at the Chinese different forms of entities the thesis contains a chapter concerning Chinese culture, especially examining the cultural issues arising when conducting business. To be able to answer the questions this thesis is focusing on examining the various forms of Chinese entities available for foreign investors as well as the Swedish Aktiebolag. The thesis will be finished with an analysis together with a conclusion.

Each chapter will begin with a short introduction to the topic to be discussed and will end with a few concluding remarks.

## 2 The legal systems in Sweden and China

### 2.1 Introduction

This chapter will provide the reader with a brief overview of the two states legal structure. There is no intent of giving extensive explanations. The purpose is rather to help the reader to understand that there are basic similarities but at the same time large differences in the way the states are being governed. These are reasons that affect the legal structure and the variations to be seen in the legal forms of entities available.

### 2.2 Constitution

China is a nation with a communistic form of government, while Sweden has constitutional form of monarchy.<sup>8</sup> Sweden is a democratic nation with several political parties and a written constitution.<sup>9</sup> Both Sweden aswell as China applies a civil law system (except Hong Kong where they practise a partly common law based judicial system<sup>10</sup>) with written legislations. China's legal foundation is based on a constitution however in practise there are two constitutions, the state constitution and the constitution for the Communist Party of China. Amendments in one constitution have a tendency to be reflected in the other.<sup>11</sup> No laws or regulations may go against the constitution. Since 1949 four constitutions has been in power in China, the latest was adopted in 1982 and that is the one referred to in this thesis.

In order to change the Chinese constitution there must be a two-thirds majority in the National People's Congress (NPC). The Communist Party of China (the CPC) was founded in 1921 and now holds the most political power in China.<sup>12</sup> To change the Swedish constitution there must be two decisions in the parliament in favour off changing

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<sup>8</sup> CIA. *The world's fact book*. Retrieved 2005-11-16, from <http://www.cia.gov/cia/publications/factbook/geos/sw.html> and <http://www.cia.gov/cia/publications/factbook/geos/ch.html>

<sup>9</sup> Halvarsson, A. et al. *Sveriges Statskick*. p. 35, 103.

<sup>10</sup> Wesley-Smith, P. *An introduction to the Hong Kong Legal System* (3rd ed.). p. 12-13.

<sup>11</sup> (2005)China: Constitution and institutions *EIU ViewsWire*.

<sup>12</sup> Wang, K.H. *Chinese Commercial Law* p. 14, 18-19.

the constitution. The decisions must be made with an election in between and the period between the decisions must be at least nine months.<sup>13</sup>

### 2.3 Judicial system

Sweden and China have a similar court system in the sense that the Supreme Court holds the highest judicial power. The Chinese Supreme Court handles acts on an appeal basis, and primarily addresses cases that may be precedential. The Supreme Court also gives judicial interpretations and is supervising the administrative of justice made by the local People's Courts and the special courts. Both nations have in addition to the general court system a system of specialist courts for such various things as environment and transportation.<sup>14</sup> This is comparable to the Swedish system where the Supreme Court performs tasks alike such as giving precedential rulings.<sup>15</sup>

In China they also make use of a parallel system called the People's Procuratorates which is the power of legal supervision and administration of justice making it China's judicial supervisory organ. It mostly deals with traditional criminal cases but is now taking a more active part in the fighting corruption and tax-related crimes. The People's Procuratorates at various levels investigate and decide whether or not to initiate prosecution or not.

The People's Procuratorates also supervise the court system, making protests against incorrect judgments made by courts at all levels. It provides interpretations to rules concerning applications of law in the procuratorial work and makes by-laws concerning the same.<sup>16</sup>

The Chinese constitution clearly states that the judiciary branch shall be independent and not subject to interference from any kind of organization.<sup>17</sup> However China has no real separation of power as the three powers, the government administration, the legislature and the judiciary, makes an overlap in the one-party state making the judiciary branch less

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<sup>13</sup> RF 8.15.

<sup>14</sup> Art 127 PRC Constitution; Wang, K.H. *Chinese Commercial Law* p. 25-27; Warnling-Nerep, W et al. *Statsrättens grunder*. p. 8-9.

<sup>15</sup> RF 11.1, RB 3.1; Halvarsson, A et al. *Sveriges Statskicks*. p. 193.

<sup>16</sup> Art 129 PRC Constitution; Wang, K.H. *Chinese Commercial Law*. p. 27-28.

<sup>17</sup> Art 126 PRC Constitution.

independent than it might be in other nations. In Sweden there is a constant strive to keep the three powers as separate and independent as possible.<sup>18</sup>

## 2.4 China in transition

In the late 1970s China's political climate started to change and the "open door policy" came into effect. At that time there did not exist a legal framework how to govern foreign investment. China realised that in order to attract the much needed foreign investment they needed to create rules to protect the foreign capital. Much has happened since then; there are now several hundreds of rules, regulations and amendments in practise to protect foreign technology and foreign direct investment (FDI).<sup>19</sup>

According to Chinese scholar Wang there is still a lack of legal consciousness in modern China, this despite China's long legal history. China has undergone a major re-structuring both when it comes to the legislation but also as a society. China is still in this process of re-structuring and much of the Chinese legislation is relatively new, much is copied from the west. It can not be expected to work smoothly from the start.

In the legislation there are many different rights which may not always indicate a wish to give human and civil rights to all people rather than creating a stable environment for foreign investment.<sup>20</sup> This may be part of the communistic legacy where the right of the individual has been forced to stand back for the greater good. One example of this legacy is to be found in the Company Law which mostly contains legislation that can be expected from the laws and regulations of most countries; however some signs of a socialist society are to be found. Article 14 states that one of the law's commitments is to "strengthen the construction of socialist culture and ideology and accept supervision of the Government and public."<sup>21</sup>

China also entered into several bilateral agreements and multilateral agreements. While Sweden has been a member of World Trade Organization (WTO) since 1995, China

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<sup>18</sup> RF 1.1, 1.4, 1.6, 1.8.

<sup>19</sup> Wang, K.H. *Chinese Commercial Law* p. 83.

<sup>20</sup> Wang, K.H. *Chinese Commercial Law*. p 46-47.

<sup>21</sup> Art 14 Company Law.

recently became a member.<sup>22</sup> In order to fully comply with the recognized rules in the WTO treaties China is forced to revise much of its legislation. This is expected to create a stable a transparent market for foreign investors. Since the accession China has been working hard in order to make the necessary revisions in their legislation to avoid conflicts between the agreed set of laws and the domestic rules. China has been given a six-year-schedule starting 2002 to fully become integrated into the global trading system. So far the basic foreign investment rules regarding Equity Joint Ventures, Contractual Joint Ventures and on Wholly Foreign Owned Enterprises all have been revised However the Chinese legislation and legal tradition will have a hard time to change that rapidly so the process of modifying the commercial legal framework can be expected to be lengthy.<sup>23</sup>

## 2.5 Concluding remarks

Concluding remarks on this chapter is that China is not that different from the Swedish system, both nations have written constitutions and applies civil law. They also have a similar structure of the court system. China still has a legacy of communism which China now tries to adjust to better fit into the global world of trade. It is a long on-going process of change that currently is taking place in China. Not only must the legislation be revised in order to reflect the WTO treaties that have been signed, but the legal society and the perception of law is also going through a period of transformation. The Swedish legislators have had more time to harmonise the legislation accordingly. The existing legislation in Sweden is not in a phase of re-structuring of the same dimension as in China which makes it more stable making it easier for companies to expect the outcomes of their actions.

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<sup>22</sup> Member Information – Sweden and the WTO. Retrieved 2005-11-16, from [http://www.wto.org/english/thewto\\_e/countries\\_e/sweden\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/sweden_e.htm)  
Member Information - China and the WTO. Retrieved 051116 from [http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm)

<sup>23</sup> Lock, G et al. *Setting up Business in the People's Republic of China* p. 127; Jingyan, H. *Changes in the Laws and Regulations Regarding Foreign Investment in China*. p 7.

## **3 World Trade Organization (WTO)**

### **3.1 Introduction**

The third chapter of this thesis will discuss the World Trade Organisation and China's accession to this organisation. The fact that China has become a member of the WTO is a milestone in China's increased development as an important player of the world economy. The accession will have widespread consequences for many actors; Chinese companies will have an easier access to the world market just as foreign investors will receive a smoother entrance to the Chinese market. The accession occurred recently and China is still in a transition period in order to harmonise its legislation according to the WTO treaties.

The first part of the WTO chapter will introduce the reader to the facts of the World Trade Organisation which is necessary to comprehend to fully grasp the importance of being part of this organisation. It is then followed by what the accession actually means to China and investors interested in the Chinese market. The chapter is being concluded by a short analysis of a survey made by the Swedish Chamber of Commerce in China concerning how Swedish companies active in China perceive the current trading climate.

### **3.2 Facts**

The WTO is a worldwide organisation consisting of 148 member states<sup>24</sup> which together holds 97 per cent of world trade. The WTO is concerned with the rules and regulations for international trade. The organisation's main task is to create stable rules for the global market in order to establish a predictable trading environment and prevent protectionism.<sup>25</sup>

The goals of the WTO are to try and accomplish a higher degree of free world trade through negotiations between the Member States and by doing so create regulations for trade. It is also to maintain specific processes to solve trade conflicts in an impartial and objective manner.

The WTO is supposed to be a democratic organization, all nations have, no matter size or power, one vote and all decisions are made according to the consensus principle. However

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<sup>24</sup> For a full list of the Member States please visit <http://www.wto.org>

<sup>25</sup> *What is the WTO?* retrieved 2005-09-29 from [http://www.wto.org/english/thewto\\_e/whatis\\_e/whatis\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm)

### 3. World Trade Organization (WTO)

as in all international organizations smaller countries have less influence than the greater nations due to these nations' larger influence and financial strength.<sup>26</sup>

The WTO is based on agreements between the member states; there are three major agreements where the first is called the General Agreement on Tariffs and Trade (GATT), with addition of agreements for textiles and agriculture industry. The two other agreements cover services through the General Agreement on Trade in Services (GATS) and intellectual property in the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs).<sup>27</sup>

The WTO's highest deciding organ is the Ministerial Conference where ministers from all member states meet. This occurs at least every two years. The next planned Ministerial Conference is scheduled to take place in Hong Kong 13-18 December 2005. The highest organ between Ministerial Conferences is known as the General Council and is the executive force in the organization. This year's conference will be discussing a range of subjects and work on issues related to the implementation of agreements arising from previous negotiations such as reductions in tariffs for thousands of products as well as negotiating new members' accession to the WTO.<sup>28</sup>

### **3.3 China's Accession to the World Trade Organization**

As a result of more than two decades of economical reforms and after 15 years of negotiations China was finally accepted as a member of the WTO. China became a member the 11<sup>th</sup> of December, 2001.<sup>29</sup> No other country has needed that much time to become a member of the WTO. The reason why China's accession was so slow were that due to China's size many nations were affected and concerned by the accession therefore forcing China to time consuming negotiations. One example of this is concerning the textile industry where China already holds a 70 per cent share of the total world market. With reduced trade barriers this is expected to increase further at the expanse of textile industry in many nations; one nation that is affected is Cambodia where textile exports accounts for

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<sup>26</sup> *Vad är WTO*. Retrieved 2005-09-29, from [http://www.kommers.se/page\\_disp.asp?node=222](http://www.kommers.se/page_disp.asp?node=222)

<sup>27</sup> *WTO*. Retrieved 2005-09-29, from [http://www.kommers.se/page\\_disp.asp?node=20](http://www.kommers.se/page_disp.asp?node=20)

<sup>28</sup> *Ministerial Conferences*. Retrieved 2005-09-29, from [http://www.wto.org/english/thewto\\_e/minist\\_e/minist\\_e.htm](http://www.wto.org/english/thewto_e/minist_e/minist_e.htm)

<sup>29</sup> Gertler, J.L. *What China's WTO accession is all about?* p. 21.

### 3. World Trade Organization (WTO)

90 per cent of the country's total export. The textile export from such countries as Cambodia is to expect to decrease as they face hard competition from China.<sup>30</sup> The WTO has a simple rule that one country can not be favoured over the rest. This means that the most favourable offer has to be offered to every country as part of the accession agreement. This principle is known as the "most favoured nation" treatment making it hard to negotiate exceptions.<sup>31</sup> All agreements made are put into a mutual protocol, this protocol outlines the current trade laws in the applicant's legislation and notes the differences between them and the requirements that the WTO demands. The WTO also states in the protocol procedure how to meet the requirements.<sup>32</sup>

One of the aims for the WTO is to abolish non-tariff trade barriers, such as quotas and standard regulations. China is strongly committed to remove non-tariff measures in order to comply with the WTO agreement. China has also agreed to remove tariffs on more than 400 products before 2005 as well as agreed to not increase or expand the remaining tariffs.<sup>33</sup> So far China has been doing well, the average rate of China's tariffs decreased from 42.9 per cent in 1992 to 10.4 percent at the beginning of 2004.<sup>34</sup>

China has accepted to implement the WTO's regulations not only when it comes to trading with goods, but also concerning establishments, services, investments and intellectual property.<sup>35</sup>

Normally the joining Member State has to be in full compliance with all provisions in the WTO at the time of its entrance into the organisation. China was not able to comply with

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<sup>30</sup> Asia Pacific Bulletin – November 21, 2003. Retrieved 2005-11-25, from <http://www.asiapacificbusiness.ca/apbn/pdfs/bulletin135.pdf>; Fawthrop, T. *The price of free trade part 2*. Retrieved 2005-11-25, from <http://yaleglobal.yale.edu/display.article?id=4627>

<sup>31</sup> *Understand the WTO – Agreements. Intellectual property: protection and enforcement*. Retrieved 2005-09-29, from [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/agrm7\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm); Yonghai, S *China's Commitments to the WTO – a Chinese perspective*. p.17.

<sup>32</sup> Panitchpakdi, S., & Clifford, M.L. (2002). *China and the WTO – changing China, Changing World Trade*. p.74-77.

<sup>33</sup> Yonghai, S *China's Commitments to the WTO – a Chinese perspective*. p.19.

<sup>34</sup> Panitchpakdi, S (2004) *China and the WTO: Challenges and opportunities for the future*. Retrieved 2005-11-17, from [http://www.wto.org/english/news\\_e/spsp\\_e/spsp32\\_e.htm](http://www.wto.org/english/news_e/spsp_e/spsp32_e.htm)

<sup>35</sup> *Kina som medlem i WTO*. Retrieved 2005-09-29, from [http://www.kommers.se/news\\_show.asp?id=43](http://www.kommers.se/news_show.asp?id=43)

### 3. World Trade Organization (WTO)

this, but because of China's importance in the world economy China was given an exceptional protocol with special phase-in periods.<sup>36</sup>

After negotiations were finalized, China agreed to make a series of essential commitments to liberalize and open up its system to become further integrated in the global economy. This would help investors to obtain a more predictable trading environment in China. Some examples of these commitments are;

- China will apply a non-discriminatory treatment to all WTO members. Meaning that all foreign individuals and companies will be treated in a no less favourable way than enterprises in China.
- China agrees to remove the dual pricing strategy as well as other differences in treatment for goods produced for sale in China in comparison with the goods meant for export.
- China undertakes to not maintain or introduce any new export subsidies on agricultural products.
- All the WTO trade agreements will be implemented in China in a uniform manner. China will enact new legislation in compliance with the WTO agreements.
- China had three years of the accession to give all enterprises full right to import and export all goods within and throughout the customs territory with only limited exceptions.

These exceptions concern products such as tobacco, fuel, minerals and also some restrictions on transportation of goods within the country.<sup>37</sup>

### 3.4 Consequences for Swedish companies

The positive general outcome of China's accession to the WTO for Swedish companies is that a major market will be opened up and be less regulated. China will reduce the import tariffs and alter the quotas on import and export. There will no longer be any joint-venture restrictions on the production of motor vehicles which is an import market for Swedish

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<sup>36</sup> A report and selected Annexes prepared for the US-China Security review Commission by the Law offices of Stewart and Stewart. (2002). *Accession of the People's Republic of China to the World trade organization*. p.1-2.

<sup>37</sup> Pouncey, C et al *China as a WTO Member: The opening-up of the Chinese Market* in the book *Doing Business with China* p69-72; A report and selected Annexes prepared for the US-China Security review Commission by the Law offices of Stewart and Stewart. (2002). *Accession of the People's Republic of China to the World trade organization*. p.15-16.

### 3. World Trade Organization (WTO)

vehicle manufacturers such as Volvo and Saab.<sup>38</sup> Importers will now be allowed to have their own distribution networks. China guarantees that Swedish companies will enjoy the same rights to trade as Chinese companies.<sup>39</sup>

Before China's entry into the WTO there were high custom duties and different quotas which now have been lowered and Swedish companies will have easier and increased market access into China. Just as Chinese companies will get an increased export market.<sup>40</sup> Not only have there been problems with tariffs and import/export restrictions, another issue dealt with is the transparency in the Chinese legal system and the many technical trade barriers. China is now far gone in the process of eliminating all measures that will direct or indirect discriminate foreign companies. China has explicitly agreed to abolish all taxes and dual pricing systems that are discriminating. China will also remove restrictions on after sales services for imported goods and remove the special rules affecting import of cigarettes, spirits, pharmaceuticals and chemicals.<sup>41</sup>

However in 2004 two thirds of the Swedish companies present in China reported to be affected by one or more trade and investment barriers according to the survey made by the Swedish Embassy and the SCCC. The largest barrier to efficient trade was the complicated and time consuming procedures for import and export. The other barrier reported was the lacking trading rights which is a direct consequence of delays in implementing the commitments China made when entering the WTO. The survey also showed that the problems with trading rights had increased since 2003.<sup>42</sup>

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<sup>38</sup> *Highlights of the EU-China Agreement on WTO*. Retrieved 2004-11-05, from <http://europa.eu.int/comm/trade/bilateral/china/high.htm>

<sup>39</sup> Magariños, C.A et al *China in the WTO – the birth of a New Catching-Up Strategy*. p.10-11.

<sup>40</sup> Hong Kong Trade Development Council. *China's WTO Accession and Implications for Hong Kong*. (2001 Ed.). p.1.

<sup>41</sup> Pouncey, C et al *China as a WTO member: the Opening-up of the Chinese Market*. P.69-70.

<sup>42</sup> Widman, E. *China business climate report 2005: Swedish business in China expands but two thirds continue to face barriers to trade and investment* p.8-10. Retrieved 2005-11-14, from [http://www.swedenabroad.com/SelectImage/20800/climate\\_report\\_2005.pdf](http://www.swedenabroad.com/SelectImage/20800/climate_report_2005.pdf)

### **3.5 Concluding remarks**

The chapter discussing China's accession to the WTO can be summed up by stating a few comments. China is a large trading party in the global economy and it is beneficial for all nations that China now is a part of the WTO so that the Chinese legislation can be revised creating a stable trading environment for companies pursuing business with or in China. The same applies for Chinese companies with an urge to expand into new markets. Harmonised rules imply that the regulations will be more familiar for the investors making it safer in the sense that it reduces the uncertainty, thereby attracting foreign investors. The outcome of this accession is that China is no longer allowed to discriminate against foreign companies, all companies shall be treated equal and be granted the same rights. China will also reduce or remove trade barriers such as tariffs and quotas. However it seems that according to Swedish companies present in China this process is slow. There are still barriers to trade and there is still a delay in implementing the commitments. One barrier that was reported was that bureaucracy is perceived as complicated. This however can be a sign of cultural confusion.

## 4 Chinese trading culture

### 4.1 Introduction

At first glance it may seem that China is one huge market. However, the people are not as homogeneous as one can think. In China there is a complex diversity culturally, ethnically, linguistically and socially as well as the different kinds of climate and geographically differences. This creates various markets and it is wrong to think that one can target them all.<sup>43</sup> This chapter will bring the reader a bit closer into the Chinese culture which will help to understand the reasons for having the different structures of entities which now exist in China. This chapter may not contain legal reasoning but it provides the reader with valuable information on Chinese culture useful when to assess what is being said concerning the entities. Focus in this chapter is on two concepts of Chinese culture, *guanxi* and *mianzi*, especially *guanxi* is important to be somewhat familiar to as it in many cases have been known to substitute for law.

### 4.2 Culture

It may look like China is being westernised however under the surface the Chinese' values and culture are still standing strong. According to Chee and West large part of China's culture is still based on the ideas of Confucius, who was born in 551 BC. He was a teacher and adviser to princes and he did not develop a form of religion but a way of thinking and a set of ethics and rules. His teachings are based on hierarchical relationships to provide for guidelines. The basic of the hierarchical relationship was to pay respect to ones ruler, then to ones parents. Next in the hierarchy is siblings and relatives and finally friends. Not only is Confucius teachings concerned with relationships but also to respect tradition and collectivism. It is important for a westerner to understand the importance of the family and bias towards collectivism.<sup>44</sup>

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<sup>43</sup> Chee, H., & West, C. *Myths about Doing Business in China*. p.4.

<sup>44</sup> Baocheng, L. *Discovering Chinese Cultural Roots*. P.176; Chee, H., & West, C. *Myths About Doing Business in China*. p.43-45.

### 4.2.1 Face - *mianzi*

The concept of face (*mianzi*) has to be understood before entering China. What face is all about is prestige, status and especially how one is perceived in a group or in the society. It is also about self respect. Usually it is hard for a non-Chinese person to understand the power of face; the loss of face is highly shameful and is something that is avoided at high cost. Face is closely connected to the concept of *guanxi* which will be dealt with further on. It should also be stressed that the individual as well as companies and organisations got a face of its own to nourish.

The concept of face can be compared to a credit card. The more face you have, the more you can use as a credit but you must be prepared to pay it back. Face is increased by such things as wealth, power but also for such characteristics as intelligence, beauty, personality or in the case of companies - image. To lose face is to jeopardise ones place in the hierarchy of society which will affect the possibility of cultivating a network of connection. Face can also be given, received, saved and recovered.

The best way for a foreigner to preserve face is to be very observant and very diplomatic. If somehow you manage to damage ones face you may lose an important connection yourself and therefore it may be good to try and recover the situation. For this purpose an intermediary is used, both in business as well for personal situation. It can be a mutual friend or a trusted person that is being used as a “go between”. Even with an intermediary it takes an effort to regain the lost face.<sup>45</sup>

### 4.2.2 *Guanxi*

“With the right *guanxi*, there are few rules in China that can’t be broken or at least bent: I have heard *guanxi* described as ‘tool to achieve the impossible’”<sup>46</sup>

As mentioned earlier, face is connected to the concept of *guanxi* which can be best described as being connected, or having an informal network. *Guanxi* is a network based on mutual trust and an exchange of favours.

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<sup>45</sup> Baocheng, L. *Discovering Chinese Cultural Roots*. p. 177-178; Chee, H., & West, C. *Myths About Doing Business in China*. p. 48-53.

<sup>46</sup> Chee, H., & West, C. *Myths about Doing Business in China* p.62-63.

#### 4. Chinese trading culture

In China many people still value *guanxi* higher than the legal system. *Guanxi* substitutes for a reliable legal system and has almost become a code of conduct substituting the rule of law.<sup>47</sup> Even if it is easy to compare *guanxi* to the western concept of networking there are differences to it. *Guanxi* is based on a long-term approach and is very concentrated. *Guanxi* is also personal, and the ties are connected to one person, while networking is based on having a wider range of acquaintances.

According to the teaching of Confucius everything is fixed in hierarchical order, and so is *guanxi*. *Guanxi* consists of four stages based on the relationship closeness.

- *Jiaren*. Family comes first, and in China the definition of family is more extended than in the west. It is very rare to have a non-family member at this stage but it may happen.
- *Zijiren*. These are your really close friends. The people you can always trust.
- *Shuren*. In this category is the place for colleagues and distant friends. Often based on common links such as origin from the same area or same background. Here are also members from different clubs and associations you have joined.
- *Shengren*. This is the lowest category of *guanxi*, these are outsiders with potential. To make a judgment of their worthiness to become a part of the top three categories can take a long time.

Not all people become part of your *guanxi* most people are just acquaintances and stay that way. For a foreigner it is often very difficult to become something more than *shengren*.<sup>48</sup>

One problem that western companies frequently encounter is that *guanxi* is based on personal ties. Many westerners wrongfully assume that the relationship is tied to the company but that is not the case. When an employee quits he or she will bring his or her acquired *guanxi* and leave the company. *Guanxi* can also be abused, one example of that is if one employee is using his or her position at the company in order to boost his or her *guanxi*. Very often the procurement process is done via *guanxi* and not through competitive bidding. One way of solving the problem is to work in teams to avoid one person to be too

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<sup>47</sup> Chee, H., & West, C. *Myths about Doing Business in China*. p.61-62; Baocheng, L. *Discovering Chinese Cultural Roots*. p. 179-180.

<sup>48</sup> Chee, H., & West, C. *Myths About Doing Business in China*. p. 63-66.

involved. Another approach to decrease the risk for abuse is to strengthen loyalty bonds to the company by activities within the company, such as bringing the employees family to visit the company and arrange family festivities. It may sound worse than it is, salespeople in the west also have been taking clients from the company when leaving.<sup>49</sup> Sweden have legislated against this concerning the public sector, the law clearly states that the procurement must be transparent, fair and in a businesslike manner.<sup>50</sup> However there are not the same rules regarding private enterprises.

### 4.3 Concluding remarks

As a conclusion over the cultural part of this thesis it should be mentioned that it is important to always keep cultural aspects in mind when assessing the facts. What may seem odd at first glance may be understandable when placed in a cultural context. Concerning China's culture it should be kept in mind that the power of *guanxi* shall not be underestimated. For a company trying to become established in the Chinese market it is essential to acquire the right *guanxi*. However it will be hard to develop *guanxi* without having a good face so the two concepts are highly connected and great respect should be given to these concepts. From a legal point of view it is *guanxi* that is the more important concept since it may substitute the law itself in the sense that with the right *guanxi* there may be a possibility to make the law a bit flexible.

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<sup>49</sup> Chee, H., & West, C. *Myths About Doing Business in China*. p.67-70.

<sup>50</sup> LoU.

## 5 Swedish entities

### 5.1 Introduction

The main Swedish entities are Aktiebolag (AB), Handelsbolag (HB), and Kommanditbolag (KB).<sup>51</sup> There are also the options of conducting business in the form of a foundation or as a sole trader. This thesis is limited to only discussing the Aktiebolag; the reason for this is that the Aktiebolag is the form of entity that is most likely to be chosen as the vehicle of business by Chinese investors. It is also most common for Swedish companies that are venturing into China to conduct business in the form of an Aktiebolag. According to “Sweden Statistics” close to one third of all forms of vehicles for business in Sweden is an Aktiebolag but the Aktiebolag is responsible for over 90 per cent of total annual turnover.<sup>52</sup> The risks that are associated with pursuing business overseas are also decreased for the owners when using a company with limited liability.

The structure of this chapter will start by an overview of the Swedish Aktiebolag followed by a review over foreign establishment in Sweden and some short concluding remarks.

### 5.2 Aktiebolag (AB)

Aktiebolagslagen is the law that governs Aktiebolag and as early as in the very first paragraph it is stated that an AB is a company with limited liability. The partners in an AB are not personally responsible for the debts of the company.<sup>53</sup> In the Swedish legislation there are two kinds of ABs, the private and the public which is being traded on the stock exchange. The same dividing of limited companies can be seen in both Germany where Aktiengesellschaft (AG) co-exists with the Gesellschaft mit beschränkter Haftung (GmbH) and in Great Britain where both public and private limited liability companies are common.<sup>54</sup> Therefore the conclusions drawn from comparing the Swedish entity may also to some extent be applied to other European entities. The initial investment in a private AB must be at least 100.000 SEK and for a public AB the starting capital can not be less than

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<sup>51</sup> BL; ABL.

<sup>52</sup> SCB. *Företagens ekonomi för industri- bygg och tjänsteföretag*. Retrieved 2005-11-25, from [http://www.scb.se/templates/Publikation\\_\\_\\_\\_139436.asp](http://www.scb.se/templates/Publikation____139436.asp)

<sup>53</sup> ABL 1.1.

<sup>54</sup> Rodhe, K. *Aktiebolagsrätt (20th ed.)* p. 22.

500.000 SEK. It is allowed to register a company in Euro.<sup>55</sup> These amounts are equal to the ones mentioned in the Chinese legislation for limited liability companies where the highest sum mentioned is CNY 500.000 followed by CNY 300.000 and CNY 100.000. (1 SEK equals 0.97 CNY [www.forex.se](http://www.forex.se) 2005-11-29.) The amounts depend on the main field of business that the company is planning on entering not whether the shares are being traded publicly or not.<sup>56</sup> The Swedish legislation allows the founder to contribute the registered capital in property instead of cash under the circumstance that the property may be useful for the company in its business.<sup>57</sup>

There are close to 300 000 Aktiebolag in Sweden but only 1100 are registered as public, these are however the largest and the ones with the most influence and financial strength.<sup>58</sup> All shares in an AB shall be equal to profit and power. There is however a possibility of separating shares into different categories giving one category of shares a stronger voting power, with a limit to 10 times the voting value of the weakest type of share.<sup>59</sup> All shares in the same category shall be given the same rights.<sup>60</sup> The voting value of shares can not be decided according to ownership, the voting value shall be fixed to the shares independently of possession. It also allowed to give one category of shares a stronger right to dividend. It is common to give up to 6 per cent dividend to one category of shares primary to the rest of the shares. How this division is done shall be clearly stated in the company's founding document as well as attached to the shares.<sup>61</sup>

The company is controlled by the board whose main task is to be responsible for the management of the company.<sup>62</sup> On the shareholders' general meeting voting is used as tool to elect the board and if someone controls 51 per cent or more of the votes that person or

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<sup>55</sup> ABL 1.3.

<sup>56</sup> Art 23 Company Law.

<sup>57</sup> ABL 2.2.

<sup>58</sup> Sandström, T. *Svensk Aktiebolagsrätt*. p. 57.

<sup>59</sup> ABL 3.1.

<sup>60</sup> Bergström, C., & Samuelsson, P. *Aktiebolagets Grundproblem*. (2nd ed). p. 69.

<sup>61</sup> Rodhe, K. *Aktiebolagsrätt (20th ed)*. p. 132-133.

<sup>62</sup> ABL 8.3.

organisation controls the company.<sup>63</sup> In a public AB there shall be a CEO, it is also allowed to have a CEO in a private AB but there is no legal demand for it.<sup>64</sup>

The principle is that the majority of the votes controls the company, there are however protection for the minority of shareholders. It is hard for the legislator to regulate an effective protection for the minority since the majority rule is necessary for the company to make efficient decisions. What the legislator has done is to give the minority owners safety valves and most of these values are to be used in connection with the general meeting.<sup>65</sup> The reason for having rules protecting the minority is to make it safer to invest in a company without having full influence. One example of this protection is the rules on how to summon to a general meeting making it hard for the majority owner to surprise the other owners. If owners to 1/10 of the votes say so a decision can be delayed. The same amount of votes make sure that there will be an investigation scrutinizing the boards behaviour which may lead to the board being forced to pay damages to the company.<sup>66</sup> In order to change the founding documents and basis of the company the voting limits are being increased in order to avoid a weak majority abusing its power.<sup>67</sup>

### 5.3 Foreign establishment in Sweden

The most common and effective forms of establishing a business in Sweden for a foreign company is through either a Swedish subsidiary company, most likely an AB or through a branch office. There is also the option of establishing a Representative Office but since it may not engage in any commercial activities except pure marketing and gathering of information it is rarely used. Sweden has no restrictions for foreign owners in Swedish companies. The only exception that may require a special license is companies in areas such as banking, insurance and financial services. There are no special requirements for a foreign investor to comply with when wishing to found an AB, it is the same procedure for a foreign investor as it is for a native investor.<sup>68</sup>

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<sup>63</sup> ABL 8.6-7, 9.1.

<sup>64</sup> ABL 8.23.

<sup>65</sup> Sandström, T. *Svensk Aktiebolagsrätt*. p. 194.

<sup>66</sup> ABL 15.7; Rodhe, K. *Aktiebolagsrätt (20th ed.)* p. 229-232.

<sup>67</sup> ABL 9.30-32; Rodhe, K. *Aktiebolagsrätt (20th ed.)*. p. 233.

<sup>68</sup> ISA, *Simplicity and transparency*. Retrieved 2005-11-14, [http://www.isa.se/templates/Normal\\_\\_\\_\\_2024.aspx](http://www.isa.se/templates/Normal____2024.aspx); ISA, *Fact Sheet – Establishing a business in Sweden*. Retrieved 2005-11-14, from

However there are certain conditions to take into consideration when establishing in Sweden. The Swedish law states that the board of directors must consist of at least three persons and no less than half of them must reside within the EEA, unless the government makes an exception.<sup>69</sup> The same applies for the managing director who must reside within the EEA.<sup>70</sup>

There are not many applications for such an exception; approximately 100-150 per year is being handed in to the Bolagsverket that is the governmental agency that gives approval for such exceptions. The reasons for an exception may be that the company need time to establish themselves in Europe. Once established there may not exist a need for an exception any longer. Conditions to receive an exception is that there is a connection to Sweden that will hopefully be stronger over time, the applicant must be well organised and well managed. The exception can be given for a certain period of time but not indefinitely. According to Bolagsverket the reason for such a residency demand is that personal attendance is highly valued, modern communications like e-mail and telephone is not enough.<sup>71</sup>

## 5.4 Concluding remarks

The AB is a good option for a foreign investor pursuing the Swedish market; it is a legal person with limited liability and holds no restriction to nationality of the owner. The only demand that a foreign investor needs to take into consideration is the demand for residency within the EEA for half the board and the managing director. The AB provides the investor with two options, either to keep it as a private company or to make it public. By making it public the share may be traded on the stock exchange and thereby attracting further capital. If there is more than one owner a shareholders' meeting must be held annually. The shareholders' meeting has the highest decisional power. There is no stipulation in Swedish legislation concerning the amount of owners neither are there any demand for having a Swedish partner of any kind.

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[http://www.isa.se/upload/english/FactSheets/Establishing\\_a\\_business.pdf](http://www.isa.se/upload/english/FactSheets/Establishing_a_business.pdf)  
;Ernst & Young. *Establishing a business in Sweden* (5<sup>th</sup> ed). p.3-6. Retrieved 2005-11-14, from  
[http://www.ey.com/global/download.nsf/Sweden/Establish\\_Sweden/\\$file/Establish%20Sweden.pdf](http://www.ey.com/global/download.nsf/Sweden/Establish_Sweden/$file/Establish%20Sweden.pdf)

<sup>69</sup> ABL, 8.1, 8.8.

<sup>70</sup> ABL 8.26.

<sup>71</sup> Telephone interview with Lars Carlsson, lawyer at Bolagsverket. 2005-11-14.

## 6 Chinese entities

### 6.1 Introduction

There is also delimitation on the numbers of Chinese entities discussed. Focus will be on the forms of entities that are available for foreign investors. There have long been a steady increase of investments made in China and since the more open attitude towards foreign investors and with China's accession to the WTO the interest in the Chinese market have increased even more. There are several options for a foreign investor to chose when seeking an opportunity to become established in the Chinese market. This chapter will provide an overview over the three most important forms of entity that are available for foreign investors. There is also the option of establishing a Representative Office which is not an entity of its own; this chapter will explain this further. In order to present the reader with some contrast this chapter will observe the State Owned Entity which is not available for a foreign investor but will give the reader insight to part of China's cultural legacy. It may also be important to be somewhat familiar to the SOE form of entity since it may be the Chinese party in one of the joint venture forms of entities.

Each entity will be presented with the facts followed by a short review of its advantages and disadvantages complete with a comparison of the different entities. The chapter will start by an overview of the Chinese company law.

### 6.2 Chinese company law

The regulations for the Chinese entities available for foreign investors are based on the *General Principle of Civil Law (GPCL)* which deals with general matters of civil law. It gives broad guidelines as well as legal explanations on the various rights and obligations of all types of legal persons and entities that take part in civil legal activities.<sup>72</sup>

Shortly after the GPCL came in to force the *Provisional Regulations of the PRC in Private Enterprises (Private Enterprises Regulation)* was introduced. The aim of this regulation is to govern the private economy and a private economy is defined by a private enterprise, meaning a privately funded economic entity that employs at least eight workers.<sup>73</sup> The

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<sup>72</sup> The General principle of Civil Law of the Peoples Republic of China (GPCL); Ostroy, S et al *China and the long march to global trade – the accession of China to the World Trade Organization*. p. 57; Wang, K.H. *Chinese Commercial Law*. p. 87.

<sup>73</sup> Art 2 of the Private Enterprise Regulation; Wang, K.H. *Chinese Commercial Law*. p. 87.

regulation provides some legal guidelines concerning formation of enterprises, various rights and obligations, taxation matters, registration, labour management, dissolution and penalties.

In the commercial Chinese legislation, rules regarding the forms of entities are less detailed than in many other jurisdictions making it more difficult to legislate the relationship between the shareholder and to adjust the types of ownership interest and especially to allocate profits and losses.<sup>74</sup> Details are to be found in *The Company Law* that governs the corporate issues such as establishment and organisation as well as accounting, merger, issuing of shares, branches and foreign companies. Companies defined in the company law have limited liability and are granted the status of a legal person.<sup>75</sup>

The Equity Joint Venture (EJV), the Cooperative Joint Venture (CJV) and the Wholly Foreign Owned Enterprise (WFOE) are the types of entities available for foreigners and they are together called Foreign Investment Enterprises (FIE). In the Chinese legislation there are rules to especially govern these FIEs, article 18 of the Company Law states that the Company Law must not interfere with the rule to be found in that special legislation, it can however be co-effective.<sup>76</sup> One example of this is concerning the issue of Shareholder's meetings. In Sweden the Shareholder's meeting is the forum for the shareholders to exercise their power and rights.<sup>77</sup> The same idea is to be found in the Company Law second chapter, where it stipulates that a limited liability company shall be the organ of power of the company and shall be composed of all the shareholders.<sup>78</sup> However according to Guanghua and Minkang together with other scholars and practitioner this does not apply to an EJV and the reason for this is said to be that it would not be practical since an EJV mostly consists of only two owners.<sup>79</sup> The EJV Law does not address the issue of

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<sup>74</sup> Paul et al. Using a Chinese Entity for an All-foreign Joint Venture in China – Does it make Sense? p. 2.

<sup>75</sup> Art 2-3 of the Company Law; Wang, K.H. *Chinese Commercial Law*. p. 88.

<sup>76</sup> Art 18 Company Law; Wang, K.H. *Chinese Commercial Law*. p. 88, 91.

<sup>77</sup> ABL ch. 9.

<sup>78</sup> Company Law art 37-44.

<sup>79</sup> Guanghua, Y., & Minkang, G. *Laws affecting business transactions in the PRC*. p. 269; Bath, V. *Venture capital investment in China after WTO entry*. Retrieved 2005-11-26, from <http://www.altassets.com/casefor/countries/2002/nz3277.php>; *Overview of common foreign investment vehicles and transaction structures in China*. Retrieved 2005-11-26, from [http://www.chineselawyer.com.cn/html/lovells/others/memos\\_Investment.htm](http://www.chineselawyer.com.cn/html/lovells/others/memos_Investment.htm)

shareholders meetings; it does however in article 6 give the right to decide in the issues normally decided by the shareholder's meeting to the board of director and by so eliminating the need for shareholder's meetings.<sup>80</sup> The same should apply for the CJV where the CJV Law contains a similar wording concerning the right for the board of directors to decide as the EJV Law does.<sup>81</sup>

### **6.3 State Owned Enterprises (SOE)**

The State Owned Enterprises is a special form of entity, which may not be available for foreign investors. It does have some value to be familiar to this form of entity since the SOE may be the Chinese part of one of the joint venture forms of entities. Furthermore it is also a good example of the fact that the socialist ideas are still present in the Chinese legislation. There is no similar form of entity in the Swedish legislation.

SOE's are governed by a law of its own aswell as certain articles in the Company Law. To classify as a SOE it must be established exclusively by state institution or governmental department.<sup>82</sup>

The SOEs are companies owned by the state, they are required to "take full responsibility for its profits and losses and [to] practise independent business accounting"<sup>83</sup>. In the SOE there is a principle of separation, the ownership and management are kept separate since the property is owned by the whole people. The rights to management are held by the enterprise that is authorised by the government. This is to make clear that the State will not bear unlimited liability for debts of these companies. That is one of the reasons why an SOE may, when in possession of sufficient funding, become a legal person.<sup>84</sup> The board of directors shall exercise the power and are appointed by the state; there are no shareholders' meetings in an SOE.<sup>85</sup> An SOE's primary task is "to develop commodity production,

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<sup>80</sup> Art 6 EJV Law.

<sup>81</sup> Art 12 CJV Law.

<sup>82</sup> Art 64 Company Law.

<sup>83</sup> Art 2 of the SOE Law.

<sup>84</sup> Art 2 2<sup>nd</sup> and 3<sup>rd</sup> paragraph SOE Law; Guanghua, Y., & Minkang, G. *Laws affecting business transactions in the PRC*. p. 76.

<sup>85</sup> Art 66, 68 Company Law.

create wealth, increase savings and satisfy the ever-growing material and cultural needs of society, in accordance with State plans and market demands.<sup>86</sup>

## 6.4 Representative Office

Just as in Sweden one option to be present in China is to set up a Representative Office. Such an office may not engage directly in any business activities in China but it may take part in business activities such as product introductions, market surveys, research and technology exchange and business liaison.<sup>87</sup> It can be perceived as a tool for communication with Chinese clients. Its main advantages are that it is very easy to set up and helps the company to be present, (multiple offices are allowed), which will make it convenient when attempting to cover more of China. However it may be expensive and since it is not a normal form of entity it does not generate any revenue. These advantages and disadvantages also apply for the Swedish form of Representative Office. The rules governing a representative office is found in the law passed in 1995, *the Detailed Rules for the Implementation of the Provisional Regulations Governing the Examination, Approval and Administration of Resident Representative Offices of Foreign Enterprises (the Detailed Rules on Foreign Representative Offices)*. To be allowed to set up a representative office there are four basic requirements to comply with. The foreign enterprise must be legally registered in its country of origin, have a good business reputation; provide true and reliable documents provided by the law and register according to Chinese law.<sup>88</sup>

## 6.5 Equity joint ventures (EJV) *Hezi Jingying Qiye*

There are two main pieces of legislation that govern Equity Joint Ventures; *The Law of the People's Republic of China on Sino-Foreign Joint Equity Enterprises (Equity Joint Venture Law)* and *the Regulations for the Implementation of the Law of the PRC on Sino-Foreign Equity Joint Ventures (The EJV Implementation Regulations)*.

There is no clear definition of an Equity Joint Venture; however the law suggests the following characteristics to describe an EJV. There must be a venture that has received

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<sup>86</sup> Art 3 of the SOE Law.

<sup>87</sup> Art 4 detailed rules on foreign Representative Offices.

<sup>88</sup> Art 8 of the Detailed Rules on Foreign Representative Offices; Dodge, L. *The Representative Office Option*. p.2; Wang, K.H. *Chinese Commercial Law*. p.92; Lock, G et al. *Setting up business in the People's Republic of China*. p.127-128; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html>

capital contributions from both a foreign party and a Chinese party and the foreign investor must have contributed with at least 25 per cent of the registered capital of the EJV. The EJV must have been established within China's territory in accordance with the law and is registered as a Chinese legal person and take the form of a limited liability company. The parties investing in the EJV share the investment, control, risk and profit according to the equity split.<sup>89</sup>

There must be a long term approach to the EJV; the duration is usually set to between 10 to 50 years.<sup>90</sup> The parties involved may choose to set or not to set the term of duration in the contract. Regardless of the choice made the duration may be extended if the parties and the relevant authority agree. There also exists a regulation to govern the duration of EJVs called *the Provisional Regulations on the Duration of Sino-foreign Joint Equity Enterprises (the Provisional Regulations on the Duration)*. This regulation clearly states that certain EJVs must fix the duration of operation in contract and others are allowed to exist for an unlimited period if approved.<sup>91</sup>

The following sectors of business may not apply for an unlimited duration according to art 3 of the *Provisional Regulations on the Duration*.

- service industries
- land development and real estate operations
- resource exploration and exploitation
- investment projects restricted by the State
- other projects that are required to stipulate the duration of their operations pursuant to other State laws and statutory regulations.<sup>92</sup>

The Chinese government expects the EJV not only to create an economic output but also according to its field of business adopt advance technical equipment and scientific management that increase the variety of products, raise the quality and output and save

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<sup>89</sup> Art 4, 7 EJV Law; Art 19 EJV Implementation Rules; Neunuebel, E.R.J et al. *Foreign Direct Investment Vehicles in China*. p. 140; Wang, K.H. *Chinese Commercial Law*. p. 95; Guanghua, Y., & Minkang, G. *Laws affecting business transactions in the PRC*. p. 268.

<sup>90</sup> Art 100-101 of the EJV implementation regulations.

<sup>91</sup> Wang, K.H. *Chinese Commercial Law*. p. 96-97; Guanghua, Y., & Minkang, G. *Laws affecting business transactions in the PRC*. p. 269.

<sup>92</sup> Art 3 Provisional regulations on the Duration.

energy and materials. The government also expects the EJV to provide benefits in terms of technical renovation of enterprises and result in less investment, quicker return and bigger profits, as well as to expand production of commodities for export that will result in increasing income in foreign currency and to organise the training of technical and managerial personnel.<sup>93</sup>

### **6.5.1 Advantages and disadvantages with an EJV**

The main advantage for the foreign investor when entering into an EJV is the reduced business risk. The Chinese partner is directly involved and the Chinese partner can most often more easily manage the necessary governmental bureaucracy due to familiarity with the system but also with a higher level of *guanxi*. This will speed up the process of efficiently being able to enter the market. The foreign investor also gets easy access to the Chinese partners existing business and production network as well as established markets which will increase the chance of success. If the Chinese partner is a SOE enterprise this means that the government will assist in supply of raw materials and the allocation of import/export quotas. A joint venture with such a governmental supported company will enable the foreign investor to take advantages of the special governmental assistance that is otherwise impossible to receive.<sup>94</sup>

There are of course also disadvantages entering into an EJV. The foreign investor is forced to consult its Chinese partner when handling management and production issues, which may cause a conflict of interest. Shared decision-making power may result in delays and confusion which will in the end harm the venture. Foreign investors must also transfer technology and valuable know-how, meaning that the Chinese party will have full access to it. Since the Chinese government have very competent authorities to control the native companies, entering into an EJV also means giving some of the control of the company to the government in a larger extent than operating a 100 per cent foreign-owned company.<sup>95</sup>

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<sup>93</sup> Art 4 of the EJV implementation regulations; Wang, K.H. *Chinese Commercial Law*. p. 96.

<sup>94</sup> Wang, K.H. *Chinese Commercial Law*. p. 97-98; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html>

<sup>95</sup> Wang, K.H. *Chinese Commercial Law*. p. 98; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html>

## 6.6 Cooperative Joint Venture (CJV) *Hezuo Jingying Qiye*

In the Chinese legislation there is another version of joint venture, called Cooperative Joint Venture. The laws governing the CJV are more recent compared to the ones governing the EJV. *The Law of the PRC on Sino-foreign Cooperative Enterprises (Cooperative Joint Venture Law)* is the primary law. Just as with EJV this law has a supplement in *The Detailed Rules for the Implementation of the Law of the PRC on Sino-foreign Cooperative Enterprises (The CJV Implementation Rules)*.<sup>96</sup>

It is not in the law clearly defined what constitute a CJV, however article 2 of the Cooperative Joint Venture Law states features that are characteristic for a CJV. A CJV is a type of joint venture and the cooperating parties share profits and risks. Both parties in a CJV shall put their obligations and every aspect of the arrangement into a written contract, which will be binding for the parties. (A CJV is also sometimes known as “a contractual joint venture”). A CJV may receive the status of a Chinese legal person and shall abide by the laws for a legal person if it complies with the provisions of Chinese law for such a person. Article 2 also states that a CJV may choose not to have such status.<sup>97</sup>

Article 14 of the CJV implementation rules stipulates that a CJV that receives the status of a Chinese legal person becomes a limited liability company. This for the foreign investor means that the foreign party must contribute at least 25 per cent of the total registered capital as stated in article 18 of the CJV implementation rules in order to fulfil the stipulations to receive legal person status. A CJV with such limited liability status enjoys both the protection of limited liability as well the flexibility that is associated with cooperative joint venture.<sup>98</sup>

The rules on a CJV without legal person status are to be found in chapter nine of the CJV implementation rules. When a CJV do not require the status of a legal person, each party in the joint venture as well as the details of the joint venture must be registered at the State Administration for Industry and Commerce (SAIC). In the non-legal person form of a CJV each party owns respectively investment unless other agreement is made when property can

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<sup>96</sup> Wang, K.H. *Chinese Commercial Law*. p. 115.

<sup>97</sup> Art 2 CJV Law; art 4, 50 CJV implementation rules; Wang, K.H. *Chinese Commercial Law*. p. 116; Neunuebel, E.R.J et al. *Foreign Direct Investment Vehicles in China*. p. 140; Guanghua, Y., & Minkang, G. *Laws affecting business transactions in the PRC*. p. 271.

<sup>98</sup> Art 14, 18 CJV implementation rules; Wang, K.H. *Chinese Commercial Law*. p. 116.

be owned jointly. Regardless legal status, property accumulated through the CJV operation is jointly owned by all parties of the venture. In the CJV with legal person status all property is regarded to be the property of the CJV.<sup>99</sup>

Normally profits are shared equally in proportion to investment, this is not necessary in a CJV. In a CJV it is allowed to negotiate methods how to share an eventual profit which is part of what differ this form of entity from the others.<sup>100</sup>

### 6.6.1 Advantages and disadvantages with CJV

The general advantages of the CJV and the EJV are similar to each other but there are some more specific advantages and disadvantages aswell.

The CJV form of entities has been very popular over the years, especially for smaller foreign investment projects. The CJV's main advantage is its flexibility where the parties put all their arrangement in a contract. For example the foreign investor can be allowed to retrieve its investment from the profit of the CJV before the Chinese party can do the same.<sup>101</sup> Not only the terms of profit-sharing can be negotiated, it is also possible to negotiate management of the venture aswell as voting rights and staffing rights. Making a CJV even more flexible giving it an advantage for investors with a desire to have control.<sup>102</sup> The price to pay for the flexibility is that a CJV is not as stable as an EJV and may not be the best choice for long term projects since, especially foreign investor, will after having retrieved the investment and anticipated profit most likely will leave the venture.<sup>103</sup> Another drawback is that the price for the flexibility may be high and it could be time consuming to negotiate all the terms.<sup>104</sup>

There is no duration of time stipulated in the laws governing CJV. However the laws are requesting the parties to enter a term of duration in the contract.<sup>105</sup> The duration may be

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<sup>99</sup> Art 51-52 CJV implementation rules; Wang, K.H. *Chinese Commercial Law*. p. 116-117.

<sup>100</sup> Art 43-44 CJV implementation rules; Paul et al. *Using a Chinese Entity for an All-foreign Joint Venture in China – Does it make sense?* p. 7.

<sup>101</sup> Art 22 CJV law; art 44 CJV implementation rules; Halasz, P.J., & Lan, L. *New rules of the game – Chinese laws on Sino-foreign cooperative enterprises*. p. 41.

<sup>102</sup> Folta, P, H. *Cooperative Joint Ventures*. p. 3.

<sup>103</sup> Wang, K.H. *Chinese Commercial Law*. p. 117-118.

<sup>104</sup> Folta, P, H. *Cooperative Joint Ventures*. p. 2.

<sup>105</sup> Art 25 CJV Law; Art 47 of the CJV implementation Rules.

extended further if applied for. In order to receive an extension there must be clear reasons for it in the application, and generally the application for extension will be rejected if the foreign party has retrieved its investment. Extension may be approved if the foreign party is willing to increase its investment and all other parties agree with the increment.<sup>106</sup>

Article 4 of the Cooperative Joint Venture Law encourages establishment of CJV if the projects are oriented towards export or brings advanced technology.<sup>107</sup>

## 6.7 EJV vs. CJV comparison

The two types of joint ventures have many similarities but also some major differences. Both the EJV and the CJV engage foreign investors as well as local and all parties in the venture jointly share the risks and losses of the project. An EJV is a limited liability company which a CJV also becomes once it is registered as a legal person and the Chinese government expects similar things from both forms of joint ventures in the form of contributions to the society.<sup>108</sup>

In both the EJV and the CJV with legal person status the foreign investor must contribute with a minimum of 25 per cent of the registered capital. However in neither of them there is any demand for this to be in cash. Just as in Sweden it is allowed to make the contribution with property. In China it is also acceptable to contribute with land-rights or intellectual property. Both nations legislation also stipulates that the property that is being contributed must be of such character that it is useful for the company in its business. The only exception to this rule is in a CJV without legal person status where there is no stipulation of the amount for the foreign investor to contribute.<sup>109</sup>

When it comes to the differences it is noticed that a CJV is more flexible since the parties have more freedom to negotiate the terms. There are more statutory requirements in order to set up an EJV. A CJV is not only more flexible in terms of negotiating terms of contract but also when it comes to distributing the profit. A foreign investor only got the opportunity to retrieve investment ahead of their Chinese partner in the form of a CJV, the

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<sup>106</sup> Art 47 CJV implementation rules; Wang, K.H. *Chinese Commercial Law*. p. 126.

<sup>107</sup> Art 6 CJV Law.

<sup>108</sup> Wang, K.H. *Chinese Commercial Law*. p. 127.

<sup>109</sup> ABL 2.2; art 5 EJV Law; art 18 CJV implementation rules; Wang, K.H. *Chinese Commercial Law* p. 106,107, 120-121.

foreign investor in a CJV is allowed to take a depreciation fee and that way regain part of the investment in advance. In a CJV the distribution of profit may not have to be in proportion to the contributed investment. As an addition, distribution of profit in the form of products is only possible in the form of a CJV. In the phase of dissolution the reversion of ownership to the fixed assets differs, the fixed assets of a CJV will return to the Chinese party. In the EJV the fixed assets will be distributed to the involved parties according to the proportion of their capital contribution.<sup>110</sup> This makes it easier and less costly to terminate a CJV especially if the CJV contract explicitly states how a termination shall proceed. A CJV contract may also be renegotiated without terminating the venture and thereby jeopardising forgoing investments and goodwill.<sup>111</sup>

The EJV seems to be the more popular choice than the CJV among the foreign investors. In 2004, 26 per cent of all companies established in China with a foreign owner were a EJV while only 3 per cent was established as a CJV.<sup>112</sup>

## **6.8 Wholly Foreign Owned Enterprises (WFOE) *Waishang Touzi Jingying Qiye***

The other option for foreign companies is to establish a Wholly Foreign Owned Enterprise, a so called WFOE. *The Law of the PRC Concerning Enterprises with Sole Foreign Investment (the Wholly Foreign Owned Enterprise Law)* was adopted 12<sup>th</sup> of April, 1986 and its rules for implementation, *the Detailed Rules for the Implementation of the Law of the PRC on Sole Foreign Investment Enterprises (the WFOE implementation rules)* came into force in 1990.<sup>113</sup>

The definition of a WFOE is to be found in article 2 of the Wholly Foreign Owned Enterprise Law, it states that a WFOE is an enterprise established in China in accordance with Chinese law and with capital totally provided by a foreign investor. A WFOE is a legal person as soon as it is registered in China.<sup>114</sup> A WFOE is regarded as a limited liability

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<sup>110</sup> Guanghai, Y., & Minkang, G. *Laws affecting business transactions in the PRC.* p. 270; Wang, K.H. *Chinese Commercial Law.* p. 127-128.

<sup>111</sup> Folta, P, H. *Cooperative Joint Ventures.* p. 3.

<sup>112</sup> USCBC. *FDI in China (Total and US) 1979-2004* Retrieved 2005-12-06, from [http://www.uschina.org/statistics/fdi\\_cumulative.html](http://www.uschina.org/statistics/fdi_cumulative.html)

<sup>113</sup> Wang, K.H. *Chinese Commercial Law.* p. 128.

<sup>114</sup> Art 2, 8 WFOE Law; Wang, K.H. *Chinese Commercial Law.* p. 128.

company.<sup>115</sup> The Chinese authorities have issued *An explanation of Several Terms Used in the Detailed Rules for the Implementation of the Law of the People's Republic of China on Sole Foreign Investment Enterprises (the Explanation Document)* and article 8 of that document states that it is allowed to establish a WFOE based on money that has been made as profit in China. For instance, a foreign investor is active in a joint venture in China. With the profit made from the joint venture the investor wishes to invest further in China. It is allowed to start up a WFOE based entirely on capital originating from China as long there are no capital contributions from Chinese Investors.<sup>116</sup>

A WFOE must be approved before it is allowed to start up its business and be registered.<sup>117</sup> The approval procedure is much more strict and complicated than for the EJV/CJV, this is because the government favours EJV/CJV where it has more influence and control. The WFOE must apply for approval at several levels of bureaucracy, the county, the local and national level. Article 10 of the WFOE Implementation Rules states that the applicant must submit a detailed report consisting of the following subjects to the local authorities;

- the purpose and aims of the proposed enterprise, its scope and scale of operations;
- a list of the type of products to be manufactured and the technology and equipment to be used;
- details of the sales ratio of domestic and overseas market for the products;
- the area of land to be used and land requirements;
- the water, electricity, coal, gas or other fuel and public utility requirements.

When the report has been approved by the local authorities the applicant must submit yet other documents to the relevant authority on a national level. The documents to submit are;

- an application to establish a 100 per cent foreign-owned enterprise;
- the written response of the local people's government at county level or above in the locality of the proposed enterprise;
- a feasibility study report;

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<sup>115</sup> Art 19 of the WFOE Implementation Rules.

<sup>116</sup> Art 26 WFOE Implementation Rules; art 8 Explanation Document; Wang, K.H. *Chinese Commercial Law* p.129.

<sup>117</sup> Art 6-7 WFOE Law.

## 6. Chinese entities

- the articles of association of the proposed enterprise;
- a list of legal representatives (or candidates for membership of the board of directors) of the Wholly Foreign Owned Enterprise;
- testimony of the foreign investor's legal certification and credit standing;
- a detailed list of goods and materials needed to be imported;
- any other necessary documents.<sup>118</sup>

Not all applicants will see their application be approved however there are criteria that will increase the chance of getting a successful application. In the WFOE Implication Rules there are criteria that are specifically encouraged and will make it easier to establish a WFOE. By complying with at least one of the following conditions the government is encouraging the WFOE to assist China's economy and achieve considerable economic results;

- the adoption of advanced technology and equipment;
- the development of new products;
- the economic use of energy and raw materials;
- the achievement of product upgrading and replacement;
- the production of import substitutes;
- the production of annual exports amounting to at least 50 per cent of the value of its total product output for the year;
- the achievement of a foreign exchange balance or surplus.<sup>119</sup>

There are some sectors that are under special control of the government where WFOE are restricted or prohibited from entering. These business sectors include;

- public utilities;
- transport facilities;
- real estate;
- trust investment;
- leasing

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<sup>118</sup> Art 11 of the WFOE Implementation Rules; Wang, K.H. *Chinese Commercial Law*. p. 132.

<sup>119</sup> Art 3 of the WFOE Implementation Rules; Wang, K.H. *Chinese Commercial Law*. p. 133.

## 6. Chinese entities

- newspapers, publishing, broadcasting, television or films;
- domestic commerce, foreign trade or insurance;
- postal service and telecommunications;
- other industries that the Chinese government prohibits a sole foreign investment enterprise from establishing.<sup>120</sup>

The approval procedures have relaxed a little in recent years, as long as the WFOE will not operate in industrial sectors that are governmentally restrained there is usually no major obstacles, although a WFOE is still subject to harder restrictions and control than other forms of entities.<sup>121</sup> The relaxed attitude towards WFOE could be a consequence of the WTO accession. More and more companies are discovering the advantages of the WFOE and there have been a steady increase in investment made in WFOEs. In 2000 47 per cent of the total foreign investment made was in a WFOE. In 2004 WFOE held 66 per cent of the foreign capital invested in a FDI. Last year WFOE was the most popular form of investment vehicle for FDI, 70 per cent of all companies in China with foreign owners were a WFOE.<sup>122</sup>

### 6.8.1 Advantages and disadvantages of WFOE

The Chinese government have over the years encouraged foreign investors to enter in to EJV/CJV. In particular EJVs have received tax incentives and special treatment. The reason the government is encouraging this form of entity is that part of the requirements is the transfer of advanced technology and equipment which is not always in the best interest of the foreign investor.<sup>123</sup> Another aspect that makes life difficult for the foreign party in an EJV/CJV is the management of the venture. There are several culture differences in management style that can prove hard to handle and clashes are to be expected. The main advantage of setting up a WFOE is to be able to have full management control and obviously there is no sharing of profit. Foreign investors are now more eager to undertake all the risks on their own rather than having to rely on a local business partner. Even if the lack of local knowledge is a disadvantage it can be mitigated by hire a consultant and make

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<sup>120</sup> Art 4, 5 of the WFOE Implementation Rules.

<sup>121</sup> Wang, K.H. *Chinese Commercial Law*. p. 134.

<sup>122</sup> Folta, P.H. Cooperative Joint Ventures; USCBC. *FDI in China (Total and US) 1979-2004* Retrieved 2005-12-06, from [http://www.uschina.org/statistics/fdi\\_cumulative.html](http://www.uschina.org/statistics/fdi_cumulative.html)

<sup>123</sup> Art 5 EJV Law.

use of qualified local managers. For companies that are concerned with the technology transfer and are competent enough to compete on the Chinese market on their own, the WFOE is an excellent option. The Wholly Foreign Owned Enterprise Law allows companies and even individuals to set up enterprise without local partnership and the legislation protects the legitimate rights of such an enterprise.<sup>124</sup>

## 6.9 Concluding remarks

The Representative Office makes for an excellent choice for a careful approach to the Chinese market. It gives an opportunity for a company to scout the market and thereby gather valuable information which could be used to make decision concerning whether or not to enter the Chinese market and if so which form of investment vehicle to use. The Representative Office is relatively easy to establish, however since it may not take part in any business activities it will need financial support. It could prove expensive to maintain a Representative Office over a longer period of time, although it could be a good investment for the future.

When wishing to take the full step to the Chinese market there are three forms of investment vehicles to take advantage of, which may be most appropriate can not be answered since this depends on the foreign investor and the investor's intentions.

Despite the Chinese government's encouragement to invest in EJV's and CJV's the WFOE entity form, as to be seen in the graph, seems to be the most popular choice of entity for foreign investors and is now responsible for 66 per cent of the total amount of foreign direct investments in China.

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<sup>124</sup> Wang, K.H. *Chinese Commercial Law*. p. 130-131; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html> ;Neunuebel, E.R.J et al. *Foreign Direct Investment Vehicles in China*. p. 141-142.

FDI by Investment Vehicle, 2004									
SOURCES: USCBC, MOFCOM									
	Number of Contracts			Amount Contracted			Amount Utilized		
		% change	% of total	\$ billion	% change	% of total	\$ billion	% change	% of total
<b>Foreign Direct Investment (FDI)</b>	<b>43,664</b>	<b>6.29</b>	<b>100.0</b>	<b>153.47</b>	<b>33.38</b>	<b>100.00</b>	<b>60.63</b>	<b>13.32</b>	<b>100.00</b>
Equity Joint Ventures	11,570	-7.60	26.50	27.64	8.37	18.01	16.39	6.46	27.03
Contractual Joint Ventures	1,343	-13.19	3.08	7.79	4.13	5.08	3.11	-18.88	5.12
Wholly Foreign-Owned Enterprises	30,708	13.97	70.33	117.28	43.70	76.42	40.22	20.49	66.34
<b>Shareholding ventures</b>	<b>37</b>	<b>94.74</b>	<b>0.09</b>	<b>0.39</b>	<b>-47.37</b>	<b>0.34</b>	<b>0.33</b>	<b>-52.93</b>	<b>0.62</b>
<b>Joint resource exploration</b>	<b>8</b>	<b>100</b>	<b>0.02</b>	<b>0.09</b>	<b>57.09</b>	<b>0.08</b>	<b>0.03</b>	<b>-87.71</b>	<b>0.06</b>

USCBC. *FDI in China (Total and US) 1979-2004*. Retrieved 2005-12-06, from

[http://www.uschina.org/statistics/fdi\\_cumulative.html](http://www.uschina.org/statistics/fdi_cumulative.html)

There are certain areas of business where it is not suitable or even allowed to conduct business in the form of a WFOE. These are the business areas that are still under governmental control such as the line of business of media, trust investment and real estate. This is similar to the Swedish system where a foreign investor may not be allowed to enter into banking and insurance business without the proper authorisation.

This chapter can be concluded by saying that the WFOE is suitable for companies that have the strength or knowledge to manage the establishment on the Chinese market on their own or with the assistance of advisors. It gives the advantage of not being forced to share management and control over the company as well as not having to share any technology or profit. The disadvantages are that there is no immediate connection to the Chinese market and there is no Chinese company to share the risk with. The Chinese bureaucracy may also be harder to manage and it may be harder to become approved by the authorities without a Chinese partner. Without a Chinese partner it may also be harder to develop the necessary *guanxi* and *mianzi*.

The EJV and CJV have all the advantages of having a Chinese partner that the WFOE is lacking. The risk is being shared with a domestic partner who is more likely to put in a greater effort. A Chinese partner may also have valuable connections and the right *guanxi* and is a very useful asset when handling the Chinese bureaucracy which many Swedish

## 6. Chinese entities

companies finds complicated. The joint venture forms of entities also have the advantage of the Chinese government's encouragement which could prove helpful in many aspects as a newly established company. However entering into a joint venture company means that the management control is being shared aswell as the profit. There may also be an amount of technology sharing which may be deterrent.

The main difference between the EJV and the CJV seems to be the approach to time; while the EJV takes a long term approach the CJV may be suitable for investor with an urge to retrieve its initial investment earlier. The structure of the CJV is more flexible compared to the EJV which may for some investors be an advantage.

## 7 Final analysis and comparison

### 7.1 Introduction

With the growing importance of international trade and the current focus on China as an attractive market for consumer goods as well as for manufacturing, many companies around the world feel the need to evaluate the possibility to enter the Chinese market. This also applies to Swedish companies who already have shown their potential on the Chinese market with a will to invest and a capacity to perform well. There are numerous Swedish companies already present in China with more to follow, but only a few Chinese companies active in Sweden which is more than likely to increase as the Chinese companies start to expand.<sup>125</sup>

### 7.2 Consequences of China's WTO accession

China appears to be showing a political will to open up and develop its economy, which will benefit the companies, both domestic as well as foreign. China has over the last decades gone through some major changes. In the last hundred years China has gone from being a state ruled by an emperor to a socialistic and communistic state to becoming a state that today is striving to preserve its ancient legacy which is mixed with socialist ideas but with an urge to be more capitalistic. It may seem like a thin line to balance on, but so far China is coping well. The Chinese market has had the highest growth of all major economies over the last years and is still growing. Foreign investors are showing an interest in China but have previously been hesitating due to the somewhat bureaucratic and not so reliable trading environment.<sup>126</sup>

In my opinion the best way to increase China's ability to attract more foreign investment is to provide a sound, stable and transparent regulatory framework for the investors. This will give the investors something to trust and rely on, which is what they demand in order to be more willing to invest in China. China's recent accession to the WTO is a positive development since this will bring familiar rules for the investors to the Chinese market,

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<sup>125</sup> ITPS. *Utlandsägda företag*. 2004. S2005:006 Retrieved 2005-11-14, from [http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Statistik/S2005/S2005\\_006.pdf](http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Statistik/S2005/S2005_006.pdf); SCB *Export och Import fördelade på länder* Retrieved 2005-11-14, from [http://www.scb.se/templates/tableOrChart\\_\\_\\_\\_142265.asp](http://www.scb.se/templates/tableOrChart____142265.asp)

<sup>126</sup> Wang, K.H. *Chinese Commercial Law*. p. 1; BBC. *China's growth hits six year high* Retrieved 2005-12-06, from <http://news.bbc.co.uk/2/hi/business/3412069.stm>

making it easier to conduct business. The accession to the WTO is obviously beneficial to the Chinese corporations as it is to foreign investors. Chinese corporations now can access all markets within the WTO just as foreign investors may explore their possibilities in China.

A further consequence of the accession to the WTO for many companies is that it will be easier to apply for a trading licence and get registered as a company in China. China will progressively lower the requirements to register for trade in China; also the scope of business allowed will be much broader than it currently is. The requirements for registered capital will also be lowered as well as requirements in performance, trade balancing, foreign exchange balancing and prior experience. This will enable more of the smaller and mid-sized companies to enter the Chinese market.<sup>127</sup> One of the single most important changes is that China can no longer discriminate foreign investors. By the accession to the WTO China has agreed to treat all companies alike no matter their origin.<sup>128</sup>

## **7.3 Entities**

### **7.3.1 Representative Offices**

Today the number of entry modes to the Chinese market has increased. It is now possible to use an agent or to set up a Representative Office for the companies wishing to be present in China but are not willing to invest too much into the Chinese venture. Although a Representative Office may be costly since it is not allowed to undertake any business activities except in the fields of information gathering, research and marketing.<sup>129</sup> It may still be an excellent option for companies that want to scout the market first before taking the leap into it. The choice of establishing a Representative Office also exists in Swedish legislation for Chinese companies and other non-Swedish investors. However the Representative Office is not common in Sweden since it is fairly easy to register a form of entity that can be profit making such as an Aktiebolag. It seems like the provisions in both Sweden and China concerning the Representative Office are similar and the advantages and disadvantages for choosing that option are also the same with the cost as the main disadvantage. Since it may not be part of profit making activities it can not support its own

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<sup>127</sup> Yonghai, S. *The Deregulation of Foreign Trade within the WTO*. p. 74.

<sup>128</sup> Pouncey, C et al *China as a WTO member: the Opening-up of the Chinese Market*. p .69-70.

<sup>129</sup> Art 4 detailed rules on foreign Representative Offices.

cost and must be funded through the mother company. The advantages are that it is easy to start up an office like this and it may be worth the cost to scout the market and gain valuable knowledge when preparing an approach to that specific market.<sup>130</sup>

### 7.3.2 Aktiebolag

The Swedish Aktiebolag can fulfil all the needs of an international investor; it is a legal person with limited liability where there can be a single owner or numerous shareholders.<sup>131</sup> The AB is not too complicated to found, the only basic requirements are to register and provide the new company the capital required.<sup>132</sup> However it lacks the flexibility of a CJV where everything can be negotiated, the Aktiebolag is strictly obliged to obey by the legislated rules on profit sharing and right to management. The shareholders' meeting has deciding power in an AB and there is also protection for the minority something that is not to be found in the equivalent Chinese entities discussed.<sup>133</sup>

In Sweden, companies wishing to pursue business in the field of banking, insurance or provide financial service must obtain a special license. There are no special regulations for foreign investors; the only stipulated rules are concerning the demand for residency. The managing director as well as half the board must be resident of an EEA state, please note that citizenship is not required. The government can allow exception from this rule although it is not that common to apply for such an exception.<sup>134</sup> According to Bolagsverket, the responsible authority for granting exceptions to the rule of residency, the reason for having such a rule is that in their opinion it should be encouraged that the persons in charge of the company have a close involvement in the company. Bolagsverket do not believe that the use of modern communication technology is enough.<sup>135</sup> There are no rules concerning ownership, a wholly foreign owned company makes no difference to a

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<sup>130</sup>Art 8 of the Detailed Rules on Foreign Representative Offices; Dodge, L. *The Representative Office Option*. p.2; Wang, K.H. *Chinese Commercial Law*. p. 92; Lock, G et al. *Setting up business in the People's Republic of China*. p.127-128; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html> ;ISA, *Fact Sheet – Establishing a business in Sweden*. Retrieved 2005-11-14, from [http://www.isa.se/upload/english/FactSheets/Establishing\\_a\\_business.pdf](http://www.isa.se/upload/english/FactSheets/Establishing_a_business.pdf)

<sup>131</sup> ABL 1.1.

<sup>132</sup> ABL 1.3, 2.9.

<sup>133</sup> ABL 9.1, 15.7; Rodhe, K. *Aktiebolagsrätt (20th ed.)* p. 229-232.

<sup>134</sup> ABL 8.1,26; ISA, *Simplicity and transparency*. Retrieved 2005-11-14, from [http://www.isa.se/templates/Normal\\_\\_\\_\\_\\_2024.aspx](http://www.isa.se/templates/Normal_____2024.aspx)

<sup>135</sup> Telephone interview with Lars Carlsson, lawyer at Bolagsverket. 2005-11-14

Swedish owned company as long as the Swedish law is obeyed, this according to the WTO demand that nations can not be allowed to discriminate direct nor in-direct.

### 7.3.3 Wholly Foreign Owned Enterprise

In China the foreign investor may establish the company as a Wholly Foreign Owned Enterprise, which is the closest form of entity compared to a Swedish AB. This form of entity is increasingly popular among foreign investors and has become the most popular form of investment vehicles.<sup>136</sup> In a WFOE aswell as in the AB the foreign investor may control everything, from the management to the reinvestment of profit. The disadvantages are that there is no-one to share the risk with and there is not anyone with the local knowledge of an unknown market.<sup>137</sup> It seems that the government prefer foreigner to invest in the EJV or the CJV therefore the application procedure to establish a WFOE may be troublesome. In order to establish a WFOE there must be approval from several agencies and authorities. The applicant must submit detailed reports of its current business and its planned business which could be both costly and a challenge to do without revealing classified business information.<sup>138</sup> In recent years this procedure has begun to become more relaxed as long as the WFOE will not operate in the industrial sector. Once passed the initial phases of establishing a WFOE it could be quite advantageous since all the decisions are made by the investor and no transfer of technology are required.<sup>139</sup>

### 7.3.4 Equity Joint Venture/Cooperative Joint Venture

The other two options are to choose one of the joint venture entities, which both have at least one foreign owner and a minimum of one Chinese owner. In the Equity Joint Venture the foreign investor is obliged to contribute at least 25 per cent of the registered capital. The EJV must register and by doing so it becomes a legal person, it also has limited liability. In the case of a CJV there is a choice of registration which is necessary to gain the status of a legal person and receive limited liability. If the CJV is to be granted limited

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<sup>136</sup> USCBC. *FDI in China (Total and US) 1979-2004*. Retrieved 2005-12-06, from [http://www.uschina.org/statistics/fdi\\_cumulative.html](http://www.uschina.org/statistics/fdi_cumulative.html)

<sup>137</sup> Wang, K.H. *Chinese Commercial Law*. p. 130-131; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html> ;Neunuebel, E.R.J et al. *Foreign Direct Investment Vehicles in China*. p. 141-142.

<sup>138</sup> Art 6-7 WFOE Law.

<sup>139</sup> Wang, K.H. *Chinese Commercial Law*. p. 134.

liability status the foreign investor must contribute at least 25 per cent of the registered capital.<sup>140</sup>

The parties in an EJV share profit, control over the company and the risk according to the equity split. The rules are similar for an Aktiebolag when looking at how to split the risk, profit and control, although in an Aktiebolag one owner is allowed to own 100 per cent. The CJV is somewhat different; normally everything is shared proportionally to investment however in a CJV the parties may negotiate the terms concerning the sharing of profit, risk and control.<sup>141</sup>

When entering into an EJV there must be a long term approach to the investment. The duration of such a venture is usually not less than 10 years and it is hard to regain the investment before the stipulated time has passed. There is no such long term approach for a CJV although the government encourages it. In both EJV and the CJV the planned duration of business should be stated in the founding documents, and the duration could be extended if applied for. In a CJV it is possible for the foreign investor to regain the initial investment earlier than the stipulated duration; it is also possible to regain the initial investment through profit sharing.<sup>142</sup>

The main differences between the two forms of joint venture entities are that the CJV is more flexible since almost everything can be negotiated. All aspects of the arrangement between the parties of a CJV are put in a contract that becomes the founding documents of the company.<sup>143</sup> The EJV is more tied up by the legislation which makes it more stable and it could also be less expensive to establish such a company. The CJV could be costly to establish since every detail has to be negotiated, which could also prove to be time consuming. Both the EJV and the CJV share the advantage of having a native investor to assist with the local knowledge and to share the risk. The Chinese government is encouraging these forms of vehicles for foreign direct investment and may give certain

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<sup>140</sup> Art 4 EJV Law; Art 2 CJV Law; Art 4, 50 CJV implementation rules; Art 14, 18 CJV implementation rules; Wang, K.H. *Chinese Commercial Law*. p. 116.

<sup>141</sup> Art 4 EJV Law; Art 43-44 CJV implementation rules; Paul et al. *Using a Chinese Entity for an All-foreign Joint Venture in China – Does it make sense?* p. 7.

<sup>142</sup> Art 100-101 of the EJV implementation regulations; Art 22, 25 CJV Law; Art 44, 47 of the CJV implementation Rules; Halasz, P.J., & Lan, L. *New rules of the game – Chinese laws on Sino-foreign cooperative enterprises*. p. 41.

<sup>143</sup> Art 2 CJV Law.

incentives. The price for having a Chinese partner is that management must be shared as well as the risk of having to share technology.<sup>144</sup>

## 7.4 Culture

It shall also be mentioned that culture can be a challenge when business is conducted in a foreign nation; however it is hard to compare which culture that is the hardest to adjust to.

The values and perception differs widely when comparing Swedish culture to Chinese culture. The Chinese society seems to place a higher value in the collective while the Swedish society more strongly emphasizes the individual. Companies active in Sweden are obviously anxious how they are perceived, however since the collective is so important in China it is also of higher importance in China how others perceive you. This is important as a company to remember since it may not be enough to make the best offer or have the best product. The idea of face or *mianzi* as it is called in China goes beyond a good reputation and the concept of such things as brand loyalty. *Mianzi* is something deeper but at the same time something harder to grasp. Face can be given and lost, taken and gained and it is imperative for companies on the Chinese market to constantly take *mianzi* into consideration when making business decisions.<sup>145</sup>

The concept of *guanxi* may be even more crucial to be familiar with since it is hard to find any comparison to in Swedish culture. *Guanxi* is highly valued in China and is in my opinion probably more respected than the law itself. The best description to *guanxi* is connections although it is much more intricate than the western concept of networking. With the right *guanxi* many rules can be bent. The problem for many companies is that *guanxi* is deeply connected to the individual and not the company itself which often is shown when one key employee leaves the company. The same problem can however occur in companies all over the world where skilled employees have made close connection to the company's clients which will follow the employee instead of staying with the company.<sup>146</sup>

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<sup>144</sup> Wang, K.H. *Chinese Commercial Law*. p. 98; *Business in Asia – Frequently Asked Questions*. Retrieved 2005-10-13, from <http://www.business-in-asia.com/faq.html>

<sup>145</sup> Baocheng, L. *Discovering Chinese Cultural Roots*. p. 176-178; Chee, H., & West, C. *Myths About Doing Business in China*. p. 43-45, 48-53.

<sup>146</sup> Chee, H., & West, C. *Myths about Doing Business in China*. p. 61-62, 67-70; Baocheng, L. *Discovering Chinese Cultural Roots*. p. 179-180.

## **7.5 Concluding remarks**

It is clear that even though the politics in China and Sweden differ, the legislation is rather similar concerning the basics. Both nations apply a civil law system where most regulations concerning the entities are to be found in written law. However the two nations have chosen different approaches when legislating concerning the legal forms of entities. China has a larger variety of entities with the legal person status and limited liability to choose from when as a foreign investor wishing to establish a company while there in Sweden is only one form of entity to pick. There are also more legal requirements and bureaucracy to fulfil for a foreign investor in order to get access to the Chinese market. There are only few such requirements in Sweden.

According to my opinion it is hard to mention an obvious choice of Chinese entity for foreign investors. All the Chinese entities available for foreign investors have the same advantage as the Swedish Aktiebolag of being legal persons aswell as being companies with limited liability. Without examining other fields of law such as tax law it is not possible to mention one form of entity that is more beneficial than the others. Since the scope of this thesis only allows for an overview of the various entities it is not possible to look at specific issues for various types of companies. It seems that the difference in choice of entity is based on what line of business the foreign investor is involved in.

## 8 Conclusion

The Chinese market has seen a tremendous growth over the last years and since the accession to the WTO this growth is believed to continue making China one of the world's largest trading nations. Although China still has a communist legacy to take into consideration it is striving to improve its financial strength in a manner that is acceptable according to their culture.

The Chinese culture is ancient and full of influences from different times, where the communistic era is just one of the later to influence China and its people. When arriving in a new market, especially one that appears to be so much different from the environment one is familiar to, it is important to gain as much knowledge as possible about that particular culture in order to make a good impression and be able to succeed. For companies it is crucial not to stress the entry into the Chinese market without taking some cultural concepts in consideration. One of these concepts is *mianzi* or face as it also might be known as. *Mianzi* is best described as how one is perceived, the reputation of the company. The reputation is important in most cultures but it seems that the reputation is of great value in the Chinese culture. This could possibly be derived from the teachings of Confucius, whose teaching much of the Chinese culture reflects. This teaching favours the collectivism over the individualism. Since the group or the society is so important it becomes essential how the company or its employees are perceived.

The other concept discussed in this thesis is *guanxi* which is strongly linked to *mianzi*. *Guanxi* is a form of network, or an exchange of favours. The amount of *mianzi* gained is linked to how powerful ones *guanxi* is. The reason for *guanxi* to be so important is that with the right *guanxi* it is possible to achieve the impossible. *Guanxi* have been said to substitute the law itself and it can be used to bend or even break the law. The problem for foreign companies is that it is difficult to create *guanxi* and that it is personal. Hiring the right staff is important since they will bring their *guanxi* to the company but they will also take it away when leaving.

These concepts are firmly rooted in the many Chinese minds which make it difficult for China to change. China is currently undergoing a large transition in order to harmonise its legislation according to the World Trade Organisation's rules and treaties. Many foreign investors are interested in the Chinese market but have been intimidated by the unfamiliar rules and the bureaucracy; through the accession to the WTO this is going to change. With

harmonised rules the legal trading environment will become more familiar and it will be less trade barriers. Major outcomes by the accession are that China is no longer allowed to discriminate against foreign companies and the Chinese legal system will become more transparent creating a more stable market.

The basics of the Chinese legal system is said to be rather similar to the Swedish in the sense that both nations uses a civil law system, have written constitutions and a court system where the Supreme Court is the highest judicial power. China is a state with a communistic form of government while Sweden has constitutional monarchy and democracy. This of course is reflected in the legislation. There are fewer restrictions in the Swedish legislation for foreign investors seeking an opportunity in the Swedish market. The only general restriction in Swedish legislation concerning the limited liability companies is that there is a demand for residency. The managing director and half the board must be citizens in an EEA state. There is no such demand in the Chinese legislation; instead there are certain forms of entities that foreign investors may register. These entities are open to investors from all nationalities as long as they fulfil the legal requisitions. It can however be a problem trying to register a company due to bureaucracy and not all applications are granted. The bureaucracy seems to be the largest problem for many companies when pursuing the Chinese market which may reflect the difference in culture that exists.

The different forms of entities that are available for foreigners may reflect the different stages of openness in the Chinese society. The EJV has a touch of socialism in its legislation in the sense that it is obliged to contribute to the society and the state is encouraging this form of entity by offering incentives. The WFOE reflects the modern China and a new degree of openness. This type of entity is allowed to be wholly foreign owned where the EJV and the CJV is required to have at least one domestic partner.

There is a trend of foreign investors to favour the entity form of a WFOE. This is most likely cause of China's accession to the WTO which has required China to revise its legislation. I believe this trend will become permanent since it is an advantage of being able to maintain full management over a company, thereby avoiding cultural clashes in management style, facilitating the possibility of quick decisions. As a consequence of China's recent growth and accession to the WTO I strongly suspect that we will see an increasingly amount of Chinese companies entering foreign markets.

## 8. Conclusions

Neither in Sweden nor in China should it be any legal problems to conduct business. The both nations' legislation offers acceptable solutions for foreign investors looking for a form of entity to become established in a foreign market. There are different approaches, cultural differences and structure in the societies but the legislations provide a reliable foundation for an establishment.

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