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# Global Business Forum

## Legal Considerations: From Guanxi to Rules-Based Exchange

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# I. “*Guanxi*” and Its Evolving Role in China

## ■ I. “*Guanxi*” and Its Evolving Role in China

- Traditional and Pre-Reform China
  
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- “Rule by Law” vs. “Rule of Law”
  
  
  
  
  
  
  
  
  
  
- *Guanxi*, Government, and Business Today



## Traditional and Pre-Reform China

- » *Guanxi*: Usually Translated as “Relationships” or “Connections”
- » Past Reliance on *Guanxi* due to Weak Legal Infrastructure and Government Control Over Access to Resources
- » Rule of Man vs. Rule of Law –
  - The West: Moses brought the Law down from the mountain.
  - China: Edicts of the emperor were the law.
- » Confucianism – Society Organized as Concentric Circles
- » Dynamics of Pre-Reform Communist China
  - Concept of “*danwei*” (or work unit) and the individual’s subordinate relationship to it.
  - Lack of business enterprises -- production an extension of government.
  - Feudalism with communist characteristics? – lack of independent legal actors.

## The Grand Transformation

- » 30 Years Ago Dominant State and Collective Ownership
  - Private enterprise often criminalized.
  - Shortages, rationing, strict price controls.
  
- » Rapid Evolution
  - Early 80's experiments with proprietorships and farmers' markets.
  - Late 70's – Sino-Foreign JV law; Mid – 80's Industrial Enterprise Law.
  - Experiments with private real estate “ownership” in 1988.
  - Civil Code, basic Contract Law and Company Law in 1990's.
  - Lift-off in 1993 -- Deng Xiaoping “to get rich is glorious” speech.
  - Stage of “primitive capital accumulation” set to close with new Antitrust Law.

## An Emerging Market Economy; Evolving Role of the State

### ■ Outmoded Concepts of “China Inc.”

- » Government procurement aside, you don't *do business with* the government.
- » Imperfect separation, but government is now an owner, not an operator
- » Some company towns remain, but business now rarely performs government functions.
- » Widespread privatization of SMEs, with State ownership focusing on key industries and enterprises -- “Grabbing the big fish, letting the little ones go” (抓大放小)

### ■ Growing Regulatory Role: Remaining Challenges

- » Reaction to corruption of early privatization
- » Curbing externalities as a political necessity (labor, environment, anti-competitive behavior)
- » WTO and steps toward leveling the playing field
- » Local protectionism – pros & cons for foreign investors
- » Central/local tension: “policies above and means of dealing with them below” (上有政策，下有对策)

## “Rule by law” vs. “Rule of law”

### ■ Function of Law:

- » “Rule by law:” ultimate holder of political power implements that power by means of public laws – but political process may be outside the law.
- » “Rule of law:” political power and its exercise is subject to the law, as enshrined in the constitution.
- » Emergence of a legal and increasingly rules-based business culture.
- » China is somewhere in the middle of a very rapid evolutionary process.

### ■ Steadily Growing Need to Operate Economy According to Published Rules

- » Maturing economy, need for long-term innovation and strategic development.
- » Need for predictability.
- » Increasing use of the courts for dispute resolution.

### ■ Cultural Factors

- » Confucian ideal state of the virtuous official – moral responsibility government.
- » Chinese people more concerned with stability, harmony and prosperity than western – style democracy.

# Guanxi, Government & Business Today

## ■ The Role of *Guanxi*

- » Tendering – inside track on evaluation criteria
- » Industry standards formulation
- » Discretionary approvals
- » Local government subsidies
- » Attractiveness of certain Chinese partners

## ■ Toward “Normal” Government Affairs Practices

- » Aligning investment with local policy and career goals
- » Developing advocates in local government
- » Relationship building as a show of commitment

## ■ Rules-Based Exchange?

- » Published laws and regulations help set parameters of business relationships
- » But terms of trade can still be influenced by government influence (both carrots and sticks)
- » Contracts as source of private rules – still subject to maturing judicial system and inconsistent enforcement

## ■ Cross – Border Business Helping to Drive Rules-Based Legal Culture

- » M&A – sophisticated documentation; increasingly sophisticated sellers
- » Outsourcing; project finance; infrastructure, etc.



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## II. Key PRC Legal Developments in 2007 & 2008

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- New Enterprise Income Tax Law
- Anti-Monopoly Law
- Labor Contract Law
- IP Protection



# New Enterprise Income Tax (“EIT”) Law

## » Legislative Background

- New EIT Law, effective January 1, 2008
- New EIT Law Implementation Rules, effective January 1, 2008

## » Key Feature: Unification of Tax Regimes Applicable to Foreign Invested Enterprises (“FIEs”) and Purely Domestic Enterprises (“DEs”).

## » Key Rates

- Unified EIT rate
- Effective January 1, 2008 25%
- Small-scale/slight-profit enterprises 20%
- High/new technology enterprises 15%
- Tax resident enterprises v. Non tax resident enterprises

❖ Non tax resident enterprises: only subject to EIT on China sourced income, enjoy 20% tax rate

## New Tax Incentive Regime for DEs and FIEs

### ■ High/New Technology Enterprises-15% Tax Rate

- Qualification requirements: own core propriety IP, minimum proportion of R&D personnel, business scope, etc.
- “Super deduction” of R&D expenses to develop new technologies, new products (150% of expense)
- Venture capital enterprises investing in the equity of non-listed small or medium high/new tech enterprise — 70% of investment amount may be offset against taxable income

## New Tax Incentive Regime for DEs and FIEs

### ■ High/New Technology Enterprises-Cont.

- Transitional Rules: high/new tech enterprises newly established in six specified zones – enjoy “2 + 3” holiday (2 years exempt of EIT, 3 years at 50% of applicable rate).
- Tax incentives for the software industry – enjoy “2 + 3” holiday or 10% tax rate;
- Tax incentives for the integrated circuit industry – “2 + 3” holiday or “5 + 5” holiday

### ■ Small-Scale, Low Profit Enterprises - 20% Tax Rate

## New Tax Incentive Regime for DEs and FIEs

### ■ Exemption/ Reduction of Taxable Income from Encouraged Projects

- Agriculture, forestry, animal husbandry, and fishing industries - Exemption or half reduction
- Infrastructure construction projects – “3+3” holiday

### ■ Environmentally – Linked Tax Incentives

- Environmental protection, energy and water conservation projects eligible for “3+3” holiday
- Enterprises utilizing approved raw materials: 90% of income taxable (10% automatic deduction)
- Qualifying equipment purchased for purposes of environmental protection, or energy or water conservation:
  - » 10% of cost may be offset against taxable income
  - » five-year carry-forward period

# PRC Anti-Monopoly Law

## »» Legislative Background

- Anti-monopoly Law (“AML”), effective on August 1, 2008
- Provisions on Declaration on Concentration of Business Operators (Draft for Soliciting Opinions), effective on August 1, 2008

## »» Anti-Monopoly Regulators to be Formed

- Anti-Monopoly Commission of the State Council
  - »» Responsible for organizing, leading, and coordinating anti-monopoly efforts
- Anti-Monopoly Law Enforcement Authority
  - »» Appointed by the State Council
  - »» Responsible for enforcement of anti-monopoly law

## PRC Anti-Monopoly Law

- Agreements or Arrangements in Restraint of Trade (“Monopoly Agreements”)
- Abuse of Dominant Market Position
- Control of Concentration of Business Operators
- Abuse of Administrative Power

(\*Actual impact of the AML will depend in large part on future implementing regulations, composition and effective powers of new regulatory bodies and enforcement policies.)

# Declaration on Concentration of Business operators & Impact on M&A

## ■ Declaration on Concentration of Business Operators

- Define “concentration of business operators”
  - » Including a company’s exertion of a decisive influence on any other company
- The parties of M&A or the control acquirer must make the declaration
- Set out the proposed thresholds for the notification requirement and procedures
  - » Turnover threshold & market share threshold
  - » Exemptions

## ■ Anti-Monopoly Review on M&A Transactions

- National security review & economic security review
- Prevent the foreign acquisition of a majority interest in any existing, strong Chinese company

# Labor Contract Law

## ■ Legislative Background

- PRC Labor Contract Law, effective on January 1, 2008
- Aim at changing unfair labor practices in China, which most FIEs do not employ
- Impact on labor costs, existing labor contracts and relations with employees

## The Labor Relationship and Contract Establishment

- A Written Contract Required for Each Employee
- Term of Labor Contract
  - » Fixed-term contract v. Open-ended contract
- Strict Limits on Probationary Period
- Non-Competition
  - » The maximum length of a non-competition obligation: 2 years
  - » Compensation for non-competition obligations
- Liquidated Damages
  - » The employer will not be able to claim liquidated damages against an employee for early termination of a labor contract, for breach of the non-disclosure agreement
- Termination – No True “At Will” Employment
  - » Severance Pay
  - » Layoffs

## Collective Bargaining and Labor Unions

- A tri-partite relationship between the employer, the labor union, and the employee
- Consult regarding the key features of the labor relationship, such as salaries, benefits, vacations, and worker safety
- Labor union can seek recourse through the local labor arbitration commission.
- The union now has the power to sign a collective labor contract on behalf of the employees, and to bring the relevant disputes to arbitration or litigation.
- Regulations on Collective Labor Contracts in Shanghai, effective on January 1, 2008

## Intellectual Property Protection – Trends?

- Law Already Fairly Complete Following TRIPS Compliance for WTO Admission
- Stage Set for Sustained Pressure from Chinese Companies and Government for Meaningful Enforcement
  - » New Tax Law – tax incentives for *bona-fide* high-tech status
  - » Policy drive to create Chinese global brands
  - » Rising costs and movement up the value-added and technology chain
- Pending Amendments to Patent Law and Trademark Law



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### III. Opportunities for Foreign Investors in 2008

## ■ III. Opportunities for Foreign Business in 2008

- Manufacturing: High/New Technology
- Service Industry
- Energy and Environment Sectors
- Central-Western Region Investment



## Manufacturing: New/High-Tech Industry

- » Encourage New and High Tech Industry, Equipment Manufacturing, New Material Manufacturing Industry
- » Legislative Background
  - Push for “indigenous innovation”
  - Intensify the promotion of industrial structure adjustment, to achieve industrial structure optimization and upgrading
  - Improve the nation’s advanced manufacturing capacities while restricting and eliminating outdated manufacturing
- » New EIT Law Preferential Policies
  - Certification by provincial-level authorities

## Service Industry

- » Encourage High-End Service, Business Process Outsourcing, Logistics, Banking, Telecommunications, Securities, Insurance and Tourism, etc.
  - » 2007 Industry Catalogues for Guiding Foreign Investment: outsourcing services and modern logistics services are newly added to the Encouraged Catalogue
- » Legislative Background
  - » Services currently account for only about 40% of China's current GDP, compared with about 80% in the U.S.
- » Up-to-date Preferential Rules:
  - » Relaxed market access, financial support of special funds provided by MOF, and facilitated filing procedures for external payments

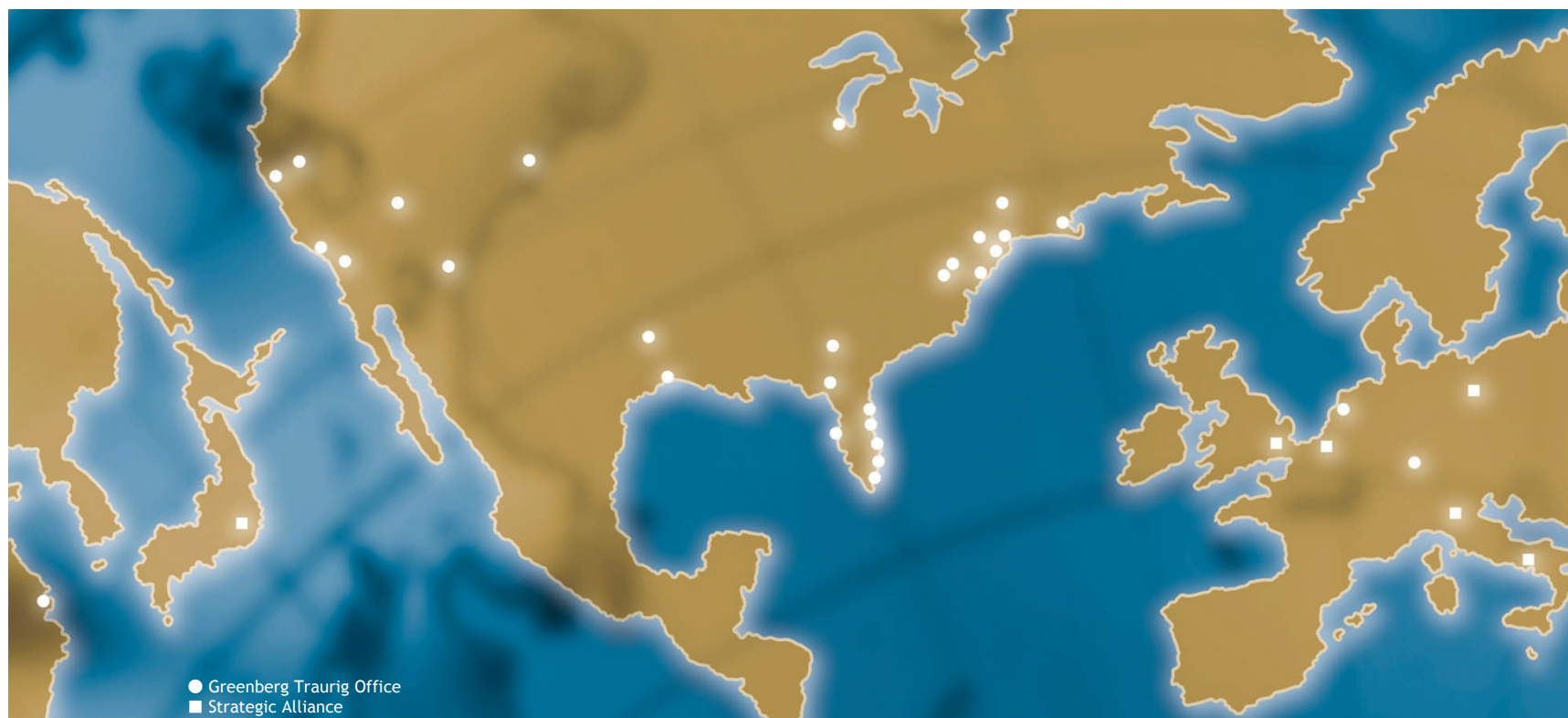
## Energy and Environmental Sectors

- » Encourage Environmental Protection and Energy-Saving Technologies
  - The protection of renewable resources and biology environment, comprehensive utilization of resources;
  - No longer encourage the exploration and exploitation of certain rare or key nonrenewable minerals;
  - Restrict or prohibit high energy or material consumptions, or heavy pollution
  
- » New EIT Law Preferential Policies
  
- » First Group of “High Pollution and High Environmental Risk” in 2008; Sanctions:
  - Cancellation of VAT rebate on export
  - Ineligible for in-bond export processing

## Central-Western Region Investment

- » Policy Background:
  - » National strategy to develop the western regions, revitalize Northeast China and other old industrial bases, and grow the central regions.
- » Schedule to Revise Catalogue for Priority Industries for Guiding Foreign Investment in the Central-western Regions
- » EIT Preferential Policy: by 2010,
  - » 15% tax rate;
  - » “3+2” holiday for enterprises of traffic, electric power, irrigation works, postal service and broadcasting or FIEs operated for 10 years in the western regions.

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