

Another way of doing business in China? Contract-based business operation

Description

It may appear new to you, I mean, the so called “contract-based business operation”. Actually, it is not new.

Contract-based business operation (the “**CBBO**”) refers to the operation of a business by a contractor, the business operator, in accordance with a contract concluded by the business owner and the contractor under which the contractor takes over the operation and management of the business and assumes business risks thereof for a specified period and pays a contracting fee (often fixed amount) to the owner. Roughly, it is like the concept of business leasing in the west.

CBBO is very common in some industries particularly the catering (food and beverage) and hospitality (hotel and hostel) among Chinese businessmen. Most cases involve an individual contracting to operate the whole or part of the business in the name of a company that holds all necessary permits, licenses for the business.

For example, a restaurant with big potential is poorly run by its owner and the contractor instead has confidence and ability to realize that potential. Therefore, the owner agrees to transfer the control and management of the business premises and equipments to contractor in turn for stable income, and the contractor without going through all bureaucracy in the course of setting up a new restaurant and with his indepth experiences can now run a restaurant to fulfill his or her ambition.

But, can a foreign investor adopt the CBBO to do business in China?

The answer in most cases is NO except the case where a foreign corporate entity (**not foreign individuals**) contracts to operate a Sino-foreign equity or cooperative enterprise (**not domestic enterprises, not WFOE**). Please pay attention to the notes in brackets.

As early as back in September of 1990, China promulgated the “Provisions on Operation of Sino-foreign Equity Joint Venture Enterprises on Contracting Basis” (《关于设立中外合资经营企业合同制经营的暂行规定》) (the “**Provisions**”). Under the Provisions, where a Sino-foreign equity JV enterprise is ill-managed and in difficult conditions, such an enterprise upon approval by foreign investment administration can be contracted for operation by a domestic or foreign company or enterprise, provided that:

- (1) the JV enterprise’s business belongs to an industry that is either encouraged or permitted one under China Catalogue of Industries Guiding Foreign Investment, and that the registered capital of the JV has been paid up by parties; and
- (2) the contractor is a legal person with at least three years business history and is engaged in the same industry as the JV enterprise, and is capable of working out a rescue plan for the JV enterprise

According to the Provisions, Sino-foreign contractual joint venture enterprises can also be operated in

CBBO way.

Other than the circumstances prescribed in the Provisions, a foreign individual is basically not allowed to adopt the CBBO to do business in China. There have been cases in which courts declared that foreigners (often Hong Kong and Tai Wan people) contracting to run business in China was illegal and the contract concluded thereby was void.

There was another issue: can a foreign company contract to run a domestic enterprise? The answer is probably No. There used to be an official reply by State Administration of Industry and Commerce at the beginning of 1991 allowing HK companies can contract to run a domestic enterprise upon going through certain filing formalities outlined in the Provisions. Later in 1998, this circular was however repealed by SAIC. Now, it is not clear. Being not clear means NO in the field of foreign investment.

Now is there a way of circumventing the legal hurdle for a foreign individual to do CBBO business in China?

A “Yes” will have to be given with great caution.

For expats or foreigners having lived or worked in China for years, they tend to believe that in China, there is always a way of working out a difficulty. Yes. For foreigners intending to do the CBBO business may do it with the help of a Chinese friend or relative. Namely, the CBBO contract will be signed by the Chinese national (a personal friend you can trust) instead of the foreigner with the business owner and then the foreigner takes control and management of the business.

The risks associated with that arrangement are multiple as listed below, and may lead to a total loss if not well managed:

(1) the business owner may later want to terminate the CBBO contract and take back the business if he or she becomes jealous of your success. His good legal ground is that as a foreigner you cannot run the business.

How to mitigate the risk? The only possible way of avoiding the risk is to disguise yourself as only a manager in all papers and documents. This requires that in the course of dealing with the business owner, you shall not leave any proof or evidence showing that you are the de facto real contractor. It is advisable for you to have a lawyer working closely in this regard. BTW, you cannot allow access by the business owner to your financial records or to the real conditions of the business.

(2) the counter measure to risk (1) above means you will have to rely heavily on your Chinese friend. Unless he or she is your better half, you will always face the risk of being betrayed or played if your friend changes color or shows a greedy face.

No good solution at law to tackle this problem. You will have to choose the right one to help you, someone you really really know. Secondly, keep your Chinese friends away from your business.

I have helped a foreign client in the CBBO business recently to run a restaurant in Shanghai. So far, it has been a successful try. I have helped to restructure the whole corporate governance of the domestic restaurant company to ensure that my client will have full control of any aspect of the business operation.

Lastly, I would like to make it clear here that in no case am I encouraging foreign investors not to comply with Chinese laws and regulations in regard of foreign investment in China. CBBO is a tremendously risky way of doing business in China. The best policy for foreign investors investing in China is to follow Chinese rules all the time. It is only applicable to those people who are really in need of alternative way of doing business here other than the normal ways.

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