THE ROLE OF OFFSHORE JURISDICTIONS IN THE PRC

KRISTIAN WILSON, A SENIOR ASSOCIATE IN THE SINGAPORE OFFICE OF BEDELL CRISTIN, LOOKS AT SOME OF THE DRIVERS FOR OFFSHORE JURISDICTIONS SUCH AS THE BRITISH VIRGIN ISLANDS (BVI) TO PLAY SUCH A SIGNIFICANT ROLE IN STRUCTURING FOREIGN DIRECT INVESTMENT (FDI) INTO AND OUT OF THE PEOPLE'S REPUBLIC OF CHINA (PRC).

The BVI is the fourth-largest recipient of global FDI inflows (receiving US$92 billion in 2013) and the second-largest investor in the PRC, providing US$10.4 billion, or 9.1%, of inward FDI into the PRC in 2010.

But why is a small island located in the Caribbean both a significant recipient of global FDI and a leading contributor of FDI into the PRC?

Many observers have tried to answer this question by suggesting that offshore jurisdictions are used in the PRC to avoid taxes and to enable the round-tripping of funds. That is a process whereby funds are routed offshore to return to the PRC as "foreign" capital and therefore allow PRC companies to utilise certain tax and legal advantages given to foreign investors.

However, these arguments are built on faulty analysis and poor data and fail to look at the wider picture. Recent Chinese legal developments have restricted the ability of Chinese enterprises to round-trip funds.

However, despite the implementation of these restrictions on round-trip investments, the popularity of the BVI has continued to grow. This suggests that there are other more important drivers behind the popularity of this jurisdiction.

LEGAL, ECONOMIC AND POLITICAL CONTEXT

To understand what has led to the popularity of BVI companies in the PRC, it is important to look at the legal, economic and political context which gave rise to the use of offshore jurisdictions.

The PRC has been in a continual state of development, opening up to the world and moving towards a more market-oriented system. This led to the PRC experimenting with different legal and economic regimes, such as the special economic zones, which operated with different tax and regulatory regimes to the rest of the PRC.

Moving offshore was simply an extension of the same concept.

Similarly, with the move to a more market-based system, the PRC was left with inadequate corporate laws that were not well suited to modern international commerce. As a result, the BVI was frequently used by PRC enterprises as a means to overcome legal and regulatory deficiencies in the Chinese legal system.

Kristian Wilson
Bedell Cristin

The BVI was a natural choice for Chinese investors given it was a common-law jurisdiction with a modern commercial court whose ultimate court of appeal was the Privy Council in London. As a result, the BVI offered legal

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stability, commercial flexibility and a modern corporate law.

INWARD FDI

Certain features of Chinese law and the PRC economy have inhibited the growth of PRC companies.

As a result, the BVI was used as a platform to access international capital and to rely on the legal rights and remedies offered by a mature and modern common-law jurisdiction.

In terms of finance, lending in the PRC was traditionally the sole preserve of state-owned banks.

This resulted in preferential treatment for state-owned enterprise, whereas private enterprise found it difficult to access finance.

By relocating in the BVI, these entrepreneurs were able to access the international capital markets, as lenders and investors were more familiar with BVI companies and comfortable with the common-law concepts underpinning the jurisdiction.

Similarly, lenders preferred BVI companies as security could be taken over their assets or shares. Additionally, offshore companies were chosen for the purposes of international listings, as it was not feasible to use PRC companies owing to a number of institutional and legal factors in the PRC which impeded the listing of their shares.

In terms of law, BVI companies were frequently chosen due to the inherent advantages of its legal system – minimal regulatory interference and a high level of corporate flexibility. Foreign law contracts are enforceable in the BVI and the law provides for certain rights and remedies available to shareholders and creditors.

BVI companies have also been used in private equity deals in the PRC. Investors have historically had concerns about investment in the PRC due to the weak shareholder protections, inadequate corporate legislation, risk of government intervention and uncertain market conditions.

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OUTWARD FDI

Offshore jurisdictions also play a significant role in outbound investment by Chinese enterprises. According to an OECD review of PRC outward investment, 80% of the PRC's outward FDI flows headed towards three economies from 2003 to 2006, namely Hong Kong, the BVI and Cayman.

Offshore jurisdictions have been popular tools for outward investment, given legal and policy limitations in the PRC which have inhibited investment. For instance, PRC enterprises had a number of domestic constraints including a cumbersome government approval process, problems with access to finance, a lack of currency convertibility and a lack of experience.

In addition to internal constraints, PRC enterprise faced external constraints, such as the problem of negotiating complex foreign regulations, the need to ensure legal certainty in the investment structure, the need to protect investments against risk, and the need for corporate flexibility.

For example, BVI companies have been used as holding companies. One study of listed Chinese companies on the HKSE, NYSE and Nasdaq found that of 72 sample firms, 42 had one or more BVI holding companies. It was observed that these holding companies were generally used as a means to control the underlying operating companies and to effect any acquisition or sale of the underlying companies at the offshore level. As a result, corporate transactions could rely on the flexibility and certainty provided by BVI law in multi-jurisdictional transactions.

BVI companies are also frequently used to structure joint-ventures, as they were used as a means of sharing legal and financial risk. Taking Africa as an example, BVI companies have frequently been used in African FDI as the joint venture, acquisition, holding or investment vehicle. However, PRC investors have encountered risks in African investment due to the unstable nature of the local business, political and legal environment.

The legal systems in African countries are often undeveloped and unfamiliar to Chinese investors and carry the risk that, in the case of disputes, the dispute may not be settled efficiently or effectively.

As a result, offshore companies have been used as they permit access to a familiar and stable system of law and ensure that disputes can be settled in a neutral jurisdiction where no party has a home-field advantage. ■