

## SEEKING TRUTH FROM FACT:

RATIONALE AND USE OF OFFSHORE JURISDICTIONS IN  
THE PRC\*

Kristian Wilson\*\*

## Table of Contents

I. INTRODUCTION .....	206
II. DEFINITIONS AND METHODOLOGY .....	207
A. Foreign Direct Investment .....	207
B. Offshore .....	208
C. Legal Perspectives on the Role of Offshore Jurisdictions in FDI.....	209
III. RECENT CHINESE ECONOMIC DEVELOPMENT .....	210
IV. INWARD INVESTMENT: FINANCING PRC ENTERPRISES THROUGH OFFSHORE STRUCTURES.....	213
A. Round-Tripping .....	213
B. Access to Capital.....	217
C. Legal Considerations .....	220
V. OUTWARD INVESTMENT: FINANCING EXPANSION THROUGH OFFSHORE STRUCTURES .....	226
A. Going Global .....	227
B. Holding Companies .....	230
C. Joint Ventures .....	231
VI. THE FUTURE OF OFFSHORE JURISDICTIONS IN THE PRC.....	235
VII. CONCLUSION .....	237

---

\* I would like to thank Stephen Adams, Alasdair Hunter and Simon Pascoe of Bedell Cristin for their support and constructive feedback. I would also like to thank Bill Maurer, Jing Li, Dylan Sutherland and William Vlcek for taking their time to correspond, provide feedback or point to useful sources on this topic.

\*\* Mr. Wilson is an attorney in the Singapore office of Bedell Cristin, an international offshore law firm which practices the laws of the BVI, Jersey, Guernsey and Mauritius. He practices BVI law and specializes in mergers and acquisitions, joint ventures, finance, private equity and general corporate law. He may be reached at kristian.wilson@bedellgroup.com.

## SEEKING TRUTH FROM FACT:

RATIONALE AND USE OF OFFSHORE JURISDICTIONS IN  
THE PRC

Kristian Wilson

## I. INTRODUCTION

In 2013, inflows of foreign direct investment (“FDI”) to the People’s Republic of China (“PRC”) amounted to US\$127 billion, making the PRC the world’s second largest recipient of inward FDI after the United States.<sup>1</sup> Slightly behind the PRC were the British Virgin Islands (“BVI”) which had received FDI inflows of US\$92 billion, making the BVI fourth in the world.<sup>2</sup> It is noteworthy that not only are the PRC and the BVI among the top four recipients of FDI, there is also a strong relationship between the two jurisdictions in terms of FDI flows. For instance, the BVI is frequently cited as one of the top three sources of FDI into the PRC (together with the Cayman Islands (“Cayman”) and Hong Kong). In 2010, the BVI was the second-largest investor in the PRC, providing US\$10.4 billion (9.1%) of total inward FDI into the PRC.<sup>3</sup>

The question then arises as to why a small island located in the Caribbean should be both a significant recipient of global FDI and a leading contributor of FDI into the PRC. This paper will look at the reasons behind this phenomenon, by examining the role of the BVI in structuring inward investment into the PRC and considering how the BVI is used to structure outward investment by PRC enterprises. This paper will also consider other offshore jurisdictions, as well as the role of Hong Kong and Macau (which are often considered to be quasi-offshore jurisdictions) in Chinese FDI.

This article will focus on the use of offshore jurisdictions from a legal perspective and consider the interplay of offshore structures with PRC law. This paper is divided into seven parts. Part I provides an overall introduction. Part II examines key definitions and

---

<sup>1</sup> U.N. Conf. on Trade and Dev., 15 *Global Investment Monitor* 5, U.N. Doc. WEB/DIAE/IA/2014/1 (Jan. 28, 2014).

<sup>2</sup> *Id.* at 6 (Interestingly, the BVI would have been higher, if not for the fact that FDI flows to Russia rose 83% to US\$94 billion, causing Russia to be ranked third. The rise in Russian FDI was “predominantly ascribed to the large acquisition by BP (United Kingdom) of 18.5% of Rosneft (Russia Federation) as part of Rosneft’s US\$57 billion acquisition of TNK-BP, which is a company registered in the British Virgin Islands”).

<sup>3</sup> Ken Davies, *China Investment Policy: An Update* (OECD Working Papers on International Investment 2013), available at [http://www.oecd.org/china/WP-2013\\_1.pdf](http://www.oecd.org/china/WP-2013_1.pdf).

perspectives. Part III looks at the economic development of the PRC and the context in which the use of offshore structures has emerged. Part IV looks at how offshore structures are used to finance PRC enterprises. Part V looks at how offshore jurisdictions have been used by PRC enterprises to structure their outward investment. Part VI will look at the future role of offshore jurisdictions in the PRC. Lastly, Part VII will make some concluding remarks.

## II. DEFINITIONS AND METHODOLOGY

Before looking at the role of offshore jurisdictions in Chinese FDI, it will be useful to clarify what is meant by “FDI” and “offshore.” We will investigate the nature, purposes and use of offshore jurisdictions in the PRC from a legal perspective.

### A. Foreign Direct Investment

There are many ways of measuring economic activity, but when considering the role of offshore jurisdictions in the PRC, the concept of FDI is frequently used. FDI is a useful concept for understanding the extent of economic activity involving offshore jurisdictions, but only when well-defined.

The Organization for Economic Co-operation and Development (“OECD”) provides the following definition of FDI:

“FDI is defined as cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise. Ownership of at least 10% of the voting power, representing the influence by the investor, is the basic criterion used.”<sup>4</sup>

An interesting feature of this definition of FDI is that the focus is not on the financial nature of the investment. Instead, the key attributes of FDI relate to influence, ownership and voting power. These attributes necessarily engage legal concepts, as they concern property rights and voting rights.

---

<sup>4</sup> ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD FACTBOOK 2013: ECONOMIC, ENVIRONMENTAL AND SOCIAL STATISTICS 86 (2013).

### *B. Offshore*

Many terms are used to describe offshore jurisdictions,<sup>5</sup> but for the sake of clarity and consistency, this article adopts the term “offshore” which is widely used and also defined by the OECD. The OECD defines offshore financial centers as:

Jurisdictions with financial centres that contain financial institutions that deal primarily with nonresidents and/or in foreign currency on a scale out of proportion to the size of the host economy. Nonresident-owned or controlled institutions play a significant role within the centre. The institutions in the centre may well gain from tax benefits not available to those outside the centre.<sup>6</sup>

This is a broad definition and also captures such jurisdictions as the United Kingdom, Hong Kong and Singapore. However, an International Monetary Fund (“IMF”) working paper suggests that the definition should also include “centres which provide some or all of the following services; low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity”<sup>7</sup> as well as providing services such as banking services, fund management, insurance, trust businesses, tax planning and company incorporation.

Again, this definition can still include many jurisdictions that are considered onshore. This is a fundamental point in thinking about offshore centers, as activities that are considered offshore, such as banking, fund management, and tax arbitrage, also take place onshore, just at a different level of intensity.

However, for the purposes of this article, the primary focus will be on the BVI and Cayman, which are Caribbean offshore jurisdictions that offer a number of the services described by the IMF. In particular, each jurisdiction specializes in some of these activities. The BVI specializes in company incorporation, being the world’s leading offshore incorporation jurisdiction, whereas the

---

<sup>5</sup> Other terms include ‘tax havens’ and ‘international finance centers.’ Neither term is particularly useful to the analysis as the first term is pejorative and excludes other uses of offshore jurisdictions (such as legal structuring) and the second term is so ambiguous that it risks becoming meaningless. Therefore this article uses the term ‘offshore’ which is familiar to most readers.

<sup>6</sup> OECD Glossary of Statistical Terms – Offshore Financial Center Definition, <http://stats.oecd.org/glossary/detail.asp?ID=5988> (Jan. 4, 2006).

<sup>7</sup> Int’l Monetary Fund [IMF], Monetary and Exchange Affairs Dept., *Offshore Financial Centers IMF Background Paper*, <http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm> (June 23, 2000).

traditional focus of Cayman is on banking and funds. Both jurisdictions, however, play a leading role in Chinese FDI.

Both the BVI and Cayman are common law jurisdictions whose ultimate court of appeal is the Privy Council in London.<sup>8</sup> The two jurisdictions are notable for the quality of their commercial law and the caliber of the professionals working in such jurisdictions.<sup>9</sup> The territories specialize in the establishment of offshore structures, such as companies, partnerships, trusts and funds. The jurisdictions are popular among international investors due to their tax neutrality (with no income, corporate or withholding taxes), light regulation (with no foreign exchange controls or takeover codes) and flexible corporate legislation.

### *C. Legal Perspectives on the Role of Offshore Jurisdictions in FDI*

There is a growing body of literature on the role of offshore jurisdictions in Chinese FDI, although it is still not widely studied as a topic. However, what is notable from the limited studies in this area is that there is an over-emphasis on the question of taxation and little analysis of the legal, practical and commercial rationale for the use of offshore jurisdictions. This emphasis is understandable, given that a key benefit of using offshore jurisdictions is that they provide a tax neutral platform to structure investments, thereby avoiding the need to have a further layer of tax in any investment structure.

However, this over-emphasis on the role of taxation leads to a misconception about the nature and types of offshore transactions.<sup>10</sup> As a result, much commentary is preoccupied with notions of round-tripping, tax and transparency, and fails to adequately address the

---

<sup>8</sup> The Judicial Committee of the Privy Council was formerly the ultimate court of appeal for the British Empire, other than the UK, but is now the final court of appeal for a number of Commonwealth countries and British Overseas Territories such as the BVI. It is composed of justices who also sit on the Supreme Court of the United Kingdom and is essentially the Supreme Court by another name. See further *Judicial Committee of The Privy Council FAQs*, <http://www.jcpc.uk/faqs.html#1> (last updated 2014).

<sup>9</sup> In particular, the BVI has developed a strong reputation for the quality of its commercial law, given that it has a dedicated commercial court with a permanent commercial judge (who is also Queen's Counsel) and that some of the leading barristers in the UK frequently appear before its court. In addition, the legal professionals that work within the industry are generally drawn from international law firms in common law countries such as the UK and Canada.

<sup>10</sup> Most commentary on offshore centers (which is generally Western) operates under the assumption that offshore jurisdictions are used primarily for tax avoidance and confidentiality, and that the use of offshore structures by the PRC suggests that Chinese FDI is routed through such centers in order to avoid tax or to mask the identity of their beneficial owners. Not only does this outlook fail to engage with the practical and commercial use of offshore structures, but this also demeans Chinese economic success. For an alternative view, See Bill Maurer and Sylvia J. Marsh, *Accidents of Equity and the Aesthetics of Chinese Offshore Incorporation*, 39 J. AM. ETHNOL SOC'Y 527, 532 (2012) (noting that the Chinese firms using the BVI are "the darlings of the U.S. press because they are the people behind some of China's most dynamic and innovative enterprises").

key drivers behind the use of offshore jurisdictions, which are essentially legal in nature and concern the management of legal and commercial risks.<sup>11</sup> Therefore, in order to seek truth from facts,<sup>12</sup> this paper will focus on the legal rationale behind the use of offshore jurisdictions by examining examples in which offshore vehicles have been used in the PRC.

A legal perspective is essential to understanding the role of offshore jurisdictions in Chinese FDI, given that the key attributes of FDI are to acquire management, ownership and control. These concepts necessarily engage legal principles. These concepts also prompt legal questions such as, how will such management, ownership and control be recognized and enforced, and is the legal environment sufficiently robust to protect these rights? In essence, an investment involves legal risks and it is essential to ensure that an investor has legal protection from such risks, whether by ensuring that the legal structure is secure or that legal complications in the regulatory environment have been overcome or protected against. These are fundamental reasons for why offshore vehicles feature in Chinese FDI, as they are used to structure investment into PRC companies and are used by PRC enterprises to structure their external investment in order to minimize risks and overcome legal complexity. These points will be considered in further detail in this article.

### III. RECENT CHINESE ECONOMIC DEVELOPMENT

In order to have a clearer understanding of the interplay between offshore jurisdictions and Chinese law, it will be instructive to take a short look at the economic development of the PRC. By looking at the growth of the PRC, we will have a deeper insight into how its laws developed and how the developing investment climate fostered the use of offshore structures.

The modern economic development of the PRC has its roots in the Third Plenary Session of the 11th CPC Central Committee in

---

<sup>11</sup> See William Vlcek, *Byways and Highways of Direct Investment: China and the Offshore World*, 39 J. CURRENT CHINESE AFF. 111, (2011). (In contrast to some literature, Vlcek recognizes that “the common portrayal of the [offshore jurisdiction] today as a tropical island “tax haven” fails to acknowledge that it provides other forms of regulatory arbitrage beyond taxation. It may be the home to mutual (hedge) funds, captive insurance and re-insurance firms, trust companies, and shipping registries, as well as an international business company (IBC) registry.” However, the analysis should also be extended to cover the fact that offshore jurisdictions provide legal protection and legal certainty as opposed to simple regulatory arbitrage.)

<sup>12</sup> “实事求是” : The idiom suggests one should take a pragmatic understanding of phenomena from the facts, rather than basing analysis on dogma. This idiom is meaningful to our analysis, given both its relevance to economic reforms and its emphasis on looking at facts rather than relying on suppositions or value judgments.

1978, which implemented the policy of reform and opening up. Shortly afterwards, the PRC approved the establishment of four Special Economic Zones (“SEZs”) between 1980 and 1984. At first, the policy makers had a dilemma as to how to push forward with economic reforms and opening up, without incurring social and political consequences. The solution was to establish these SEZs, which were initially conceived to be free trade and export processing zones, which would be used in a limited capacity and, if successful, would act as a blueprint for the rest of the nation.<sup>13</sup>

The initial SEZs had modest success and fourteen more SEZs were approved in 1984, with further SEZs approved in the years thereafter. Furthermore, in 1985 the objectives of the SEZs were clarified and expanded upon:

to experiment with the development of an outward-looking market oriented economic system, and to serve the country as a ‘window’ and a ‘base’ along these lines. As it was later summarised, the rest of the domestic economy could be connected to the outside world through the window, without the door wide open. The SEZs functioned as a laboratory where various methods aimed at overcoming the drawbacks associated with a central-planning system could be developed. Fresh concepts that originated in market economies outside China could be introduced into, absorbed by, and tested in the SEZs.<sup>14</sup>

As a result, the SEZs were allowed to operate under a different set of legal and financial rules as they had special tax incentives for foreign investment, less red tape and greater independence in setting international trade policy. In essence, the PRC had set up its own form of offshore centers, which operated within the PRC, and yet had different tax, regulatory and policy rules from the rest of the onshore PRC.<sup>15</sup>

In addition to creating the SEZs, the PRC also acquired two further economic zones in the form of Hong Kong and Macau. Hong Kong was handed over to China in 1997, when it became a Special Administrative Region. The Hong Kong Basic Law provides for the principle of “one country, two systems.” Hong Kong shares attributes with offshore jurisdictions in that it provides financial services to non-residents on a scale incommensurate with its domestic economy

---

<sup>13</sup> Ge Wei, *Special Economic Zones and the Economic Transition in China*, in 5 ECONOMIC IDEAS LEADING TO THE 21ST CENTURY 43 (1999).

<sup>14</sup> *Id.* at 49.

<sup>15</sup> See e.g., Ronen Palan, *The Emergence of an Offshore Economy*, 30 FUTURES 63, 69 (1998).

and is a significant banking and company incorporation center. Additionally, Hong Kong has a low tax environment with a well-developed legal system and is also the leading source and destination for Chinese FDI.

Similarly, Macau was handed over to China in 1999 and became a Special Administrative Region. Like Hong Kong and other offshore financial centers, Macau can be considered as offshore to the extent that it provides financial services to non-residents on a scale that is disproportionate to its domestic economy. However, unlike Hong Kong, Macau has taken active steps to position itself as an offshore jurisdiction. For instance, just prior to the handover, the Governor of Macau signed and approved the Offshore Law of Macau which provides for the incorporation and regulation of offshore vehicles in Macau, although it has not achieved widespread use as an offshore financial center. The reasons for this are unclear, but one reason may be that Macau operates under a civil law system, and such systems are generally ill-suited for the incorporation of offshore companies.<sup>16</sup> Another reason may be that Macau has achieved success as a gambling center and otherwise captures FDI flows by virtue of the gambling revenue that passes through it.<sup>17</sup>

Unlike the SEZs, the PRC did not expressly set out to endow Hong Kong and Macau with offshore attributes, as these regions were handed over rather than created. However, the PRC has accepted their positions as quasi-offshore centers by virtue of the one country, two systems principle and minimal central interference with the operation of such regions.

The economic reforms in the PRC, the establishment of the SEZs, and the handovers of Hong Kong and Macau are instructive for two key reasons. First, they illustrate the tension between the need to establish a more open economic system while simultaneously externalizing this system from the dominant political narratives within China. Second, the existence of the SEZs, Hong Kong and Macau illustrates that the PRC was prepared to accept the coexistence of two systems: the dominant legal and economic system

---

<sup>16</sup> For example, civil law jurisdictions often have increased costs and complexities because corporate acts are public. As a result, many corporate activities require compliance with onerous civil law procedures and/or must be sworn before a notary, which often increases costs and delays. Additionally, it is often argued that common law jurisdictions are more open to legal change and innovation and protect investors more effectively. For an interesting study on such differences, see Francisco Reyes & Erik P.M. Vermeulen, *Company Law, Lawyers and "Legal" Innovation: Common Law versus Civil Law*, Kyushu U. Legal Res. Bull. (Apr. 9, 2012), <http://www.law.kyushu-u.ac.jp/programs/english/Erik.pdf>.

<sup>17</sup> For a meaningful analysis on this point, see William Vlcek, *Taking Other People's Money: Development and the Political Economy of Asian Casinos*, THE PACIFIC REV (forthcoming 2012).



in the mainland and the different system of rules and tax incentives in the SEZs, Hong Kong and Macau.

On one level, offshore jurisdictions are simply an extension of the type of deregulated and free-market space which the PRC was experimenting with. However, given the political narratives in the PRC at the time, and the impracticality of achieving such a level of deregulation, this pure form of a deregulated free market space was simply not feasible within the PRC.<sup>18</sup> However, the use of such a space *offshore* was more politically acceptable as this would not distress the internal political narratives. On another level, since the PRC allowed the exercise of two separate and co-existing systems in the same territory, then there is little practical or conceptual difficulty with adopting the tax and legal principles of a third system that exists outside of such territorial space.

#### IV. INWARD INVESTMENT: FINANCING PRC ENTERPRISES THROUGH OFFSHORE STRUCTURES

##### *A. Round-Tripping*

As mentioned in Part II, most literature on Chinese FDI assumes that a substantial proportion of Chinese activity in offshore centers is due to the round-tripping of funds.<sup>19</sup> Round-tripping describes the process whereby capital is moved overseas and then returned to the PRC in the guise of foreign investment, by virtue of being routed through a company incorporated in the BVI or Cayman. The round-trip is made in order to benefit from certain tax and regulatory benefits made available to foreign investors under PRC law.

There are a number of problems with this analysis. First, this approach is founded on a number of assumptions about the nature of Chinese FDI. As facts on Chinese FDI are scarce, this means that such theories are necessarily based on inference rather than fact. As a result, most literature that focuses on the topic of round-tripping tends to speculate about the level and extent of round-tripping or disregards the role of offshore jurisdictions entirely. This latter observation leads to a second problem, namely that some literature on this subject simply excludes offshore jurisdictions from an analysis of Chinese FDI on the assumption that it is round-tripped

---

<sup>18</sup> Indeed, it is not practical for most large states, given that laws are created as a compromise between different interest groups and to regulate various types of different activity. However, in small offshore states, it is more feasible to create such pure deregulated and tax neutral spaces. The advantage of this approach is that it provides the developed states with the tools that they are unable to craft themselves.

<sup>19</sup> See Xiao Geng, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications* (ADB Institute Discussion Paper 7, 2004).

capital.<sup>20</sup> This approach is particularly unhelpful as it essentially fails to engage the topic in any meaningful way. It replaces analysis with supposition, and fails to develop an understanding of the particular historic, economic and legal circumstances within the PRC, which necessitated the use of offshore jurisdictions.<sup>21</sup>

This blind approach to the role of offshore jurisdictions in Chinese FDI is a significant issue. Not only does it raise questions of methodology, but it also fails to address a number of facts that undermine the validity of the theory.

First, the round-tripping theory is based on the premise that there is something unusual in the use of offshore jurisdictions in the PRC. A natural conclusion to draw from this premise is that such flows are not representative of normal commercial activity. However, studies have found that FDI levels in the PRC are actually normal and correspond with other nations in similar periods of development. For example, when looking at outward FDI, Cheng and Ma noted that “the growth of China’s aggregate FDI outflows during 1998 to 2002 were quite similar to those of South Korea during the same period and to Japan’s outflows in the period of 1968 to 1992.”<sup>22</sup> A further study looked at Chinese overseas FDI and noted that the structure of outward FDI from the PRC mirrored international patterns in this respect.<sup>23</sup> On a related, but significant point, Sutherland, Matthews and El-Gohari looked at FDI flows from the BVI and Cayman to and from the PRC and noted that the net FDI flows stood at a surplus of around US\$16 billion in the 2004 to 2006 period, concluding that “if

---

<sup>20</sup> See, e.g., Ivar Kolstad & Arne Wiig, *What Determines Chinese Outward FDI?*, 47(1) J. WORLD BUS. 26 (The authors asserted that as financial flows from offshore jurisdictions “likely reflect motives different from other FDI flows, and since data on key explanatory variables is not available for these locations, we exclude them in the subsequent analysis”. Not only is this type of unsupported assertion unhelpful to an analysis of the role of offshore jurisdictions, it is also, unfortunately, an approach that is frequently taken.).

<sup>21</sup> There is, however, some insightful analysis in this area. See Vlcek, *supra* note 11. See also Sutherland, D., El-Gohari, A., Buckley, P. J. & Voss H., *The Role of Caribbean Tax Havens and Offshore Financial Centres in Chinese Outward Foreign Direct Investment* 25, 25–26 (2nd Copenhagen Conference on: ‘Emerging Multinationals’: Outward Investment from Emerging and Developing Economies, Copenhagen Business School, 2010), available at [gdex.dk/ofdi10/Dylan-Sutherland%20%20-%20et%20al.pdf](http://gdex.dk/ofdi10/Dylan-Sutherland%20%20-%20et%20al.pdf).

<sup>22</sup> Leonard K. Cheng & Zihui Ma, *China’s Outward Foreign Direct Investment*, in CHINA’S GROWING ROLE IN WORLD TRADE 545, 547 (Robert C. Feenstra and Shang-Jin Wei, eds., 2010).

<sup>23</sup> Shujie Yao, Dylan Sutherland & Jian Chen, *China’s Outward FDI and Resource-Seeking Strategy: A Case Study on Chinalco and Rio Tinto*, 17 ASIA PAC. J. ACCT. & ECON. 313, 313–25 (2010) (“in general a large share of all global FDI has been carried out by a relatively small number of the very largest TNCs (UNCTAD, 2007). China’s OFDI is also concentrated in hands of a small number of large business groups (Morck, Yeung and Zhao, 2008; Sutherland, 2009). In this regard, the considerable concentration of China’s OFDI in a comparatively small number of big business groups mirrors international patterns”).

round-tripping alone was the answer, they should roughly balance themselves out” but instead the picture is more complex.<sup>24</sup>

Secondly, the round-tripping theory overlooks the fact that other nations have made significant investments into the PRC. For example, Li conducted a study of venture capital investment into the PRC and found that the majority of venture capital investments were made by U.S. Funds. Taking a sample of 467 private equity and venture capital transactions in the mainland PRC from 1990 to 2005, Li noted that “as to the origin of investors, it is obvious ... that most of them are foreign venture capitalists. Being the unquestionable leader in the global venture capital industry, the U.S. also excelled in the Chinese market in the sense that 129 out of the total of 290 VC funds and 92 out of the total of 211 VC firms came from the U.S.”<sup>25</sup>

Third, it is important to recognize that not only does the PRC use offshore financial centers to structure investment, but many European and U.S. investors also use offshore jurisdictions. Taking the private equity industry again as an example, a recent study found that 55% of all hedge funds were domiciled in the BVI and Cayman and 12% of all private equity funds were domiciled in these two jurisdictions.<sup>26</sup> Given the significant role that the BVI and Cayman play in the global funds industry, it is not surprising that they are significant contributors to Chinese FDI because other nations also use such jurisdictions to structure their investments.

Fourth, the round-tripping argument fails to account for the fact that the PRC has instituted a variety of legal restrictions for the round-tripping of funds.<sup>27</sup> In particular, most literature on the topic fails to recognize that (i) in 2005 the State Administration of Foreign Exchange (“SAFE”) issued Circular No. 75 which required PRC residents to register with the local SAFE branch before establishing or controlling any offshore company with assets or equity in a PRC company for the purpose of an offshore equity financing, (ii) in 2006,

<sup>24</sup> Dylan Sutherland, Ben Matthews & Ahmad El-Gohari, *An Exploration of How Chinese Companies Use Tax Havens and Offshore Financial Centres: ‘Round-Tripping’ or ‘Capital Augmenting’ OFDI?* (TMD Working Paper Series 3, 2009); see also Daniel H. Rosen & Thilo Haneman, *China’s Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, (June 24, 2009) <http://www.iie.com/publications/pb/pb09-14.pdf> (“despite the rapid growth of China’s OFDI, it is important to emphasize that China’s net FDI position is still negative, with an inward FDI stock of \$876 billion compared with an outbound stock of only \$170 billion in 2008”).

<sup>25</sup> Li Jing, *Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations*, 1 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 39 (2012).

<sup>26</sup> Press Release, Stefan Jaeklin, Oliver Wyman et al., *Domiciles of Alternative Investment Funds*, (2011), available at [http://www.alfi.lu/sites/alfi.lu/files/files/Publications\\_Statements/Press\\_releases/Oliver-Wyman-presentation-written-21-11-11.pdf](http://www.alfi.lu/sites/alfi.lu/files/files/Publications_Statements/Press_releases/Oliver-Wyman-presentation-written-21-11-11.pdf).

<sup>27</sup> See e.g., HOWARD CHAO & WALKER WALLACE, O’MELVENY & MYERS LLP, *ONSHORE FINANCIAL INVESTING IN CHINA* (Feb. 2011) (for a more detailed discussion of Circular No.75).

six Chinese ministries jointly issued the amended Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (“M&A Rules”) which required central government approvals for any round-trip investments (and it should be noted that virtually no approvals have been granted under the M&A Rules), (iii) in 2008 a new Enterprise Income Tax Law removed preferential tax treatments for foreign investment, thereby removing a key rationale for round-tripping, and (iv) in 2009 the State Administration of Taxation issued Circular No. 698 which applied certain reporting requirements on the transfer of a direct or indirect interest in a Chinese tax-resident enterprise meaning that such transactions may give rise to a tax liability unless a reasonable business purpose is established.<sup>28</sup> However, since the implementation of such laws, the use of offshore jurisdictions in Chinese FDI has continued, which suggests that round-tripping is not a key driver for the use of the BVI and Cayman in Chinese FDI.<sup>29</sup>

Fifth, the round-tripping theory ignores the critical role that offshore jurisdictions play in providing legal and practical solutions. Specifically, offshore structures are used to manage legal complexity and ensure investor protection through structuring the deal offshore. This usage accords with the definition of FDI discussed in Part II which concerns questions of ownership and control, which are essentially legal issues. This fundamental point was recognized by Maurer who observed that, although the PRC had removed FDI tax preferences, Chinese companies continued to make use of offshore jurisdictions. He therefore concluded that “tax minimization through the Caribbean offshore thus seems to be less a motivating factor than

---

<sup>28</sup> It is generally considered that Circular 698 is not triggered if a reasonable business purpose can be established, such as incorporating an offshore holding company in anticipation of a listing. However, in 2013, the local SAT office in Heilongjiang found a Cayman subsidiary of a U.S. private equity fund liable for tax on the basis that the transfer of shares held in a listed Cayman company was a taxable event. The rationale was that the ‘effective management’ of the listed company was the same as its PRC subsidiary and therefore the listed company was tax resident in the PRC. Circular 698 was not engaged, and it is unclear whether other local SAT offices will follow the same approach, but this does suggest that consideration should be given with any offshore structuring as to the effective management of the company and as to its business purposes.

<sup>29</sup> Unfortunately, most literature continues to cite Xiao as authority for the argument that round-tripping is a significant factor, despite the fact that these laws came into effect after Xiao published his article on round-tripping in 2004. As a result, it is inappropriate to rely upon Xiao’s analysis for an understanding of FDI in the PRC after 2005. However, some commentators continue to do so. *E.g.*, Daniel H. Rosen & Thilo Haneman, *supra* note 24, at 3 (asserting that round-tripping is a factor and that “some analysts think it could be more than one third of all inward FDI” despite only citing Xiao’s 2004 paper as a source in support of this contention.).

property rights, investment seeking and institutional arbitrage.”<sup>30</sup> These key factors will be explored in the following sections.

### *B. Access to Capital*

A key rationale for the use of offshore jurisdictions in the PRC has been the need for Chinese enterprises to access finance and capital. Offshore financial centers assist with raising finance as they provide a legally secure and internationally accepted platform for fundraising.

The question of access to finance has been a concern for PRC enterprises, given that the domestic financial markets have historically been undeveloped, have given preferential treatment to state-owned rather than private enterprises, and have existed in a legal and regulatory framework that has made fundraising difficult.

Lending in the PRC has traditionally been the sole preserve of state owned banks. This has resulted in preferential treatment for state owned enterprises and made it difficult for private enterprise to access finance. As Poncet notes, “Chinese private companies are often discriminated in terms of property rights protection and market opportunities in comparison to state or foreign enterprises. Despite the large size of the banking sector, many private enterprises are excluded from the credit market, because lending of state banks is determined by policy reasons, rather than by commercial motives. Such an uneven playing field motivates private entrepreneurs to look for a foreign investor.”<sup>31</sup>

In the absence of local financing options, PRC enterprises were able to find foreign investment through the use of companies incorporated in the BVI and Cayman, which offered tax-neutral platforms for finance-raising acceptable to international lenders. Foreign banks were prepared to lend to BVI and Cayman companies and international investors were willing to invest in such vehicles. This advantage was noted by the OECD, which observed that, not only do PRC enterprises avoid domestic constraints by incorporating in an offshore jurisdiction, but “by transferring capital to these offshore financial centers, large Chinese enterprises may also

---

<sup>30</sup> Bill Maurer, *Jurisdiction in a Dialect: Sovereignty Games in the British Virgin Islands*, in *EUROPEAN INTEGRATION AND POSTCOLONIAL SOVEREIGNTY GAMES* 130, 142 (Rebecca Adler-Nissen & Ulrik Pram Gad eds., 2013).

<sup>31</sup> Sandra Poncet, *Inward and Outward FDI in China*, in *CHINA AND THE WORLD ECONOMY, CONSEQUENCES AND CHANGES* 1, 11 (David Greenaway et al. eds., 2009).

diversify domestic risks and gain flexibility in corporate financing and intra-corporate restructuring.”<sup>32</sup>

As a result, the BVI and Cayman offered an effective and inexpensive platform for PRC enterprises to access international capital and transcend the limitations of the local financial markets.

A specific advantage of using offshore companies in financing structures can be seen in their use in debt financing transactions. Offshore companies offer certain advantages due to their ability to provide security over their assets and take security over their shares. This is a key issue in structuring an acquisition finance deal, as “a PRC target does not generally have the ability to give credit support (by way of guarantee or security over its assets) to a lender of offshore acquisition debt.”<sup>33</sup> The ability to take adequate security is a key consideration for lenders, which illustrates one important use of offshore companies engaged in financial transactions.

Another related reason for using offshore jurisdictions has been the desire to raise finance through an IPO listing on the international capital markets.<sup>34</sup> The popularity of this approach can be seen by looking at the number of offshore companies listed on the Hong Kong Stock Exchange (“HKSE”). For instance, in conducting a review of the companies listed on the HKSE as of the end of 2012, the author found that 1,137 companies, or approximately 75% of all listed companies on the HKSE Main Board and Growth Enterprise Market, were incorporated in an offshore jurisdiction.<sup>35</sup>

Offshore companies are used to affect such listings because they are accepted listing vehicles for many international exchanges, such as the New York Stock Exchange, London Stock Exchange and HKSE. The fact that such companies operate in a light regulatory

<sup>32</sup> OECD, *OECD Investment Policy Review: China* 72 (2008), [www.oecd.org/china/WP-2013\\_1](http://www.oecd.org/china/WP-2013_1).

<sup>33</sup> Pierre-Luc Arsenault, Jesse Sheley & David Patrick Eich, *Chapter 5: China*, in *THE PRIVATE EQUITY REVIEW* 172 (Kirk August Radke ed., 2012) (Offshore vehicles are sometimes preferable to US companies in acquisition finance for similar reasons. For instance, the authors note that in one transaction involving a PRC enterprise, as “the target was incorporated in the United States (Florida) as opposed to, for example, the Cayman Islands, it was subject to US tax laws that limit the security that can be given to secure the acquisition debt without adverse US tax consequences”).

<sup>34</sup> Of course, IPOs, much like debt financing, can be used for both internal FDI (raising funds for the development of existing PRC enterprises) and external FDI (raising funds for expansion into external markets).

<sup>35</sup> HKEx, *HKEx Fact Book* (2012), <https://www.hkex.com.hk/eng/stat/statrpt/factbook/factbook2012/fb2012.htm> (Based on a review of the public information contained in this source. The relevant jurisdictions comprise Bermuda, BVI, Cayman and Jersey, with the actual breakdown being Bermuda (487 companies), BVI (3 companies), Cayman (644 companies) and Jersey (3 companies) out of a total of 1,547 companies. The slight presence of the BVI and Jersey is explained by the fact that they were only recently admitted as accepted jurisdictions on the HKSE, although their use is now increasing, with further listings of such companies in 2013 and 2014).

environment and offer maximum corporate flexibility has only increased their popularity for listings.<sup>36</sup>

The need for an adequate listing vehicle has been important, given that there are a number of institutional and legal factors in the PRC which have impeded the listing of shares of PRC enterprises. Xu examined the various limitations on the domestic listing markets, noting that:

In the shareholding system in China, the transfer and trading of legal person shares are largely restricted. They can only be disposed in a restricted private sale, typically associated with low liquidity and unfair price. This discourages the exiting of venture capital investments in China through domestic listing. Another obstacle for foreign venture capital investment in China is foreign exchange control, which requires investors to obtain government agency approval to convert the proceeds of stock sales to foreign currencies before they remit outward.<sup>37</sup>

In order to overcome such constraints, PRC enterprises would incorporate an offshore BVI or Cayman company as a holding company in order to gain the greater flexibility and liquidity offered by an international listing. This was of fundamental importance for private equity and venture capital investment into the PRC, as a key concern for such investors was that the fund would be able to realize its investment, either by way of a private sale or IPO exit. The incorporation of BVI and Cayman companies therefore became a popular route for venture capital investment in PRC enterprises, as “among the 18 China Venture-backed IPOs listed on NASDAQ between 2000 and 2005, 13 of them were incorporated in the Cayman Islands or British Virgin Islands, while others were incorporated in the U.S. or Hong Kong.”<sup>38</sup> Additionally, many other initial public offerings of PRC enterprises listed in Hong Kong and Singapore were also structured by using companies incorporated in Cayman and BVI.

---

<sup>36</sup> For example, in terms of regulation, the BVI and Cayman have no foreign exchange controls or takeover codes. In terms of corporate flexibility, the corporate laws of each jurisdiction allow many corporate actions to be conducted efficiently (the BVI is particularly flexible in this respect, given that BVI companies have no concept of share capital, which allows for redemptions and distributions to be conducted with ease). Another important factor is that, as common law jurisdictions, the principles of corporate governance applicable to offshore companies are familiar to other common law attorneys.

<sup>37</sup> Xiaoping E. Xu, *Venture Backed IPOs and the Exiting of Venture Capital in China*, 11(3) J. ENTR. FIN. & BUS. VENTURES 39, 41 (2006).

<sup>38</sup> *Id.* at 41.

It should be noted that the desire to use offshore structures to encourage investment was not just motivated by financial concerns, but also for commercial and legal reasons. A study by Quer, Claver and Riendra looked at the main problems and challenges faced by Chinese enterprises. Challenges included (i) limited experience in mergers and acquisitions, (ii) a lack of international experience, particularly market knowledge, (iii) the fact that state ownership of many enterprises made them vulnerable to political risk in countries where the assets sought were strategic, and (iv) the fact that the less developed status of the home stock markets and lack of transparency resulting from state ties made their governance weaker.<sup>39</sup> Many of these factors relate to questions of risk and corporate governance, for which legal issues must. For this reason, it is also appropriate to give consideration to the legal environment behind the use of offshore jurisdictions.

### *C. Legal Considerations*

As noted above, the BVI and Cayman are common law jurisdictions, based on English law, whose ultimate court of appeal is the Privy Council in England. As common law jurisdictions, there are shared legal principles and cultural values with other common law jurisdictions, such as the U.K., U.S. and Hong Kong. As a result, the onshore legal professionals that set up such structures are comfortable with the BVI and Cayman and have trust in the jurisdictions and the professionals that administer and advise in respect of such offshore structures.

Given the shared legal culture, the BVI and Cayman were often the first choice for onshore counsel when considering an appropriate corporate vehicle with which to structure an investment into the PRC. Not only were the legal principles in the BVI and Cayman familiar, but they also offered a high level of flexibility, given that they can be used to ring-fence liabilities, are internationally recognized by regulators, are tax-neutral, have low administration costs, no filing requirements, minimal regulatory interference, and a high degree of corporate flexibility. Additionally, foreign law contracts are enforceable in the BVI and Cayman, which allows for deals to be structured and agreements drafted using the most appropriate governing law for the deal. In effect, BVI and Cayman companies offered a blank canvas, which could be adapted to meet the demands of local regulatory and legal requirements without

---

<sup>39</sup> DIAGEO QUER ET AL., CHINA'S OUTWARD FOREIGN DIRECT INVESTMENT: DRIVING FACTORS, THEORETICAL BACKGROUND AND STRATEGIC IMPLICATIONS (2008), available at <http://www.eiba2008.ttu.ee/public/Papers/21.pdf>.



imposing any further requirements or legal impediments to structuring a deal.

Given the legal flexibility in structuring investments through a BVI or Cayman company, they have been frequently used to overcome imperfections in PRC law. They offer advantages in both negotiating the complexity of PRC regulation, and in providing a secure legal environment for structuring investment.

For example, offshore jurisdictions are frequently involved in M&A deals involving PRC companies.<sup>40</sup> In terms of M&A transactions, BVI and Cayman companies have often been used to effect the indirect acquisition of a PRC companies.<sup>41</sup> It is usually preferable to structure the acquisition of a PRC company offshore, as such transactions are generally not subject to PRC jurisdiction and review (although certain antitrust and tax provisions may have effect).<sup>42</sup> As a result, it has been easier and more cost effective to structure an acquisition offshore. Similarly, offshore companies are often preferred for mergers, as the merger regime in jurisdictions like the BVI is straightforward and also provides for cross-border mergers. In contrast, mergers are not frequently seen in the PRC<sup>43</sup> and cross-border mergers are not recognized under PRC law, which prevents PRC companies from entering into such mergers and limits the possibilities for structuring M&A deals within the PRC.

A growing area of M&A activity involving PRC entities and offshore vehicles can be seen in going-private transactions, which are generally structured as mergers.<sup>44</sup> A going-private transaction is one where a PRC enterprise, typically listed on a U.S. stock exchange through a BVI or Cayman company, is acquired by a third party and delisted. Offshore companies are frequently used to effect such transactions and are frequently the listed target, given their popularity as listing vehicles. For instance, “five of the nine significant Chinese companies that announced or closed a going-private transaction in 2011, were Cayman companies that accessed

---

<sup>40</sup> Daniel H. Rosen & Thilo Haneman, *supra* note 24, at 4 (“around 60 to 70 percent of total Chinese OFDI volume can be attributed to M&A deals” which are generally structured using special purpose vehicles in third countries).

<sup>41</sup> Other types of acquisition, such as the acquisition of direct equity interests in PRC companies or the purchase of assets owned by PRC companies are outside the scope of this article.

<sup>42</sup> Note that the law in this area is complex, given that a number of different PRC laws govern the acquisition of control or a minority interest in PRC companies and certain sectors of the economy may be prohibited or restricted to foreign investors. For a good summary of the regulatory background, see Arsenault et al., *supra* note 33, at 160–61.

<sup>43</sup> The PRC does recognize two domestic types of merger: merger by absorption and merger by new establishment.

<sup>44</sup> There are a number of ways to structure a merger with an offshore company. Taking the BVI as an example, a BVI company can effect a merger either by way of statutory merger, a squeeze-out transaction or by way of scheme of arrangement.

the public markets through a conventional IPO.”<sup>45</sup> It is often preferable that the listed target be an offshore company, as opposed to a U.S. vehicle, for example, given the lighter regulatory regime which allows for deals to be conducted efficiently. For instance, a company incorporated in a U.S. state will be subject to U.S. federal proxy rules, may require majority approval by shareholders who are unaffiliated with the purchaser, and may include go-shop periods. However, where an offshore company is the target, this may result in lower litigation risks, lower costs, reduced review by the SEC and less time involved in concluding the transaction.<sup>46</sup> For example, a merger conducted with a BVI company is often faster and more cost-effective, given that a statutory merger under BVI law simply requires shareholder approval by the holders of a majority of the shares (or class of shares) present and entitled to vote on the merger, unless the constitutional documents of the company provide for a greater percentage.<sup>47</sup> Given that purchasers often have a significant equity stake in the target, the use of an offshore company increases the chance of the going-private transaction proceeding quickly and successfully.

In addition to M&A transactions, offshore companies have frequently been used in private equity deals in the PRC.<sup>48</sup> A review of private equity activity is instructive, given that such investments illustrate the interplay between finance (such as the need for PRC enterprises to access funding and private equity investors to ensure an exit) and law (given the need for legal certainty and adequate legal structures to ensure that such investments are protected).

It has been observed that, when financing firms in developing markets, venture capital funds are exposed not only to industry and firm level risk, but also legal and institutional failure. Key concerns for such investors are “intellectual property protection, shareholder protection, government intervention, supply of risky capital, transparency of financial reporting requirements and IPO markets for exits.”<sup>49</sup> These concerns are paramount in the PRC, which has historically been “characterised by a lack of clearly codified

---

<sup>45</sup> Arsenault et al., *supra* note 33, at 167.

<sup>46</sup> See e.g. Morrison & Foster, *The MoFo Guide to U.S. Privatisations* (2012), <http://www.mofo.com/files/Uploads/Images/121119-The-MoFo-Guide-to-US-Privatizations.pdf>.

<sup>47</sup> Contrast Cayman use official title of jurisdiction, or its abbreviation, which requires approval by a special resolution, requiring at least a two thirds majority of the shares present and voting.

<sup>48</sup> However, where the intention is for the foreign investor to invest along with the Chinese partner, this structure is not always appropriate or used, given the ownership limitations and prohibition on round-trip investments following the M&A Rules, see Arsenault et al., *supra* note 33, at 163.

<sup>49</sup> Sophie Wang et al., *Venture Capital Performance in China* 6 (2013) (unpublished manuscript) available at <http://www.asb.unsw.edu.au/schools/bankingandfinance/Documents/Venture-capital-performance-in-China.pdf>.

information, unpredictable government regulation, and uncertain market conditions directed at entrepreneurial activities.”<sup>50</sup>

A key aspect of private equity deals is that such transactions are structured to provide certain preferential rights to the investor. These include preferred voting rights, rights to dividends, or rights upon liquidation. However, it has been difficult to replicate such structures in the PRC, as similar legal concepts do not exist. As Liang notes:

[N]o Chinese legislative document, judicial interpretation or court ruling has provided explicit guidance on how a company could issue multiple classes of shares, including preferred shares, to different groups of shareholders. The concept of anti-dilution provisions, common in the Western legal context, thus remains unfamiliar and largely without a secure legal foundation in Chinese law.<sup>51</sup>

Of course, as Liang notes, there are ways to attempt to resolve or alleviate this problem. However, the usual solution to such problems is to structure the deal offshore. As Li observes:

[I]f the transaction is structured offshore in which capital is actually injected into the holding company outside China, the parties will have the liberty to mutually choose from other laws than the Chinese law ... parties may get access to more efficient legal rules that are not entirely available in China” and therefore provide for “special economic rights such as liquidation preferences, anti-dilution adjustments and other rights in the investment contracts, as well as to effectively monitor the invested company.”<sup>52</sup>

A related concern for private equity investors has been the relative lack of investment targets. This has historically been due to the corporate form of PRC enterprises. For example, the PRC only recognizes two types of companies: limited liability companies and joint stock companies. Only joint stock companies are able to issue shares and list on stock exchanges. In order to attract international investment, it was thus necessary for a PRC enterprise to be structured as a joint stock company. However, there were higher costs, larger capital requirements and greater approvals required to incorporate a joint stock company, which meant that by 2004 the

---

<sup>50</sup> *Id.* at 6.

<sup>51</sup> Liang Tao, *The Enforceability of Anti-Dilution Provisions in Private Placement Transactions in China*, 6 TSINGHUA CHINA L. REV. 45, 46–47 (2013).

<sup>52</sup> Li, *supra* note 25, at 30–31.

PRC had 1.3 million limited liability companies and only 8000 joint stock companies.<sup>53</sup> Therefore, it was difficult for venture capital to directly invest in PRC enterprises as there was a lack of valid targets. As a result, it was often a simpler solution to incorporate an offshore holding company in order to attract venture capital investment.

In addition to providing legal solutions and legal certainty in the absence of an adequate legal infrastructure, offshore companies have also been used to negotiate imperfections within the wider regulatory framework. For example, offshore companies have been used to ameliorate the strictness of regulations governing internal investment and ensure the efficient allocation of capital into the PRC.

One such example can be seen with historic investments into the PRC from Taiwan. Historically there were various restrictions imposed upon investors and companies from Taiwan on making direct investments into the PRC. For example, the ‘be patient, go slow’ policy in the mid-1990’s imposed investment caps on projects at US\$50 million, reduced the limits for equity in PRC joint ventures to 30%, and placed restrictions on investment in certain sectors of the PRC economy. As the political and economic climate improved during the 1990s, the existing investment restrictions were increasingly seen as having “slowed the process of exchange and made transactions inefficient”<sup>54</sup> as it was difficult for Taiwanese investors to fund large scale investment in the PRC. In order to overcome such structural impediments, entrepreneurs were driven to find innovative solutions to achieve their commercial aims of investing into the PRC and increasingly used investment vehicles incorporated in Hong Kong, the BVI and Cayman, which would allow them to indirectly invest into the PRC, by routing their investment through a third jurisdiction, and teaming up with other international investors to attract the necessary capital for investment projects.<sup>55</sup>

This shows again how offshore jurisdictions can be used to provide practical solutions in order to overcome structural inefficiencies and gain access to international capital. The key point to note is that the primary motivation is not tax arbitrage, but to obtain management control and access to new markets. Again, this rationale accords with the wider definition of FDI noted in Part II.

A contemporary example of such regulatory arbitrage can be seen with the use of variable interest entities (“VIEs”). The basic VIE structure is one in which an offshore entity (typically a BVI or

---

<sup>53</sup> *Id.* at 13–19.

<sup>54</sup> Karen M. Sutter, *Business Dynamism Across the Taiwan Strait: The Implications for Cross-Border Strait Relations*, 42(3) *ASIAN SURV.* 522, 527 (2002).

<sup>55</sup> *Id.* at 527.

Cayman company) is established to hold a wholly-owned foreign enterprise (“WFOE”) in the PRC. The WFOE enters into certain contracts with a domestic Chinese entity formed under PRC law, which gives the WFOE the ability to control the domestic enterprise through contractual methods rather than equity ownership. This allows the foreign investor to avoid certain ownership restrictions under PRC law.<sup>56</sup> A further advantage is that, by structuring ownership through such contractual methods, the offshore holding company is permitted to consolidate its accounts with the WFOE and domestic Chinese entity, which facilitates the listing of the holding company. A number of well-known PRC enterprises, such as Sina, Baidu and Alibaba, have used this method in order to structure their Chinese operations and achieve an international listing.<sup>57</sup>

This structure permits foreign investors to invest in sectors of the Chinese economy that would otherwise be restricted to foreign investment and to circumvent certain approval requirements under the M&A Rules on the basis that the VIE does not involve the acquisition of a PRC company by a foreign investor or involve a direct equity transfer. The benefits of the VIE structure can be seen in that it has brought much needed capital, management expertise and the transfer of technology and know-how to the PRC without compromising PRC controls on direct equity ownership of restricted enterprises.

There are, however, a number of risks associated with VIEs. The regulatory regime governing the structure is uncertain. The contractual arrangements governing the VIE may contravene PRC law and that there are structural risks in terms of monitoring and ensuring compliance at the level of the PRC enterprise. However, this has not prevented VIEs being used in the financing and listing of large PRC enterprises.<sup>58</sup>

A key point to note, however, is that notwithstanding the presence of offshore vehicles in the VIE structure, the use of offshore

---

<sup>56</sup> For example, the China National Development Commission and the Ministry of Commerce jointly issued the Catalogue of Industrial Guidance for Foreign Investment, which separates foreign investment into various industries and classifies each industry as encouraged, permitted, restricted or prohibited.

<sup>57</sup> See Chao et al., *supra* note 27, at ; see also David Schindelman, *Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for Foreign Investors Part of China's Economic Development Plan?* 21 CARDOZO J. INT'L & COMP. L. 195 (2012) (noting that the laws concerning VIEs are complex and it outside the scope of this paper to explore the relevant legal framework in great detail. However, for a useful overview of the legal and commercial framework, the reader is referred to these works).

<sup>58</sup> Arguably, the PRC has tacitly accepted such structures (although notices have been issued which expressly prevent their use in some sectors of the economy) and will not expressly prohibit these structures, given the significant market uncertainty that would result from taking such actions.

jurisdictions is not central to the regulatory arbitrage envisioned by the VIE, which occurs at the PRC level rather than the offshore level. Instead, the offshore company simply acts as a holding company. In effect, any company could perform the role of holding company, but the BVI and Cayman are frequently chosen due to their unique advantages described earlier.

Offshore companies have been used for a variety of purposes in order to navigate difficulties in the Chinese legal landscape. An analysis of Chinese FDI requires a legal approach because the regulatory landscape governing investment into the PRC has undergone a transitional process, requiring novel legal solutions found in offshore jurisdictions.<sup>59</sup> The use of offshore jurisdictions has been bound to the economic development of the PRC in that investors have crossed the river by feeling the stones.

#### V. OUTWARD INVESTMENT: FINANCING EXPANSION THROUGH OFFSHORE STRUCTURES

The statistics on Chinese outward FDI are as impressive as those relating to inward FDI. For example, by “the end of 2006, more than 5,000 Chinese firms had established 10,000 overseas subsidiaries, joint ventures, and representative offices in 172 countries.” In 2006, the total FDI flow of the PRC had reached US\$21.16 billion.<sup>60</sup> By 2012, the volume of outward FDI from the PRC had effectively trebled to US\$62.4 billion.<sup>61</sup>

Offshore jurisdictions also play a significant role in outbound investment by PRC enterprises. According to an OECD review of the PRC’s 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.<sup>62</sup> Given the leading role of BVI and Cayman in Chinese outbound FDI, it is important to look at the reasons for their use in structuring outward investment.

---

<sup>59</sup> It can also be argued that offshoring not only provided novel solutions but also provided PRC investors with insight and access to novel systems of law. The work of Bill Maurer and Sylvia J. Martin, *Supra* Note 10, is instructive here. They argue that part of the appeal of offshore jurisdictions such as the BVI to the PRC was the accidental discovery by Chinese investors of the common law principles of equity. This article is too nuanced to summarize here but it does provide a meaningful and alternative view from an anthropological perspective.

<sup>60</sup> Leonard K. Cheng & Zihui Ma, *China’s Outward Foreign Direct Investment, in CHINA’S GROWING ROLE IN WORLD TRADE* 553 (Robert C. Feenstra & Shang-jin Wei, eds., 2010), available at <http://www.nber.org/chapters/c10475.pdf>.

<sup>61</sup> OECD, *FDI in Figures April 2013*, available at <http://www.oecd.org/daf/inv/FDI%20in%20figures.pdf>.

<sup>62</sup> OECD, *supra* note 32, at 72.

In effect, some of the reasons for the use of other jurisdictions in Chinese outbound FDI are the same as those applicable to inward investment into the PRC. As the OECD notes:

Part of the attraction of offshore financial centres as OFDI destinations may result from the fact that the Chinese government's long-term capital controls have hampered the deepening of China's domestic capital market. In the face of domestic financial constraints, these financial offshore centres can be effectively used as locations of regional headquarters, holding companies or special vehicle enterprises for which efficient financial services and unconstrained financial flows are crucial.<sup>63</sup>

Again, the key rationales for the use of offshore jurisdictions are efficiency, avoiding domestic constraints, and obtaining access to finance. This reinforces the structural importance of offshore companies for PRC investment.

Aside from structural reasons, offshore companies also provide access to overseas skills and knowledge. For instance, Clegg and Voss described how the BVI and Cayman “are gateways for FDI because they offer professional services and institutional support unavailable in China.”<sup>64</sup> Such support has been provided by law firms, trust companies and other service providers, both onshore and offshore, that set up and administer such structures.<sup>65</sup> This is unsurprising, given that an express objective of the reform and opening up was to acquire foreign skills and knowledge. The use of offshore jurisdictions, however, has not only complimented the policy goals of the reform era but also served as useful tools for China's new policy of going global, as illustrated below.

### A. Going Global

The use of offshore jurisdictions in Chinese outward FDI reflects China's recent “go global” policy (走出去战略). This policy was officially adopted in the Tenth Five Year Plan (2001–2005), where it

---

<sup>63</sup> *Id.*

<sup>64</sup> Jeremy Clegg & Heinrich Voss, *Chinese Overseas Direct Investment in the European Union* 16, EUROPE CHINA RESEARCH & ADVICE NETWORK (2012), available at [http://www.chathamhouse.org/sites/default/files/public/Research/Asia/0912ecran\\_cleggvoss.pdf](http://www.chathamhouse.org/sites/default/files/public/Research/Asia/0912ecran_cleggvoss.pdf).

<sup>65</sup> Interestingly, many law firms and trust companies have recently set up offices in Hong Kong and Mainland China, thereby directly contributing to the development of skills in the PRC and creating local employment.

was adopted as one of the key platforms of Chinese economic policy. The policy was further promoted in the Eleventh Five Year Plan (2006–2010) and is a dominant narrative behind the outward expansion of PRC enterprises. The essence of the policy is that PRC enterprises should invest overseas in order to gain access to resources and expand markets and operations.<sup>66</sup>

Offshore companies play a role in the go global policy by facilitating the investment of PRC enterprises overseas and providing them with the legal protections and tools necessary to ensure effective and prudent investment in foreign countries. Certainly, these benefits have been recognized within the PRC. For instance, an article in the China Daily considered the role of offshore companies and noted that:

According to Ministry of Commerce researcher Wang Zhiyue, offshore companies certainly have their worth as they provide an alternative way of thinking for our “go-global” policy. In addition, Dong Yuping, a researcher in the Chinese Academy of Social Sciences considered that offshore companies have their positive aspects. Offshore companies provide an operating platform for overseas finance and investment and provide a buffer zone against liability and risk.<sup>67</sup>

In terms of the specific factors which lead to the use of offshore companies in going global, Korniyenko and Sakatsume observed that PRC enterprises had a number of domestic constraints to outward expansion, including a cumbersome government approval process, problems with access to finance, a lack of currency convertibility and a lack of experience.<sup>68</sup> In addition to these internal factors, there are also external constraints, such as the problem of negotiating complex foreign regulations, the need to ensure legal certainty in an investment structure, the need to protect any investment against risk, and the need to ensure corporate flexibility in managing an

<sup>66</sup> See OECD, *supra* note 32, at 83.

<sup>67</sup> *Duojia Zhongguo Qiye yi Li'an Fangshi Bishui, Mao Shu Youxi Rengzai Jixu* (多家中国企业以离岸方式避税 猫鼠游戏仍在继续) [Many Chinese Companies Use Offshore Methods for Tax Evasion; The Cat and Mouse Game Is Still Continuing], ZHONGGUO RIBAO (中国日报) [CHINA DAILY], Aug. 2, 2011, available at [http://www.chinadaily.com.cn/dfpd/jingji/2011-08/02/content\\_13029717\\_11.htm](http://www.chinadaily.com.cn/dfpd/jingji/2011-08/02/content_13029717_11.htm) (“在商务部研究员王志乐看来，离岸公司为我国国有企业“走出去”，提供了另一种思维，值得肯定。对此，中国社科院金融所研究员董裕平也认为，离岸公司有其积极的一面。离岸公司为企业海外投资、融资提供了一个操作平台和风险规避的“缓冲层””).

<sup>68</sup> Yevgeniya Korniyenko & Toshiaki Sakatsume, *Chinese Investment in the Transition Countries*, 19 (European Bank for Reconstruction and Development Working Paper No. 107, Jan. 2009).



investment. All of these are factors that tend toward the use of offshore vehicles.

An important point to consider is that, in going global, PRC enterprises were confronting the complexity of dealing with new and foreign jurisdictions and differing laws and practices. This is often a problem with cross-border transactions, which are frequently complex, involving diverse corporate structures and multiple jurisdictions with different legal systems. Often, the variety and complexity of actors and jurisdictions can be cumbersome and costly. As a result, there is often value in simplifying the legal structure to such deals, and BVI companies are often chosen to play this role because they operate within a simple and predictable legal framework and are easy to interpose within international transactions to ensure that the deal occurs at the offshore level.<sup>69</sup> The use of BVI and comparable offshore companies offers a standard that lawyers from many jurisdictions are familiar with and the flexibility of the offshore corporate form permits their use in all manner of legal environments.

To take one example, BVI and Cayman companies are often used in project financing. One advantage, as noted above, is that they have modern security regimes and allow security to be taken over their assets with free choice as to the governing law of the underlying security agreement with minimal formalities. Additionally, at least in the case of the BVI, there is a statutory regime for the public registration of security, which allows secured parties to take priority over competing security interests.<sup>70</sup> The ease and flexibility with which security can be taken is of importance in project finance and assists with the ability of a group to raise finance, given that lenders are familiar with these offshore structures and can be certain of the integrity of any finance and security package.

Although these are general reasons for the use of offshore vehicles in outbound FDI by the PRC, it would be instructive to consider a few specific examples in order to have a clearer idea as to

---

<sup>69</sup> See e.g. Peter Buckley, Dylan Sutherland, Hinrich Voss & Ahmad El-Gohari, *The Economic Geography of Offshore Incorporation in Tax Havens and Offshore Financial Centres: The Case of Chinese MNEs*, 1 J. ECON. GEOGRAPHY 16 (2013) ("qualitative research on Chinese investors using the BVI shows they have particular regard for the BVI's legal system (Maurer & Martin, 2011). This may explain why the overwhelming majority of property rights transactions in our sample firms are undertaken in the BVI").

<sup>70</sup> This is unlike the regime in Cayman, which does not have a public system of security registration and, although a Cayman company is required to maintain an internal register of charges, failure to do so does not render the security void. As a result, BVI companies are usually preferred vehicles (from the lender's perspective) in project finance transactions.

their practical usage.<sup>71</sup> For this reason, the following sections will look at the role that offshore companies play as holding structures and as joint venture vehicles. What will become apparent is that offshore companies are used in a variety of different roles to overcome an array of different legal problems and to protect against various forms of risk.<sup>72</sup>

### *B. Holding Companies*

A key use of offshore companies is as investment holding companies. Offshore companies are used in this capacity by a variety of different actors, from state bodies to multinational corporations. A prominent example is The State Administration of Foreign Exchange (“SAFE”), which is a public body in the PRC responsible for managing China’s foreign exchange reserves and has approximately US\$567.9 billion in assets. SAFE has a number of sovereign wealth enterprises under its administration, which are comprised of three enterprises incorporated in Singapore, the U.K. and the BVI. The BVI enterprise, Beryl Datura Investment Limited, is responsible for infrastructure investments around the world.<sup>73</sup> Given the role and nature of this entity and the total assets administered by SAFE, it could be assumed that this enterprise alone may well be responsible for a significant proportion of the PRC’s outward FDI that flows through the BVI.

It is also possible to understand the use of offshore companies by examining their use in listed group structures. For example, a review of prospectuses relating to BVI listed companies with PRC operations reveals that BVI companies are not only used as the listing vehicle, but also as holding companies in the group structure. For example, the listed BVI company, Winsway Coking Coal Holdings Limited, another listed BVI company and one of the leading suppliers of imported coking coal into the PRC, has six BVI subsidiaries, and China New Town Development Company Limited, a developer of new towns in the PRC, has eight BVI subsidiaries, which are described in the prospectus as investment holding companies. It should be noted that this use of offshore companies is

---

<sup>71</sup> It should be noted that information about the use of offshore vehicles in outbound FDI is limited, so it is difficult to obtain and present information in a systematic way. However, it is possible to use publicly available information and illustrate some incidences of the use of offshore vehicles.

<sup>72</sup> One such example is the use of offshore companies to effect reverse mergers within the U.S. and thereby achieve listing through the back door. This form of regulatory arbitrage suggests that PRC entrepreneurs have learnt from their experience of structuring inward FDI and have applied the same tools to outward investment. An important point, however, is that like the VIE structure the offshore company is not integral to the arbitrage. Instead, it is simply used as the vehicle to effect the reverse merger, as a result of its corporate flexibility and ability to be used in cross-border mergers.

<sup>73</sup> See The SWF Institute, available at <http://www.swfinstitute.org/swfs/safe-investment-company/>.

not unique to the PRC, as other listed companies employ the same structures. For instance the Canadian listed company, China Gold International Resources Company Ltd has a number of offshore subsidiaries, including BVI and Cayman companies.

To understand the rationale for the use of offshore companies as holding companies, a review by Sutherland et al is instructive. They conducted a review of listed Chinese companies on the HKSE, New York Stock Exchange and NASDAQ and found that of 72 sample firms, 62 firms were incorporated in Cayman, and of these firms, 42 also had one or more BVI holding companies directly held by the Cayman listing vehicle.<sup>74</sup> They observed that the holding companies were generally used to control the underlying operating companies and as a means to effect the acquisition and/or sale of underlying companies by structuring the deal offshore.<sup>75</sup>

### C. Joint Ventures

In addition to their use as holding companies, offshore companies are frequently used to structure joint ventures.<sup>76</sup> Joint ventures also feature heavily in Chinese outward FDI as a means to share legal and financial risks in overseas investment projects.

Taking PRC investments into Africa as an example, by 2011 the PRC had invested a total of over US\$40 billion, making Africa the fourth largest investment destination for China. In addition, there were over 2,000 Chinese enterprises doing business in Africa by the end of 2011.<sup>77</sup> Joint ventures are generally the preferred form of investment by PRC enterprises into Africa, with the OECD noting that “China’s FDI flows to Africa have mainly taken the form of equity joint-ventures with local enterprises. Chinese enterprises consider that finding a suitable local firm as a business partner is very important for project success.”<sup>78</sup>

By partnering with a local partner in Africa, PRC enterprises can gain access to local borrowing facilities, resources, tax breaks and

<sup>74</sup> See Lutao Ning & Dylan Sutherland, *Internationalization of China’s Private Sector MNEs: An Analysis of the Motivations for Foreign Affiliate Formation*, 54(2) THUNDERBIRD INT’L BUS. REV. 170 (2012) (where the authors conducted a review of 104 privately owned Chinese MNEs, which were held by offshore holding companies, as well as their 227 foreign affiliates).

<sup>75</sup> See Sutherland et al., *supra* note 21, at 13–15. Also note generally that there are other reasons for the use of offshore holding companies such as (i) their low costs and tax neutrality, (ii) the ability to ring fence assets, (iii) the ability to separate parts of the group to partition regulatory or commercial risks, (iv) to ensure protection against creditors (such as by shifting dividends up to the holding company), and (v) for the efficient structuring of inter-group financing.

<sup>76</sup> U.N. Conf. on Trade and Dev., *supra* note 1, at 7 (A prominent example being the TNK-BP joint-venture).

<sup>77</sup> Zhu Weigdong, *A Brief Analysis of the Disputes Arising from China-African Civil and Commercial Transactions*, 7 J. CAMBRIDGE. STUD. VOL 74, 75 (2011).

<sup>78</sup> OECD, *supra* note 4, at 110.

goodwill. Additionally, “political considerations in SSA [(“Sub-Saharan Africa”)] sometimes make JVs the only feasible mode of entry into the area. Many SSA nations are still considered less developed, which often means that their political environments and business systems are unpredictable. The SSA partner in a JV can insulate the other partners from this instability because of its understanding of the nation’s problems and its ability to navigate through them.”<sup>79</sup>

As offshore companies are frequently used to structure joint-ventures, or serve as investment holding vehicles within a joint-venture structure, it is unsurprising to find that they are frequently used in Chinese FDI into Africa. Relevant examples include the recent acquisition and joint-venture between the Zijin Mining Group Co., Ltd and the China-Africa Development Fund Co., Ltd<sup>80</sup> of interests in gold mining, production and refining facilities relating to mineral projects in Congo, where BVI companies were used in a number of different capacities, such as acquisition vehicles, holding vehicles and investment vehicles.<sup>81</sup> A similar example can be seen in the recent joint venture entered into by a BVI subsidiary of Zhongda International Holdings Limited and certain South African companies in respect of the construction and operation of an electronic infrastructure project in South Africa.<sup>82</sup> Similarly, Hoifu International Trading entered into a joint venture agreement with Profit High International Enterprise Limited, where a BVI company was used as the joint venture vehicle for the purpose of pursuing Africa-related business development.<sup>83</sup>

Of course, there are risks involved in investment into foreign jurisdictions, as the “downside of a joint-venture is that it is sometimes difficult to manage the joint-venture because cooperative

---

<sup>79</sup> Herbert A. Igbanugo, *Joint Ventures in Sub-Saharan Africa: A New FCPA Minefield*, The African Counsel Newsletter (Sep., 2012), available at <http://www.igbanugolaw.com/resources/Joint-Ventures-In-SSA-A-New-FCPA-Minefield.pdf>.

<sup>80</sup> The China-Africa Development Fund was established for the purpose of investment into Africa, in line with the go global policy. First phase funding amounted to US\$1 billion, intended to rise to US\$5 billion. Interestingly, the investment policies of the fund provide that it will establish joint ventures for investment in Africa, with such joint ventures being established either within or outside Africa, and to acquire interests in enterprises and projects with major assets in Africa, notwithstanding that the enterprise is incorporated outside Africa. As a result, the use of offshore companies is permitted and perhaps envisaged by such policies. See further <http://www.cadfund.com>.

<sup>81</sup> HKSE, *Announcement Regarding Proposed Acquisition of Platmin Congo (BVI)* (2010), available at <http://www.zjkn.cn/portals/1/LTN20100507861.pdf>.

<sup>82</sup> HKSE, *Announcement Regarding Connected and Discloseable Transaction Involving the Formation of a Joint Venture for the EMS Project in South Africa* (2010), available at [http://notice.singtao.com/ADMA/00909/epdf/e909\\_EMS%20Project\\_19May10.pdf](http://notice.singtao.com/ADMA/00909/epdf/e909_EMS%20Project_19May10.pdf).

<sup>83</sup> HKSE *Announcement Regarding Formation of a Joint Venture Company* (2013), available at [http://www.hoifuenergy.com/eng/2013/LTN20130306274\\_C.pdf](http://www.hoifuenergy.com/eng/2013/LTN20130306274_C.pdf).

partners may have differences in business cultures and management processes.”<sup>84</sup> In addition to management and cultural risks, a joint venture with a foreign partner can also involve legal risk, and the PRC has frequently confronted such risks in its African investments.

For example, Zhu conducted a review of disputes involving PRC enterprises in Africa and noted that, with the development of business relations between Chinese and African parties:

[T]he civil and commercial communications between both sides become more and more frequent ... having resulted in large amounts of disputes. Whether the disputes can be settled efficiently, effectively and reasonably will have a great impact on the development of business relations.<sup>85</sup>

Unfortunately, Zhu noted that it had been difficult to ensure that such disputes were resolved efficiently. In particular, the key issues facing PRC investors in Africa are that (i) there is a lack of effective bilateral or multilateral judicial assistance mechanisms between China and African countries, which results in protracted and uncertain litigation, and (ii) that the lack of mutual knowledge in respect of Chinese and African legal systems caused unnecessary delays, leading Zhu to conclude that, in the case of dispute, PRC enterprises “do not know what remedy can be resorted to immediately, or sometimes they will fear or worry to litigate in the other party’s country, which will lead to the slow settlement process.”<sup>86</sup>

These fundamental concerns show why offshore companies are frequently used in investment and joint-venture structures in overseas investment. By structuring investment through an offshore company, a PRC investor can protect itself from liability or the risk of expropriation and the parties can take comfort that disputes can be resolved in a neutral third jurisdiction which offers stability, predictability and security with no home field advantage to either party.<sup>87</sup>

---

<sup>84</sup> Qiang Ding, Michele E.M. Akoorie & Kathryn Pavlovich, *Going International: The Experience of Chinese Companies*, 2 INT’L BUS. RES. 148, 150 (2009).

<sup>85</sup> Zhu, *supra* note 78, at 75.

<sup>86</sup> *Id.* at 80–81.

<sup>87</sup> Frequently, the BVI is chosen as a joint-venture vehicle, not only for the reasons noted above, but also because it has unique statutory provisions that allow for a director of a BVI company, when acting in a joint-venture, and where permitted by its constitutional documents, to act in the interests of a shareholder or shareholders, even though it may not be in the interests of the company (see section 120(4) of the BVI Business Companies Act, 2004). This overcomes a common tension for directors acting in joint ventures, where they are sometimes divided between their loyalty to their appointing shareholders and their duties to the company.

Of all the offshore jurisdictions, the BVI is frequently chosen to establish joint-ventures. Part of the appeal is the quality of its legal infrastructure and expertise in respect of shareholder disputes. The Economist recently noted that the “courts in the British Virgin Islands hear a good share of all disputes involving international joint ventures.”<sup>88</sup> This is certainly evidenced by the level and nature of commercial litigation before the BVI courts, which frequently concern disputes relating to shareholder rights and corporate governance matters. For instance, a review of reported BVI judgments maintained with the Eastern Caribbean Supreme Court showed that between 2011 and 2013, among the many cases before the court, at least fifteen judgments had been reported which specifically involved PRC entities and these judgments related to the type of matters that one would expect to see in a commercial court, such as property rights, the ownership of shares, shareholder remedies and procedural matters.<sup>89</sup> Clearly, the BVI provides a useful forum for the resolution of disputes.<sup>90</sup>

Therefore, when faced with the uncertainty and risk of investing into a legally uncertain or undeveloped jurisdiction, one way of containing the legal risks is to structure the joint venture in the BVI or similar offshore jurisdiction, in order to rely on the familiar and predictable protections of the offshore jurisdiction. By incorporating an offshore company as the joint venture vehicle, the parties can take comfort that the courts will generally enforce foreign judgments. In addition, the parties are also able to rely on the stable corporate governance principles of a common law jurisdiction, as well as gain the corporate flexibility of an offshore vehicle, which can be tailored to meet the terms of the deal and can operate with standard U.S. or U.K. style shareholder protections. This also avoids the legal risks of structuring the investment in a foreign jurisdiction, which may involve the risk of protracted and uncertain litigation, expropriation, unforeseen costs or political interference with any legal process.

Outward FDI raises similar problems for PRC investors as those faced by foreign investors seeking to invest into the PRC. Just as foreign investors have used offshore structures to ensure efficient

---

<sup>88</sup> *Unbundling the Nation State*, THE ECONOMIST, Feb. 8, 2014, at 50.

<sup>89</sup> Note that this research only related to reported judgments available from the website of the Eastern Caribbean Supreme Court and such research would not disclose any matters which were unreported, did not proceed to trial, or were resolved through arbitration (which is not only popular with PRC investors but is also private rather than public).

<sup>90</sup> BVI law has a number of protections which assist with the effective resolution of disputes and allow investors to protect their rights, such as member's remedies (which are provided for under the BVI Business Companies Act 2004) and the availability of injunctive relief, among other protections and actions open to aggrieved parties.

investment into the PRC, Chinese investors have adopted the same tools and strategies to protect their outward investments.

## VI. THE FUTURE OF OFFSHORE JURISDICTIONS IN THE PRC

It is likely that offshore jurisdictions will continue to play a role in Chinese FDI, although the role of such jurisdictions is likely to evolve and adapt to the changing nature of the Chinese economy, the continuing development of PRC law and the evolving needs of PRC enterprises.

Certainly, there has been a change in the use of offshore jurisdictions in the PRC, as Hong Kong has taken a more dominant role in Chinese FDI. For instance, between 2004 and 2009 inward FDI into the PRC from Hong Kong rose by 141%, whereas the increase was 69% for the BVI and 36% for Cayman.<sup>91</sup> In terms of outward FDI, flows from Hong Kong rose by 1,365% in the same period, while flows from BVI rose 1,489% and Cayman 171%. These figures show the increasing importance of Hong Kong in Chinese inward FDI, due to Hong Kong's tax benefits and preferential treatment under the Closer Economic Partnership Agreement.<sup>92</sup> However, in terms of outward FDI, both BVI and Hong Kong play increasingly important roles.<sup>93</sup>

The importance of offshore companies in inbound FDI into the PRC could become less pronounced as PRC laws mature. For example, the PRC will likely develop and permit the use of preferred shares and related shareholder protections. Certain Chinese regulators have already expressed their intention, in the Twelfth Financial Plan, to explore ways to establish a preferred stock system<sup>94</sup> which would improve the environment for private equity investment and corporate governance in the PRC. Similarly, there has been an improvement in internal listing options, such as the Shenzhen SME Board, which was established to provide a platform for small and medium enterprises to list their shares and for venture

---

<sup>91</sup> William Vlcek, *From Road Town to Shanghai: Situating the Caribbean in Global Capital Flows to China*, BRIT. J. POL. INT'L REL. (2013) (compiled from the China Statistical Yearbook).

<sup>92</sup> See Sutherland et al. *supra* 21, at 19 (regarding tax benefits, for instance, PRC law imposes a 10% withholding tax on dividends paid by an FIE to a foreign holding company, unless the foreign jurisdiction has a tax treaty with the PRC, in which case different arrangements may apply. Hong Kong has an arrangement whereby taxes on dividends are subject to a rate of no more than 5%, explaining its increased use in structuring investments into the PRC.).

<sup>93</sup> It is also clear that offshore companies continue to be used in other capacities in the PRC's special administrative regions. For instance, in Macao, approximately 50% of all company ownership comes from outside the region, with the BVI accounting for about 18% of all shareholdings, See *Macao Economic Bulletin, 2nd Quarter* (2013), available at [http://www.amcm.gov.mo/publication/Publication\\_main8.htm](http://www.amcm.gov.mo/publication/Publication_main8.htm).

<sup>94</sup> See Liang, *supra* note 51, at 61.

capital funds to achieve an exit. Historically, venture capital did not have the opportunity to raise funds in this manner, given that “the domestic stock markets were designed primarily for large state owned enterprises to raise funds, in which VCs had little role to play.”<sup>95</sup> Of course, such developments are not without their risks. For instance 2013 saw a moratorium on initial public offerings in the PRC, which created uncertainty as to the viability of the domestic listing markets. However, the continual development of PRC law does evidence its growing sophistication in commercial matters, and suggests that the scope for offshore structures in inward FDI may be reduced as the legal environment continues to improve.

However, offshore structures will likely continue to play a significant role in Chinese outward FDI. As the go global policy continues to gain momentum, as PRC companies become more involved in complex cross-border projects, and as PRC enterprises continue to operate in difficult legal environments, there is clearly a continuing need for offshore companies.<sup>96</sup>

Additionally, with changing Chinese demographics, and the rise of a new middle class, it is likely that offshore jurisdictions will be utilized in new and innovative ways. The generation that found wealth in the reform and opening up period now needs to consider how to manage, preserve and transfer that wealth. A key concern arises in succession planning, as many Chinese entrepreneurs hold their wealth through corporate structures (both offshore and onshore). On the occurrence of significant events, like death or divorce, disputes frequently arise as to the ownership, control and division of assets. These individuals will need to consider how their assets should be passed on. These are significant issues, and it is notable that a number of the reported BVI judgments involving PRC entities concern questions of succession and share ownership, suggesting that these issues are increasingly important. As a result, there is a current need to review existing corporate structures and prepare for forthcoming succession issues. In practice, consideration is already being given to this issue in respect of listings, given that offshore trust structures are increasingly used in pre-IPO planning

---

<sup>95</sup> Jerry Cao, *The Sustainability of Private Equity in China*, ASIA PRIVATE EQUITY INSTITUTE, PRIVATE EQUITY INSIGHTS (2014) available at <http://apei.smu.edu.sg/sites/default/files/apei/pdf/peinsights2013q4i.pdf> (Cao also notes that “around 44% of the 164 companies listed on the Shenzhen SME Board had been backed by one or more VC or PE funds” which attests to the success of the exchange).

<sup>96</sup> And clearly there is a need for BVI companies in this respect, as the use of BVI companies in outbound FDI has increased by 1,489% in a five year period, and given the various legal reasons outlined in this article.



exercises in order to avoid such risks in the lead up to an IPO.<sup>97</sup> Again, these are areas in which offshore structures are prominent, as BVI, Cayman and Jersey trusts are frequently used as wealth management tools in this area.<sup>98</sup>

## VII. CONCLUSION

Offshore jurisdictions have fulfilled an array of legal and structural needs in the course of the PRC's economic development and may well continue to play this role. The prominence of offshore jurisdictions in Chinese FDI can be mainly seen as serving a legal need. Legal solutions were required in order to ensure the effective management, ownership and control of investments into the PRC and such solutions were found by utilizing offshore structures.

One cannot understand the role of offshore structures in the PRC without also understanding the rationale behind Chinese economic reforms. The PRC has moved from a state system to a market economy in a very short time. Legal reforms have occurred gradually and PRC policymakers have learned at the same time as they have implemented such changes. As a result, where legal deficiencies have arisen, offshore companies have been used to find practical solutions. Furthermore, the economic reforms were designed with a need to experiment and innovate. PRC enterprises found such innovation through the use of offshore structures and continue to adapt such innovative legal techniques through the use of offshore structures in their outward expansion.

---

<sup>97</sup> For instance, where an individual holds a significant stake in an offshore company, and the intention is to list the company, there is a period in which the IPO may be at risk, given the long lead time to final listing. If any succession issues or disputes emerged during this period, there is a risk that the controlling interest in the listing vehicle might be paralyzed while such issues were being determined. As a result, offshore trust structures are often used to resolve this risk, given that a corporate trustee will be the shareholder of record and will not have the succession or capacity issues that can occur with individuals.

<sup>98</sup> Note, however, that the PRC already provides for trusts under the Trust Law, 2001. It is unclear to what extent that this law may give rise to an indigenous private wealth management industry within the PRC. These questions are outside the scope of this article but do merit further investigation.

