PAUL, WEISS, RIFKIND, WHARTON & GARRISON

THE LEASING INDUSTRY'S LEGAL ENVIRONMENT IMPROVES

LESTER ROSS - C. STEPHEN HSU

PUBLISHED IN *THE CHINA BUSINESS REVIEW*
JANUARY - FEBRUARY 2001

The leasing industry in China is becoming a viable avenue for foreign investors, after encountering serious difficulties in the late 1980s and early 1990s. These difficulties stemmed from the industry's inadequate legal framework.

Indeed, as with other economic institutions in post-1978 China, leasing appeared not so much because a law or notice permitted it, but because no law or notice prevented it at the time. It was not until 1985 that the former Ministry of Foreign Economic Relations and Trade, former State Planning Commission, and former State Economic Commission issued the Notice on Approving the Establishment of Chinese-Foreign Cooperative Leasing Companies. Foreign (principally Japanese) and Chinese-foreign joint-venture lessors, operating in an uncertain legal environment, relied heavily on explicit or implicit local-government guaranties rather than the creditworthiness of the lessee and the enforceability of the contract (*see The CBR*, July-August 2000, p.48). Under-capitalization, shortages of trained personnel, and lax supervision spawned a host of irregularities among Chinese-invested leasing companies, including failure to deliver or maintain the leased item, government protection of lessees who failed to perform their obligations, and inaccurate record-keeping.

The central government rendered local-government guaranties invalid in 1988, which undermined the industry's legal foundation. In 1992, the Supreme People's Court held that guaranties issued prior to the 1988 decision were valid. Notwithstanding central-government directives issued in 1994 and 1996, and the allocation of some central-government funds to help localities honor their guaranties, funding and enforcement problems left many guaranties unperformed. Only the aircraft leasing industry continued to develop, in part because the leased assets were operated internationally and therefore subject to repossession by the foreign lessors in the event of default. At the time, the most commonly leased items were capital equipment, including manufacturing equipment, medical devices, construction equipment, and civil aircraft. Recently, automobiles, computers, telecommunications equipment, and construction equipment have become popular items to lease.

Beijing's support for the leasing industry grows...

Despite such a troubled start, by the late 1990s the central government recognized that a vibrant leasing industry could reduce upfront capital expenses, stimulate consumption, and help develop a more comprehensive financial industry in the runup to China's entry into the World Trade Organization (WTO). Renewing its focus on the development of an indigenous leasing industry, particularly financial leasing, the central government has licensed several financial leasing companies since 1999 in Shenzhen, Guangdong Province, and elsewhere. According to officials from the relevant government authorities, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) has approved 42 equity-joint-venture leasing companies, and the People's Bank of China (PBOC) has approved 15 domestic financial leasing companies. And more than 300 non-bank financial institutions are exclusively or partially engaged in financial leasing.

However, Article 42 of the Commercial Banking Law prohibits commercial banks from engaging in commercial leasing.

... but foreign investment remains stunted

The Catalogue Guiding Foreign Investment in Industry (Guiding Catalogue) classifies the financial leasing industry as "restricted" rather than "encouraged." Therefore, foreign-invested financial leasing companies may be established only as joint ventures. In contrast, Chinese-invested operating leasing companies are classified as service businesses subject only to registration with the State Administration for Industry and Commerce and loose regulation by the State Economic and Trade Commission. The approval requirement for foreign-invested operating leasing companies should be eliminated after China joins the WTO. (Unlike a financial lease, the lessee under an operating lease does not assume the economic risks of ownership, and the lessor generally provides all of the maintenance and services with respect to the leased asset.)

Currently, the establishment of foreign-invested financial leasing companies is subject to MOFTEC approval, but after their formation they are subject to PBOC regulation. However, pending regulations will transfer approval and licensing authority to PBOC, as is the case with foreign banks. Under the Administrative Measures on Financial Leasing Companies (discussed below) released in 2000, PBOC indeed seems to have claimed the licensing authority over non-bank foreign-invested financial leasing companies. A transfer of approval authority with respect to leasing companies would resolve the current jurisdictional inconsistency.

Such a move would also be consistent with China's pending accession to the WTO, which prohibits regulatory burdens on foreign investors that do not apply to their domestic counterparts. Under the US-China bilateral market-access agreement, foreign bank branches and financial leasing corporations will be permitted to offer financial leasing services when Chinese institutions are permitted to do so. Chinese commercial banks face a steep learning curve, however, which may jeopardize their ability to compete with their foreign counterparts.

A stronger legislative foundation

Recent central-government support notwithstanding, China's leasing industry remains relatively small. Annual industry volume is less than 10 percent of South Korea's and less than 1 percent of the US leasing industry's, according to *Market Outlook (Shichang Liaowang)*. For China's leasing industry to develop, it needs a sound legislative foundation establishing the basic elements of the transaction, the rights and obligations of the parties, and the basis for enforcement. The 1999 Contract Law and the Administrative Measures on Financial Leasing Companies (the Financial Leasing Company Measures) issued in 2000 constitute important steps in the establishment of this necessary legal foundation. The Contract Law is helpful even for contracts with foreign lessors that are governed by foreign law. The Administrative Measures on Foreign-Invested Financial Leasing Companies are reputedly in preparation but have not yet been promulgated. They may appear in the next year or so.

In addition to chapters of general application to economic contracts, the Contract Law includes two chapters on leases. Neither chapter is very detailed, but together they establish the basic rules for lease contracts. The absence of excessive detail allows the parties substantial discretion to craft a mutually agreeable contract. In practice, lessors are able to prepare form contracts that satisfy their requirements as long as they do not violate any of the rules relating specifically to lease contracts or other applicable laws.

Chapter 13 of the Contract Law, entitled "Lease Contracts," covers both operating and real estate lease contracts. The lessor is required to deliver the leased item to the lessee in accordance with the lease contract and to maintain the item for the use provided in the contract (Article 216). The obligation to maintain and repair the leased item falls on the lessor unless otherwise agreed (Articles 220-21). The lessee is conversely required to use the item in accordance with the use specified in the contract or, if the use is unspecified or unclear, in a manner consistent with the item's nature (Article 217). The lessee bears no liability for damage to or depletion of the leased item provided that it is so used (Articles 218-19), but is liable if the item is damaged or lost because of the lessee's failure to exercise due care (Article 223).

Chapter 13 includes several lessee-friendly provisions. The lessee is entitled to a reduction or suspension of rent if a third-party claim prevents the lessee from using or earning income from the leased item (Article 228), or if the leased item is damaged or lost for reasons not attributable to the lessee (Article 231). Articles 228 and 231 apply even if the parties agree to shift the burden of maintenance and repair to the lessee, so a prudent lessor should procure sufficient insurance to cover such risks. Indeed, the lessee may cancel the contract if its purpose cannot be achieved because the leased item has been damaged or lost (Article 231).

The lessee may cancel the contract at any time, even after the leased item has been accepted and entered into service, if the leased item presents a danger to the lessee's security or health (Article 233). The reach of this provision remains unclear, although some commentators have argued that a leased item may not be deemed dangerous merely because it is substandard. Nevertheless, these lessee-friendly provisions together substantially diminish the enforceability of a net lease or "hell or high water" clause.

Financial leases are governed by Chapter 14. Though also rather thin, Chapter 14 adheres more closely to the typical features of a financial lease. The lessor is required only to warrant the lessee's right to possession and use of the leased item (Article 246). The lessor bears no liability if the leased item does not conform to the contract, unless the lessee has relied on the lessor in determining the leased item or the lessor has interfered in the selection of the leased item (Article 245).

Financial leasing companies

The Financial Leasing Company Measures govern the licensing of non-bank financial institution leasing companies. Their promulgation followed the crackdown on financial irregularities begun in 1998, which closed some unlicensed leasing companies. No company may include "financial leasing" (*jinrong zulin*) in its name unless PBOC

licenses it to do so. To address the problem of undercapitalization, such companies are required to have a minimum registered capital of ¥500 million ($60.4 million). To engage in foreign exchange business, financial leasing companies must have additional foreign exchange capital funding equivalent to $50 million.

PBOC supervises financial leasing companies through various capitalization and other prudential ratios, management qualifications, and other supervisory rules. Rent and processing fees are determined by the parties, however, not by PBOC or any other regulatory authority.

Individuals are only permitted to hold shares in public financial leasing companies. Foreign investment is permitted, although the financial leasing industry is still restricted under the Guiding Catalogue. Additional clarification governing foreign investment may have to await the release of the Administrative Measures on Foreign-Invested Financial Leasing Companies.

Lease approval and registration requirements

China does not have general government approval requirements for lease contracts or for the registration of interests in leased items, with some exceptions, notably civilian aircraft. The civil aviation industry is closely regulated by the Civil Aviation Administration of China, which approves all aircraft acquisitions to regulate competition and conserve foreign exchange.

Medium- and long-term foreign exchange financial leases from foreign and foreign-invested enterprise lessors are treated as foreign exchange loans subject to approval and registration by the State Administration of Foreign Exchange under the 1997 Procedures on the Administration of Borrowing of International Commercial Loans by Domestic Organizations. Short-term financial loans are subject to less-stringent verification requirements. Neither operating leases nor foreign exchange financial leases from Chinese-invested financial lessors are subject to such requirements.

Furthermore, non-financial institution legal persons may undertake foreign exchange leases from foreign or foreign-invested financial lessors only after satisfying several preconditions, including three successive years of profitability and government permission to engage in foreign trade.

Which taxes apply?

Foreign-invested leasing companies and foreign leasing companies with an establishment in China are subject to the same enterprise income tax as other FIEs: 30 percent national tax and 3 percent local tax, subject to any preferential taxes for which they may qualify. Foreign leasing companies without establishments in the PRC, or that derive income from PRC sources unconnected with their PRC establishments, are subject to a 20 percent withholding tax, which itself is subject to reductions under applicable tax treaties. Foreign leasing companies without establishments in the PRC were exempt from withholding tax with respect to income derived from civilian aircraft leases until 1999.

The State Administration of Taxation issued Notice No. 514 in July 2000 to clarify, among other things, whether business tax or value-added tax (VAT) should be levied on lease transactions. The Notice assesses a 5 percent business tax on financial leasing companies licensed by PBOC and other financial leasing companies if title to the leased item is not transferred to the lessee. VAT, which is more onerous, is assessed if the lessor is not licensed by PBOC and title to the leased item is transferred to the licensee. To avoid the VAT obligation, then, contracts should specify that the title remains with the lessor. The contract may provide, however, that title belongs to the lessee at the end of the term, at which time the value of the item will have depreciated, and thus VAT will be less burdensome.

Proponents of a vigorous leasing industry have argued that China could further stimulate expansion by providing greater tax incentives. For example, accelerated depreciation rules would make leasing more attractive to lessors by reducing the cost of leased items. The restoration of the income tax exemption for rental income of foreigners without an establishment in China, abolished in 1990, would also help. However, foreign financial lessors without an establishment in China are eligible for reduced withholding tax treatment if the effective interest rate of the lease does not exceed the export loan interest rate in the lessor's country. Such an incentive is of little value outside the world of subsidized exports, however.

Settling disputes

Although many lessors may elect to resolve disputes through arbitration, foreign-invested leasing companies should be familiar with China's rules for judicial resolution, which may guide arbitration tribunals. In 1996, prior to enactment of the Contract Law, the Supreme People's Court promulgated the Regulations on Certain Issues in the Trial of Disputes Involving Financial Lease Contract Matters (the Trial Regulations). The Trial Regulations were promulgated to help the judiciary cope with the surge in litigation involving financial lease contracts, in which the courts lacked experience. While the Trial Regulations ought to be amended or superseded to conform to the Contract Law, in practice their close correspondence to the Contract Law should render the Trial Regulations a reliable map for the handling of such disputes even under the new statutory regime.

The Trial Regulations provide that the parties may select any forum with jurisdiction for adjudication. Thus, a Shanghai-based lessor may demand that disputes involving its leases be adjudicated in Shanghai, rather than where the lessee lives or where the leased item is located. Foreign-invested lessors should monitor the work of the courts in their jurisdiction to determine whether the courts perform in a predictable manner and are hospitable to lessors.

As with other contracts, a financial lease contract is deemed invalid if government approval is required but not obtained. The lessor must therefore ensure that all government-approval and registration requirements are satisfied, including foreign exchange registration requirements for foreign financial leases treated as loans. The Trial Regulations also provide that a financial lease contract is invalid if it violates applicable

state laws and regulations. Given the troubled history of financial leasing in the PRC, it is not surprising that the Trial Regulations also deem invalid any guaranty issued by a government body that exceeds the scope of that body's powers. The Trial Regulations provide that a government body that issues an invalid guaranty is obligated to pay damages to the creditor or lessor, but enforcement of that provision has proven difficult.

Smoother sailing ahead

After a long and rocky beginning, the prospects for the development of China's leasing industry have improved dramatically. A stronger legal foundation provides the parties with substantial discretion in crafting a mutually agreeable contract. More thorough and comprehensive supervision by PBOC should have a healthy effect on the financial leasing industry as a whole and should benefit foreign-invested lessors, who tend to have both more experience and stronger capitalization. Such supervision would facilitate the lifting of the ban on commercial banks' participation in leasing, and thereby increase investment and competition in the industry. But more stringent requirements for the licensing of FIEs than Chinese firms, and limitations on foreign equity investment, continue to impede foreign investment in the financial leasing industry, and some sectors of the economy remain off limits with respect to operating leases. Lower business tax rates, as opposed to VAT rates, are available under financial leases—provided that the contract makes the critical distinction between a sale of goods and a lease. Even more generous tax incentives concerning depreciation, which would hasten the development of the leasing industry, would have to overcome strong resistance from the Ministry of Finance, and for the foreseeable future remain unlikely. Nevertheless, the prospects for crafting viable leasing arrangements in China are better than they have ever been.

* * *

Lester Ross is counsel in the New York and Beijing offices of Paul, Weiss, Rifkind, Wharton & Garrison. C. Stephen Hsu (Xu Chuanxi) is an associate in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison.