Singapore Management University

Institutional Knowledge at Singapore Management University

Research Collection Yong Pung How School Of Law | Yong Pung How School of Law

1999

Choice of Business Forms for International Entrepreneurship through Direct Foreign Investment

George Thomas Luis Shenoy
Singapore Management University, georgeshenoy@smu.edu.sg

Follow this and additional works at: https://ink.library.smu.edu.sg/sol_research

Part of the Law Commons

Citation

Shenoy, George Thomas Luis. Choice of Business Forms for International Entrepreneurship through Direct Foreign Investment. (1999). *Proceedings of the 9th Endec World Conference*.
Available at: https://ink.library.smu.edu.sg/sol_research/163

This Conference Paper is brought to you for free and open access by the Yong Pung How School of Law at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Research Collection Yong Pung How School Of Law by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email cherylds@smu.edu.sg.

CHOICE OF BUSINESS FORMS FOR INTERNATIONAL ENTREPRENEURSHIP THROUGH DIRECT FOREIGN INVESTMENT

George Shenoy
Nanyang Business School, Singapore

ABSTRACT

An entrepreneur who seeks to carry out substantial business activity by direct investment in a foreign country needs to establish a physical presence there. The main ways of doing this are by establishing a subsidiary, or a branch, or by entering into a joint venture. The key advantage of establishing a subsidiary is that it becomes a separate legal entity, which shields the holding company against any liability for its debts. Alternatively it is possible to establish a branch in the foreign country. However, a branch is an extension of the parent company, and has no separate legal entity in the foreign country. Lastly, one can do business in a foreign country by means of a joint venture, which involves two or more venturers coming together to undertake some business jointly. There are three main forms of joint ventures, namely, the corporate joint venture, the partnership, and cooperation agreement. The emerging trends with regard to new forms of joint ventures are considered. The paper discusses the legal aspects relating to the various business forms and concludes by considering the criteria for making the proper choice of the business form.

INTRODUCTION

For an entrepreneur, venturing abroad is a natural progression in business growth. The nature and extent of expansion beyond one's national boundaries can differ from business to business depending on various factors. There are many available forms of doing business abroad and the choice has to be made according to one's particular needs. Two main modes of these are: doing business *with* a country and doing business *in* a country. In the former, the local entity, through business arrangements with a foreign entity, is able to make its goods and services available in the foreign country. These arrangements may include agency, distributorship, licensing, and franchising. In the latter, which forms the subject matter of this paper, the local entity actually establishes a presence or place of business in the foreign country. This is known as direct foreign investment. An entrepreneur who seeks to carry out substantial business activity in a foreign country needs to establish a physical presence there. The main ways of doing this are by establishing a subsidiary, a branch, or by entering into a joint venture. This paper discusses the legal aspects relating to these business forms and concludes by considering the criteria for making the proper choice of the business form.

Establishing a physical presence in a foreign country

An entrepreneur venturing abroad may frequently find himself on familiar ground if the legal system in that country is similar to that of his own. For instance, if he is from a country with the common law system, there may be a choice of various business forms available to him including the sole proprietor, partnership and companies. In a domestic set up, an entrepreneur may weigh the pros and cons of choosing one or the other of these forms.

Though often even in a domestic setting the advantages of choosing the corporate form outweigh the disadvantages, there may yet circumstances when an entrepreneur may choose proprietorship or a partnership for the advantages that they offer. However, circumstances are different while venturing abroad. Even if the foreign country permits persons from abroad to avail of any of the business forms (some may not, or may allow with restrictions), the preferred choice of international entrepreneurs tends to be a corporate form or a joint venture.

Even where an entrepreneur finds himself on familiar ground because of the similarity of the legal system in the country in which he intends to invest, he ought to be aware that there are other considerations which do not arise in a purely domestic set up. While operating in his own country, he needs only to be concerned with the laws of his own country. But once he ventures abroad, there are several other laws that he needs to know.[1] For instance, he must know of the usual domestic laws (including the corporate law) of the host country. He must know the laws relating to foreign investment. He must be aware of the implications of the branch of law known as private international law or conflicts of law. And, he would have to be aware of international treaties and conventions that have a bearing on international business.

Establishing a corporate presence: subsidiary company

The usual way of establishing a presence in a foreign country is to incorporate a company there. This would be done under the domestic law of the foreign country. Almost every country has legislation providing for the establishment and management of companies, though there may be some differences from country to country depending on their legal system.[2] It is assumed that the entrepreneur is operating in his own country through a company which he owns and controls and that he would be using it as a vehicle to venture abroad. This would be the holding company (or parent company) that will incorporate a new company under the domestic laws of the foreign country. Such a company is known a subsidiary company.

In Singapore, a corporation is deemed to be a subsidiary of another, if

(a) that other corporation:

  (i) controls the composition of the board of directors of the first-mentioned corporation;
  (ii) controls more than half of the voting power of the first-mentioned corporation; or
  (iii) holds more than half of the issued share capital of the first-mentioned corporation (excluding any part thereof which consists of preference shares); or

(b) the first mentioned corporation is a subsidiary of any corporation which is that other corporation's subsidiary.[3]

It may be noted that category (b) above does not add to the definition in any way, except to explain that the subsidiary of a subsidiary is deemed to be a subsidiary.

Generally there is no distinct body of law governing the relationship between the parent and subsidiary, and ordinary rules of company law are applied to them as though no special relationship existed. Consequently, the assets of such companies are owned by them, both legally and beneficially, as legal entities. A holding company is not treated as owner of any of its subsidiaries' assets. The rights and obligations of other persons are not affected by the fact that the company with which they deal is a member of a group. The directors of holding company owe no duties as such to its subsidiaries and the directors of the subsidiary owe no duties as such to the holding company. For example, the directors of a subsidiary cannot justify transactions entered into by them to the detriment of the subsidiary by showing that its parent company has benefited.[4]

The key advantage of establishing a subsidiary is that it becomes a separate legal entity, which shields the holding company against any liability for its debts. Under the concept of corporate personality, a company is a separate legal entity, distinct from its shareholders. This is crucial with regard to the liability for debts. The liabilities of companies which are members of the same group are those of the individual companies which incur them: there is no group liability imposed by law for the obligations of the individual members of the group. Under the principle of limited liability of a company, the company is liable to its creditors to an unlimited extent, but in the event that the company is unable to pay the creditors, the creditors cannot look to the shareholders for payment. The worst that can happen is that the company may go into liquidation, but the investors would not be liable to anything more than the amount that they have invested. There are however a few situations where a holding company may be held liable for the debts of its subsidiary. These include situations where the subsidiary is an agent or a mere puppet of the holding company or where it is a devise in a fraudulent scheme. In such cases, the court may lift the corporate veil and hold the holding company liable. But as a general rule, the courts will not interfere with the principle of separate entity of a company, and will not lift the corporate veil except in very exceptional circumstances.

If the entrepreneur decides to establish a subsidiary company, he would have to observe in particular the company law of the host country. The company law generally tends to be a major piece of legislation as it has to provide for the formation, management and the winding up of companies. It has to provide for the protection of the interests of various groups of people, including the shareholders, the creditors, the management, the minority, the employees, the tax and other government authorities. Some of these interests may at times be competing or conflicting, as in the case of shareholders and creditors in the event that the company is being wound up. An entrepreneur will have to consider and provide for these aspects.

Establishing a branch

Alternatively, the entrepreneur can set up a branch of his company in the foreign country. Thus a foreign company registered in Singapore is often referred to as a "branch". It should be

noted, however, that the Companies Act does not use the word as such. It is a colloquial word, and a "branch" in this context only means a foreign company.

A branch is a mere extension of the parent company, and legally it is regarded as part of the parent company. It follows that, since there is no separate legal entity, the parent company will be fully accountable for the actions of the branch and liable for all its debts.

Apart from this, there are other significant differences. A subsidiary is regarded as a local company and is therefore is free to operate within the legal system. While, the branch of a foreign company is regarded as a foreign company and may be subject to restrictions. A subsidiary may be allowed to venture into areas that are not open to foreign companies, or where the foreign companies are allowed to operate, they may be subject to administrative or licensing restrictions. Further, depending on the laws of particular countries, the tax treatment of the two may be different.

Even where the foreign companies are allowed to operate freely, as in Singapore, they are still subject to regulation under the company legislation of the host country.[5] According to s 4 of the Singapore Companies Act, a "foreign company" is defined as, a company, corporation, society, association or other body incorporated outside Singapore; or an unincorporated society, association or other body which under the law of its place of origin may sue or be sued, or hold property in the name of the secretary or other officer of the body or association duly appointed for that purpose and which does not have its head office or principal place of business in Singapore.

According to the above definition, an entity having its place of origin outside Singapore would be considered a foreign company. It would include all bodies incorporated outside Singapore, by whatever name called. It is significant that even bodies which are not incorporated would be considered as foreign companies in Singapore, if they can sue or be sued in their own name, or hold property. Thus a partnership registered in England or Malaysia (which may under their respective rules of court be sued in the partnership name) would be considered as to be a foreign company in Singapore.

Sections 365 to 386 of the Singapore Companies Act make specific provision in respect of foreign companies. These sections apply to a foreign company only if it establishes a "place of business" or is "carrying on busisness" in Singapore. Section 368 read with s 365 requires every foreign company to lodge with the Registrar for registration certain documents before it establishes a place of business or commences to carry on business in Singapore. There are specific provisions relating to submission of accounts (s 373), identity (s375), service of notice (s 376) and cesser of business (s 377). Apart from these, the Companies Act, in general, does not apply to a foreign company.

Representative offices

It is a common practice for businesses to establish representative offices in foreign countries. They are mentioned here to highlight the fact that, from a legal point of view they do not

constitute a "physical presence" in the foreign country. Thus in Singapore, the provisions of the Companies Act apply to foreign companies only if they "carry on business" in Singapore. If such a company is not carrying on business but wants to have an office in Singapore, then it can set up a "representative office". Representative offices are usually set up to promote sales. If the representative office is only carrying out promotion and liaison work in Singapore, then it does not need to register as a foreign company. The difficulty, however, is in determining when promotion and liaison become actual sales.

The role of the representative office would be to give product information, technical advice and promote sale. Such an office could be set up, for instance, by a foreigner who travels in the region and uses Singapore as a base. He does not need to register it as a foreign company. However, he cannot transact business or conclude contracts in Singapore. He would have to refer the contract to the head office or a foreign office which would confirm the acceptance. Under the Trade Development Board's guidelines, only companies in the manufacturing, trading, trade logistics and services sectors can register representative offices in Singapore.

Joint ventures

A joint venture involves two or more venturers coming together to undertake some business jointly and for the sharing of risks and profits. The joint venture is the most common method of doing business in Asia.[6] Its attractiveness lies in the pooling of resources. For example, a joint venture may facilitate the combination of the foreign party's expertise, product, goodwill and capital and the local party's knowledge and access to markets, raw materials, or other local requirements such as local equity requirements.[7] In some countries, the joint venture is the only form by which foreigners are permitted to do business.

There are three main forms of joint ventures, namely, the corporate joint venture, the partnership, and cooperation agreement. In a corporate joint venture two or more parties start a new company which would be incorporated under the domestic law of the host country. They would each takes shares in it. Such a company would have the advantage of operating as a local company and can avail of all the incentives and concessions given to local entities. In the case of a partnership two or more entities will enter into a partnership agreement and each party contributes to the capital. The last form is known as a contractual joint venture, or a non-equity joint venture. The parties do not set up any new entity but merely have an agreement to cooperate or to collaborate. There are many variations of joint ventures and some of the emerging trends with regard to new forms of joint ventures are noted below later.

Though there is a tendency to conclude that any joint venture must be a limited liability company, it will be noticed that many joint ventures are not structured as companies. What form the joint venture will take will very much depend on the needs of the respective parties. A joint venture will have to be so structured as to satisfy the requirements of the parties. The three main forms of joint ventures are considered below.

Corporate joint venture

In a corporate joint venture, two or more parties start a new company and each takes shares in it. This is done under the corporate law of the country of investment.This form has the advantage of using a corporate form that most people are familiar with, regardless of the legal system to which they belong. A company has a separate legal entity, perpetual succession and limited liability. Though company law across various jurisdictions in Asia differs in terms of its background and history, there is a certain commonality in approach with regard to its objects and methods.[8] Indeed, it is most often the chosen form for precisely the same reasons why a businessman would choose it while doing business in his own country. The separate legal entity of a company distinguishes it from the members who constitute it; the perpetual succession ensures that the company is unaffected by change in membership or management; and the principle of limited liability ensures that the entrepreneur or the holding company would not be liable for the debts of the subsidiary. Thus a holding company may have subsidiaries in many countries, some of which may be profitable, while others may incur losses. In the latter case, regardless of the extent of the loss the holding company would not be liable to anything more than the capital it has invested.

A study on joint ventures in 13 Asian countries (Malaysia, Indonesia, Thailand, Philippines, Singapore, Vietnam, Hong Kong, China PRC, Taiwan, South Korea, Japan, Australia and New Zealand) indicated that a corporate vehicle was available in each of them and was the preferred mode of joint venture in those countries.[9]

Partnership

In the case of partnership, each party also contributes to capital. The parties may decide to establish a partnership because it is the only form available in some countries in certain industries. For example, in some countries professional practice in areas such as law and accountancy cannot be carried on in corporate form. A partnership may also be more advantageous than a company as far as taxation is concerned. In countries with two-tiered taxation, a corporate joint venture may subject the entrepreneur to tax twice: corporate tax imposed on the joint venture and tax on receipt of dividends by the shareholders. In such a situation, from a taxation viewpoint a partnership may be more advantageous. However, a partnership comes with all the disadvantages associated with that form, the principal of which is the unlimited liability of the partners for the losses of the firm. The lawyer will have to work around this problem in consultation with the parties.

Co-operation

This form of joint venture is known as non-equity joint venture or contractual joint venture. The cooperative enterprise form was devised as an alternative to the corporate joint venture form. Its main advantage is that it permits the partners to enter into a loose relationship which is regulated solely by contract. Mutual profit is sought without sacrificing mutual independence. Since the relationship is not formalised, it is easier to maintain, or if need be to terminate. The parties do not set up any new entity but merely have an agreement to co-operate and collaborate. One example is a BOT (Build-Operate-Transfer) project. These

contain joint-venture type provisions, but they are purely contractual in nature. Such joint ventures would include production sharing and natural resource extraction concessions. They have in common with other types of joint ventures the elements of sharing the risks and profits.

The parties and the documentation

It has been pointed out that choosing a partner is the single most important determinant as to whether the joint venture will be successful.[10] Knowing the parties is critical, and it is important to explore jointly their purposes and philosophies for the joint venture. It is amazing how many joint ventures collapse within the first few years over such fundamental issues as how the joint venture is to be managed.

One glaring recent example was the joint venture between China and Singapore for the development of Suzhou Industrial Park in the Jiangsu Povince of China. Originally, it was agreed that Singapore would develop the 78 sq km park. But recently it was reported that, because of differences with the joint venture partner, Singapore has decided to cut down its stake from 65% to 35% and hand over the management of the park to the Chinese government on 1 January 2001 after developing only 8 sq km of it.[11]

If the joint venture is a strategic alliance, it is important to identify the strengths of the parties as well as sources of potential conflict. From the point of view of the international entrepreneur, it is essential to determine that the partner has the relevant expertise in marketing and distribution or the necessary connections.

Documentation forms an important part in establishing a joint venture. Joint ventures are complex arrangements that require a careful study, negotiation and documentation. It is crucial that the parties understand the reasons why they are coming together and the exact nature of their joint venture. Generally, at the end of negotiations the lawyer would be asked to draft a document setting out the principal terms of the transaction. This would be the Letter of Intent or the Memorandum of Understanding. This forms the basis of the joint venture agreement.

A joint venture is usually documented through a series of inter-related agreements. The joint venture agreement is the principal document between the parties. Depending on the structure of the joint venture, this document may be known as a shareholders agreement, partnership agreement or co-operation agreement. Regardless of the form of joint venture used, the parties must be clear as to the major issues including contribution of each party, management and control, capital (including future requirements), policy as to profits and dividends, restrictions on transfer, and exit mechanisms. All these will have to be carefully agreed upon and spelt out in the principal joint venture agreement.

An equity joint venture would in addition have constitutional documents such as the memorandum of association and articles of association. Care must be taken to avoid any confusion or ambiguity that might arise from inconsistency between the joint venture

agreement and the constitutional documents. In most jurisdictions, in the event of conflict, the latter will prevail.

Apart from the principal agreement, there may also be ancillary agreements such as licensing agreements, technical assistance agreements, management agreements and supply agreements. These also will require close attention.

New forms of international joint ventures

As the trend towards regionalisation and globalisation of business accelerates, businessmen have had to devise newer and more innovative forms of international joint ventures to accommodate changing concerns and demands. Three factors are said to have led to the development of new forms of international joint ventures. First, transnational corporations (TNCs) have become increasingly concerned to husband capital resources in the light of opening up of new countries to foreign investment and the high cost of some modern investment projects. Second, they are becoming reluctant to transfer technology to developing countries for fear of leakages of information from the receiving end. Third, experience has shown that many corporate joint ventures break up earlier than intended, particularly if both partners are strong.[12] This has given rise to some of the following types of joint ventures:

Low-equity joint ventures:
The traditional type of corporate joint venture is a high-equity one. Capital constraints and the enormous cost of some projects have spawned corporate joint ventures in which the share capital is low and the bulk of the funding is sought from non-recourse project financing or from the development banks. Low-equity structure is only viable if the venture is in the national interest of the host country and the host government is involved, or provides a guarantee to the lenders.

Coproduction arrangements:
The high cost of labour in developed countries has induced many TNCs to shift production to developing countries. Rather than set up the production facilities of their own, they frequently prefer to enter into coproduction arrangements with local partners. Such arrangements may come in different forms. For example, a local manufacturer and a foreign manufacturer who make the same type of product may enter into a joint working arrangement to enter into each other's market. The local manufacturer may import components to combine with the locally made components for sale of the final product in the local market, and export the locally made components to the foreign manufacturer for the same purpose. The advantage of this arrangement is that no transfer of technology is involved. The profits on total sales are shared by the two manufacturers in proportion to the work done by each, who also pay their own respective taxes.

BOT Contracts:
Governments, especially those of the developing world, are seeking ways to shift the burden of infrastructure development from the public sector to the private sector. BOT (Build, Operate, Transfer) contracts with their many variations have been found to be the best method of doing this. In a BOT contract, an equity company which raises funds from investors and

lenders, is awarded the concession to build the infrastructure facility. The construction is carried out by a consortium of contractors on a turnkey basis. The equity company operates the facility for an agreed period and recoups its capital investment and return on the invested capital. The joint venture companies are seeking and obtaining government guarantees as to the minimum revenue charge and/or minimum annual revenue income. In some cases, including in India and in China, they have succeeded in obtaining government guarantees as to the minimum return on the invested capital.

International subcontracting:
International subcontracting has become a popular new form of international joint venture. Many factors have contributed to this. It makes sense for manufacturers in developed countries to farm out the manufacture of components to manufacturers in developing countries where costs are lower. It makes good business sense to do this, as owing the number and complexity involved in the production, fewer manufacturers will attempt to manufacture all the components that they need. There is also an impetus from the developing world to industrialise and export, and international contract manufacturing can be a good beginning towards this end. This type of joint venture holds much promise for developing countries.

Governmental regulation

It should be borne in mind that governmental approvals and controls often play an important part in international joint ventures. Many developing countries specify the areas of business in which foreigners are permitted and those in which they are not. The necessary approvals must be secured. There may also be restrictions as to the level of local participation, the repatriation of profits and the amount of fees chargeable by the foreign party in respect of the ancillary agreements. In a survey of joint ventures in the 13 Asian countries referred to above, it was noted that the scope of activity was limited to varying degrees in all countries except two of them (Singapore and Hong Kong).[13]

The extent of regulation of international joint ventures appears to be independent of the type of legal system used by a country. From the study referred to above, it seems that the type of legal system of the host country does not determine the type of regulation it applies to international joint ventures. Many countries have adopted specific codes to govern foreign joint ventures in their jurisdiction. All except three countries referred to above (Singapore, Hong Kong and Japan) had specific investment codes to govern foreign joint ventures.[14] But this appears to have been determined more by economic expediency than by their legal system. This is particularly evident on the question of the scope of economic activities which are open to foreign joint ventures in each country. Some countries in Asia (Indonesia, Philippines and South Korea) use a "negative list" to identify areas which are closed to foreign joint ventures. Other countries adopt more discretionary methods to screen the admission of direct foreign investment, by using "guidelines". In such cases, the foreign joint venturers must apply for approval on a case by case basis.

An observation that may be made, based upon the country reports referred to above, is that they are conspicuous for their differences rather than their uniformity. Among other things,

these jurisdictions differ in they way they regulate, tax and encourage foreign joint ventures. Even the way the foreign joint venturers are permitted to remit foreign exchange also differs.

CONCLUSION

It is quite likely that an entrepreneur who wants to venture abroad will do so through a joint venture. Though there is no bar on his venturing alone, for example by establishing a wholly-held subsidiary company where the host country permits it, he would have an uphill task in operating his business unless he has intimate knowledge of the business environment in that country. It would be much simpler to harness the synergy by relying on the expertise of the local partner, his marketing network and his administrative and government connections. For these reasons international joint ventures with their many variations have become popular. The international entrepreneur has to decide which type of joint venture suits his needs best. This would depend on the nature of his business, the scope of his expansion plans, sources of his capital, and the choice of appropriate local partners. It is apparent that, for reasons that have been discussed above, a corporate joint venture is best suited in most cases of international entrepreneurship.

---

[1] For a general discussion, see Low Kee Yang, "Venturing Overseas: Legal Aspects", in George Shenoy & Toh See Kiat (eds), *Legal Aspects of Doing Business in Singapore*, pp.327 ff, Addison-Wesley Publishing Co., 1996.
[2] George Shenoy & Pearlie Koh, "Company Law in Asia: Recent Developments", 1997, 16 *AsiaBLR* 27.
[3] Companies Act (Cap 50), s. 5(1).
[4] Robert R Pennington, *Company Law*, 6th ed., 1990 at p.37.
[5] For example, for Singapore, see Part XI, Division 2 relating to foreign companies, Companies Act, Cap 50, ss.365-386.
[6] For a survey on joint ventures in Asia, see "International Joint Ventures in Asia" in 1994, issues 3-6 of *AsiaBLR*.
[7] Michael C. Neus, "Establishing Transnational Joint Ventures: Commercial and Practical Issues for Lawyers", 3 *AsiaBLR* 52.
[8] See Note 2 above.
[9] Benny S Tabalujan, "International Joint Ventures in Asia - An Overview", in 6 *AsiaBLR* 27 at 28.
[10] Note 7 above, at p.53.
[11] *The Straits Times*, Singapore, 29 June, 1999, p.1.
[12] Phiroze K Irani, "New Forms of International Joint Venutres", 7 *AsiaBLR* 53.
[13] Note 9 above.
[14] Note 9 above.