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## LOOKING FOR LAW IN CHINA

STANLEY LUBMAN\*

### PART ONE: THE LEGAL ENVIRONMENT FOR FOREIGN DIRECT INVESTMENT

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## PART ONE: THE LEGAL ENVIRONMENT FOR FOREIGN DIRECT INVESTMENT

### I. INTRODUCTION

I have been looking for law in China for over forty years. When I started in 1963, only a handful of other Westerners had also embarked on what then seemed an exotic academic excursion. Since then, after U.S.-China relations were reestablished in 1972, many other Americans have had reason to join in the search. Now, the growing potency of China's economic strength and international reach has made efforts to understand China more important than ever, and law has become a necessary medium for use in such efforts.

This article offers insights into critical institutions and practices that mark the legal environment as it has been developing since 1979, when the People's Republic of China (PRC) first gave foreign direct investment (FDI) a hesitant welcome. It analyzes the high degree of legal uncertainty that foreign investors and their Chinese counterparts have encountered and how they have coped with it. The uncertainty that initially marked the rules and vehicles for foreign investment when they were introduced has been reduced as they have matured, but as new rules are introduced, they, too, will generate new uncertainty. Chinese law relating to foreign investment is likely, for the foreseeable future, to continue to exhibit what I describe as *rolling uncertainty*.

In sum, both economic and legal reform remain works in progress without clear goals. The Chinese Communist Party (CCP) values its control over Chinese society more than it does legal reform; the Party-state's institutions for making and implementing law remain in considerable disorder; strong controls over the Chinese bureaucracy's exercise of discretion are lacking; localism weakens the application of laws and policies adopted by Beijing; and Chinese society is beset by severe strains that weaken the force of law. The impact of all of these factors that inhibit the development of changes in legal culture is discussed here.

Neither the existence of uncertainty nor its persistence should be surprising, given the profound historical and institutional burdens that Chinese law reform must bear. In 1979, when China began to fashion laws not only for FDI but for the domestic economy as well, it was challenged both by thousands of years of Chinese cultural tradition and by three decades of Maoist governance. For more than twenty centuries before the PRC was established in 1949, formal law had been treated as a

set of commands instructing bureaucrats on how to govern the country; after 1949, law became a politicized and shrunken symbol of governance, used instrumentally as a mere vessel for changing policies. The role of law was even further diminished during the Cultural Revolution (1966-1976), when the very concept of law was denounced as an alien bourgeois notion. The past, both distant and recent, left behind neither traditions nor institutions that would support a legal system appropriate for a market-driven economy.

Part One first addresses the increasing importance that has been given to law and to the new or rebuilt institutions that have been created since 1979 to implement the new laws. Virtually every element of contemporary Chinese law was either revived or newly created during the course of the last twenty-five years. To illustrate the breadth of legal construction, I point to the fashioning of rules dealing with contracts and business organizations, areas obviously critical for the market economy that the Chinese leadership insists it is working to build. I then trace the evolution of the legal framework for FDI, emphasizing and illustrating both the tentativeness that has marked both the drafting and implementation of laws and the continuing significance of policies that frequently trump law. I then review the development and operation of legal institutions, especially the courts.

Against this background I focus on some notable characteristics of Chinese legislation and the organization of the Chinese Party-state that combine to create legal uncertainty: legislative techniques, formalism, lack of transparency, multiple and often inconsistent sources of law, and the operation of a fragmented bureaucracy endowed with broad discretion. I include examples from my own law practice to illustrate problems that foreign businesses encounter today.

Part Two surveys some of the strategies adopted by foreigners and Chinese alike to cope with legal uncertainty, assays some of the forces that will influence the future of legal reform, and concludes with thoughts on the near and long-term prospects for Chinese legality.

## II. LEGAL REFORM SINCE 1979

### A. *The Context: Economic Reform*

Legal reform and FDI have been driven by the larger enterprise of economic reform. In industry, the scope of state planning has been greatly reduced, price controls loosened, and much of the central government's power over budgets and administration decentralized. The planned sector of the economy, which had been declining since the late

1970s, is now rivaled by a growing and increasingly differentiated non-state sector in which enterprises under widely varying degrees of control by private owners and local governments have emerged alongside foreign-invested enterprises. China's gross domestic product (GDP) has grown over nine percent annually for 25 years; foreign invested enterprises (FIEs) have been a major contributing factor to this growth, and now account for well over half of China's exports. China's accession to the World Trade Organization (WTO) has given impetus to further reforms, although compliance with obligations required by the terms of accession has been uneven.

Economic reform has expanded the power of local governments over productive enterprises and transformed them from providers of administrative services into economic entrepreneurs. Fiscal reform has given local governments a share in tax revenues, and enabled them to go into business themselves. Local officials have sometimes become entrepreneurs and formed alliances with private enterprises; in other cases, they have sometimes benefited from the ambiguous legal status of private firms by peddling influence and protection, allowing many private firms to register as collectives only in return for payments to local officials. Thus local government and local business interests are often closely aligned.

Local governments, while remaining agents of central industrial policy, have simultaneously gained the power to promote local policies and investments more intensively and effectively than before. Often, local governments place local considerations ahead of national priorities and in practice frequently encourage or approve transactions that violate national law. The revenues generated by local enterprises, in turn, contribute mightily to the extra-budgetary resources of local governments that are monitored either poorly or not at all by the central government. As the economic power of local governments has increased, their rule has become more parochial and China has become more fragmented. Decentralization and local government links to local businesses combine to contribute to legal uncertainty and obstruct the maturing of a legal and business culture that supports legality. The implications of this for foreign investors are discussed later in this article.

#### *B. Legalization: The New Role of Law*

In order to initiate and carry out economic reforms, within an extremely short period of time the Chinese Party-state has generated an extraordinary outpouring of laws within an extremely short period of time that is one of the most extensive attempts in modern history to legislate

the institutions of a state. Law reform efforts have necessarily involved the basic decision to *legalize* administration, that is, to use promulgated laws of the state as the primary vehicles for declaring and implementing policy. This has represented a major change in the Chinese Communist Party's (CCP) approach to governance, because, as already noted, for the first 30 years of the PRC's existence the Party had ruled without any legal codes and with little regard for law at all; many, if not most, laws and administrative regulations were not even promulgated and were for *neibu* (内部, internal) circulation only. Bureaucrats had relied on these rules and on Party policies, all usually drafted in very general terms so that they could be applied flexibly in practice. Promulgated laws have now largely superseded the use of internal rules, although the innovative development of a legal framework for a marketizing economy in general and for FDI in particular must inevitably be a work in progress.

The legislation that has been generated since 1979 is vast because the task the drafters have faced has been so challenging; law had to be used to define and govern nothing less than new relationships, economic actors, and transactions among persons and organizations outside the state apparatus (many formerly forbidden). As a result, whole areas of law such as civil law appeared for the first time since the Nationalist codes were abolished in 1949. Chinese law reformers have had to construct core elements of a legal system in an astonishingly shorter period of time than the centuries which similar Western legal institutions had to develop.

### C. *Legalization Illustrated*

#### 1. Contracts

The creation of rules for contracts and business organizations illustrates the new legalization. Contract was one of the first institutions to be the focus of new legislation, in a 1981 law applicable to purely domestic transactions. It was followed by a succession of other laws, some of which increasingly recognized nonstate enterprises as independent economic actors while others laid down rules for Sino-foreign contracts.

In 1986, departure from the central economic plan was signaled by the adoption of a decisive piece of legislation, the General Principles of Civil Law (GPCL), which partially codified rules of civil law in a format that reflected the influence of European civil codes. The new law articulated certain basic concepts that are the foundation for market-economy transactions, including definitions of natural and legal "persons"

with legal rights and the "acts" that create, modify, or terminate these rights; it also defined ownership and enumerated specific property rights. The GPCL, by recognizing natural and legal "persons" as the parties to contracts and, therefore, as independent legal actors, formally brought regulation of contract and property relations within the Chinese equivalent of Western "private law," and thereby made an important political statement, as the late William Jones observed.<sup>1</sup>

China's law drafters grappled for twenty years with the task of fashioning legislation applicable both to contracts among Chinese and between Chinese and foreigners. In 1999 the Unified Contract Law, its structure and concepts further reflecting heavy Western influence, codified the rules applicable to contract that previously were separately classified as "civil" or "economic," domestic or foreign-related, and repealed the laws that had independently regulated those transactions.

## 2. Business Organizations

As the economic reforms proceeded, the entities that could lawfully participate in transactions new to the domestic Chinese economy had to be defined. The early 1980s saw the beginning of an ongoing process of eking out necessary laws in piecemeal fashion.

The definition of business entities had expanded as categories of ownership underwent enlargement and modification. The 1982 Constitution mentioned three types of ownership: socialist public ownership; collective ownership; and "the individual economy of urban and rural working people, operated within the limits prescribed by law," which was characterized as a "complement" to the "socialist public economy." The GPCL later identified "enterprise legal persons," which were state-owned enterprises (SOEs), collective enterprises, foreign-invested joint ventures, and wholly foreign-owned enterprises (WFOEs).

In 1988 a constitutional amendment declared that the Chinese state would "permit a private economy to exist and develop within the limits prescribed by law." Regulations adopted in the same year legalized private enterprises for the first time, although many had been operating for years outside of the law. Private enterprises were defined as privately funded economic entities that employed at least eight persons and were classified as sole investment enterprises, partnerships, and limited liability companies. Rural households engaged in business and rural collectives

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<sup>1</sup> William C. Jones, *Some Questions Regarding the Significance of the General Principles of Civil Law of the People's Republic of China*, 28 HARV. INT'L L.J. 309 (1987).



were also explicitly recognized. The PRC Partnership Enterprises Law, promulgated in February 1997, defined a flexible new business vehicle.

In 1994, after years of discussion, a Company Law was adopted for domestic enterprises that provided for two types of companies, the Limited Liability Company (LLC) and the joint stock company.<sup>2</sup> The Law required minimum capitalization, articles of association and registration with the state for both types of companies, as well as institutions for corporate governance by a shareholder's meeting, a board of directors, managers, and a supervisory board based on a German model. Rules on corporate governance were adopted in 2002 for the small number of listed companies.<sup>3</sup> Additional rules to protect minority shareholders, such as a provision for lifting the corporate veil when a controlling shareholder abuses the privileges of incorporation, were issued by the Standing Committee of the National People's Congress effective in January, 2006. Concurrently, new rules were issued on other aspects of company law. All of these rules continue to evolve and develop. The Company Law was amended in 2005 to permit shareholders of a company to bring a civil lawsuit in the interests of the company and in their own names with respect to the job-related acts of directors, supervisors or senior managers that violate laws, regulations or the articles of association and cause injury to the company. The amended Company Law also improves the rules on transfer of equity held by shareholders of a limited liability company and transfer of shares held by sponsors, directors, supervisors, or senior managers of a company limited by shares.<sup>4</sup>

Meanwhile, the development of standards and good practices in corporate governance remains hampered by the basic policy of maintaining state control over certain enterprises. The difference between rules for private sector enterprises and those that favor the maintenance and exercise of state control has thus far been unbridgeable; nation-wide standards for Chinese corporate governance remain confused and ineffective, and China's corporate culture remains muddled and its standards unclear – as shareholders and, sometimes, foreign investors often discover when they encounter corruption in Chinese companies.

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<sup>2</sup> 中华人民共和国公司法 [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective Jun. 1, 1994), *translated in* CHINALAWINFO (LEXIS) PRCLEG 641.

<sup>3</sup> 中国上市公司治理准则 [Code of Corporate Governance for Listed Companies in China] (issued by the China Sec. Reg. Commission & State Econ. & Trade Commission, Jan. 7, 2002) *translation available at* <http://www.csrrc.gov.cn/en/jsp/detail.jsp?infoId=1061968722100&type=CMS.STD> (last visited Dec. 11, 2006).

<sup>4</sup> 中华人民共和国公司法（2005 年修订） [Company Law of the PRC (2005 Amendments)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006).

*D. Foreign Trade Before Reform*

When the Chinese leadership made its unprecedented decision to "open" China to FDI, many in the West wondered whether the PRC would be able to erect a credible legal framework that would encourage foreign investors to believe that their investments would be adequately protected under Chinese law. There had been no foreign investment from non-Communist nations since the early 1950s, when foreign investors were forced to leave China. To understand how far China has come since the days of the Maoist policy of "self-reliance," it is useful to recall the manner in which China's foreign trade was conducted in the years before the "opening" policy appeared. A glance at the not-so-distant past makes it possible to appreciate how deep the changes in legal culture have had to be in order to displace the long-lived mindsets and mental habits of the Chinese who dealt with foreigners.

It is no understatement to say that between 1949 and 1979 China's foreign trade was conducted in a legal vacuum. The vast majority of transactions were simple purchases and sales of standardized commodities handled by a small number of centralized state trading corporations. Negotiators used very simple standard form contracts that they treated as virtually unalterable by the foreign parties. The only common additions to the scanty terms of payment and shipment in the standard forms were brief specifications as to quality standards. The contracts usually made no reference to dispute settlement or even to Chinese law, because there was no law governing trade with foreigners. Even Chinese purchases of complicated machinery or equipment or occasional whole-plant imports including technology transfers were handled conceptually as purchases of commodities; the contracts were sparse apart from ample technical appendices and attachments and warranties by the foreign sellers held them to only very broadly phrased standards of quality.

When disputes did arise, they were almost always settled through negotiations conducted against a background of past dealings and in anticipation of the continuation of future business relations. From the early 1950s until the early 1970s, China's trade with the non-Communist West was dominated by a relatively small number of veteran trading firms; in Western Europe, the most noteworthy were in London and Hamburg. These traditional trading firms were no more enthusiastic about third-party dispute settlement than their Chinese counterparts, and were usually just as willing simply to work out disagreements in the context of their ongoing relationships.

The only form of dispute settlement that the standard Chinese form contracts ever expressly provided for – if they mentioned any – was arbitration before the Foreign Trade Arbitration Commission of the China Council for the Promotion of International Trade, established in 1956 and since renamed the China International Economic and Trade Arbitration Commission (CIETAC). Even when a foreign party insisted on arbitrating a dispute in Beijing, the Commission would do its utmost to bring about a negotiated compromise rather than to conduct formal arbitrations under its own procedures.

This bare description illustrates that when foreign investors began coming to China after the reform policies were announced, foreign trade with non-Communist countries was purely bureaucratic and the adoption of legal rules to govern both the foreign newcomers and the bureaucrats who would regulate them was a radical innovation. It was, however, an innovation, for which the mentalities of most bureaucrats – and indeed, most Chinese – were not prepared.

#### *E. Evolution of the Legal Framework for FDI*

##### *1. Initial Creation of Investment Vehicles*

Over the years, legislators and administrators have created an increasingly complex framework to provide guidance to foreign investors and their Chinese counterparts. At the outset, it is important to underline one outstanding characteristic of legislation that is a significant cause of uncertainty: newly promulgated laws have often been explicitly provisional or tentative, reflecting the difficulty of filling what had been a legal vacuum, and these new laws have had to be subsequently supplemented by additional legislation. This law-making pattern has marked FDI legislation from the start.

The first, skeletal PRC Sino-Foreign Equity Joint Venture Law that appeared in 1979 was barely three pages in length. It was supplemented in 1983 by implementing regulations that were of only limited utility because they loosely defined only one type of joint venture, the limited liability company that became known as the equity joint venture (EJV). Under this initial legislation, profits had to be shared in proportion to the capital investment by the parties. Some investors, however, wanted to be entitled to receive their share of profits earlier than a payout computed strictly according to the ratio of their investments would permit; and some investors did not want to bother with the boards of directors required for EJVs. These investor desires led to the appearance of a new type of investment vehicle, the contractual joint

venture (CJV), which had not been mentioned in the 1979 law. As new laws appeared to deal with various FDI-related matters such as customs and taxation, they referred to CJVs, *even though that form of business had not yet been specifically recognized in legislation applicable to the authorized investment vehicles*. It was not until 1988 that a law was promulgated that described the basic characteristics of the CJV.<sup>5</sup> Before then, in the absence of specific legislative authority for the creation of the CJV, lawyers had had to advise clients contemplating creation of such a venture that the laws applicable to EJV's seemed to be applicable by analogy, although they had no legislative authority for doing so.

The 1988 law essentially legalized the already existing arrangements, and also continued the official policy of flexibility that had been shown to them. It specifically addressed a form of CJV that was a partnership in which the partners' liability was not limited, unlike in EJV's. But before the law was enacted some investors had already set up CJVs with limited liability – although no such entity existed under Chinese law – and had obtained approval for such enterprises by local officials. The 1988 law did not mention them at all, and therefore was interpreted as leaving room for continuation of the “equity-type” CJV that was a limited liability company. As one perceptive foreign commentator noted about the new law, “practice, as a popular Chinese catch phrase puts it, remains in many cases the sole criterion of truth.”<sup>6</sup>

Even after the new law appeared, foreign investors and government officials alike continued to refer to the rules on EJV's as they had done in the past because the more recent law was vague in many areas. It was not until 1995, fifteen years after CJVs had themselves emerged, that regulations implementing the CJV law clarifying details about their establishment, structure and management appeared.

In the meantime, another vehicle for doing business, the Wholly Foreign-Owned Enterprise (WFOE), was created in response to the desire of some foreign investors for full ownership of their ventures. Although WFOEs were not authorized in 1979, by the early 1980s a few were authorized in the Special Economic Zones (SEZs), which were created to encourage foreign companies to invest in export-oriented enterprises by offering concessions on tax rates and customs treatment. A law on

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<sup>5</sup> 中华人民共和国中外合作经营企业法 [Sino-Foreign Contractual Joint Venture Law of the PRC] (promulgated by the Nat'l People's Cong., Apr. 13, 1988, effective Apr. 13, 1988), translated in CHINALAWINFO (LEXIS) PRCLEG 1189.

<sup>6</sup> Timothy A. Gelatt, *China's New Cooperative Joint Venture Law*, 15 SYRACUSE J. INT'L L. & COM. 187, 201 (1989).

WFOEs was promulgated in 1986, followed by implementing regulations in 1990.

## 2. Creation of Additional Vehicles and Institutions

As the rules on investment vehicles grew, other legislation appeared as well. New laws on taxation of Sino-foreign joint ventures were among the first to be adopted, in 1980, and additional laws on foreign enterprises' permanent establishments appeared. In October of 1986, the State Council issued Provisions for the Encouragement of Foreign Investment, and national and local implementing regulations ensued. This new legislation provided incentives and preferential treatment to joint ventures that at times had the effect of amending the provisions of previous legislation. Local authorities in provinces, major cities, special economic zones and economic and technological development zones also issued their own rules on such matters as labor, registration, land use, procurement of materials, and the procedures for negotiation and approval of projects.

China's Constitution was amended in 1982 to declare that the "lawful rights and interests" of foreign investors would be protected. The 1990s saw the continuing expansion of legislation further enlarging the scope of FDI. By the end of the decade, special zones offering investment inducements established by provincial and sub-provincial governments easily numbered one hundred. In practice, though, their policies were not uniform and, in some localities, were not entirely compatible with national law and policy.

Under the Company Law, discussed above, it became possible for FIEs to be established as, or converted into, joint stock companies.<sup>7</sup> Legislation in the 1990s added holding companies that could be used by foreign investors with multiple projects in China to unify management of their ventures. A new area of law, merger and acquisitions, was addressed by a series of regulations that greatly expanded the applicable body of rules. Initial provisions were issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Administration for Industry and Commerce (SAIC) in late 1999; these were followed by "Interim Provisions on Introducing Foreign Investment to Reorganize State-owned Enterprises,"<sup>8</sup> the "Provisional Rules on the

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<sup>7</sup> 中华人民共和国公司法 [Company Law of the PRC] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective Jun. 1, 1994), *translated in* CHINALAWINFO (LEXIS) PRCLEG 641.

<sup>8</sup> 利用外资改组国有企业暂行规定 [Interim Provisions on Introducing Foreign Investment to Reorganize State-owned Enterprises] (promulgated by the State Econ. & Trade

Acquisition of Domestic Enterprises by Foreign Investors,”<sup>9</sup> and “Provisional Measures Governing Transfer of State Owned Assets of Enterprises;”<sup>10</sup> the first two became effective in 2003, and the third in 2004. As one commentator wrote:

[T]hese rules increase disclosure, transparency and certainty in the M&A regulatory regime and ensure that state assets are not sold or transferred at below market value. They make it possible for mergers and acquisitions to be structured more efficiently.<sup>11</sup>

Now, as a result of the increased clarification of the applicable rules, foreigners have been enabled to consider investing in existing enterprises rather than establishing start-up “foreign-invested enterprises” (FIEs) as they are commonly referred to, and they can buy into existing supply chains and distribution networks. However, this relatively new area of investment has its own problems; a report issued by a committee of the Organization for Economic Co-Operation and Development (OECD) notes that among the problems presented by the current regulatory framework is that it is complex and incomplete, lacks transparency on policy toward “strategic assets” (large SOEs), insists that foreign purchases of all the equity in an SOE be structured as the creation of a new WFOE, and requires cumbersome approval procedures.<sup>12</sup> The OECD report further notes a massive lack of transparency in SOEs targeted for acquisition, as detailed in a report by Pricewaterhouse Coopers.<sup>13</sup> Despite these and other problems, the new M&A activity is

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Commission, Ministry of Fin., State Admin. Bureau of Indus. & Com., & State Admin. of Foreign Exchange, effective Jan. 1, 2003), translation available at [http://www.tdctrade.com/report/reg/reg\\_030101.htm](http://www.tdctrade.com/report/reg/reg_030101.htm) (last visited Dec. 11, 2006).

<sup>9</sup> 外国投资者并购境内企业暂行规定 [Provisional Rules on the Acquisition of Domestic Enterprises by Foreign Investors] (promulgated by the Ministry of Foreign Trade and Econ. Cooperation, the State General Admin. of Taxation, the State General Admin. of Industry & Com., & the State Admin. of Foreign Exchange, March 7, 2003, effective April 12, 2003), translation available at [http://www.tdctrade.com/report/reg/reg\\_030402.htm](http://www.tdctrade.com/report/reg/reg_030402.htm) (last visited Dec. 11, 2006).

<sup>10</sup> 企业国有产权转让管理暂行办法 [Provisional Measures Governing Transfer of State Owned Assets of Enterprises] (promulgated by the State Owned Assets Supervision and Admin. Commission, Jan. 8, 2004, effective Feb. 1, 2004), translation available at [http://www.tdctrade.com/report/reg/reg\\_040501.htm](http://www.tdctrade.com/report/reg/reg_040501.htm) (last visited Dec. 9, 2006).

<sup>11</sup> Neil Torpey, *Merger Rules Smooth the Way*, FIN. TIMES, Mar. 3, 2004, at 10.

<sup>12</sup> OECD Directorate for Financial and Enterprise Affairs Investment Committee, *Preliminary Findings and Issues for Guidance by the Committee*, in CHINA’S MERGERS AND ACQUISITIONS POLICIES 2005 PROJECT 23-27 (Oct. 14, 2005).

<sup>13</sup> *Id.* at 29, citing a report by Pricewaterhouse Coopers at [www.pwcglobal.com/cn](http://www.pwcglobal.com/cn).

noteworthy as a further expansion of the scope of foreign investment, as well as a means for restructuring and privatizing many SOEs.<sup>14</sup>

While legislation was being crafted in these areas, additional rules were created for a variety of joint venture issues such as approvals, capitalization, and debt. Other foreign investment matters now encompassed by legislation include patents and trademarks, labor, customs, foreign exchange, bank lending and guaranties, and export and import licenses. Legal evolution has also been illustrated by a succession of laws regulating contracts for the transfer of technology. In addition to legislation at the national level, much local legislation has also appeared.

The frequent sparseness and tentativeness of the legal rules implementing policies favoring the expansion of FDI is understandable, but incompleteness and long delays in providing important details have sometimes frustrated ambitious plans by both foreigners and Chinese to open new sectors to foreign participation. A prime example is the rise and decline of the interests of foreign investors in infrastructure projects in the 1990s. One review of the status of wholly foreign-funded infrastructure projects found that although detailed rules had been developed for the preparation and approval of such projects, the construction and operational phases that were to follow were insufficiently regulated.<sup>15</sup> The legal regime relied exclusively on contractual stipulations among contracting parties to establish project quality standards, but no legal basis was given for determining the standards that had to be followed. Insufficient controls existed over project construction costs. Moreover, the uncertainty was compounded because local governments had gained greater authority and control over infrastructure projects. In transactions involving power plants, the power purchaser and the power dispatcher had no contractual relations with the engineering, procurement and construction agreement, and legal rules to govern these relationships were absent. Also, according to one experienced lawyer, when project finance was used, inadequate legal

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<sup>14</sup> Of course the appearance of a new mode of structuring investment brings with it new choices. If a foreign investor chooses to invest equity in an SOE rather than forming a joint venture, it may avoid hidden liabilities, including obligations to employees. Moreover, the foreigner does not have to take over assets he does not want along with those he desires. Also, the cumbersome approval processes are avoided. On the other hand, an equity investment does not avoid hidden liabilities including overdue taxes, and does not avoid the perils of taking on risks in the entire business and assets of the target enterprise. For a comparison of the two types of transactions, see David Wang & Roland Sun, *The Successful Structuring of Foreign Investment Deals in China: Assets or Equity?*, CHINA L. & PRACTICE, Sept. 2005, at 29.

<sup>15</sup> Wang Weidong & Tang Jie, *Deregulation of Wholly Foreign-owned Infrastructure Projects: Problems and Solutions*, CHINA L. & PRACTICE, July-Aug. 2002, at 25.

remedies created difficulties for creditors.<sup>16</sup> The author added that after the failure of some projects had led to litigation in the Chinese courts in the late 1990s, rules were developed that encouraged Chinese lenders to believe that remedies such as direct repossession of borrowers' assets were available, which in turn led to a revived willingness to lend to limited recourse projects.

While FDI has advanced unevenly, the transformation of foreign trade has been dramatic. The monopoly of a small number of state trading corporations has ended and the right to engage in foreign trade has been greatly broadened; by 1990, foreign trading rights had been decentralized to provincial and municipal governments, but still remained monopolized by the state. Since then, trading rights have been increasingly granted, first to many manufacturing enterprises and then to many FIEs. By the time China's accession to the World Trade Organization (WTO) became effective in 2001, manufacturing enterprises needed only to register with a government authority to import and export goods for their own use, while enterprises that intended to engage in trade by importing products and reselling them still had to be approved by the Ministry of Foreign Trade and Commerce (MOFCOM), which continued to limit the number of participants authorized to engage in foreign trade. As a consequence of accession, trading rights have been so broadened that FIEs will be able to operate and organize their business models in China similar to the way they would be able to in most other Western nations.

The creation of capital markets and a securities industry has been underway since the 1980s. Recent markers of expanding legislative activity in this area have been the *PRC Securities Law*, adopted at the end of 1998, a takeover code,<sup>17</sup> and rules added in 2002 permitting certain qualified foreign investors to gain access to the A-Share market previously restricted to domestic PRC investors.<sup>18</sup> In October 2005, the concept of the "foreign strategic investor" (FSI) was introduced; these FSIs could acquire tradable A shares of China-listed companies held by public shareholders provided that they met certain conditions.<sup>19</sup>

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<sup>16</sup> Li Xiaoming, *Back in the PRC*, PROJECT FINANCE, May 2003, at 44.

<sup>17</sup> 上市公司收购管理办法 [Acquisition of Listed Companies Administrative Procedures] (promulgated by the China Sec. Reg. Comm., Sept. 28, 2002, effective Dec. 1, 2002).

<sup>18</sup> See *China Opens A-shares Market to Foreign Investors*, PEOPLE'S DAILY, Nov. 8, 2002, available at [http://english.people.com.cn/200211/08/eng20021108\\_106508.shtml](http://english.people.com.cn/200211/08/eng20021108_106508.shtml) (last visited Dec. 11, 2006).

<sup>19</sup> 外国投资者对上市公司战略投资管理办法 [Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors] (promulgated by the Ministry of Commerce, the China Securities Regulatory Commission, the State Administration of Taxation, the State



The thrust of legal reform has been downward from the central government, necessarily generating much local legislation, but reformers have also looked beyond China's borders for guidance. As China has become increasingly engaged with the international community, it has entered into a number of bilateral investment treaties and acceded to a number of multilateral treaties whose rules have become part of Chinese law, such as the Vienna Convention on Contracts for the International Sale of Goods, whose provisions now supplement often scanty Chinese form contracts. When China acceded to the WTO and agreed to the rules in the Agreement on Trade-related Investment Matters (TRIMs) it assumed considerable obligations to modify rules relating to foreign investment.

The creation of the framework outlined above is a considerable legislative accomplishment that has gradually reduced some of the uncertainty that initially plagued foreign investors in the 1980s. Notwithstanding the fact that FDI legislation now provides some guidance on many important questions for foreign and Chinese parties establishing their first investment vehicles, uncertainty is still fostered by national policies and by contradictions between competing policies.

### III. POLICIES AND UNCERTAINTY

#### A. *Tension between State Control and Opening Markets*

Chinese policy toward foreign investment is shot through with a basic tension between encouraging economic activity outside the state sector with one hand while trying to control it with the other. The process of obtaining approvals for FIEs, which was especially irritating to eager foreign investors during the 1980s, has epitomized the perceived need of the state to control and regulate FDI, despite the emergence of some clarification in the 1990s.

Each SOE is under the operational oversight of a "department in charge" which, depending on its size, could be a local or province-level department or, for national enterprises, a ministry in Beijing. The

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Administration of Industry and Commerce and the State Administration of Foreign Exchange, Dec. 31, 2005, effective on Jan. 30, 2006). Under these regulations, a listed company will be registered as an FIE if a foreign investor acquires at least 10% of all shares in the target company. In addition to the overall investment guidelines discussed in the following section of this article, the company must comply with ceiling percentages in any industry-specific regulations, as well as with a range of prudential considerations. See Jean-Marc Deschandol & Charles Desmeules, *New Rules on Strategic Investments by Foreign Investors in Listed Companies*, CHINA L. & PRACTICE, Feb. 2006, at 13.

“department in charge” must evaluate and approve proposed FIEs that would include an SOE. Approval by a Beijing ministry (MOFTEC until 2003, MOFCOM thereafter) or one of its local units has been required, depending on the level of investment and the type of project involved. Until recently, the approval process began when the Chinese enterprise considering a joint venture submitted a preliminary feasibility study to its “department in charge” in order to obtain preliminary approval. After the foreign and Chinese parties prepared their feasibility study, it would be sent to the relevant Chinese departments charged with oversight of various aspects of the FIE, such as the departments responsible for the supply of utilities or raw materials. After the parties concluded their negotiations, their contract and related documentation, including the detailed feasibility study and specifications for any technology that was to be transferred by the foreign party, would be submitted to the appropriate approval authority. The contract would then be reviewed for conformity to regulations on a wide range of matters; these include a clear definition of the scope of business, the amount of cash and other contributions to capital of the proposed FIE, the ratio of these contributions to total investment, considerations of foreign exchange and technology transfer, documentation of land use rights, and stipulations regarding building materials and utilities, labor and employment, duration, and termination. If the contract was approved, the joint venture parties had to submit the proposed FIE’s name for registration with the State Administration of Industry and Commerce, which would register the name and issue a business license. As noted below, the approval procedure for FIEs has been modified and may become more lenient, although it is too early to measure the effects of the changes on actual practice. Also, FIE policy has not been consistent, because, as one scholar-practitioner has observed, “Inconsistent regulatory performance is often the product of the conflicting goals of different bureaucracies, whose regulatory power is subject to few effective limits.”<sup>20</sup>

Sometimes, even though a joint venture was approved and already in business, a change in policy could severely affect its activities. In just such a case in my law practice, a 1980s-era Sino-American joint venture that was formed to manufacture small cotton gins for sale to peasant cooperatives was hampered when a protectionist Ministry of Commerce

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<sup>20</sup> Pitman B. Potter, *Law Reform and China's Emerging Market Economy*, in CHINA'S ECONOMIC FUTURE: CHALLENGES TO U.S. POLICY 221, 239 (Cong. of the U.S. Joint Econ. Committee ed., 1997). He cites, for example, a regulation by the Bank of China prohibiting foreign bank representative offices from engaging in profit-making activities, which was contradicted by tax authorities who imposed taxes on “deemed profits” made by representative offices.

directive required that cotton be processed only at state-run ginning centers, thereby reducing the market for the joint venture's products.

Some major changes in policy have given guidance to foreign investors. In June 1995, the State Planning Commission issued investment guidelines in a "Foreign Investment Industrial Guidance Catalogue" that classified projects as "encouraged," "permitted," "restricted" and "discouraged." (Other internal guidelines also existed, which limited the market share that foreign firms could have in certain industries.) Then, in January, 1998, new guidelines were issued. The category of "encouraged" investments displayed a heightened emphasis on advanced technology; some types of projects now faced the additional requirement of high output capacities; others were moved to the "restricted" category, while controls were increased in some areas already in that category. Subsequent revisions of the Catalogue have seemed to reflect movement in China's national policy toward FDI and selective encouragement, rather than emphasizing tight control over foreign presences in the economy.<sup>21</sup> This suggests that investors whose projects fall within the "encouraged" or "permitted" categories ought to find the approval process fairly routine, while those who wish to apply for investments in the "restricted" category will encounter greater difficulty. More recent adjustments, however, have also closed some areas or shifted them out of the "encouraged" category.<sup>22</sup>

New problems have been created by recent reforms in the investment approval process that enlarged the powers of local governments. In July 2004, the State Council issued *The Decision on Reforming the Investment System*,<sup>23</sup> which raised the threshold on local government approvals of investment projects from US\$30 million to \$100 million for projects falling within the "encouraged" and "permitted" categories in the Foreign Investment Industrial Guidance Catalogue mentioned above, and to \$50 million for projects in the "restricted" category. The Decision also provided that foreign investment projects that did not utilize state funds would no longer have to be examined and

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<sup>21</sup> Liu Hongchuan, *The Revised Foreign Investment Catalogue: Grounds for Optimism?*, CHINA L. & PRACTICE, Apr. 2002, at 23.

<sup>22</sup> See, e.g., Deacons, *China: Foreign Investment Catalogue Updated*, Feb. 25, 2005, available at [http://www.hg.org/articles/article\\_495.html](http://www.hg.org/articles/article_495.html) (last visited Dec. 9, 2006).

<sup>23</sup> 国务院关于投资体制改革的决定 [The Decision of the State Council on Reforming the Investment System] (issued by State Council, July 16, 2004) [http://en.ndrc.gov.cn/policyrelease/t20060207\\_58851.htm](http://en.ndrc.gov.cn/policyrelease/t20060207_58851.htm) (last visited Dec. 11, 2006); Michael Han, *Reforming China's Approval System for Investment Projects*, CHINA L. & PRACTICE, Sept. 2004, at 91.

“approved,” but instead would only have to be “verified;” in addition, a project proposal and feasibility study would no longer be required.

Two observers noted that the new rules seemed to allow the parties, rather than government authorities, to decide on commercial aspects of their proposed projects, while reviewing proposals mainly “from the perspective of protecting economic security, reasonable exploitation of resources, environmental protection, avoiding monopolies and allowing fair market access.”<sup>24</sup> However, although they also seemed to signal a retreat from discussing the commercial aspects of proposed investments such as market surveys, forecasts of sales and profitability, and technical feasibility,<sup>25</sup> the apparent further liberalization of the investment process was further modified, and not necessarily in the same direction. The National Development and Reform Commission (NDRC) issued the Tentative Procedures on Administration of the Verification of Foreign-Invested Projects, which came into force in October, 2004.<sup>26</sup> Under these rules, the investor must submit an “application report” to the NDRC with information on the project’s operation, construction scale, location, natural resources requirement and environmental impact. The NDRC is required to complete verification within 20 days after it receives the application report. After the State Council decision of July 2004 appeared, one foreign law firm noted that although the “verification process” had been streamlined into one “application report,” informal discussions with investment authorities suggested that “although the application report may be simpler in form, it will probably incorporate most of the criteria from the old approval process.”<sup>27</sup>

One recent analysis of the Tentative Procedures states that, “far from making the system simpler it appears to make the establishment process for FIEs more complicated, time-consuming and unpredictable.”<sup>28</sup> The authors note that the scope of application broadens rather than narrows the types of projects that must be approved by the NDRC. Formerly new projects or increases in the capital of existing non-

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<sup>24</sup> Xu Ping and Mark Schaub, *Progress or Setback? Looking at the New Approval Procedures for Foreign Investment Projects*, CHINA L. & PRACTICE, Nov. 2004, at 44, 46.

<sup>25</sup> *Id.* Even though a feasibility study is no longer required, foreign investors would be ill-advised not to conduct one anyway for obvious reasons; they may have been given more freedom from regulation, but it is also more freedom to make their own mistakes.

<sup>26</sup> 外商投资项目核准暂行管理办法 [Tentative Procedures on Administration of the Verification of Foreign-Invested Projects] (promulgated by the Nat’l. Dev. & Reform Commission, effective Oct. 9, 2004), translated in CHINA L. & PRACTICE, Nov. 2004, at 39.

<sup>27</sup> Freshfields Bruckhaus Deringer, *Reforming China’s approval system for investment projects*, CHINA NOTES, Sept.-Oct. 2004, at 2.

<sup>28</sup> Xu & Schaub, *supra* note 24, at 45.

manufacturing FIEs had to be approved only by MOFCOM or its local body, but the new rules seem to require NDRC approval as well. Also, the new rules require that acquisition of domestic enterprises by foreign companies also have to be approved by the NDRC, although under the existing rules on M&A only MOFCOM approval was required.

As the scope of foreign investment widens, new legislation will necessarily be tentatively drafted and implementation will be affected by inconsistencies in policy. This is particularly true for industries deemed politically sensitive and for certain other industries that the leadership wishes to insulate from foreign competition.

### 1. Politically Sensitive Industries: Media

The prime example of policy influences on FDI is the leadership's desire to keep out of China foreign influences that it views as conveying ideas that could impair or subvert CCP rule. Thus, the issue of foreign investment in the media provokes continuous attention. A succession of rules on foreign companies operating in the media and publishing industries has limited their abilities to operate. China's State Administration for Radio, Film and Television (SARFT) issued regulations in October 2004 that permitted FIE participation in China's domestic television program production enterprises.<sup>29</sup> Although some observers hailed this issuance as recognition by China's regulators of the need "to become a world-class provider of Chinese-language media,"<sup>30</sup> at the same time Sino-foreign television production JVs were also forbidden from participating in producing news programs. The ambivalence of the Chinese leadership about the role and influence of the media soon grew more evident. In February 2005, SARFT issued an interpretive notice providing that foreign investors that had already applied and received approval to form a joint venture would not be allowed to establish further joint ventures. SARFT was very clear about its reasons:

[W]e must control the contents of all products of joint ventures in a practical manner, understand the political inclinations and background of foreign joint venture parties, and in this way prevent harmful foreign ideology

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<sup>29</sup> 中外合作制影片摄电 31 管理定规 [Order No. 31: Provisions on the Administration of Chinese-Foreign Cooperative Production of Films] (promulgated by the State Admin. of Radio, Film & Television, July 6, 2004, effective Oct. 1, 2004), *translation available at* CHINALAWINFO (LEXIS) PRCLEG 3647.

<sup>30</sup> Jeanette Chan & Auria Styles, *The Great Leap Forward for TV*, FIN. TIMES, Nov. 24, 2004, at 12.

and culture from entering the realm of our television program production through joint investment and cooperation.<sup>31</sup>

Subsequent notices and regulations have emphasized that newspapers and magazines may only be published by approved organizations, and that all cooperation between local TV and radio stations with foreign companies must be approved.<sup>32</sup> A document issued by the Propaganda Department and four other ministries has prohibited foreign investors from “establishing news organizations, broadcasting stations, TV stations and film manufacturing companies, performing troupes, film imports, exports and distribution; foreign investors were also barred from book and magazine publishing, printing, and advertising.”<sup>33</sup> Another source of potentially corrupting cultural influences was hit by a SARFT notice in September, 2005 requiring that all foreign animation films to be examined and approved before they could be shown.<sup>34</sup>

Even more clearly reflecting the Chinese leadership’s concern with regulating foreign media to keep out subversive influences was a directive issued in September, 2006 that requires all foreign media to seek

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<sup>31</sup> 新规定出台：外资影视传媒只能开一家合资公司 [New Rule Publicized: Foreign-Invested Broadcast Media May Operate Only One Company], 人民网 [PEOPLE’S DAILY ONLINE], Mar. 7, 2005, available at <http://media.people.com.cn/GB/40641/3223812.html> (last visited Dec. 9, 2006); Cong.-Executive Commission on China, *Chinese Government Restricts Foreign Participation in TV and Film Production*, in VIRTUAL ACADEMY, Mar. 14, 2005, <http://www.cecc.gov/pages/virtualAcad/index.phpd?showsingl=8037> (last visited Nov. 12, 2006).

<sup>32</sup> Congressional-Executive Commission on China, *New Joint Order Restricts Popular Access to Foreign Films and Television Programs*, in VIRTUAL ACADEMY, Aug. 31, 2005, <http://www.cecc.gov/pages/virtualAcad/index.phpd?showsingl=19506> (last visited Dec. 9, 2006).

<sup>33</sup> *China Bans Foreign Investors from News Industry*, RADIO FREE ASIA, Aug. 5, 2005, [http://www.rfa.org/english/news/politics/2005/08/05/china\\_media/](http://www.rfa.org/english/news/politics/2005/08/05/china_media/) (last visited Dec. 9, 2006); the article was reporting on the release of the document, 关于加强文化产品进口管理的办法 [Regulations Regarding Strengthened Monitoring of Cultural Imports], available at [http://www.ccnt.gov.cn/xwzx/whbzhxw/t20050803\\_12776.htm](http://www.ccnt.gov.cn/xwzx/whbzhxw/t20050803_12776.htm).

<sup>34</sup> 广电总局关于禁止以栏目形式播出境外动画片的紧急通知 [Urgent Notice Concerning the Prohibition of Broadcast of Foreign Animation Film in the Form of Featured Programs], (issued by the State Admin. of Radio, Film & Television, Sept. 13, 2005), available at <http://www.sarft.gov.cn/manage/publishfile/35/3295.html> (last visited Dec. 9, 2006), summarized in Transasia Lawyers, *Newsflash: Urgent Notice on Broadcast of Animation Films*, in PRC TELECOMS, MEDIA & TECHNOLOGY LAW NEWSLETTER, Sept. 26, 2005. This was followed by new rules issued at various times during May-August 2006 requiring producers of television dramas, animated television programs and films to submit to SARFT Chinese-language summaries of screenplays. The new rules are summarized in Transasia Lawyers, *Newsflash: New Filing and Public Announcement System Introduced for Television Dramas, Films and Animated Television Programs*, July 31, 2006.

the approval of Xinhua, China's official news agency, to distribute news, pictures and graphics within China.<sup>35</sup>

## 2. Politically Sensitive Industries: The Internet

Emblematic, too, of the difficulty of enhancing legal predictability in emerging areas of economic activity is the problem of designing a regulatory regime for the Chinese internet. It was estimated in mid-2005 that by the end of the year, more than 120 million Chinese would be internet users. In August, 2005, Yahoo, the US portal, announced that it would pay one billion dollars to gain a 40% interest in Alibaba, a Chinese e-commerce company. An analysis by the *Financial Times* at the time captured the essence of the problems posed by such dramatic expansion of the internet in China. As the article noted, the impact of the internet in China is greater than elsewhere, because "it has created a zone for communication and information exchange far freer than any other in a nation still under the political sway of an authoritarian Communist party."<sup>36</sup> At the same time, the article continued:

[I]nternet entrepreneurs must still contend with an opaque and unpredictable regulatory environment. It is unclear how responsible the Chinese government plans to hold online auction sites for the products sold through their websites. Chinese propaganda officials have also recently ordered tighter controls on any media imports or internet activities that might threaten "national cultural security" – an edict aimed in part at companies, such as Yahoo, that operate portals with a wide range of content.

The article continued by commenting that "changes of policy or regulation are a constant hazard for Chinese internet companies." It also noted that foreign-owned companies encounter state efforts at "thought control," such as when Microsoft, conceding to pressure from Chinese censors, cut the words "democracy" and "freedom" from parts of its MSN website. Yahoo has done the same. When Google, which prior to 2006 had not operated a server in China, decided to meet foreign competition

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<sup>35</sup> *Measures for Administering the Release of News and Information in China by Foreign News Agencies*, XINHUA NEWS AGENCY, Sept. 10, 2006, available at [http://news.xinhuanet.com/english/2006-09/10/content\\_5072528.htm](http://news.xinhuanet.com/english/2006-09/10/content_5072528.htm) (last visited Dec. 11, 2006).

<sup>36</sup> Mure Dickie & Richard Waters, *Yahoo search is complete: Alibaba Finds A Way to Reap the Riches of Online China*, FIN. TIMES, Aug. 12, 2005, at 15.

by doing so, it effectuated a compromise with Chinese policy by agreeing to restrict content on its server only after inserting a disclaimer in the search results explaining that the content had been censored in accordance with Chinese law. Likewise, it decided not to offer e-mail or blogging services within China so that it would not have to censor blog postings or disclose dissidents' personal information to Chinese authorities, as Yahoo had done in a number of cases.<sup>37</sup>

*B. Policies Intended to Protect or Control Certain Industries*

In other important areas, as the United States Trade Representative (USTR) reported in December, 2005:

Since acceding to the WTO, China has increasingly resorted to industrial policies that limit market access by non-Chinese origin goods or bring substantial government resources to support increased exports. The objective of these policies seems to be to support the development of Chinese industries that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less competitive domestic industries.<sup>38</sup>

Several examples suffice:

1. Automobiles

An internally circulated draft of state policy was reported to require that by 2010 half of the intellectual property of cars built in China be of Chinese origin.<sup>39</sup> In March, 2006 the United States and the European Union requested WTO dispute settlement consultations with China in response to China's implementation of regulations that imposed a tax on imported auto parts equal to the tariff on a complete automobile – typically 28 percent – if the final assembled vehicle failed to meet certain local content requirements.<sup>40</sup> Previously, tariffs on auto parts had ranged from only 10 percent to 14 percent. The USTR asserted that the new regulations violated China's commitment, when it acceded to the WTO,

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<sup>37</sup> See, e.g., Clive Thompson, *Google's China Problem (and China's Google Problem)*, N.Y. TIMES MAG., Apr. 23, 2006, at 64.

<sup>38</sup> UNITED STATES TRADE REPRESENTATIVE, REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE 6 (2005).



to eliminate all local content requirements and to lower and bind its tariffs on auto parts. In September, 2006 the USTR announced that it would formally request the establishment of a WTO dispute settlement panel to address the controversy – the first time the US has invoked the formal procedure in a controversy with China.<sup>41</sup>

## 2. Software

A drafted regulation would have ordered Chinese government departments to favor locally produced software over foreign competitors. For a software product to be considered “domestic,” vendors would have had to prove that at least 50% of its development costs had been spent in China.<sup>42</sup> After strenuous U.S. protest, China agreed to withdraw the regulation.<sup>43</sup> Nevertheless, despite the Chinese government’s assurances to the contrary, signs indicate that international software companies – as well as international companies in other sectors – remain locked out of the government procurement process.<sup>44</sup>

## 3. Banking

Policy on foreign participation in China’s troubled banking industry has been indecisive. In April 2005, an editorial in the *Financial Times* reported that China’s deputy bank regulator had stated that expansion by foreign banks needed to be “managed” and “constrained,” and that therefore China was considering restricting expansion by foreign banks through implementing policies such as limiting ownership of shares in China’s state-owned banking institutions to two.<sup>45</sup> Later in 2005, a

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<sup>39</sup> See James Mackintosh & Richard McGregor, *A Leap Over the Cliff: Are the Big Profits to be Made in China Blinding Foreign Carmakers to the Risks Ahead?* FIN. TIMES, Aug. 25, 2003, at 15.

<sup>40</sup> Request for the establishment of a panel by the United States, *China – Measures Affecting Imports of Automobile Parts*, WT/DS340/8 (March 30, 2006).

<sup>41</sup> Press Release, United States Trade Representative, United States Requests WTO Panel in Challenge of China’s Treatment of U.S. Auto Parts (Sept. 15, 2006), available at [http://www.ustr.gov/Document\\_Library/Press\\_Releases/2006/September/United\\_States\\_Requests\\_WTO\\_Panel\\_in\\_Challenge\\_of\\_Chinas\\_Treatment\\_of\\_US\\_Auto\\_Parts.html](http://www.ustr.gov/Document_Library/Press_Releases/2006/September/United_States_Requests_WTO_Panel_in_Challenge_of_Chinas_Treatment_of_US_Auto_Parts.html) (last visited Dec. 9, 2006).

<sup>42</sup> Mure Dickie, *China to Restrict Foreign Software Purchases*, FIN. TIMES, Nov. 26, 2004, at 9.

<sup>43</sup> CONG.-EXECUTIVE COMMISSION ON CHINA, ANNUAL REPORT 104 (2005).

<sup>44</sup> CONG.-EXECUTIVE COMMISSION ON CHINA, ANNUAL REPORT 154 (2006).

<sup>45</sup> *Braking China: Beijing is Considering Restricting Expansion by Foreign Banks*, FIN. TIMES, Apr. 28, 2005, at 20.

number of China's major banks began to sell shares to foreigners, and chairman of the China Construction Bank Guo Shuqing announced that "the most important change will be the transition from a government structure to a completely commercialized operation."<sup>46</sup> It was clear that Beijing was employing a similar policy in insisting that outsiders could hold no more than 25% of total equity, and no single investor could hold more than 20%.<sup>47</sup> Yet in April, 2006, it was reported that a vice-chairman of the commission that regulates banks had stated that "the principle of state control only applies to large banks and not to small and medium-sized lenders."<sup>48</sup> In November 2006, the State Council issued regulations that established conditions on the operations of foreign banks that considerably restricted their activities.<sup>49</sup>

C. *The Persistence of Underlying Concern about the Scope of FDI*

More ominous recent limitations on foreign investment have appeared: after a U.S. private equity group agreed to acquire an 85% interest in China's largest construction equipment maker in March, 2006 the Chinese Ministry of Commerce imposed strict conditions that resulted in the U.S. purchaser agreeing to take a 50% interest; by mid-February, 2006, approval had still not been granted.<sup>50</sup> In addition, foreign firms were banned by the CSRC from acquisitions of domestic brokerages in September, 2006;<sup>51</sup> and Christie's auction house recently discovered that joint ventures were forbidden to sell Chinese cultural items.<sup>52</sup> These developments have emerged against evidence of increased concerns "among Chinese officials and academics that foreign companies are seizing control of strategic industrial sectors."<sup>53</sup> The Ministry of

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<sup>46</sup> *China Construction Bank Prices IPO*, CHINA DAILY, Oct. 13, 2005, available at [http://www.chinadaily.com.cn/english/doc/2005-10/13/content\\_484720.htm](http://www.chinadaily.com.cn/english/doc/2005-10/13/content_484720.htm) (last visited Dec. 11, 2006).

<sup>47</sup> Brian Bremner, *Betting on China's Banks*, BUS.WK., Oct. 31, 2005, at 18.

<sup>48</sup> Richard McGregor, *China May Loosen Grip on Bank Ownership*, FIN. TIMES, Apr. 11, 2006, at 8.

<sup>49</sup> UNITED STATES TRADE REPRESENTATIVE, REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE, 82-83 (2006).

<sup>50</sup> Doug Cameron, Francesco Guerrero, & Richard McGregor, *Beijing stalls Carlyle's Xugong takeover*, FIN. TIMES, March 29, 2006, at 26; Andrew Batson & Laura Santini, *Carlyle Scales Back Planned Stake in China Firm*, WALL ST. J., Oct. 18, 2006, at A12.

<sup>51</sup> *China Bans Foreigners From Buying Brokers*, INT'L HERALD TRIB., Sept. 15, 2006, at 13.

<sup>52</sup> Will Bennett, *China's New Millionaires See Capital Gain in Art*, FIN. TIMES, Sept. 30, 2006, at 6.

<sup>53</sup> Mure Dickie, *Chinese Takeover Fears Grow*, FIN. TIMES, Aug. 4, 2006, at 6. See also Geoff Dyer, Sundeep Tucker & Tom Mitchell, *Forbidden Country? How Foreign Deals in China are Hitting Renewed Resistance*, FIN. TIMES, Aug. 8, 2006, at 11; Harry Harding, *Chinese Checks*,

Commerce was given power in September, 2006 to block foreign purchases of Chinese companies that involve “key industries,” described as those whose operations influence or might influence “State economic security.” Affected transactions include those involving transfer of control over domestic enterprises that own “famous Chinese trademarks” or “old Chinese trade names.”<sup>54</sup> None of these terms were defined. In December, 2006, Li Rongrong, the chairman of the State Assets Supervision and Administration Commission, stated that the State must have “absolute control [over] strategically important sectors.” These are armaments, power generation and distribution, oil, petrochemicals and gas, telecommunications, coal, aviation and shipping industries. In addition, “[c]entral SOEs should also become heavyweights in sectors including machinery, automobiles, IT, construction, iron and steel, and non-ferrous metals.”<sup>55</sup> Such concerns do not promise to vanish soon, and will obviously contribute to uncertainty for prospective foreign investors.

#### IV. INSTITUTION-BUILDING: PROGRESS AND PROBLEMS

To assess more deeply the legal aspects of reform, it is necessary to consider not only the laws but the institutions that issue and implement them. The discussion that follows reviews the building of those institutions beginning in 1979. Because changes in the allocation and exercise of powers involve basic issues in the governance of the Party-state, the fashioning of post-Maoist policies on these matters has been even more difficult for the leadership to deal with than most of the issues of economic reform and FDI.

##### A. *Law-Making at the National and Local Levels*

As the need for laws has grown, so has the need to revise law-making institutions. The role of the National People’s Congress (NPC) is slowly shifting; originally it was a rubber stamp, and although it still meets only once a year for one month, with most of its business being handled by its Standing Committee which meets regularly throughout the

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WALL ST. J., Oct. 14, 2006, at A18 (noting that the “main focus” of Beijing’s defensive economic nationalism is on “making it more difficult for foreign companies to operate in China”). See also Jan Borgonjon & James A.C. Sinclair, *Signs of More Protectionist Times?* CHINA BUS. REV. Nov.-Dec. 2006, 44.

<sup>54</sup> See, e.g., Peter A. Neumann & Tony Zhang, *China’s New Foreign-Funded M&A Provisions: Greater Legal Protection or Legalized Protectionism?*, CHINA L. & PRACTICE, Oct. 2006, at 21.

<sup>55</sup> *Control Over Key Industries ‘Crucial’*, CHINA DAILY, Dec. 19, 2006, available at [http://english.people.com.cn/200612/19/eng20061219\\_333839.html](http://english.people.com.cn/200612/19/eng20061219_333839.html) (last visited Feb. 22, 2007).

year, its growing staff has become increasingly professionalized and its specialized committees draft and review proposed legislation.

The expansion of the need for legislation has led to organizational problems for the Chinese bureaucratic apparatus. Notably, the jurisdiction of the NPC and the State Council (equivalent to the cabinet, at the head of the executive branch of the government) is poorly defined. According to the Chinese Constitution, “basic laws” are enacted by the NPC, whereas “laws” can be enacted by its Standing Committee, and the State Council can issue “administrative laws.” None of these critical terms, however, are defined. In practice, most legislation originates in the State Council, which issues “administrative regulations,” while the more than 60 ministries, commissions and bureaus that are subordinate to the State Council issue “administrative rules.” Provinces and sub-provincial governments issue “local regulations” and “local rules” but the relative authority of these norms has been poorly defined and very badly coordinated.<sup>56</sup> The slow development of the institutions intended to resolve these organizational issues is discussed below.

### *B. The Rebuilt Courts*

As more and more legal rules appeared and as reform stimulated the growth of commerce, the need to reorganize the judicial system became pressing. The courts, thrust into oblivion by the Cultural Revolution, were rebuilt into a four-tier system and the number of disputes brought before them increased steadily through the 1980s and 1990s; their caseloads, however, have inexplicably failed to grow since 2000.<sup>57</sup> The powers of the courts are subject to serious limitations because although the reforms reconstructed them, they remain part of a state apparatus that still reflects the severe limits that the doctrine,

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<sup>56</sup> Some clarification of the exclusive powers of the NPC and the Standing Committee was supplied by the 中华人民共和国立法法 [Legislation Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective June 1, 2000), translated in CHINALAWINFO (LEXIS) PRCLEG 386. See generally, Chen Jianfu, *Unanswered Questions and Unresolved Issues: Comments on the Law on Law-Making*, in LAW-MAKING IN THE PEOPLE'S REPUBLIC OF CHINA 235 (Jan Michiel Otto ed., 2000). Hereafter, legislated norms are termed “laws,” and all administrative norms are termed “regulations.”

<sup>57</sup> In 2005, according to the annual report to the NPC by Xiao Yang, President of the Supreme People's Court, the courts tried a total 4,360,184 first-instance cases during 2005, of which 1,132,458 were domestic and marital disputes and cases involving property inheritance; 121,516 labor disputes; 70,129 contract disputes in the building; 268,119 contract disputes in various service industries. 95,707 first-instance administrative lawsuits were heard by the courts. 肖扬 [Xiao Yang], 最高人民法院工作报告, 在第十届全国人民代表大会第四次会议上 [Supreme People's Court Work Report to the 4th Session of the 10th National People's Congress], XINHUA DOMESTIC SERVICE, March 11, 2006.

structure and practice of the pre-reform Maoist Party-state places on the judiciary.

In addition, the courts have been severely hampered by judges' low levels of legal education and professional standards. Until 1995, judges were not required to hold a college degree, and many were recruited from the ranks of retired military officers, law enforcement personnel, or Party cadres. Although there has been a steady rise in the educational level of judges – as of 1997, 80 percent of all judges had at least a junior college-level education, albeit not necessarily in law – estimates have put the percentage of judges with proper LL.B degrees at less than ten percent.<sup>58</sup> Not until 2002 were applicants for judgeships required to take a national bar examination. The quality of the courts varies widely from the relatively advanced large coastal cities to the poorer western regions. In many locales the quality of the lowest-ranking judges still remains quite poor, and corruption among judges remains a pervasive concern. In 2004, for example, Hunan province investigated bribery charges against the former president of the Higher People's Court and dismissed ten judges from their posts.<sup>59</sup> Although in his annual report on the work of the courts for 2005, the President of the Supreme People's Court (SPC) stated that the number of "judicial personnel" who had been held criminally liable for taking bribes had fallen from the previous year, he made reference to the need for continuing efforts "to fight corruption and conduct activities promoting incorruptibility."<sup>60</sup>

A more basic issue is presented by the limited authority of the courts. In the bureaucratic hierarchy, courts are only parallel to, rather than superior to, other units of the Chinese bureaucracy. When courts seek to enforce judgments, agencies whose actions are required to assist the courts sometimes refuse to cooperate. Banks, for example, when requested to freeze a depositor's account, may refuse or delay in doing so.

Furthermore, the decision-making behavior of the courts is similar to that in administrative agencies. Adjudication is only very slowly becoming differentiated from other bureaucratic decision-making processes. The persistence of a bureaucratic mentality is illustrated by the practice of lower courts requesting instructions from higher courts even while cases are pending before them, thereby nullifying appellate

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<sup>58</sup> 法律年鉴 [CHINA LAW YEARBOOK] 91 (1998), cited in Donald C. Clarke, *Empirical Research into the Chinese Judicial System*, in BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW 164, 176 (Erik G. Jensen & Thomas C. Heller, eds., 2003).

<sup>59</sup> *Corruption, Economic Crime in China Jan.-Feb. 2005*, BBC MONITORING INTERNATIONAL REPORTS, June 14, 2005.

<sup>60</sup> Xiao, *supra* note 57, at § 3.4.

procedures. The practice has been controversial, and some Chinese law reformers have advocated its abolition. Moreover, judicial decisions are subject to interference by legislatures, which, as the supreme organs of government under the Constitution, exercise a supervisory function over the courts. Petitions complaining about judicial disposition of cases sometimes succeed in enlisting local People's Congresses to interfere with the integrity of the process of adjudication. The CCP may also generate further external influences on the courts via local Political-Legal Committees and the Adjudication Committees within the courts; cases deemed to be "complex" or "difficult" under the Civil Procedure Law are decided by the Adjudication Committees, which are composed of senior judges, all of whom are likely to be members of the Party Committee at the court.<sup>61</sup>

The need for deeper judicial reform can be illustrated by an additional problem. Until recently, most opinions issued by Chinese courts have been short, formalistic and often without detailed legal reasoning. The courts have often limited themselves to expressing conclusions (e.g., "under article X of statute Y, the contract is unenforceable") without explanation or analysis. This has been due in part to the low educational levels of many judges and in part to the general lack of transparency in government; frequently, judicial opinions simply are not made available to the public.

One profound problem remains intractable. The power of local courts is impaired by local protectionism, which critically blunts the effectiveness of China's judiciary. Judges are selected and paid by local governments, a relationship that leads to pressure on the courts to favor their localities in litigation involving foreigners and parties from elsewhere in China, consequently impeding fair adjudication and enforcement of judgments. Successive presidents of the SPC and many other officials and judges have long criticized this obstacle to the establishment of a nationwide rule of law, and the President of the SPC said in his official report to the NPC in 2004 that "[t]he difficulty of enforcing civil and commercial judgments has become a major 'chronic

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<sup>61</sup> "The Political-Legal Committee usually includes the deputy Party Secretary in charge of political-legal matters, the president of the court and the Procuracy, and the heads of various ministries or bureaus including public security, state security, justice, civil affairs, and supervision." RANDALL PEERENBOOM, *CHINA'S LONG MARCH TOWARD THE RULE OF LAW* 302 (2002). On the use of the Adjudication Committees, which has come under question, especially from legal scholars, *see, e.g., id.* at 323-324.

ailment' often leading to chaos in the enforcement process; there are few solutions to the problem."<sup>62</sup>

This problem came vividly to life in a case in which I provided legal services to a US client. After discovering that certain industrial products purchased from two Chinese sellers and imported into the U.S. were defective, the client began arbitration proceedings at CIETAC. Both arbitrations took place in Beijing between 1995 and 1999, and were conducted by two three-man tribunals that eventually, in 1999, awarded damages of \$300,000 against one defendant in Beijing and over \$1million against the other, in the northern city of Taiyuan.

In late 1999 the client sued in the appropriate Beijing and Taiyuan courts to enforce the awards. Both courts, however, actively supported strenuous efforts made by the local defendants to prevent execution of the arbitration awards issued against them. They allowed the defendants to use a variety of obstructive tactics, including assertion of blatantly specious, irrelevant and frivolous arguments, causing extensive delays. The courts took years to reject these arguments; at one point a Taiyuan judge even told my Chinese attorney colleague that the file in the case had been lost and that the judge in charge of the case had retired.

Progress occurred through my informal but persistent conversations with a senior judge at the SPC in Beijing over a period of two years. This led the SPC to pressure the Beijing court to compel the Beijing defendant to agree, almost four years after the arbitration award was issued, to pay the client the principal of the amount awarded plus a portion of the interest owed. The Taiyuan defendant, evidently, had been on the verge of insolvency for years, which is probably why the local court had stalled for so long and why no money had ever been paid. The most bizarre aspect of this case was CIETAC's publication of a false statement that the U.S. claimant had recovered \$2,000,000.<sup>63</sup>

The President of the SPC has repeatedly reaffirmed the need to raise the professional level of the courts, to reform their decision-making, to reduce local protectionism, to raise the standards of judicial ethics, and to stamp out corruption. In recent years the training of judges and their level of professionalism have slowly improved. The quality of judicial opinions has shown slight improvement, and transparency has grown as more opinions are being published both in newspapers and on the internet.

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<sup>62</sup> 肖扬 [Xiao Yang], 最高人民法院工作报告, 在第十届全国人民代表大会第二次会议上 [Supreme People's Court Work Report to the 2nd Session of the 10th National People's Congress], March 10, 2004, quoted in *Enforcement of Civil Judgments: Harder than Reaching the Sky*, CHINA L. & GOVERNANCE REV., June 2004, at 10.

<sup>63</sup> See Stanley Lubman, *Law of the Jungle*, CHINA ECON. REV., Sept. 2004, at 24.

Consideration is being given to creating circuit courts that would have jurisdiction across the boundaries between counties and provinces, thereby reducing localism. But progress has been slow, and no major reforms appear in sight on the horizon. In October 2005, The President of the SPC announced a five-year “reform program” for the courts that echoed an earlier 1999 program,<sup>64</sup> but there seems little prospect that the position of the courts vis-à-vis the CCP and the organs of the bureaucracy will soon be elevated; indeed, in the reform program the importance of Party leadership and supervision of the courts by local people’s congresses is underlined. There remains a tension between the conceptions of judges as loyal servants of the Party-state and as independent adjudicators, and the Party leadership has been reluctant to strengthen the autonomy of the courts.

Foreign businesses have rightly sought to avoid litigating disputes in Chinese courts. The most likely alternative within China is arbitration at CIETAC which, although it has enjoyed a good reputation in the past, has recently been cogently criticized.<sup>65</sup> Local arbitration commissions, established nationwide in recent years, provide another alternative, although little has been reported about the experience of foreign companies in those forums.

### C. *Lawyers*

China’s law schools, already politicized by the late 1950s, were closed at the beginning of the Cultural Revolution and were the last educational institutions to reopen, in 1979. Today, hundreds of schools grant bachelor’s degrees in law and almost a hundred award doctorates as well. Unfortunately, legal education emphasizes the study of abstract legal concepts imported from abroad and memorization of legal rules rather than critical thought about those concepts and rules.

In 2000 there were slightly over 100,000 lawyers, but of these only an estimated 25 percent held law degrees and no more than half had passed a bar examination. The number of qualified lawyers is slowly growing. Professional standards among many lawyers, however, remain low; it is common for lawyers to not only discuss pending cases with judges privately, but also to cultivate personal and frequently corrupt

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<sup>64</sup> 人民法院第二个五年改革纲要(2004-2008) [Second Five-Year Reform Program for the People’s Courts (2004-2008)] (issued by the Sup. People’s Ct., Oct. 26, 2005), *partial translation available at* <http://www.cecc.gov/pages/virtualAcad/index.phpd?showsingle=38564> (last visited Dec. 11, 2006).

<sup>65</sup> Jerome A. Cohen, *Time to Fix China’s Arbitration*, FAR EASTERN ECON. R., Jan.-Feb. 2005, *available at* <http://www.feer.com/articles1/2005/0501/free/p031.html> (last visited Dec. 11, 2006).



relationships with judges by giving them gifts and entertaining them. Some of the ambiguities in the position of Chinese lawyers are illustrated by the difficulties frequently encountered by lawyers who represent defendants in criminal cases or other sensitive matters, such as protests against illegal seizures of land or houses by local governments.<sup>66</sup>

## V. LEGAL UNCERTAINTY: SOME MAJOR CAUSES

In addition to the problems caused to foreigners and Chinese alike by tentative or incomplete laws, other and more basic problems create further difficulties. An increasing number of laws and regulations have added definition to the business and investment environment and provide considerable general guidance on many important questions to foreign and Chinese parties negotiating trade and foreign investment transactions. In practice, however, some of the guidance that has been offered by legislation has frequently been clouded by extraordinary disorder among law-making and rule-making institutions, unclear or vague drafting, lack of transparency, and by the ways in which bureaucrats exercise discretion in making decisions.

### A. *Disorderly Allocation of Jurisdiction and Power Among Law-Making Agencies*

Problems encountered by Chinese and foreigners alike stem from confusion among the basic organs of the Chinese state over the sources of law and the allocation of powers to make and interpret laws and regulations. Although the growing complexity of the economy increasingly creates problems that must be dealt with by legislation or administrative regulations, the previously identified multiple sources of legislative and administrative norms have not been arranged in an orderly system. As noted, under the Constitution adopted in 1982 the NPC, its Standing Committee and the State Council may each enact different types of laws or regulations. This scheme, however, is wide-ranging in scope, since the categories of rules are nowhere defined. In practice, the respective jurisdictions and relationships of the three bodies are worked out through informal negotiations on each new law that is adopted.

Also, once legislation is enacted by the NPC, the State Council exercises its power to draft implementing legislation that may distort or pervert the very legislation on which it is purportedly based. In practice, the boundary between the “administrative” legislation that is supposed to

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<sup>66</sup> See, e.g., CONG.-EXECUTIVE COMMISSION ON CHINA, ANNUAL REPORT 55-58 (2006).

originate in the State Council and the “legislative” activity that is reserved to the NPC is obscure.

Moreover, when the departments supervised by the State Council implement laws and regulations, they sometimes issue rules that depart from or ignore the intent of the drafters. Their authority may derive either from specific grants of such power by a legislative body such as the Standing Committee of the NPC or from a technically distinct general rule-making power that is deemed to be inherent in the individual departments and agencies. “Departmental rules” have general binding authority and are superior to all local enactments.

The breadth and the fragmentation of the rule-making power of the bureaucracy are major structural problems in the organization of the Chinese state, with serious implications not only for foreign businesses that wish to ascertain the law on a particular subject but also for the very future of Chinese legal development.

#### *B. Inconsistencies between National and Local Legislation*

Provincial and lower-level governments also issue a variety of regulations and rules, and because considerable power has been delegated to them, their capacity to frustrate national policies and laws has been greatly expanded. For example, provincially approved tax incentives for foreign investors have sometimes varied so widely from national legislation that the central government has had to repeatedly issue declarations forbidding lower-level governments from offering incentives more generous than those authorized under national law. Such contradictions have become more marked over time as competition has increased among local governments to attract foreign investment and to generate employment for workers laid off by failing SOEs. Thus the prospects for greater uniformity in practice are not encouraging. The central government has encountered great difficulty in curbing local disregard of restrictive approval requirements, as will be shown in greater detail in Part Two of this article.

To some extent, the contradictions described here may arise not because Beijing is unaware of their existence, but because it is willing to tolerate them in the interest of local experimentation, allowing these variances as trial cases. Even if this is so, extensive local departures from central policies increase uncertainty for both foreigners and Chinese because they often lead to the application of greatly divergent patterns rather than of universal rules. One scholar’s recent observation is that a “fundamental characteristic “of China’s current legal system is “its radical polycentricity,” by which is meant that:

as a practical matter, there is no single source of ultimate authority in the system. Indeed, to make this claim might be the equivalent of saying that there is no single Chinese legal “system,” that there are instead many Chinese legal systems, each with its own jurisdiction, hierarchy of authority and way of operating.<sup>67</sup>

Despite the proliferation of inconsistent rules and regulations, the central government has moved, albeit slowly, to create mechanisms that promote consistency between central and local legislation. The PRC Legislation Law,<sup>68</sup> enacted by the NPC in March 2000, reaffirmed the supremacy of legislative bodies in interpreting the laws and regulations that they have promulgated. The Standing Committee of the NPC has taken steps to strengthen central-level examination of lower-level legislation and rules for consistency with national laws and policies by creating a new division of the Legal Affairs Commission of the Standing Committee that will, according to an article by Xiao Yang, President of the Supreme People’s Court, “examine the constitutionality” of statutes, administrative regulations and other rules “[a]t its own discretion or at the request of citizens.”<sup>69</sup>

The State Council has also responded to the need for greater coherence in law-making by expanding the activities of its Legislative Affairs Office (LAO). The LAO is responsible for overseeing the drafting of the State Council’s administrative regulations (行政法规) and reviewing the administrative rules (行政规章) of its ministries and commissions, local laws and judicial interpretations, on its own initiative or in response to requests from citizens.<sup>70</sup> Soon after China’s accession to the WTO, all local governments were required to file their legislation with the State Council for review by the LAO. Although citizens could request such review, one observer noted in March 2004 that “citizens have not adequately taken advantage of the review process, even though official sources acknowledge that some filed local rules are inconsistent

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<sup>67</sup> Donald C. Clarke, *How Do We Know When an Enterprise Exists?: Unanswerable Questions and Legal Polycentricity in China*, 19 COLUM. J. ASIAN L. 50, 64 (2005).

<sup>68</sup> Legislation Law, *supra* note 56.

<sup>69</sup> Editorial, *Legislation Review Panel to Smooth Legal Bumps*, CHINA DAILY, June 21, 2004, available at [http://www.chinadaily.com.cn/chinagate/doc/2004-06/21/content\\_341141.htm](http://www.chinadaily.com.cn/chinagate/doc/2004-06/21/content_341141.htm) (last visited Dec. 11, 2006).

<sup>70</sup> Meng Yan, *New Agency to See to Constitution Application*, CHINA DAILY, June 21, 2004, available at [http://www.chinadaily.com.cn/english/doc/2004-06/21/content\\_341048.htm](http://www.chinadaily.com.cn/english/doc/2004-06/21/content_341048.htm) (last visited Dec. 11, 2006).

with national laws.”<sup>71</sup> Even more suggestive of the persistence of the threat of legal incoherence, another observer noted that many local laws are not deposited with higher-level bodies as required by law, and furthermore in practice “the mechanism of change or annulment of local law is not yet functioning,” and even when higher-level organs regard norms deposited with them as improper they usually request changes rather than exercising their power to nullify.<sup>72</sup>

### C. *Loose Drafting*

Loose drafting has long marked Chinese legislation and contributed to its lack of precision. National legislation is intentionally drafted in broad terms that permit bureaucrats to exercise considerable ingenuity in promoting local interests, which not only hampers the development of nationwide uniformity but also allows interpretations that stray widely from the legislative intent. Often, too, the language of laws is so general that, even with good faith attempts at interpretation, the legislature’s intent is simply unclear.

New legislation continues to exhibit characteristics that marked earlier norms. For example, after years of discussion, a law on government procurement was adopted by the NPC and went into effect in January 2003.<sup>73</sup> Such a law had long been needed to address problems of corruption, local protectionism and lack of transparency, among others. The involvement of a respected foreign development agency, the German GTZ Advisory Service to Legal Reform in China was undoubtedly helpful, but as two of its members wrote, the new legislation presents characteristic problems. The authors state that although drafts of the law

were relatively clear in wording and addressed many critical issues that allowed them to generally provide for feasible solutions, the law finally promulgated lacks many of these qualities. This is mainly so because the intention of the drafters was to leave points crucial to the application and effectiveness of the legislation for clarification by implementing provisions and

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<sup>71</sup> Veron Hung, *Opinion, China’s Constitutional Amendment is Flawed*, INT’L HERALD TRIB., Mar. 5, 2004, at 8.

<sup>72</sup> Zou Keyuan, *Harmonizing Local Laws with the Central Legislation*, CHINA PERSPECTIVES, Mar.-Apr. 2004, at 44.

<sup>73</sup> 中华人民共和国政府采购法 [Government Procurement Law of the PRC] (promulgated by the Nat’l People’s Cong., Jun. 29, 2002, effective Jan. 1, 2003), *translated in* CHINALAWINFO (LEXIS) PRCLEG. 2386.

interpretations that can be changed much more easily than the law itself.<sup>74</sup>

Lack of clarity in legislation on intellectual property protection has been another area of great concern to many foreign companies. The Supreme People's Court issued a document on the "interpretation" of a number of critical issues in criminal cases involving violations of intellectual property.<sup>75</sup> A representative of the International Anti-Counterfeiting Coalition testifying before the U.S.-China Security Review Commission identified serious defects in the document issued by the court: although the new interpretations were intended to clarify earlier prosecution guidelines that had been "hopelessly ambiguous, illogical and provided little practical guidance," he noted that the new interpretation would "still leave many questions unanswered and contains vague, ambiguous and undefined terms."<sup>76</sup> An example given was the problem of calculating the value of counterfeit goods sold, which appears to consist of determining the actual sales price used by the counterfeiter, requiring the court to use a deflated figure that would not meet a minimum threshold of \$6,000. For unsold goods, the interpretation provides that the value shall be calculated by the "indicated price,"<sup>77</sup> but that term is nowhere defined, creating incentives for the infringers to tag their counterfeit goods with absurdly low prices.

It is entirely appropriate for legislators addressing a complex set of major issues arising out of entirely new situations across a vast country to begin with broadly worded general provisions and then to supplement their applications with narrower provisions. In China, the continuing insistence on what some Western students have called the instrumental

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<sup>74</sup> Immanuel Gebhardt & Matthias Mueller, *China's New Government Procurement Law: A Major Step Towards Establishing a Comprehensive System?*, CHINA L. & PRACTICE, July-Aug. 2002, at 20, 23-24.

<sup>75</sup> 关于办侵犯知识产权刑事案件具体应用法律若干问题的解释 [Several Issues Concerning the Specific Application of the Law when Handling Criminal Cases Involving the Infringement of Intellectual Property Rights Interpretation] (promulgated by the Sup. People's Ct. & the Sup. People's Proc., Dec. 8, 2004, effective Dec. 22, 2004), *translated in* CHINA L. & PRACTICE, Feb. 2005, at 30. It should be noted that the Supreme People's Court has assumed an active role in issuing authoritative interpretations of legislation, and has become "the most important and active interpretation authority in China." CHEN JIANFU, CHINESE LAW: TOWARDS AN UNDERSTANDING OF CHINESE LAW, ITS NATURE AND DEVELOPMENT 108 (1999).

<sup>76</sup> Timothy P. Trainer, President, Int'l AntiCounterfeiting Coalition, Inc., Testimony on China's Compliance with WTO Obligations before the U.S.-China Commission, at 4 (Feb. 4, 2005), *transcript available at* [http://www.uscc.gov/hearings/2005hearings/written\\_testimonies/05\\_02\\_3\\_4wrts/trainer\\_timothy\\_wrts.pdf](http://www.uscc.gov/hearings/2005hearings/written_testimonies/05_02_3_4wrts/trainer_timothy_wrts.pdf) (last visited Dec. 11, 2006).

<sup>77</sup> *Id.*, at 6.

use of law as a tool to serve short-term policy may also underlie loose drafting. Considerable Chinese legislation is often still interpreted and applied as policies were before reform. Many officials, even in the highest echelons of government, have grown accustomed to treating legal rules with the flexibility that they have long applied to more general declarations of policy. For example, bureaucrats have difficulty distinguishing law from policy because before reform they were never required to do so, and therefore continue to apply the laws in spirit rather than in a more literal manner.<sup>78</sup>

#### D. *Weak Implementation*

After rules are promulgated, little attention may be paid to enforcing them or ensuring uniformity in implementation. At the same time, whatever problem was addressed by a law or regulation may be regarded by the officials in charge of implementing it as having been solved simply because a rule has been formally established. A prominent example is intellectual property law, an area in which one observer among many has noted that “the effectiveness of intellectual property protection is asserted on the basis of the enactment of legislation rather than being based on empirical reality” which has often provoked criticism from the United States.<sup>79</sup>

#### E. *Lack of Transparency*

The Chinese bureaucracy has frequently and aptly been dubbed “impenetrable.” In the early years of FDI, Chinese negotiators and officials did not understand, or affected an inability to understand, the need for governmental transparency. The most starkly illustrative manifestation of this facet of Chinese legal culture was the use, throughout the 1980s, of many regulations and rules that were for internal (内部 *neibu*) use only.

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<sup>78</sup> PETER HOWARD CORNE, FOREIGN INVESTMENT IN CHINA: THE ADMINISTRATIVE LEGAL SYSTEM 90 (1996). See also Donald Clarke, Peter Murrell & Susan Whiting, *Law, Institutions, and Property Rights in China*, in CHINA’S ECONOMY: RETROSPECT AND PROSPECT 42, 43-44 (Loren Brandt, Thomas G. Rawski & Gang Lin eds., 2005) (“Chinese legislation is often remarkable for its lack of institutional anchoring. Like the policy documents it has come largely to replace, it is often evidently intended more for edification than for litigation, and continues, a quarter of a century into the reform era, to contain broad statements of policy and legally unenforceable norms”).

<sup>79</sup> PITMAN B. POTTER, THE CHINESE LEGAL SYSTEM: GLOBALIZATION AND LOCAL LEGAL CULTURE 81 (2001).

The applicability of hidden laws was sometimes explicitly asserted in negotiations. For example, during the 1982 negotiations of an offshore oil exploration between foreign petroleum companies and the China National Offshore Oil Corporation (CNOOC), the draft contract presented to the foreign companies stated that the foreigners would have to obey all “Chinese laws.” In one negotiation in which I participated, it was only after some persistence that the Chinese agreed to alter the language to insert “promulgated” to describe the laws that would bind the oil companies.

Many Chinese encountered by foreign counterparts in negotiations during the 1980s simply assumed that *neibu* laws were a feature of the Chinese system that had to be accepted by foreigners. In one negotiation for an industrial venture in a large Chinese city in which I assisted a client, a Chinese negotiator went so far as to base his position on one issue solely on the *false* assertion that a *neibu* regulation governed the problem and therefore, that the foreigner had no choice but to accept the Chinese position. The issue in question was the level of benefits that the proposed joint venture would have to pay to workers in the joint venture factory. The Chinese negotiator stated that the level of social insurance to be paid was a percentage of the total wages that exceeded the applicable level stated in a published regulation that had been issued in the city in which we were negotiating.

Where had the difference come from?, I asked. His response was memorable: “It is true that [local] regulations require a payment of 30% for social insurance, but an ‘internal regulation’ that is ‘secret’ states that this figure should be 48%. I am not even supposed to tell you about [the *neibu* rule]. You should trust me.”

Thereafter, I contacted an official of the local Investment Commission, who told me quite bluntly that the “secret” regulation of which I had been told did not exist, and that the assertion of its supposed existence was simply a bargaining tactic. What is interesting is that the Chinese negotiator assumed that the use of internal rules was something that foreigners should accept without question. In more recent years this attitude has changed, and as the discussion that follows immediately below indicates, China’s entry into the WTO marked the formal recognition of the need to reform bureaucratic practice.

#### *F. Transparency Since China’s Accession to the WTO*

China’s accession to the WTO stimulated increased transparency in Chinese governance. Although foreigners had high expectations that major legal reforms would follow the accession, it is necessary to recall

that “the WTO does not mandate a perfect legal system, or even a basically fair one, outside of a few specific areas.”<sup>80</sup> Those few areas merit mention here.

China has promised to administer in “a uniform, impartial and reasonable manner all its laws . . . pertaining to or affecting trade[.]”<sup>81</sup> Uniformity, however, is difficult to achieve in practice. For example, a trade publication reported on the efforts of a Chinese law firm to obtain an opinion on a land-use issue that could be applied consistently across the country. The firm contacted land-use authorities in Beijing, Shanghai and Tianjin. A lawyer reported the following:

The answers were totally different. And their interpretations were not even consistent with what the law says. We have to try and understand their positions and points because the black and white letter of the law doesn’t stand for much sometimes, and there is no case precedent or court cases that are binding. How do you advise your client in such a case? This is the real challenge.<sup>82</sup>

In its WTO accession agreement, China agreed to enforce only those trade-related laws that had been published and were “readily available to other WTO members, individuals and enterprises.”<sup>83</sup> China also agreed to publish an official journal of such laws, to provide “a reasonable period for comment” before they were implemented, and to establish “an enquiry point” at which individuals, enterprises or other WTO members could obtain information about any measure that was required to be published.<sup>84</sup> This commitment to transparency in Chinese legislative and rule-making processes in trade-related matters resonates

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<sup>80</sup> Donald C. Clarke, *China's Legal System and the WTO: Prospects for Compliance*, 2 WASH. UNIV. GLOBAL STUDIES LAW REV. 97, 111 (2003).

<sup>81</sup> Protocol on the Accession of the People's Republic of China, art. 2 (A) 2, WT/L/432, in COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION 3 (2001) [hereinafter Protocol].

<sup>82</sup> Arjun Subrahmanyam, *Growth and Change: The Diverse Challenges Facing Chinese Law Firms*, CHINA L. & PRACTICE, June 2004, at 17, 19.

<sup>83</sup> Protocol, *supra* note 81, art. 2(C)(1), at 4.

<sup>84</sup> Protocol, *supra* note 81, art. 2(C)(2), at 4. Measures were not taken to establish or create a single official journal until March, 2006, when the State Council directed all central, provincial and local government entities to begin sending copies of all of their trade-related measures to MOFCOM for immediate publication in the MOFCOM Gazette. The USTR reported at the end of 2006 that “adherence to the State Council’s notice is far from complete.” UNITED STATES TRADE REPRESENTATIVE, REPORT TO CONGRESS ON CHINA’S WTO COMPLIANCE 96 (2006).



with other recent measures to widen consultation with the public in rule-making generally. Progress, however, remains slow.<sup>85</sup>

## VI. LEGAL UNCERTAINTY: DISCRETION AND ITS DISCONTENTS

Agencies of the Chinese government are endowed with great discretion in interpreting laws, which raises complex and disorderly obstacles to legality not only for foreigners but for Chinese as well. Long before the CCP's victory in 1949, officials regarded laws as instructions to themselves, not to the populace at large or to persons specifically affected by the laws and regulations. Chinese Communism's commitment to promoting social upheaval in aid of revolution added further rationale for disregarding even the use of legal rules, and created a system in which administrative discretion flourished unchecked by law. But China's current leaders are concerned with maintaining social stability in the midst of the changes generated by recent policies, and therefore perceive legal rules as necessary. The 1990s saw China's first attempts to create legal institutions that could limit the powers of administrative agencies, and although further developments of administrative law remain on the Chinese legislative agenda, progress toward greater legality can only slowly overcome the legacy of history.

The arbitrariness of China's bureaucracy is legendary among all who have encountered it, foreign and Chinese alike. Some concerns of the Chinese populace serve as background to the considerations and difficulties met by foreign investors. Migrant workers, over 120 million of them, must bribe police or use subterfuge to obtain residence or business permits; local officials frequently order peasants to pay taxes exceeding amounts stipulated by law and to surrender cultivable land for inadequate compensation; and the houses of urban residents are often demolished with little notice, opportunity to protest, or compensation.

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<sup>85</sup> These transparency obligations are in Protocol, *supra* note 81, art. 2 (C), at 3-4. The US-China Business Council in 2003 commented that "China's uneven implementation of its commitments regarding transparency remains a particular disappointment for foreign firms." U.S.-China Bus. Council, China's WTO Implementation: A Mid-Year Assessment I (June 17, 2003). The USTR has since commented that "basic compliance with China's notice-and-comment commitment continued to be uneven, both in 2004 and 2005." U.S. TRADE REPRESENTATIVE, *supra* note 38, at 89. Foreign businesses still complain about the opaqueness of Chinese administrative decision-making and the persisting use of *neibu* documents that has been so symptomatic of Chinese governance. More recently, the "much better record" of China's ministries and agencies in making new or revised regulations available to the public has been noted by the USTR in its 2006 report on China's compliance with its WTO obligations, as well as "uneven" performance of its notice-and-comment obligations. UNITED STATES TRADE REPRESENTATIVE, REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE 96-97 (2006).

The discussion that follows summarizes some of the principal characteristics of the bureaucracy as it has affected FDI and as it is likely to be encountered by foreign businesses in any complex transaction.

*A. Aspects of Chinese Bureaucracy that Promote Legal Uncertainty*

So much has been written in the West about the Chinese bureaucracy that only some of the most obvious causes of problems for foreign investors are surveyed below.

1. Personalized Rule at the Top

A principal characteristic of the Chinese bureaucracy is that leadership is highly personalized, both at the top of the hierarchy and throughout its lower levels, which leads to a cautious mentality among bureaucrats. For foreigners negotiating projects, it has sometimes been glibly suggested that they get to know the leader who is responsible for the decision. Unfortunately, foreigners may encounter great difficulty in learning very much about the lines of authority in the bureaucracies that have jurisdiction over a project on which they are negotiating, much less about the specific officials who may be involved in decisions to approve the project in question.

Foreign investors may believe, often out of despair, that there is *someone* at the top to whom complaints should be addressed. Sometimes that is true. In one joint venture in the 1980s, an FIE required a certain amount of steel each year, which at the time was still allocated under the state plan. When the foreign engineers arrived to help start up the plant, they were told that the steel was not available. Shortly after this problem arose, I met with representatives of the Chinese partner. Extensive conversations only produced expressions of helplessness and regret by the Chinese. We suggested that the foreign partner had been misled, especially by a vice-mayor who had promised full support to the joint venture when the contract was signed. Finally, the same vice-mayor appeared, and announced that he had obtained assurances that the steel for the current year would be made available (although he was unable to venture any prediction for future years.)

In many cases it is not always clear that appeals to high-ranking officials may help relieve problems that lower-level bureaucrats were unable or unwilling to resolve. Sometimes a central leader's general approval of a transaction or project is taken by the foreigners to suggest that all questions that might arise in the future have been covered by the

leader's blessing, only to find that lower-level officials have considerable discretion and latitude that may well be unaffected by a high leader's superficial approval. Such was the case in the mid-1990s with regard to an industrial zone that Singaporean companies sought to establish in Suzhou. The highest Chinese leadership had agreed with Singapore's Prime Minister Lee Kuan Yew that such a project was desirable – but the city of Suzhou, which had not been approached by the Singaporean government, decided to open its own industrial zone. After some years of competition between the two parties, the Singaporean government eventually retreated from its investment.<sup>86</sup>

Frequently, foreigners begin negotiations with a hunt for a top-ranking official who they think possesses enough power to bring the transaction to fruition. Investment projects that begin in this manner, unfortunately, run a substantial risk of failing unless the proper groundwork has been set with lower-level local officials and others who are the ultimate counterparts of the foreign businessman.

## 2. Fragmented and Hierarchical Bureaucracy, Interagency Bargaining

Academic research, as well the experience of foreigners who have negotiated in China, suggest that administrative units are organized into tight hierarchies with strict lines of vertical communication. Such units are principally attentive only to others in their own bureaucratic "system." Informal personal connections or some other incentive must exist to provide a motive for crossing bureaucratic lines. The foreigner must try to understand the relationship of the organization with which he is dealing, such as a factory in a proposed joint venture or technology transfer, with other organizations in the same bureaucratic hierarchy.

As a result of the hierarchical and compartmentalized organization of the bureaucracy, many interagency relationships are negotiated and bargained for informally and remain invisible to official oversight. A foreign business that appears on the scene of this complex bureaucracy may not be able to determine with whom the Chinese counterpart has to build consensus in order to achieve the desired business aim.

Not only will the lines of authority be difficult to ascertain, but even when decisions are reached they may reflect bargaining among various Chinese agencies and therefore be expressed and formulated in a manner that the foreigner may find unsatisfactorily vague. This

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<sup>86</sup> *Singapore's Suzhou Indus. Park: Lessons Learned*, CHINA ONLINE, Oct. 7, 1999.

bureaucratic phenomenon contributes to the frequency with which Chinese often desire ambiguous contracts that allow room for the parties to be flexible and adaptable.

The tight verticality of agencies leads to a fragmented structure of authority, in which policy is made by a variety of agencies that are only loosely coordinated. The “system” is also cellular, with different organizations at the same level often withholding information from others while pursuing their own agendas in isolation. This insularity is a major cause of the time-consuming need to establish consensus on particular issues that is a frequent source of frustration among foreigners. Additional complications are created by disunity among Chinese counterparts. For example, Chinese managers in an industrial factory and their superior in an administrative bureau might not wish to discuss with taxation authorities whether or not the joint venture would be eligible to reap the benefits of certain tax incentives. They may also be likely to show a similar disinclination to carrying out effective liaisons with other bureaus and entities that are of significant importance to the proposed joint venture on such matters as utilities and customs duties. Not only might Chinese and foreigners have different ideas on how to operate a business enterprise, but different generations of managers on the Chinese side may also have very different ideas on the same subjects. The patterns of conduct that have been described in this article were powerful and recurrent in the early years after FDI was first welcomed, but in more recent years it has become increasingly possible to achieve administrative coordination among agencies at the same level, especially in cities and provinces along the China coast that have accumulated the most experience.

#### *B. Some Problems Won't Disappear*

Now that FDI has been in China for over twenty-five years, practice and experience on many issues involving joint ventures has grown, and the approval process has become more stable. Nevertheless some matters, particularly the liquidation and dissolution of a joint venture, continue to pose problems for local officials. The applicable laws require joint venture parties to agree to liquidation,<sup>87</sup> and even if the

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<sup>87</sup> 中华人民共和国中外合作经营企业法实施细则 [PRC Sino-Foreign Cooperative Joint Venture Law Implementing Rules] (approved by the State Council, Aug. 7, 1995, promulgated by MOFTEC, Sept. 4, 1995); 中华人民共和国中外合资经营企业法实施条例 [PRC Sino-Foreign Joint Venture Implementing Regulations] (promulgated by the State Council on Sept. 20, 1983 and amended by the State Council on Jan. 15, 1986, Dec. 21, 1987 and July 22, 2001). *See, generally,*

Chinese partner is willing, local officials may resist liquidation out of concern for local unemployment. Also, local investment officials may fear that dissolution of a failed FIE could damage the area's reputation for being hospitable to FDI. The applicable laws require that the local investment authorities (as well as the Chinese partner, its "department in charge" and every agency with which the joint venture is registered) must approve the liquidation, and obtaining the necessary approval has sometimes posed an insuperable obstacle to a foreign party's desire to terminate a venture. In one case a foreign investor's Chinese partner failed to pay in its share of capital, had attempted to reproduce without permission transferred technology in a nearby factory that it operated, had knowingly entered into contracts disadvantageous to the U.S. partner, had held board meetings and made decisions about which the U.S. partner was not informed, and had taken in a partner without notification. The Chinese partner refused to agree to dissolve the venture; while the local investment authorities agreed that the Chinese partner had behaved improperly, they were unwilling to approve liquidation. Arbitration in a third country according to the applicable dispute settlement clause would have been expensive, and the Chinese party was so hostile that it surely would not have paid an award. The foreigner abandoned the project.

In some cases foreign investors' problems can be traced back to their own errors. The American partner in the failed joint venture described above did not conduct any due diligence on the prospective Chinese partner, relied on an Overseas Chinese who wanted to bring benefit to his native city, signed a Chinese form contract without obtaining legal advice, and failed to put any of his own personnel at the site of the venture. This account ought to indicate the obvious need for the prospective foreign investor to undertake essential preparatory research before venturing, literally and otherwise, into China.

## VII. ASSESSMENT

The problems that have been described above have generated practices that underscore the weaknesses of China's legal institutions. Part Two of this article surveys some of those practices, but before proceeding it is useful to emphasize the magnitude of the problem of constructing effective legal institutions.

The piecemeal, flexible and incremental approach to creating laws for FDI reflects China's overall approach to law reform.<sup>88</sup> Much reform has been carried out because the relevant laws do not exist or have become outdated because of the pace of economic reform. In the process, devices have been used to condone illegal practices, such as regulations that depart from national law or apply inconsistent local regulations; highly flexible interpretation or adaptation of laws; and use of internal documents, generated by the CCP or government departments, to grant administrative guidance to deal with new developments. The bureaucratic discretion that has been described above is so broad that officials can quickly formulate or adapt rules to deal with new developments and to encourage experimental reforms. Bureaucratic flexibility is not necessarily inconsistent with the rule of law, since it can enhance institutional adaptability to rapidly changing conditions.<sup>89</sup> However, officials also produce *ad hoc* decisions that are too easily detached from principle or accountability, or may well be tainted by the interests of the rule maker. Quite apart from the lack of institutional controls over the decision-makers, they do not share well-developed traditions and doctrines that can facilitate the development of consistent or predictable patterns of legal interpretation. The conclusion of one long-time academic observer of Chinese law, Perry Keller, should come as no surprise: "Law in China . . . does not function as a fundamental source of certainty and predictability in social, commercial or administrative relationships."<sup>90</sup>

It remains to be seen to what extent modification of existing institutions and procedures will be deemed necessary by the Chinese leadership and their legal advisors, but certainly strong political will and a long process of development will be necessary to develop administrative procedures and administrative law. The Chinese bureaucracy does not yet seem ready to change its ways, and transparency has increased only

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<sup>88</sup> Perry Keller characterizes the growth of China's legislative institutions as a "sprawling and haphazard consequence of an aggressively pragmatic effort to establish a workable system of law where little existed before." Perry Keller, *The National People's Congress and the Making of National Law*, in *LAW-MAKING IN THE PEOPLE'S REPUBLIC OF CHINA* 77 (Jan Michiel Otto, ed., 2000). Keller further concludes that the program of modernization has been carried out with little fundamental improvement in the effectiveness of laws enacted by the NPC or clarification of its role, and that the structure of the Chinese Party-state, marked by the entwinement of state and Party organization, weakens the legislative authority of the NPC and, of course, local People's Congresses.

<sup>89</sup> This view is emphasized in Linda Chelan Li, *The "Rule of Law" Policy in Guangdong: Continuity or Departure? Meaning, Significance and Processes*, 161 *CHINA Q.* 199, 218-219 (2000).

<sup>90</sup> Keller, *supra* note 88, at 78.

slowly in recent years.<sup>91</sup> At the same time, impatient foreign investors and other Western critics of China's administrative arbitrariness should recall that the currently imperfect Western legal systems required centuries to develop.

Manifold uncertainty has presented enormous challenges to foreign investors and to Chinese officials. It is useful to examine how they have coped well enough to have created businesses that have made China a powerful generator of exports and a growing supplier of goods for the domestic market. The discussion that follows focuses on examples of the strategies they have devised.

## PART TWO: PRACTICE IN THE FACE OF LEGAL AND POLITICAL UNCERTAINTY

### I. INTRODUCTION

This Part first explores how foreign businesses and Chinese officials have been affected by, and have responded to, the legal uncertainty created by the problems in the efficacy of Chinese law and administration discussed in Part One. I next speculate on prospects for change in the legal regime affecting FDI in the context of two factors: the outlook for deeper legal reform generally, and the extraordinary social flux that China is experiencing as a consequence of its dramatic economic reforms. I conclude by considering signs of change in China's legal culture.

Uncertainty has varied with time and with the specific interests of investors but, faced with legal ambiguity, many if not most foreigners have employed a variety of strategies to navigate these murky waters, often with the active cooperation of Chinese officials. Some of these strategies are discussed here; wherever possible, changes and continuities from 1979 until the present have been noted in an attempt to tease out conclusions that go beyond common generalizations about defects in Chinese legal institutions. Discussion begins with the most striking tactic,

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<sup>91</sup> A newspaper report in April 1997 on a survey by the European Commission of 200 European companies active in China stated that "incomprehensible or unpredictable rules and legislation remain the principal obstacle to investment in China," and 65 percent of the companies complained that "a lack of transparency in rules and laws was seriously hindering their investments in China." *European Companies Complain of 'Incomprehensible Regulations,'* S. CHINA MORNING POST, April 25, 1997. Progress in increasing transparency by bringing laws and regulations into compliance with WTO requirements is noted in CONG.-EXECUTIVE COMMISSION ON CHINA, ANNUAL REPORT 144-45 (2006).

evasion of or outright violation of the requirements of applicable Chinese laws.

## II. EVADING THE LAW WITH THE APPROVAL OF SENIOR CHINESE OFFICIALS

### A. *Rupert Murdoch*

In some cases, even where the law has not been ambiguous but clearly forbade particular types of investment, foreigners have nevertheless been able to proceed after getting the go-ahead by high-ranking officials. Although not every prospective foreign investor gains access to the highest levels of the Chinese leadership, well-documented efforts to curry favor with high-level political leaders are instructive about the lengths to which foreigners sometimes go in order to achieve commercial success. Such efforts also suggest the low integrity that foreigners may find in Chinese officials, and the low opinion, in turn, that some Chinese may have of favor-seeking foreigners.

One journalist wrote that “In Hong Kong the polite word for bumsucking is shoe-polishing. Few foreigners have polished more Chinese shoes more energetically than Rupert Murdoch.”<sup>92</sup> Murdoch is perhaps the most visible foreigner to engage in public shoe-polishing in China. In the early 1990s, he was broadcasting the BBC into China from the Hong Kong satellite owned by his News Corporation, and in 1993 he stated publicly that satellite TV represents “an unambiguous threat to totalitarian regimes.”<sup>93</sup> After he decided that he wished to do business in China, he ended the BBC broadcasts and set about demonstrating his dependability by spending, as reported in the *Financial Times*, eight years “repairing a reputation” that he had damaged.<sup>94</sup> He made a series of statements intended to find favor in Beijing, such as denouncing the Dalai Lama by favorably quoting “cynics who say that he’s a very old political monk shuffling around in Gucci shoes,” and suggesting that China has done much for Tibet since it occupied that region.<sup>95</sup> A publishing company that Murdoch controlled broke its contract with former Hong Kong Governor Chris Patten to publish the latter’s book on Sino-Western disputes with China and his views of Sino-Western relations. At the time,

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<sup>92</sup> Jonathan Mirsky, *In Bed with the Reds*, THE SPECTATOR, Nov. 10, 2001, at 41.

<sup>93</sup> James Kyngé & Robert Thomson, *Murdoch Set to Break into China TV*, FIN. TIMES, Sept. 5, 2001, at 1.

<sup>94</sup> *Id.*

<sup>95</sup> William Shawcross, *Murdoch’s New Life*, VANITY FAIR, Oct. 1999, at 268, 321.



Murdoch stated, "I told them not to publish Patten's book . . . . We are trying to get set up in China. Why should we upset them? Let somebody else upset them."<sup>96</sup>

Murdoch was rewarded for his ingratiating gestures. He was allowed to invest in China Netcom Corporation, the board of which includes former Chinese President Jiang Zemin's son. Although foreigners were not then permitted to participate directly in Chinese telecom enterprises, the rule was waived when Murdoch was allowed to invest in Netcom's Hong Kong subsidiary.<sup>97</sup> Murdoch's News Corporation was also given permission to broadcast TV programs into Guangdong province in 2001. It is no wonder that the *Financial Times* observed that "the kowtow still works."<sup>98</sup> Rupert Murdoch's high-profile kowtow was particularly noteworthy because his reward was an equally high-profile Chinese disregard for the illegality of his investment in China Netcom. The extent to which he was willing to go is also remarkable because it epitomizes and caricatures the search by Western businessmen for close relations, or *guanxi*, with Chinese officialdom.<sup>99</sup>

#### B. CCF

Other foreigners, less visible than Murdoch, have also sought promises from high-ranking officials of favorable treatment for a proposed investment, even when the project would violate relevant Chinese law. A notable example from the early 1990s was a scheme to evade a prohibition on foreign investment in the telecommunications industry that was created as a result of competition between Unicom, the first Chinese telecommunications company, and China Telecom, which was spun off from the Ministry of Information Industry to attract foreign

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<sup>96</sup> Mirsky, *supra* note 92.

<sup>97</sup> "Chinese law does not permit direct equity participation by foreigners in domestic telecoms companies. Details of how this regulation has been circumvented were unclear." James Kynge, *News Corp Wins Foothold in China Telecoms*, FIN. TIMES, Feb. 20, 2001, at 21.

<sup>98</sup> Editorial, *Tune into China*, FIN. TIMES, Sep. 5, 2001, at 16.

<sup>99</sup> *Guanxi* [关系] is discussed in greater detail below. More recently, Murdoch's ambition to beam Fox TV into China ran afoul of Chinese efforts to control foreign media incursions into China. He made a deal with a television broadcaster in Qinghai under which the Qinghai company retained legal responsibility for broadcasts while an intermediary in which Star TV invested would control content. Even Murdoch could not overcome what the *Financial Times* characterized as Beijing's worry "about the implications of giving News Corp commercial say over even a minor broadcaster in a poor province." Mure Dickie, *Star TV Falls Back Down to Earth in China*, FIN. TIMES, Aug. 31, 2005, at 22. Murdoch's disappointment is surely not the final chapter in the story of his assault on China, colored as it has been by his shameless cultivation of Chinese leaders and their prejudices. At the moment of writing, however, his disappointments in 2005 demonstrate that the kowtow does not necessarily generate a blanket license to ignore Chinese leadership sensitivities.

investment. Unicom devised an arrangement in which the foreign company invested, not directly in Unicom, but instead in joint ventures between Unicom and the foreign companies that provided services to Unicom. These joint ventures were Chinese legal persons, but the foreign investor had no direct stake in the actual Chinese provider of the services. In these “Chinese-Chinese-Foreign” (CCF) enterprises, the foreign investors were paid a variety of fees for management contracts, equipment leasing, consulting and license royalties in lieu of a share of profits.

High-ranking officials led a number of foreign companies to believe that this device could serve as a substitute for equity ownership. According to one newspaper report, “Although the CCF deals were executed within a recognized legal vacuum, they have nevertheless won open endorsement from several top officials.”<sup>100</sup> Another report stated that the CCF deals “have been given the repeated blessings of top Chinese officials, including the former premier, Li Peng, and Wu Jichuan, minister of information industry.”<sup>101</sup>

CCF enterprises came under criticism, however, and were declared illegal late in October 1998.<sup>102</sup> In late 1999, foreigners who had used this device in forty five projects were warned that they had to divest themselves of their interests in these joint ventures.<sup>103</sup> The Ministry ordered “revision” of the contracts, which led to the foreign investors having to accept much smaller shares and returns. Unicom returned \$1.2 billion in investments, paid \$487 million in compensation to some investors, and granted warrants to buy shares in its 2000 IPO.<sup>104</sup>

### III. EXCESSIVE RELIANCE ON OVERSEAS CHINESE CONNECTIONS AND INTERMEDIARIES

The previous examples of high-level countenancing of violations of law to benefit favored transactions became publicly known because of the high visibility of the investments that were involved. Less conspicuous cases have been common. In the mid-1990s, a U.S. company asked me to review a contract and a feasibility study for a major

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<sup>100</sup> James Kynge, *China Cuts Off Foreign Telecom Investors' Hopes*, FIN. TIMES, Sept. 23, 1998, at 4.

<sup>101</sup> James Kynge, *Beijing to Close Door to Foreign Investors*, FIN. TIMES, Sept. 22, 1998, at 8.

<sup>102</sup> *Id.*

<sup>103</sup> See, e.g., *The Waiting Game: Ordered to Abandon Their Investments in China Unicom, Foreign Investors Find Strength in Numbers – and Time*, BUS. CHINA, Feb. 28, 2000, at 6, 7.

<sup>104</sup> Mark Landler, *Vodafone and Unicom Agree to Work Together in China*, N. Y. TIMES, June 14, 2000, at C4.

industrial project in which the U.S. company would invest in conjunction with a well-known Hong Kong businessman. Even a quick review indicated that some of its terms violated Chinese law. Also, the feasibility study, conducted not by all of the prospective parties but solely by a Chinese industrial institute at the insistence of the Hong Kong investor, was woefully inadequate. It did not, for example, specify the location of a major site essential to the project. When the client was informed of the problems, he replied that the Hong Kong investor had assured him that regardless of any deficiencies in the documentation, the project would be approved because of his personal relations with very high ranking officials in Beijing. The project did not, to my knowledge, go forward, but one can only wonder how often such slapdash approaches to major investments were followed by foreigners who simply relied on verbal assurances that powerful officials would approve a proposed arrangement.

This case should not be taken as blanket criticism for enlisting overseas Chinese to assist foreign investors. Ideally, any foreigner who is involved in negotiating a significant transaction in China should have at his side a Chinese-language speaker, regardless of nationality, who is familiar with the business and cultural environment.

Informed foreigners of one's own nationality may have an obvious appeal, but the potential client must conduct due diligence to ascertain the candidate's experience and business acumen. Overseas Chinese may fit the perceived need of the foreign investor, but their backgrounds, connections with present-day China and attitudes toward the ancestral motherland are complex. Overseas Chinese, especially from Southeast Asia, often have very strong traditional attachments to family, to their ancestral home in China, and to Chinese ethnicity generally. Moreover, by virtue of their ethnicity, PRC counterparts may press overseas Chinese to do business or advise their Western partners in a manner that benefits the motherland. Some, like the aforementioned Hong Kong investor, may be inclined to stress the importance of their personal relationships with key officials at the expense of sound business considerations. Also, some may focus more heavily than foreign companies on short-term gains.

Foreign-educated Chinese present complicated choices to foreigners who need counsel on doing business in China. Chinese of Hong Kong origin educated at American colleges and graduate schools with years of experience working on Wall Street may be quite impressive, but some may be regarded in China as outsiders due to the regional differences in custom as well as language. The numbers of PRC Chinese with education and work experience in the United States, and who can provide useful assistance, have been increasing steadily; they can often

help to bridge the gap between disparate cultures, although they, too, may have complex ties of loyalties to China. Use of any of these advisors, however, cannot obviate the need for foreign investors to work unceasingly to acquire and deepen their knowledge and sophistication about the Chinese business environment.

#### IV. RELIANCE ON DUBIOUS GUARANTEES

The early 1990s saw a euphoric rush of foreign investment bankers into Hong Kong and China, a frenzied search for investment opportunities, and the subsequent disappointment of many not long after their arrival.<sup>105</sup> Some, for example, incurred considerable losses by seeking and relying upon third-party guaranties from Chinese organizations which, they were warned, or should have been warned by their lawyers, were not empowered to give guaranties that bound any Chinese government, central or local.

One of those organizations was the Guangdong International Trust and Investment Corporation (GITIC). At that time, Chinese law restricted foreign banks from lending to mainland companies. GITIC, like other "ITICS" established all over China, was created to finance infrastructure projects, and had foreign exchange certificates under the dual currency scheme then in operation. GITIC was a "window" through which eager foreign companies could lend, and it used the flood of loans that it obtained from foreign banks throughout the 1980s and early 1990s to finance a wide range of projects. Many of the foreign lenders were so eager to lend that they failed to exercise the type of due diligence in which they might have engaged during quieter times, and were willing to overlook the frequent lack of transparency in GITIC's dealings. A newspaper account summarized the bankers' attitudes:

One banker said during initial loan talks company officials provided only a copy of GITIC's 25-page annual report. "It was impossible to obtain break-downs of their investments," he said. Another banker said: "And if you asked too much they would say other banks are not requiring this, why are you?"<sup>106</sup>

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<sup>105</sup> These blunderings have been colorfully described in JOE STUDWELL, *THE CHINA DREAM: THE QUEST FOR THE LAST GREAT UNTAPPED MARKET ON EARTH* (2002).

<sup>106</sup> Matthew Miller and Lana Wong, *GITIC Troubles Scar Country's Image*, S. CHINA MORNING POST, Oct. 26, 1998, at 5.

The same article states that bankers “were willing to overlook ordinary due diligence, with the understanding GITIC was operating with the complete and unqualified support of the provincial government.”<sup>107</sup>

Unfortunately for the bankers who made this assumption, under Chinese law, provincial and other local governments were forbidden to give binding guaranties for the repayment of debts of Chinese enterprises. The most assurance that foreign lenders could obtain was a “letter of comfort” from GITIC, which would not be binding upon the Guangdong government. Nonetheless, many went ahead, preferring to regard GITIC as an entity of the provincial government. GITIC, however, failed, and it turned out that “money [it] borrowed from banks, ostensibly for investment in China, was used to bet on the stock market and to invest in Hong Kong’s overheated property market.”<sup>108</sup> GITIC also borrowed from abroad without registering such loans with the Chinese foreign exchange authorities, as it was required to do. It filed for bankruptcy in early 1999 and then shut down. GITIC repaid the local depositors from whom it had taken funds without authorization to do so, but foreign lenders were left with large losses and no remedy.<sup>109</sup>

## V. RELIANCE ON LOCALLY ENCOURAGED VIOLATION OF CENTRAL LAW AND POLICIES

### A. *In General*

One of the most important lessons about China that any prospective foreign investor must absorb is that there is not one China, but many. Officially China is a unitary state, but in fact power is greatly decentralized, devolved not only to provinces and major cities, but to lower levels of government as well, and often controlled and coordinated from above with surprising futility. Once foreign investors ventured beyond Beijing during the 1980s, most were often surprised to learn how little China resembled the totalitarian one-party monolith they had

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<sup>107</sup> *Id.*

<sup>108</sup> Philip Segal, *Capital Controls Are No Protection Against Bad Management; China Provides the Proof With GITIC’s Squandering*, INT’L HERALD TRIB., Oct. 17, 1998, at 11.

<sup>109</sup> Soon after GITIC was closed, the liquidation committee appointed by the People’s Bank of China announced that domestic depositors would be immediately repaid 779 million RMB ( \$94.1 million) although the foreign creditors would have to have recourse through bankruptcy proceedings. Mitchell Silk & Michael Oppenheimer, *The Lessons of GITIC*, CHINA BUS. REV., May-June 1999, at 36, 37. Creditors of GITIC and its sister company Guangdong Enterprises, which also went bankrupt, “were expected to wait years to receive around 20 cents on the dollar.” STUDWELL, *supra* note 105, at 190.

imagined. Even before reform, China had not been so authoritarian that orders issued from the center or from higher levels were obeyed without question. Since the onset of reform, local powers have grown; existing regional differences have been further accentuated by the fact that sophistication and experience vary widely around the country.

The practical implications of this disorder understandably cause discomfort among close observers of FDI:

the opacity and the regulatory tangle of China's market grow more serious by the day and are not likely to abate at any time soon. This is largely due to China's loose political organization. As soon as economic reforms are announced, some regions use them as an excuse to engage in on-the-edge experiments that never receive the full sanction of the local government. Other regions respond by initiating power grabs for local bureaucrats. Each reform, then, leads to accretion of confusing and sometimes contradictory local interpretations.<sup>110</sup>

A plain statement by an Australian business consultant identifies the local financial pressures at work: "Officials use their discretionary local power to advantage their income-gathering, even though their actions may be at odds with central government policies and laws."<sup>111</sup> Some examples follow.

#### *B. Violation of Law by Local Officials*

In Chinese governance, lack of transparency converges with the extremely broad discretion that has been given to officials to interpret and apply laws. As a result, official action is veiled not only from the public, but very frequently from other units of government, including higher-level organizations that theoretically ought to be cognizant of activities below them. Local officials' arbitrary exercise of discretion has been a major source of investor anxiety and resentment since foreign investors

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<sup>110</sup> The US-China Business Council, CHINA OPERATIONS '98 FOREIGN DIRECT INVESTMENT 8 (Feb. 18, 1998).

<sup>111</sup> CAROLYN BLACKMAN, CHINA BUSINESS: THE RULES OF THE GAME 177 (2000). A broader analysis is Kenneth Lieberthal, *Completing WTO Reforms*, CHINA BUS. REV., Sept.-Oct. 2006, at 53, 55, in which he writes, "The state has become a flexible, dynamic, and growth-oriented political machine whose core incentives for officials at all levels are such that the national leadership now tries every year with only limited success to slow GDP growth. Many localities routinely circumvent national-level orders."

were invited back into China in 1979. Foreign investors have often been asked to agree to contracts that structure an FIE in a form deliberately designed to evade the law and central scrutiny.<sup>112</sup>

Lower-level violation of central government laws and policies is a matter of continuing concern for Beijing, because it has been endemic in FDI. Some illustrations in matters other than investment transactions will serve to introduce the problem.

The late Michel Oksenberg, a political scientist who specialized in China throughout his long career, conducted extensive research on the governance of a single county in northern China. After repeated visits over a period of years, during which time he came to be known to county officials, he asked the head of the county Financial Bureau to see the county's budget. The reply: "I can't show that to you, I don't even show that to Beijing."

Similar problems arose in international trade transactions before controls over them were loosened. Two extreme violations of laws or regulations that arose in two sales of electrical generating equipment by a California client in the late 1980s further illustrate the extent of the ongoing problem. In the first, the seller, after several years of negotiations, entered into a contract to sell five units to a provincial-level power authority. Some months after the contract was signed, the seller received a telex from the China National Machinery Equipment Import & Export Corporation (Machimpex) head office in Beijing, notifying it that the buyer had lacked authority to sign the contract. The foreign currency that would have been used to pay the seller had been allocated from Beijing and could only be expended with the consent of the Machimpex head office. Consequently, the contract had been "assigned" to Machimpex, so it was necessary to renegotiate the terms of the contract. However, it was pointed out to Machimpex that under applicable Chinese law, a contractual right could be assigned only with the consent of the bearer of that right, which had not occurred. In a subsequent negotiation in Beijing the Machimpex negotiator protested that the buyer had not only entered into the contract without Machimpex authorization, but that it had also deviated from standard Chinese practice when it agreed to a price that included all costs, insurance and freight that would be fixed by the seller, rather than insisting on freight to be arranged by the buyer. Reluctantly, Machimpex agreed to perform the contract under the terms to which the initial parties had agreed.

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<sup>112</sup> See generally Nicholas Howson, *When the Center Doesn't Hold*, CHINA BUS. REV., Jan.-Feb. 1995, at 8.

The second transaction, in the early 1990s, was an even more extreme violation, an attempt by the Chinese buyer to evade a central government regulation that required the purchase of the equipment involved to be handled by international tender rather than by a negotiated contract. The buyer, the provincial power authority that had previously purchased the five units in the transaction to which Machimpex had objected, contracted directly with the seller to purchase an additional seven units. Thereafter, the validity of that contract was cast into doubt when the seller received an invitation from a central agency to bid on a project which, although not named, was clearly identifiable by the specifications as intended to require equipment like the seven units that it had sold some months earlier. The seller contacted the provincial representatives who had negotiated the original contract; they freely confessed that they had attempted to evade the Beijing regulations, but insisted that the contract would be awarded to the seller if it bid in response to the invitation to tender. The seller complied and was awarded the contract, but only after another negotiation on the price. The earlier contract was never mentioned.

Local governments continue to exercise their power in a variety of ways and in many areas that depart from national laws and policies. The extent of local disregard for central policies was demonstrated in an extreme and purely domestic case early in 2005 when the Chinese press reported that the State Environmental Protection Administration had suspended work on 30 large construction projects, 26 of which were in the power industry, because they had begun work before their environmental impact statements had been approved.<sup>113</sup>

C. *Local-Level Violation of Policy on Foreign Investment in Retail Enterprises*

The extent to which local governments may flout national laws and policies is vividly demonstrated by the history of the opening of the retail trade to foreigners in the early 1990s. In early 1994 a famous Italian designer inquired if he could sell his products in retail outlets without establishing a joint venture to manufacture them in China, which was then required by law. Until 1992, reflecting policy that limited incursions by foreigners into the domestic economy, retail sales were entirely off limits to foreigners unless the products were manufactured in China, and even then only limited percentages of the products could be sold locally.

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<sup>113</sup> Lester Ross, *The Emperor's Very Long Reach*, FIN. TIMES, Jan. 26, 2005, at 9.



Foreign retailers had long expressed intense interest in selling to China's many millions of prospective customers, and in 1992 the State Council responded by issuing regulations that implemented a new and tentative policy. The directive authorized *only one or two* FIEs to engage in retailing in each of only six named cities and five Special Economic Zones that had been established to promote exports, making a maximum of 22 FIEs altogether; and specifically provided that *each* such FIE, regardless of the size of the investment, had to be approved by the local authorities, the Ministry of Internal Trade and by the State Council itself.<sup>114</sup>

Research in response to the Italian inquiry disclosed that, in addition to 10-15 retail joint ventures that the State Council had authorized by the time the Italian client had expressed interest, localities such as Beijing, Guangzhou, Chengdu and Wuhan had also permitted establishment of such joint ventures without obtaining the necessary approvals from the central government. Further inquiry indicated that local governments' evasions of national law and policy had already led to the establishment of *hundreds* of Sino-foreign retail activities, far exceeding the number permitted by law. Among the devices that we knew of were the following:

- A contract with a Chinese foreign trade corporation under which the corporation imported the goods and resold them, sharing the profits with the foreigner;
- An agreement that a hotel would sell the foreign products;
- A production joint venture that would violate limits on the percentage of products that could be sold on the domestic market;
- The lease of a counter in a department store; and
- An agreement with a Hong Kong trading company to engage in the above transactions on behalf of the foreigner.

These were the stratagems that only preliminary research uncovered, and it was obvious that there had been others. I discussed the rules and their evasion with three lawyers at MOFTEC, one of them very senior. Should the client comply with rules and risk frustration because the limits on formally approved retail joint ventures had already been

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<sup>114</sup> See, e.g., Alexa C. Lam, *Tapping the Retail Market in China*, CHINA BUS. REV., Sept.-Oct. 1995, at 23; *Jurassic Park: How Foreign-Invested Service Providers Find a Way*, BUS. CHINA, June 9, 1997, at 6; Steven Shi & Anne Stevenson-Yang, *Retail Roundabout*, CHINA BUS. REV., Jan.-Feb. 1998, at 43; James Kyne, *It's As Much About Buying As Selling*, FIN. TIMES, Dec. 12, 2002, at 5.

reached? Or should he enter into a transaction that was not approved and theoretically illegal, running the risk that a subsequent crackdown by the State Council would endanger whatever illegal activities into which he had entered? The Ministry lawyers only laughed, possibly with embarrassment, and offered no guidance for the client. Not long after this conversation, the client's products began appearing in China – without approval from the central level.

For years thereafter, although the State Council repeatedly addressed the problem, there was no publicized definitive solution to the uncertainties that had been created by the myriad of unauthorized ventures.<sup>115</sup> Other foreign companies continued to rush in, and eventually the State Council issued not one but a series of documents that were written to rectify the wholesale violations of law that had occurred all over China. These documents included:

- A “circular” issued in 1998 on the “screening and rectification of non-experimental foreign investment commercial enterprises”;
- A notice in 1999 on procedures or “pilot projects for commercial enterprises with foreign-invested commercial enterprises”;
- The “notice on immediate cessation of unauthorized approval and covert establishment of foreign-invested commercial enterprises” in 2000; and
- A “circular” in 2001 on “further improving the screening and rectification of non-experimental foreign-funded commercial enterprises.”

Following the appearance of the 1998 and 1999 measures, more than 35 outlets were closed and some foreign investors were forced to sell their shares to their Chinese partners.<sup>116</sup> The 1999 measures, which were applied with limited success, broadened the framework for joint venture distribution enterprises (JVDE); the new rules, together with other provisions, limited the equity percentage of foreigners with more than three outlets to 49%.

Nonetheless, some foreigners persisted in engaging in conduct that violated the applicable rules, and one, Carrefour, the French chain, defied them with dramatic success. In February 2001, Carrefour was

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<sup>115</sup> See Tao Jingzhou & Tang Jie, *New Guidelines on Foreign Investment in China's Commercial Areas: A Green, Amber or Red Light?*, CHINA L. & PRACTICE, Aug, 1999, at 22.

<sup>116</sup> James Kynge, *Beijing Forces Restructuring on Carrefour*, FIN. TIMES, Feb. 8, 2001, at 33.

reported to be the most successful foreign retailer in China, having gained its position not by obtaining government approval for any of its 27 stores, but “relying instead on the goodwill of local authorities.”<sup>117</sup> It was ordered to suspend new supermarket openings, and negotiations ensued; later that year it was authorized to resume opening its supermarkets under agreements negotiated at provincial and city levels,<sup>118</sup> and was permitted to own up to 65% equity in some of its joint ventures.<sup>119</sup>

It is surely relevant that while it was establishing markets at which it would sell goods, Carrefour pursued a vigorous program of sourcing products in China, and in 2001 it had purchased over \$1.3 billion in goods.<sup>120</sup> By the end of 2002, as one observer noted, “the final reprimand was fairly light”<sup>121</sup> because it was the largest foreign retailer in China, with 31 stores, and was planning to double its purchases in the next few years.<sup>122</sup> In 2004 the number of its stores rose to 40.

These developments were hardly lost on Chinese retailers, and at the annual meeting of the Chinese retailers’ association in February 2004, participants expressed their “widespread anger . . . at the speed foreign companies have gained market share, through legal and illegal means.”<sup>123</sup> Moreover, restrictions on the number of stores that foreigners could operate were slated to disappear at the end of the year under the terms of China’s accession to the WTO. They have since disappeared, and currently Carrefour is the largest foreign retailer in China, with 73 “hypermarkets.”<sup>124</sup>

These events teach more than one lesson. The growth of technically illegal foreign-invested retail enterprises illustrates not only the frequent weakness of the central government in permitting the spread of establishments lacking the required approvals, but also the muddiness of law and practice with regard to the consequences for violations of rules that appeared – at the time – to be clear. It also raises difficult questions

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<sup>117</sup> *Id.*

<sup>118</sup> Michael De Grandi, *Carrefour to Resume Chinese Expansion*, FIN. TIMES, Nov. 9, 2001, at 26.

<sup>119</sup> Tong Xinchao, Luka Lu, Chen Feng & Li Ning, *Investing in a Distribution Channel: Current Legal Framework and Implications After WTO*, CHINA L. & PRACTICE, Dec. 2001-Jan. 2002, at 31, 32.

<sup>120</sup> *Id.*, at 32.

<sup>121</sup> Kyngé, *It’s As Much About Buying As Selling*, *supra* note 114.

<sup>122</sup> Kyngé, *It’s As Much About Buying As Selling*, *supra* note 114.

<sup>123</sup> Mark O’Neill, *China’s Open and Shut Case for WTO*, S. CHINA MORNING POST, Feb. 11, 2004, at 2.

<sup>124</sup> Peter N. Child, *Lessons From a Global Retailer: An Interview With the President of Carrefour in China*, MCKINSEY Q. (SPECIAL EDITION), 2006, at 70, available at [http://www.mckinseyquarterly.com/article\\_page.aspx?ar=1799](http://www.mckinseyquarterly.com/article_page.aspx?ar=1799) (last visited Dec. 13, 2006)

for foreigners and their advisors. What is “legal” and what is “illegal” when the central government makes a rule, local governments ignore the rule, and the central government *knowingly* allows that situation to persist? The president of Carrefour in China has described his approach by saying that when the government sought to impose rules on foreign retailers, “together the central government and Carrefour solved the problem because if you operated 100 percent by the official rules at that time, you couldn’t do business.”<sup>125</sup> Doesn't the question then become what is a reasonable business risk under the circumstances for a foreign investor considering doing something “illegal”? What does this tell us about acceptable risks when contemplating such defiance? Further, the most difficult issue for lawyers is, what advice should be given to the client? How can a prospective investor assess the business risks of choosing to ignore central policy and law if a local government proposes or agrees to an arrangement that seemed to violate the stated law at one level, but is consistent with locally approved practice at the lower level?

*D. Local Approval of Unauthorized Investment Incentives*

Another example of local violation of central laws and policies has been the granting of excessive incentives to investors. It has long been the central government’s policy to give incentives such as reduced income tax rates for stated periods of time to foreign investors, especially if they establish their projects in specially designated zones along the coast. Local governments have also been given discretion to offer additional incentives; a survey published in 2000 noted that in many areas, discretion had been used to offer these tax incentives indefinitely rather than only for limited periods of time.<sup>126</sup> In addition, some of the zones offered incentives that were entirely unauthorized by the central government, such as substantial tax refunds.

Beijing has long tried to restrict such unauthorized conduct, but its lack of success illustrates the uncertainty of its control over these local deviations from central law and policy. A State Council directive issued in 1993 declared that all unauthorized preferential taxes were void; five years later another State Council directive repeated the earlier warning and stated that officials who had authorized the illegal incentives would be prosecuted. In 2000, a third State Council directive was targeted at the specific abuse of granting unauthorized tax refunds. Recent research

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<sup>125</sup> *Id.*

<sup>126</sup> Lawrence Sussman & Lu Chai, *In Practice: Local Governments Lure FIEs with Outlawed Tax Incentives*, CHINA L. & PRACTICE, Apr. 2000, at 46.

suggests that, despite such directives from the center, some provinces are continuing their previous illegal practices, and concludes that discretionary tax incentives are still a subject of close negotiations.

*E. Arbitrary Imposition of Fees on FIEs*

In addition to problems arising in practice based on rules or on discretion that is authorized by national laws, FIEs frequently encounter attempts by local officials to obtain revenues unauthorized by any law or policy. In the early days of FDI, when the prices of local inputs or raw materials were still fixed according to the state plan, local government agencies would sometimes arbitrarily increase prices. This became impossible when the prices of most products were no longer controlled by the plan, but other techniques for extracting extralegal payments from FIEs have persisted. Central government regulations issued in 1986 to encourage investment condemned the practice of imposing indiscriminate fees and taxes on FIEs by various local governments and departments.

A trade publication commented in 1997, “[f]or cash-starved Chinese authorities, foreign investors appear to represent a golden goose that is increasingly hard to resist.”<sup>127</sup> The article pointed to some costs that were not disclosed to investors until their FIEs were already in operation. Sometimes, fees that supposedly had to be paid by all enterprises had been assessed in practice only against FIEs. Illustrating the imposition of fees unauthorized by law, one FIE that sought a construction permit was presented with a lengthy list of fees for such items as “white ants,” contribution to a local education fund, a “civil air defense fee,” a “special garbage fee,” and a “greening fee.” These were ultimately reduced or waived after negotiations. Such fees are often unpredictable, imposed without any semblance of transparency and at random, and have varied widely across China. Central control over local imposition of fees and taxes has been weak, and the usual remedy for the foreigner is to negotiate the amount that will satisfy the local agency.

One study characterized local governments as “feudal,” and commented:

The arbitrary nature of taxation and fees tends to further institutionalize feudalistic relationships: firms, especially foreign enterprises, can be dependent on the whims of local officials who have the power to increase their costs

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<sup>127</sup> ‘United Front’ the Best Defense Against Random Fee Demands, CHINA JOINT VENTURER, May 1997, at 1.

significantly or even shut them down if they do not cooperate.<sup>128</sup>

Another analysis characterizes the power wielded by local governments as “corporatist,” denoting an alliance between local businesses and local officials, which raises nothing less than the question of “the decline of the central state.”<sup>129</sup> In this regard, too, the Under Secretary of the U.S. Department of Commerce commented in April 2004 that because Beijing’s control over local governments has loosened, Beijing may face difficulties enforcing laws in areas such as intellectual property throughout the country.<sup>130</sup>

## VI. LOCALISM AND THE APPROVAL PROCESS

### A. *In General*

The most widespread problems of local departure from rules laid down by the central government arise out of the exercise of local discretion to manipulate the many approval processes that investors must encounter before they may begin operations. In the past, approvals were given either by the Ministry of Foreign Economic Relations and Trade (MOFERT, later renamed MOFTEC), its successor MOFCOM, or by local commissions, depending on the total capitalization of the project. Further decentralization of the procedures in 2000 led to new uncertainties.<sup>131</sup>

The approval process has been complicated by the convergence of localism with the strong inclination to regulate foreign investment. The problem was signaled in the early 1980s after one of the first joint Sino-foreign ventures had been negotiated. The European investors had returned home after the signed contract and other documents had been filed with the local investment authorities. The first telex from the Chinese partner announced, “Good news: The contract has been

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<sup>128</sup> David Ahlstrom, Michael N. Young & Anil Nair, *Navigating China’s Feudal Governance Structures: Some Guidelines for Foreign Enterprises*, S.A.M. ADVANCED MGMT. J., Winter 2003, at 4, 9-10.

<sup>129</sup> Pitman M. Potter, *Foreign Investment Law in the People’s Republic of China: Dilemmas of State Control*, 141 CHINA Q. 155, 184 (1995).

<sup>130</sup> Andrzej Zwaniecki, *U.S. Says It Wants to Help China Define Market Reforms*, WASH. FILE, U.S. DEP’T ST., Apr. 13, 2004, <http://usinfo.state.gov/eap/Archive/2004/Jul/02-756476.html> (last visited Dec. 13, 2006).

<sup>131</sup> Andrew McGinty & Fang Jian, *MOFTEC Changes FIE Approvals: Headway or Headache?*, CHINA L. & PRACTICE, Mar. 2000, at 49, 52.

approved.” This was followed, however, by, “Here are the clauses that must be renegotiated.” The Europeans had no choice but to return to continue negotiations that they had been led to believe had been concluded. This episode foretold the recurrence throughout the 1980s of foreign investors’ common complaints that after Chinese and foreign counterparts had agreed on all of the details of their joint venture, the approval authorities might insist that certain provisions be renegotiated; in the approval process, every basic document in the transaction that created an FIE was open to review.<sup>132</sup>

Although the initial approval process for joint ventures has become more transparent in recent years, some agencies, such as those responsible for foreign exchange control, customs, taxation, and labor, may also continue to regulate the post-approval operations of FIEs. Chinese law still requires local approval for a variety of transactions, including transferring capital interest by a joint venture partner and borrowing in foreign exchange by a Chinese partner. As noted in Part One, if a foreign partner wishes to exit a joint venture by means of dissolution, multiple approvals remain necessary for such a fundamental change, but may be difficult to obtain.

The long-established insistence on multiple approvals for foreign projects remains relevant here, as suggested by an experienced U.S. law firm:

China has been careful to hedge each form of FIE with complex rules for qualification and approval designed to foster various aspects of Chinese industrial policy, channel foreign investment into particular economic or geographic areas, protect local Chinese business interests, promote China’s technological development, or protect China’s balance of payments. The result is a complex system of laws, regulations and guidelines that sometimes apply across-the-board to all FIES and sometimes only to a particular kind of FIE. The chief characteristic of this system is its rigidity, with government approval necessary

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<sup>132</sup> Writing in 1987, two lawyers noted that “foreign investors have become frustrated by the frequency with which PRC examination and approval authorities demand changes in crucial terms which the parties can agree on between themselves under Chinese law. . . . The result . . . is that the foreign company often feels that it has been placed in an unfair bargaining position, especially when, as frequently happens, it is informed of the conditions for approval shortly before the date scheduled for the festivities announcing the contract.” Jerome Alan Cohen & Stuart J. Valentine, *Foreign Direct Investment in the People’s Republic of China: Progress, Problems and Proposals*, 1 J. CHINESE L. 161, 200 (1987).

at nearly every important stage of business and great difficulties or uncertainties for even the simplest restructurings.<sup>133</sup>

After 25 years of experience, the investment approval authorities on the Chinese coast have an established body of practice. More importantly, there has been a greater degree of permissiveness in Chinese policy toward the “encouraged” and “permitted” projects discussed above. As a result, impressionistic research suggests that where an EJV, CJV or WFOE – that is, the forms of investment that have been on the scene for two decades – must be approved, there are likely to be fewer surprises from the approval authorities than there might have been twenty or even ten years ago.

The uncertainty that affected establishment of the investment vehicles first created in 1979 and the early 1980s is more likely to reappear when authorities are presented with such newer investment transactions as mergers and acquisitions. The continued expansion of FDI has seen investors acquiring interests in existing joint ventures, rather than in SOEs. MOFTEC and the SAIC issued regulations on merger and division of FIEs in 2000. As one authoritative commentary noted, the new regulations increased the flexibility of foreign investors in organizing and managing their investments in China, but, it added, “the authors of the new Regulations have been careful to preserve the current regulatory system’s controls over the business scope and capital structure of FIEs.”<sup>134</sup> Among other required procedures, there is a mandatory requirement that the documentation related to the establishment of the original joint venture being acquired be inspected before a merger is approved.

Foreign investors in developing countries frequently face the need to obtain a multitude of government approvals and to negotiate with differing government agencies, and China is no exception.

### *B. Imposition of Local Policies*

Although formal law has given FIEs considerable discretion in hiring and staffing matters, local authorities can withhold their approvals if some of their concerns fail to be addressed to their satisfaction. For

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<sup>133</sup> Patrick M. Norton & Nicolas Groffman, *Reorganizing Foreign Invested Enterprises in China: The New Merger and Division Regulations*, in O’Melveny & Myers LLP, TOPICS IN CHINESE LAW, Apr. 2000, at 1, 2.

<sup>134</sup> *Id.* at 1.



example, if the foreign investor wishes to reduce the number of workers at the FIE, the local authorities may resist because they do not wish to increase unemployment.<sup>135</sup> Similarly, before China's accession to the WTO, it was common for local authorities to insist that an FIE within their jurisdiction shoulder an annual export quota even when national legislation did not require it.<sup>136</sup> Authorities also imposed requirements that FIEs favor sources of domestic supply of necessary inputs for their production activities.

Manipulation of the valuation of assets contributed by the parties to a joint venture has been a concern to central investment authorities, especially during the early 1990s when local enterprises eager for foreign investment were found to be undervaluing the local assets contributed to FIEs. Applicable regulations required a state agency to independently value the assets contributed by both parties. Nevertheless, local practice under these regulations has been criticized by some foreigners as leading to arbitrary undervaluation of foreign-contributed assets,<sup>137</sup> while there is impressionistic evidence of continued undervaluation of Chinese-contributed assets as well.<sup>138</sup>

Continued expansion of FDI has carried with it old problems. For example, when China joined the WTO, it agreed to permit foreigners to conduct retail and distribution activities and, to that end, it committed to issuing new rules by the end of 2004. New rules were issued, effective June 1, 2004 – six months ahead of schedule, reflecting the central government's willingness to comply with Chinese obligations under WTO rules – that permit investors to establish wholly owned distribution networks and enterprises for retail sales. The Ministry of Commerce was to begin granting to foreign wholly owned enterprises the rights to import and export finished goods without any geographical restrictions, and without being required to make substantial capital investments or transfers of technology. It would no longer be necessary, as it previously had been, to manufacture the goods in China in order for the investor to be permitted to sell them in China.<sup>139</sup>

Implementation of the new policy encountered a problem long familiar to foreign investors. The American Chamber of Commerce in

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<sup>135</sup> DANIEL H. ROSEN, BEHIND THE OPEN DOOR: FOREIGN ENTERPRISES IN THE CHINESE MARKETPLACE 90-91 (1999).

<sup>136</sup> See, e.g., *Id.* at 65.

<sup>137</sup> *Legal Innovations Brighten Prospects for China M&A*, CHINA JOINT VENTURER, Mar. 1997, at 8, 9.

<sup>138</sup> See generally, Keith Yan, *Asset Valuation*, in 2 DOING BUSINESS IN CHINA, § III, Ch. 4 (Freshfields Bruckhaus Deringer, ed. 2006).

<sup>139</sup> Douglas Markel, *New Rules Help Groups Expand*, FIN. TIMES, Apr. 28, 2004, at 12.

China pointed out in a 2005 white paper that the national regulations required local approvals as well as approval from MOFCOM. This was because new stores operated by foreign-invested distribution companies had to “suit the urban and commercial development plans of the city in which the store will be located,”<sup>140</sup> and therefore had to obtain local government agreement when they submitted their applications. The Chamber observed, “Given the discretionary latitude possessed by local officials in this regard, this requirement could be used as a market-entry barrier to restrict the number of foreign distribution operations in a given city.”<sup>141</sup> Thus, application of changes in the substantive law applicable to this particular area of FDI remained open – and vulnerable – to local government discretion, exercised in a manner contrary to the spirit and intention underlying the law itself. Complaints to the central government in this case resulted in the Ministry of Commerce issuing a circular ordering local governments to accelerate their approvals.<sup>142</sup>

### C. *Evasion of Approval Limits*

Another example of lower-level flouting of central laws and policies has been the eagerness of local governments to evade rules that allowed FIEs capitalized at levels below a specified threshold, long maintained at \$30 million, to be approved only locally, while those with greater investment valuation had to be approved by central authorities. One commentary has noted that “the local approval threshold . . . of less than US\$30 million has become the stuff of legends among the foreign investment community.”<sup>143</sup> The rule has been routinely evaded by officials who press investors to artificially divide proposed projects into smaller segments, each nominally involving investment values below the threshold limit in order to evade the notice of the Beijing authorities. The degree of risk to the foreigner is in considerable part determined by whether the local disregard of approval ceilings for projects of a particular type may have been so consistently ignored by higher-level authorities that the investor can bet that he is assuming only a minor risk.<sup>144</sup>

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<sup>140</sup> 2004 White Paper – Trade and Distribution, AM. CHAMBER OF COM., PRC (2004), <http://www.amcham-china.org.cn/amcham/show/content.php?Id=342> (last visited Dec. 13, 2006).

<sup>141</sup> *Id.*

<sup>142</sup> Daniel Hilken, *Beijing Clarifies Distribution Rules*, THE STANDARD, Apr. 29, 2005.

<sup>143</sup> McGinty & Fang, *supra* note 131, at 49; see also Li Xiaoyang, *Decentralized Approval of Encouraged FIE Project: Good News or Bad News?*, CHINA L. & PRACTICE, June 2000, at 44.

<sup>144</sup> The practice is not limited to FDI; thresholds have been applied to purely domestic investment projects as well. A newspaper account in May 2004 reported on an effort led by a Chinese entrepreneur to construct a complex of steel mills in Jiangsu Province. To hide the project from

In one transaction, a major multinational corporation proposed to invest in a facility to manufacture products used in automobiles. The ambitious foreign investor contemplated a total investment in excess of \$30 million, and the local partner pressed to structure the venture so that it would commence operations on a smaller scale with the clearly understood objective of applying later for enlargement in a “second stage.” The investor argued that the project only made economic sense if it began to manufacture its products on the larger scale. Foreign lawyers had to advise the investor that the letter of Chinese law should be observed and that the feasibility study prepared by the parties had to present an accurate picture of the project, including anticipated increases in production capacity and sales.

In another example, an investor based in Southeast Asia sought an American partner for a mammoth project that would have required a total investment of over \$100 million. When advised that the size of the project would necessitate approval in Beijing, the Asian partner proposed dividing the project into small stages, each under \$30 million. Apparently the local authorities were willing to accept this stratagem.

Central control over the size of investments was further officially loosened in July 2004, as has already been noted in Part One of this article. It is unclear how responsibly local governments will exercise their greater freedom. A recent OECD report noted that, as in the past, the division of authority between local and central approval agencies

is open to abuse because it encourages local authorities to split projects valued at over USD 100 million into smaller segments to avoid having to submit them to national level authorities . . . . A project which is submitted only to local, not national approval is more likely to be approved, as local authorities seek to maximise revenue and employment creation of FDI projects, while national authorities have to take into account other factors (such as the perceived need to avoid localised overcapacity and overall macroeconomic considerations) which may cause approval not to be granted.<sup>145</sup>

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Beijing officials concerned with the pace of investment, it was broken down into 22 smaller segments and the local banks classified loans to it under a heading that did not require regional or national approvals. Matt Pottinger, *He Lost His House To a New Steel Mill That Promised Work*, WALL ST. J., May 18, 2004, at A1.

<sup>145</sup> Organization for Economic Cooperation and Development, CHINA IN THE GLOBAL ECONOMY: GOVERNANCE IN CHINA 443 (2005).

Although according to national law the foreign investment in CJVs and EJVs must be at least 25% of the total invested capital, local governments have been willing to bypass or alter the rule in order to attract investors; at the same time, the rules that set a floor for minimum investment amounts have sometimes been disregarded with Beijing being none the wiser.

*D. Secret Side Agreements*

Another tactic for avoiding the impact of established policy has been an agreement by investors and investment authorities that an applicable policy would not be enforced at all. In one case, a foreign investor established a particular type of joint venture that was required by policy at the time to export a minimum percentage of its annual production. After negotiations, the local investment authorities proposed that despite the export quota stated in the project documentation, they should also enter into a secret side agreement. The agreement would have stated the foreigner's export-related obligation as only being "responsible for assisting the joint venture with the sale of its products," and would also have specified that the agreement would override any inconsistent contract provisions. This is only an example of the many types of violation of higher-level law and policy that local governments have been known to foster because of their desire to attract foreign investment.

*E. Accommodating the Demands of Local Governments*

An experienced consultant on business in China, Carolyn Blackman, has described the arbitrariness and unpredictability of local governments and the "unexpected, locally imposed burdens foreign companies have encountered in China."<sup>146</sup> Her account offers sound analysis. Companies that have based their forecasts and projections on national taxes and regulations "will find their projections undermined by new taxes and levies imposed by local and municipal authorities."<sup>147</sup> Examples have already been given of the imposition of taxes unauthorized by law. The "inherent power" that is given to local governments to make and interpret laws and regulations remains wide, and because local bureaus are linked upwards to higher levels, FIEs are

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<sup>146</sup> Carolyn Blackman, *Local Government and Foreign Business*, CHINA BUS. REV., May-June 2001, at 26.

<sup>147</sup> *Id.*

sometimes subjected to taxes from lower and higher levels of the same bureau.

Such demands raise the issue of how FIEs should respond. In practice, the locally imposed taxes and fees are often negotiable. One businessman is quoted as saying, "It is always a case of having to sit down with the authorities and negotiate your way through these things because they can make life extremely difficult for you . . . . Obviously one tries to negotiate down as far as possible and dispose of the issue, retain your relationship with the local authorities, and continue production."<sup>148</sup>

Blackman notes further that it is necessary for foreign businessmen to understand the personalized nature of the Chinese bureaucracy, and the resulting necessity to develop personal relationships with officials with power over their businesses. It is important for foreign businessmen to "establish a good relationship" with officials, "as equals and friends trying to reach a logical conclusion . . . . Western executives would do well to take a positive approach and accept relationship building as a major business strategy."<sup>149</sup> The subtleties that are implied in this statement merit separate treatment of this much discussed approach to doing business in China.

## VII. LOCAL GOVERNMENTS AND FOREIGN BUSINESS: RELATIONSHIPS

The Chinese term for the "relationships" that many Western analyses of business in China have urged as a key (sometimes *the* key) to successful operations is *guanxi*. Foreign investors have had to confront the nature and significance of building personal relationships among the parties to a transaction, and with officials whose approvals and assistance are important to the success of their projects. Their importance is rightly said to be a distinguishing characteristic of Chinese life, commercial and otherwise. At the same time, because too often *guanxi* is excessively described as completely different in kind and intensity from comparable behavior in the West, it is necessary to put it and Western views of it into perspective.

The instrumental use of personal relationships in business is hardly unique to China. The term "old boy network" was first used in England to express business and career links among mutual acquaintances who shared important elements of their social origins and educational

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<sup>148</sup> *Id.* at 29.

<sup>149</sup> *Id.* at 31.

backgrounds. The continued relevance of personal relationships to business in the West is so obvious that it does not require extended discussion here. What does appear different is that, historically, in the West, a lack of personal acquaintance was not an absolute bar to entering into business relationships and impersonal business grew faster and earlier in the West than in China.

A. *Guanxi: A Definition*

*Guanxi* has been defined as relating to “particularistic ties,” which are “based on ascribed or primordial traits such as kinship, native place, and ethnicity, and also on achieved characteristics such as attending the same school . . . serving together in the same military unit, having shared experiences, such as the Long March, and doing business together.”<sup>150</sup> For another scholar, *guanxi* denotes

‘social connections,’ dyadic relationships that are based implicitly (rather than explicitly) on mutual interest and benefit. Once *guanxi* is established between two people, each can ask a favor of the other with the expectation that the debt incurred will be repaid sometime in the future.<sup>151</sup>

Emphasis on the importance of these informal relationships is deeply rooted in Chinese tradition. Commerce in imperial times was largely unregulated by formal law and was intensely relational, and people generally conducted business with counterparts they knew personally or with whom they came into contact through mutual acquaintances or relatives. Informal relations operated as a mechanism that substituted for the rules, procedures and enforcement mechanisms associated with a formal legal system.

Traditional *guanxi* was based on “reciprocal obligations and indebtedness,”<sup>152</sup> but Western perceptions have often overlooked one aspect:

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<sup>150</sup> Thomas Gold, Doug Guthrie & David Wank, *An Introduction to the Study of Guanxi* [hereinafter Gold et al.], in *SOCIAL CONNECTIONS IN CHINA: INSTITUTIONS, CULTURE AND THE CHANGING NATURE OF GUANXI* 3, 6 (Thomas Gold, Doug Guthrie & David Wank, eds., 2002) [hereinafter Gold et al., *SOCIAL CONNECTIONS*].

<sup>151</sup> MAYFAIR MEI-HUI YANG, *GIFTS, FAVORS & BANQUETS: THE ART OF SOCIAL RELATIONSHIPS IN CHINA* 1 (1994).

<sup>152</sup> Gold et al., *supra* note 150, at 7.

Although many foreign commentators (business people prominent among them) believe that *guanxi* functions almost exclusively for instrumental purposes, Chinese frequently stress that true *guanxi* must possess an affective component.<sup>153</sup>

This component is sentiment, *ganqing*, and is reflected in the “warmth and intensity” of the relationship between the parties concerned.<sup>154</sup>

Today, however, it has been noted that *guanxi* has in practice sometimes become “commodified”<sup>155</sup> so that monetary payments replace more subtle practices, and the practice “begets money or the means for acquiring money.”<sup>156</sup> As a result, for the foreigner who must sort out instrumentalism and sentiment, *guanxi* is even more difficult to understand and to put into practice when he attempts to use it “to navigate institutionally uncertain environments.”<sup>157</sup>

*B. Guanxi: Necessary? Indispensable?*

Some foreigners may assume that only *guanxi* matters. Two observers not only argue that, for foreigners doing business in China, getting to know counterparts is more important than in the West, but insist that *guanxi* is indispensable. They go so far as to say, conclusorily, that *guanxi* will take care of risk if “properly and patiently managed.”<sup>158</sup> They further address the relationship between contracts and *guanxi* in this way:

Chinese businesses rely on relationships rather than legal bonds. A contract is worth only the paper it is written on; the real contract exists in the minds of the parties and its strength consists in their relationship and whether they believe they can trust each other. To many Chinese, a broken contract does not signify that one party has done

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<sup>153</sup> Gold et al., *supra* note 150, at 7.

<sup>154</sup> Gold et al., *supra* note 150, at 8 (quoting MORTON H. FRIED, *THE FABRIC OF CHINESE SOCIETY: A STUDY OF THE SOCIAL LIFE OF A CHINESE COUNTY SEAT* 103 (1953)).

<sup>155</sup> YANG, *supra* note 151, at 48.

<sup>156</sup> YANG, *supra* note 151, at 171.

<sup>157</sup> Gold et al., *supra* note 150, at 15.

<sup>158</sup> TIM AMBLER & MORGEN WITZEL, *DOING BUSINESS IN CHINA* 149 (2d ed. 2004).

something dishonest; it merely signifies that the original contract had little value in the first place.<sup>159</sup>

Another Western observer advises that “[i]f you have *guanxi*, there is little you can’t accomplish . . . . There are few rules in China that can’t be broken, or at least bent, by people or firms with the right *guanxi*.”<sup>160</sup> A more balanced analysis suggests an appropriate approach to *guanxi* and its contemporary functions. As a fact of economic life, “it is clear that *guanxi* meets a real need and provides real economic benefits to the economy.”<sup>161</sup> One explanation suggests that when local governments and businesses build particularistic ties that often lead to violations of national laws and policies, these are justified by the need to adapt them to local conditions.<sup>162</sup> In another view, the uncertainties of Chinese law justify and indeed require the use of personal relationships to accomplish constructive business results.<sup>163</sup> The question remains, then, of how foreigners should cope with this disorder.

### C. *An Alternative View of Relationship-Building*

Blackman has counseled a focus on building relationships, but, significantly, without using the term *guanxi*. Rather, she recommends that the foreigner must, even while getting to know influential individuals and valuing relationships with them, also build credibility by taking Chinese questions seriously and bargaining while remaining mindful of the need not to cause the Chinese counterpart to “lose face.” The foreigner must also keep an “emotional distance” and “use informal occasions to check facts and assumptions.”<sup>164</sup>

This analysis nowhere conflates *guanxi* with corruption, as some foreigners do. The difference, at least in principle, is not difficult to perceive: *guanxi* is generally legal while corruption is not; it more often

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<sup>159</sup> *Id.* at 110.

<sup>160</sup> Scott D. Seligman, *Guanxi: Grease for the Wheels of China*, CHINA BUS. REV., Sept.-Oct. 1999, at 34, 34-35.

<sup>161</sup> Howard Davies, *Interpreting Guanxi: The Role of Personal Connections in a High Context Transitional Economy*, CHINA BUSINESS: CONTEXT AND ISSUES 155, 162 (Howard Davies, ed. 1995).

<sup>162</sup> David Wank, *Business-State Clientelism in China: Decline or Evolution?*, in Gold et al., SOCIAL CONNECTIONS, *supra*, note 150, at 97, 108.

<sup>163</sup> “[G]*uanxi* facilitates business dealings while formal bureaucratic rules often inhibit them. . . . [A]lthough China has enacted thousands of laws, rules, and regulations, almost none is completely enforced.” LUO YADONG, GUANXI AND BUSINESS 84 (2000).

<sup>164</sup> CAROLYN BLACKMAN, NEGOTIATING CHINA: CASE STUDIES AND STRATEGIES 132-136 (1997).



involves longer-term relationships than corrupt ones, and “builds on trust” rather than on a “commodity” exchange between money and power.<sup>165</sup>

*D. How Should Relationships Work in Practice?*

Relationships with Chinese counterparts or powerful officials must be balanced against other factors of obvious importance, such as the economic feasibility of a project under negotiation. Relationships cannot make up for the absence of a sound commercial basis for the business for which support may be desired. Thus, a feasibility study jointly conducted by the parties ought to underlie any contract for an FIE whether or not it is legally required, and the foreign investor should participate actively in its preparation.

Foreigners must keep in mind that *guanxi* is personal – and that, therefore, the person with whom the relationship has been established may cease to be available to help the foreigner who has cultivated him. Also, the *guanxi* on which the foreigner might be tempted to rely may always be subject to potentially superior or competing sources of power.

*E. The Complementarity of Law and Guanxi*

Although some Western observers seem to regard *guanxi*-based relations as the functional equivalent of law-based expectations and property rights, it is more accurate to consider *guanxi* and law as complementary. One scholar, Pitman Potter, has argued that *guanxi* relations and formal legal rules can be seen to work together.<sup>166</sup>

Illustratively, in informal conversations with Shanghai businessmen, Potter found some acceptance of formal legal rules on the *formation* of civil law relations, i.e., using documents to evidence agreements to lend money, but simultaneous preference for using informal methods regarding *performance and enforcement*. Difficulties in contract relations arise when Chinese partners ask to modify contract terms due to changed conditions; foreigners may view such requests as evidence of bad faith, while Chinese may expect that the parties to the transaction ought to assist each other because they are in a relationship.<sup>167</sup>

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<sup>165</sup> LUO, *supra* note 163, at 199-202.

<sup>166</sup> Pitman B. Potter, *Guanxi and the PRC Legal System: From Contradiction to Complementarity*, in Gold et al., *SOCIAL CONNECTIONS*, *supra* note 150, at 179, 183.

<sup>167</sup> In the settlement of disputes that have gone to litigation or arbitration, Potter finds that “the inadequacy of formal rules controlling the behavior of counsel and their clients permits *guanxi* relations with judicial and arbitral decision-makers to distort dispute settlement processes.” *Id.* at 190.

Potter concludes that, because of difficulties in obtaining contract performance and enforcement, “*guanxi* relations play an essential role by providing predictability to legal actors.” The incompleteness of the legal system means that it would “have little effect at all were it not for the informal mediating mechanisms such as *guanxi* relations.” He further predicts that the complementary relationship between *guanxi* and law will continue to mark the Chinese legal system “for the foreseeable future.”<sup>168</sup>

### VIII. CORRUPTION AND BRIBERY

The spread of official corruption throughout China that has followed economic reform is regarded as a persistent source of difficulty by many foreign investors. It is so ubiquitous that extended discussion is unnecessary. The U.S.-China Business Council reported in early 1998:

The corruption problem seems only to worsen. So tightly knit are corrupt practices into the fabric of modern Chinese society that they are almost invisible . . . . For businesspeople, corrupt practices have layered cost upon cost, as each government organization with any say over a given deal has to be negotiated with, cajoled, and managed in order to fend off the rent-seeking behavior.<sup>169</sup>

A more recent overall assessment is gloomier:

China’s recent economic development has been among the most dramatic in world history, and rapid economic change of this sort inevitably presents fertile ground for official graft. China’s development has also involved widespread privatization of state assets, presenting numerous opportunities for the misappropriation of state-owned resources. Additionally, profound economic changes have coincided with the decentralization of political decision-making and law enforcement, further loosening the reins of executive control. Judicial institutions remain underdeveloped and subject to political influence. China’s poorly paid government officials are highly vulnerable to corruption in this environment, especially when government leaders proclaim that “to get

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<sup>168</sup> *Id.* at 195.

<sup>169</sup> US-China Business Council, *supra* note 110, at 8.

rich is glorious” and officials see others (including recent colleagues) enriching themselves.<sup>170</sup>

A study of FIEs that utilized extensive interviews with foreign investors comments on the high incidence of bribery in connection with sales and approvals. A “significant” number of managers complain of consultancies that “sanitized bribes” by resolving disputes over supposed liability for tax underpayments, or to convince Customs to classify an imported product in a lower tariff class.<sup>171</sup> Payments to customers that would be “rebates” after a purchase instead become bribes when paid before purchase.

The extent of corruption does not seem to have been reduced by repeated central government campaigns against it.<sup>172</sup> Extensive audits of enterprises and state-owned banks, for example, have revealed enormous and ongoing fraud. What is less commonly discussed by foreign investors, however, is that they often not only have to go along with local corruption but that they engage in illegal conduct themselves.

The impact of corruption on foreign businesses is obvious. American businesses must comply with the Foreign Corrupt Practices Act (FCPA),<sup>173</sup> which contains provisions that punish bribery, impose accounting controls on US companies that require accuracy in their financial data, and require companies to report bribes. Businesses in countries that are members of the OECD are also required to follow FCPA-type obligations under the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.<sup>174</sup> The FCPA requires US businesses to ensure “that their local agents and partners do not pass on part of their remuneration to government officials in exchange for business.”<sup>175</sup> This presents a difficult problem in China, where, as has already been stated, foreign investors must establish

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<sup>170</sup> Patrick M. Norton, *The Foreign Corrupt Practices Act: A Minefield for US Companies in China*, CHINA L. & PRACTICE, Nov. 2004, at 15, 16.

<sup>171</sup> ROSEN, *supra* note 135, at 218-220.

<sup>172</sup> See, e.g., Kathy Chen & Andrew Batson, *As China's Economy Thrives, so Does Graft*, WALL ST. J., June 19, 2006, at A8; Edward Cody, *China Leader Makes Appeal on Corruption; President Sounds Alarm Loudly on Party Anniversary*, WASH. POST, July 1, 2006, at A14; *China Corruption Cases Becoming More Sophisticated, Says Prosecutor*, XINHUA FIN. NETWORK NEWS, May 10, 2006.

<sup>173</sup> 15 U.S.C.S. § 78dd-1 (2006).

<sup>174</sup> OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, 17 Dec. 1997, 37 I.L.M. 1, available at [http://www.oecd.org/document/21/0,2340,en\\_2649\\_201185\\_2017813\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/21/0,2340,en_2649_201185_2017813_1_1_1_1,00.html) (last visited Dec. 13, 2006).

<sup>175</sup> Norton, *supra* note 170, at 17.

“relationships” with local officials to be able to reduce the uncertainty in which they must operate.

One experienced and thoughtful observer of foreign business in China has concluded, “[t]he sad fact is that the Chinese system today is almost incompatible with honesty” because the CCP wants to keep the party’s ruling elite above the law “unless their behavior or party politics necessitate making an example of them.”<sup>176</sup> At the same time, although he describes rampant corruption, he also notes that large multinationals “can operate above the muck because their deals are often very large, very visible, and they are interacting with senior government and party officials.”<sup>177</sup> Below that level, he says, “China becomes a swamp” and he singles out American companies for using middlemen to avoid the FCPA, although using middlemen does not avoid the impact of the Act. And yet, as cynical as his discussion becomes, he also adds that “[a]s China becomes more wealthy and sophisticated, it is getting easier to avoid corruption. There are many foreign companies that have policies of zero tolerance for corruption in China, and still enjoy good business because their products are the best and in demand.”<sup>178</sup>

## IX. CONCLUDING THOUGHTS: LOOKING BACK

The preceding two decades have been marked by dramatic and impressive accomplishments in the development of investment vehicles, and of critical substantive areas of law. At the same time, the influence of CCP policies continues, manifested for example in the Catalogue and the operation of an often opaque approval process. Substantive commercial law still lacks important details in such areas as securities law and real property law. And although governmental transparency is growing, many administrative regulations remain *neibu*, leaving much to be desired in the level of transparency.

Fundamental problems confront efforts to create and implement an effective legal regime. The legal uncertainty that is dissected in this article continues to exist not only because carrying out economic reform and dealing with its social consequences are difficult processes that will necessarily require much time, but also because defining the goals of economic reform and guiding its course are works in process. It need only be noted that while privatization of the economy has continued, there

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<sup>176</sup> JAMES MCGREGOR, ONE BILLION CUSTOMERS: LESSONS FROM THE FRONT LINES OF DOING BUSINESS IN CHINA 96 (2005).

<sup>177</sup> *Id.* at 118.

<sup>178</sup> *Id.* at 122.

is continued uncertainty about the future of large SOEs, the inefficiency and insolvency of which have led state-controlled banks to provide huge amounts of nonperforming loans that imperil the entire banking system. In the meantime, the building of a social safety net is a slow process. Also, the non-state economy is growing in complexity, presenting new problems of legal definition and regulation.

Another factor, mentioned at the beginning of Part One but requiring emphasis because it overshadows all other policies, is that the overriding goal of the CCP continues to be maintaining its dominance. As a result, the political will of the leadership to deepen law reform remains weak. The current CCP policy on the role of law is, on its face, one that no Western democracy could criticize: "Rule the country by law" (依法治国). This national policy was announced in 1994 by President Jiang Zemin and given wide publicity. But the phrase was only part of the sentence in his speech. He then said that another element of the CCP policy was to "protect the long-term stability of the nation," a code reference to maintenance of the dominant leadership of the CCP. Although the phrase, "rule the country by law," was later inserted into the Constitution, the Constitution still enshrines the guiding principles of China Marxism-Leninism, Mao Zedong Thought and Deng Xiaoping Theory, all doctrines that insist on CCP dominance. Thus, as much as "rule by law" is formally emphasized, the unwillingness of the CCP to place itself within the reach of the law remains unchanged in practice.<sup>179</sup>

Critical too is the autonomy of local governments, which, as has been shown, challenges the frequent weakness of the center in holding them to adherence to national laws and policies. Localism and local protectionism impact the courts, and are manifested in the wide discretion that local officials exercise over the administration of FDI. But these and related emphases must also be considered as forces that reflect a constant and currently unresolved tension between the center and local level governments. Recent research has looked at the impact of that tension on China's capacity to meet its obligations under the WTO. Mertha and Ka observe that local protectionism is so strong that "it is practically impossible for the leadership in Beijing to maintain sustained and systematic monitoring across China, with the possible exception of a handful of key issues, because enforcement costs are prohibitive."<sup>180</sup> With this in mind they have looked at attempts to centralize regulatory bureaucracies in three areas: the standardization of commercial practices,

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<sup>179</sup> STANLEY LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 300 (1999)

<sup>180</sup> Andrew C. Mertha & Ka Zeng, *Political Institutions, Resistance and China's Harmonization with International Law*, CHINA Q., June 2005, at 319, 328.

the regulation of financial services and the regulation of the production and sale of agricultural commodities, all “part of the attempt to decrease their vulnerability once China lifts its trade restrictions on services and agriculture.”<sup>181</sup>

Among their conclusions is the belief that although there is “tremendous variation” among attempts at centralization where it has been attempted, it stops at the provincial level, and that while provincial governments can “rein in local excesses,” the central government “does not necessarily re-establish control in Beijing, but, rather, concentrates it among China’s provinces, autonomous regions and provincial-level municipalities.”<sup>182</sup> They conclude that in the three sectors they discuss,

clashes between macro-level economic policy making and entrenched bureaucratic and local interests dim the prospect of the smooth implementation of WTO-related policy and institutional change, at least in the short and medium term.<sup>183</sup>

These statements not only underline the significance of the fragmented authoritarianism that marks Chinese governance today, but its depth and tenacity. At this point, it is impossible to predict how the central-local tensions will play out, but it seems certain that they will continue to be in contest for the near term, and, as a result, will further contribute to a lack of uniformity and consistency in the making and implementation of law, with inevitable consequences for certainty in Chinese law.

Moreover, underlying both the continuing creation of and experimentation with new institutions are deeply-imprinted cultural patterns and expectations that shape the wielding of authority, especially outside Beijing; these can only be changed gradually. I hold to this view despite the signs of growing legal consciousness among the Chinese population, awareness in the central government that it is indeed growing, and the ongoing efforts of a cohort of Chinese law reformers who are working on or promoting new legislation that some, at least, regard as legal reforms that may promote political reform.<sup>184</sup>

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<sup>181</sup> *Id.* at 331.

<sup>182</sup> *Id.* at 332.

<sup>183</sup> *Id.* at 337.

<sup>184</sup> I am not alone in these views. In 2000, Thomas Jones and Susan Finder, two American lawyers and veterans of the China practice, looked back on its development during the preceding two decades, much as I have here. Thomas E. Jones & Susan Finder, *PRC Law: A Millennium Retrospective*, CHINA L. & PRACTICE, Dec. 1999-Jan. 2000, at 53. Their conclusions and mine are

Against the background of my own experiences in China and my general appraisal of the legal environment for FDI, early in 2004 I met in Beijing with a group lawyers and businessmen who have all been involved in one way or another with FDI in China for considerable periods of time, some for many years, and who are knowledgeable about the matters I have discussed here. I asked them to assess the current business environment.

The consensus was a commonsensical one that carries a mixed message: in the longest-established areas of FDI, such as setting up joint ventures of the types originally authorized in 1979, the accumulated body of experience is now considerable. Regulation and its procedures have grown in standardization, transparency and regularity; consequently, uncertainties have been reduced in these areas. Also, as experience has been accumulated by foreigners who entered into joint ventures, the difficulty of finding reliable Chinese partners and working well with them has led numerous foreign investors to prefer WFOEs instead.

The group further agreed that in newer and emerging areas such as capital markets, foreign equity investment, venture capital, and mergers and acquisitions, uncertainties abound. Corporate governance standards are nascent in their formulation and more often than not unheeded in practice. We also agreed that the distinction between relatively developed areas of law and newer ones is not absolute, and that as a general matter, progress is being made only slowly in increasing transparency and bringing the acts of administrative agencies under closer scrutiny and control according to legal standards.

Significant agreement with these views has been expressed elsewhere in the U.S. business community in China. For example, the American Chamber of Commerce in Shanghai noted in 2004 that Shanghai officials had “announced a new openness initiative that will make available internal documents and allow local officials to directly address problems of citizens and foreign companies alike.” At the same time, however, the report adds:

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very similar, and they balanced the achievements and continuing problems in much the way I have. They, too, pointed to continuing CCP influence, and characterized the approval process as both “opaque and unpredictable, often involving the re-negotiation of executed contracts.” As an example of insufficiencies in existing securities legislation they cited the lack of protection for minority shareholders. Of land law, they noted that “[w]hile Chinese land legislation has proliferated since the 1980s, practice remains volatile.” They pointed also to structural problems that have been addressed here, including excessive discretion vested in the bureaucracy coupled with weak controls over administrative authorities, lack of transparency, and weak courts marked by an “overall low level of judicial training in dealing with the challenges presented by an internationalized economy.” They, too, concluded that while the body of laws adopted since 1979 is “impressive,” legal institutions must be strengthened and limits on the exercise of government authority established.

Recent progress notwithstanding, our members continue to see inconsistency in local officials' interpretation of Chinese regulations. Decisions on fees or fines are often imposed arbitrarily and without uniformity. Many regulatory documents are still restricted to internal use (*neibu*) [sic] and are thus not always shared with interested companies.<sup>185</sup>

Consistent with this report is the conclusion in a survey of members of the U.S.-China Business Council, which found that lack of transparency was ranked as the third most important issue of concern to them in 2005, although it had been sixth in the survey of the preceding year.<sup>186</sup>

A look back over the history of FDI in China since 1979 yields a mixed picture of accomplishments and persistent problems, and it is not easy to sort out the prospects for the future. Contemplating the future is even more difficult if we expand our perspective beyond the legal framework for foreign businesses to take into account essential features of the society into which foreign businesses situate themselves and which inevitably affect the meaningfulness of law.

## X. CONCLUDING THOUGHTS: LOOKING AHEAD

### A. *The Limits of Legal Change with China in Flux: Social Change and the Crisis of Values*

It is not only the structure and policies of the Party-state that impede legal reform; ongoing changes in Chinese society further complicate the task.

A dramatic alteration in the involvement of the Party-state in the lives of the populace, for example, has occurred. State control over the lives of many Chinese has been noticeably relaxed. They are increasingly free of the tyranny that their work units exercised over them; they are relatively freer than they have been since 1949 to speak and think as they please, although within certain boundaries; some have gained social mobility and economic opportunities unparalleled in prior Chinese history. Swept up in these changes, China is

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<sup>185</sup> 2004 White Paper – Shanghai Issues, AM. CHAMBER OF COM., PRC, (2004), <http://www.amcham-china.org.cn/amcham/show/content.php?id=377> (last visited Dec. 13, 2006).

<sup>186</sup> US-China Bus. Council, *China's WTO Implementation: An Assessment of China's Fourth Year of WTO Membership*, Sept. 14, 2005, at 8, available at [http://uschina.org/public/documents/2005/09/ustr\\_testimony.pdf](http://uschina.org/public/documents/2005/09/ustr_testimony.pdf) (last visited Dec. 13, 2006).



undergoing a crisis in values. Although more than half a century of Communist rule has eroded older traditions, after a quarter century of reform the Communist ideology has increasingly lost its coherence and legitimacy, and now appears glaringly hollow to many Chinese. This means that law reform must be carried out amidst a whirl of conflicting values that disturb and confuse Chinese society. An obvious result of the decline of faith in socialism is the moral vacuum in which new spiritual cults and Western religions rise to challenge the Party. Closer to the concerns of foreign investors are the questionable business ethics they often encounter: a recent survey has noted that some foreign companies argue that although they are complying with Chinese labor laws and their own codes of conduct, their information is often faulty because they are relying on falsified information provided by the Chinese factories from which they are sourcing products.<sup>187</sup> This is only one illustration of the manifestations of larger problems that affect all of Chinese society. The difficulties become more apparent to foreign investors when they attempt to understand corporate governance in Chinese companies.

*B. Opportunistic Conduct in Contemporary China:  
Corporate Governance and Business Ethics*

Foreign businesses frequently encounter an opportunistic mentality that has arisen in a legal atmosphere of loose, partial, and uncertain regulation. Clear illustrations are evident in corporate governance. Two observers have written that in the business culture of SOE managers, “the prevalent mindset . . . is that capital raised from the financial markets is free money that can be squandered with impunity,” an attitude inherited from the planned economy.<sup>188</sup> An American scholar of Chinese law commented on the opening of opportunities for foreign investors to purchase from newly established Asset Management Companies’ equity in SOEs via debt-for-equity swaps. He noted that

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<sup>187</sup> “Factory managers in China are becoming increasingly sophisticated at falsifying worker time cards and payroll documents to disguise irregularities including underpayments, excessive hours and inadequate health and safety provision. . . . The widespread forging of records threatens to undermine the aims of the corporate social responsibility movement, a response by multinationals to the concerns of customers, non-governmental organizations and trades unions about issues including human rights and the environment.” Lauren Foster & Alexandra Harney, *Doctored Records on Working Hours and Pay are Causing Problems for Consumer Multinationals as They Source More of Their Goods in Asia*, FIN. TIMES, April 22, 2005, at 17.

<sup>188</sup> Steven Shi & Drake Weisert, *Corporate Governance with Chinese Characteristics*, CHINA BUS. REV., Sept.-Oct. 2002, at 40, 43.

Anecdotal evidence suggests that the original management of the SOE – which often remains firmly in place – will be resistant to pressures for transparent governance or real returns on equity. Even a majority equity stake in the SOE does not necessarily translate into stronger management influence.<sup>189</sup>

Analysis suggests that although China is aiming to transform the ownership framework of SOEs by converting them into shareholding companies and selling shares to private investors, it still lacks an *internal governance* regime that will ensure that owners can adequately monitor managers and that agents will act in the interests of their principals. Missing, too, are *external governance* rules such as strict accounting standards, hard budget constraints, financial disclosure requirements, or hostile takeovers and bankruptcy proceedings to minimize the problem of imperfect information.<sup>190</sup> Under these conditions, managers expropriate shareholders as a body, and large shareholders expropriate small ones.<sup>191</sup>

The consequences for Chinese retail investors have often been disastrous. As the Wall Street Journal comments, the nation's stock exchanges "have turned out to be full of rotten companies that relied on political connections to get listed. Regulators have had little success fighting rampant insider trading and poor disclosure."<sup>192</sup> The current situation is summarized cogently in an opinion offered in the wake of the collapse of China Aviation Oil Holding Company, an SOE that suffered derivative losses of \$550 million and then sold a 15% interest in its Singapore subsidiary without disclosing the losses:

China's nascent capitalism seems to be producing a particularly virulent strain [of fraud]. The country's authorities have worked hard to impose a framework of rules for listed companies, including a requirement to produce quarterly results. But the gap between theory and

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<sup>189</sup> Nicholas C. Howson, *The AMCs' Debt-for-Equity Swaps: Opportunities for Foreign Capital?*, CHINA BUS. REV., Sept.-Oct. 2001, at 56, 57.

<sup>190</sup> Lan Cao, *Chinese Privatization Between Plan and Market*, L. & CONTEMP. PROBS., Autumn 2000, at 13.

<sup>191</sup> See, e.g., Donald Clarke, *The Institutional Environment of Corporate Governance in China and Its Policy Implications* (May 4-5, 2003) (paper presented at Conference on Corporate Governance in East Asia, Berkeley Center for Law, Business and the Economy, Boalt Hall School of Law, University of California, Berkeley).

<sup>192</sup> James T. Areddy & Peter Wonacott, *As China Rises, Sinking Stocks Spark Middle-Class Protests*, WALL ST. J., Apr. 21, 2005, at A1.

practice is wide. There is no effective enforcement and corporate governance is poor. Chinese companies, which are state companies run by political fiat or private firms controlled by entrepreneurs or family members, have little experience in looking after minority shareholders and only a partial understanding of such concepts as board independence, independent auditing of results and the need for proper risk control.<sup>193</sup>

The quoted discussion of corporate governance is focused on SOEs, but foreign investors in joint ventures have often encountered problems with their Chinese partners which, in the words of one consulting group, “can vary from outright criminal activity to serious non-compliance issues.”<sup>194</sup> As stated at the beginning of this section, to understand the difficulties that confront Chinese legal reform, it is necessary to look beyond the problems that beset both FDI and economic reform. The discussion that follows looks at the larger social context that must be taken into account.

### C. *The Roiled Social Context of Chinese Legal Reform*

Some of the most obvious problems that China faces today and which directly confront the task of law reform include the growth of economic disparities, not only between the countryside and cities and between the China coast and inland, but also between winners and losers in the economic reforms: the gap between richest and poorest is one of the largest in the world.

In the meantime, social mobility has increased – over 125 million migrant workers have left the countryside to work in the cities – and there has been a breakdown of communal and workplace ties. These dramatic changes have contributed to social unrest. Crime is rising; the number of public protests and demonstrations is increasing, and in the countryside legal resources are sadly lacking for peasants who wish to use formal legal means to protect the rights of which they have become aware.

The Chinese leadership mistrusts civil society, and therefore closely watches and regulates non-governmental organizations for fear that they could become centers for political dissent and apply pressure for political change. The leadership is so paranoid about political opposition

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<sup>193</sup> *Fools Rush In: The CAO Derivatives Fiasco*, THE ECONOMIST, Dec. 11, 2004, at 72, 72.

<sup>194</sup> Klaus Koehler, *Fraud and Corporate Governance in Foreign Invested Enterprises in China*, in CHINA INVEST NEWSLETTER (Klako Group), Mar. 2005, available at <http://www.klakogroup.com/atc/ci/mar05.html#FCG>.

that it continues to limit media freedom, block access to Internet sites that might spread ideas deemed politically subversive, and restrict public discussion of sensitive topics.

Among the changes in values that have been set in play by the reforms is legal culture, an admittedly vague but useful catchall concept meant to encompass attitudes toward law on the part of officials and the populace alike. Although it may appear indefinite and is difficult to measure, demonstrable manifestations of it are critically relevant to understanding legal uncertainty in China today, as the preceding discussion of corporate governance should suggest. As a preliminary to speculation on possible paths of legal development in the near and long terms, the following discussion contrasts some obvious attitudes of the Party leadership with others that seem to exist, both within the Chinese Party-state and among the Chinese populace.

#### *D. Perspectives on Legal Culture*

##### *1. Slow Development of Administrative Law*

As committed as the leadership is to maintaining the dominant role of the CCP, it has also recognized the need to implement law to respond to popular concerns about the need to control official behavior and to protect newly defined private rights. Acceleration of economic reform was a motive for the leadership's decision in the late 1990s to accelerate China's joining of the WTO; accession has generated further impetus and necessity for advancing legal reform, notably in expanding control over administrative arbitrariness. In recent years, law reformers' attention has been focused on revising and expanding the scope of laws adopted in the 1990s that began to create a body of administrative law not previously known in China. These include the Administrative Litigation Law, which came into force in 1990 to permit, under limited circumstances, suits against government agencies;<sup>195</sup> the State Compensation Law, adopted in 1994, under which state agencies could be subjected to tort liability, although standards of liability are seriously unclear;<sup>196</sup> and the Administrative Reconsideration Law of 1999, which

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<sup>195</sup> Although in the late 1990s the number of cases instituted yearly rose to 115,000, currently they have fallen to 80,000. The scope of the law is limited, and as a result, most administrative actions remain beyond challenge in the courts. For example, courts may only review alleged misapplication of laws but not discretionary acts, and they also lack power to declare invalid a law that violates the Constitution or a superior law or regulation.

<sup>196</sup> While this article was being completed, a committee of legal experts was preparing a revision of the law under the auspices of the Legislative Affairs Commission of the NPC.

created procedures for review within agencies, but without external oversight over such reviews. Other laws have been adopted to standardize the imposition of sanctions by administrative authorities and procedures that govern their handling of licenses. Transparency in the legislative process and in administrative rulemaking, by for example utilizing public hearings, is also being encouraged, although tentatively and unevenly.<sup>197</sup>

The mere existence of a law under which agencies may be sued symbolizes both the progress that legal reform has made since it was begun in 1979 and the distance that has yet to be traveled before China's legal institutions evolve into a legal *system* that upholds the rule of law. An uncertain territory lies between a frail nascent legality and a vast expanse of official behavior that is unregulated or barely regulated by law. Further efforts to narrow the gap remain under consideration both in the LAO of the State Council and the Legal Affairs Committee of the Standing Committee of the NPC.

## 2. Reform Aimed at Changing the Legal Culture of Officials

The realization has grown among some higher level officials that creating a meaningful legal system involves more than merely staffing courts and passing laws. Recognition is slowly growing that in order to strengthen legal institutions, government officials and the general populace at large must value and support them, thereby granting them legitimacy. The amalgam of traditional and Maoist attitudes carried over from pre-reform legal culture cannot change quickly, especially given the ambivalence of the Chinese leadership toward law as well as the persistence of legislative techniques and bureaucratic practices which, reflecting previous attitudes and practice, impede the growth of law and attitudes toward law that would strengthen legality.

The State Council has turned its attention to this problem, as evidenced by promulgation in 2004 of the "Implementation Programme for Comprehensively Promoting the Exercise of Administrative Functions in Accordance With the Law."<sup>198</sup> This document noted that

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<sup>197</sup> Obligations that China assumed when it acceded to the WTO, already noted briefly in Part One, are relevant in this regard. China has promised that "China shall make available . . . upon request, all laws, regulations and other measures pertaining to or affecting trade . . . before such measures are implemented or enforced." Protocol, *supra* note 81, art. 2(C)(1), at 3 (2001).

<sup>198</sup> 全面推进依法行政实施纲要 [Implementation Programme for Comprehensively Promoting the Exercise of Administrative Functions in Accordance With the Law], *translated in Text of Chinese*

Administrative policy-making procedures and mechanisms are not sufficiently sound. Non-compliance with the law, law enforcement of the law, and failure to investigate violations of the law happen from time to time, causing significant resentment among the people. Mechanisms for supervising and restraining administrative acts are not sufficiently sound; some unlawful and improper administrative acts are not stopped or corrected in a timely and effective manner; and there is no timely recourse for the harm done to the legitimate rights and interests of the parties that are subject to administrative management.<sup>199</sup>

The balance of the document calls, essentially, for adherence to the rule of law in a manner that echoes values consistent with the Western ideal of the rule of law: it emphasizes the need for clear definition of the functions of administrative agencies, standardized behavior, fairness, transparency, effective supervision, and effective safeguards. Institution-building, full and correct enforcement of norms, and uniformity in the legal system are stressed, and rationality and procedural regularity are repeatedly mentioned. In discussions in March 2004, LAO officials emphasized that the mentalities of officials had to be shaped so that they would understand, accept and discharge their functions in a manner consistent with these principles.

To what degree progress toward these lofty goals will be achieved remains, of course, in doubt. Premier Wen Jiabao, in a speech in 2004, stated that the "Implementation Programme" noted above "puts forward the necessity of basically attaining the goal of building a government with the rule of law through making unremitting efforts for about 10 years."<sup>200</sup> Institution-building will be a work in progress for a long time, and changing the legal culture will take even longer. Wen stated that "crucial" to promoting administration through law was whether "the leadership attaches importance to work in this respect and grasps implementation."<sup>201</sup> Leadership commitment to raising the level of Chinese legality, however, has obviously been crucial all along, and the

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*Plan on Developing Law-Based Administration*, BBC MONITORING INTERNATIONAL REPORTS 1, Apr. 26, 2004.

<sup>199</sup> *Id.* at § I(1).

<sup>200</sup> *Chinese Premier Stresses Administration According to Law*, BBC MONITORING INTERNATIONAL REPORTS 1, June 30, 2004.

<sup>201</sup> *Id.*

basic contradiction between the rule of law and CCP dominance remains unaddressed. The Congressional-Executive Commission on China has observed that the Chinese government has placed “heavy rhetorical emphasis on respect for the Constitution and ‘administration according to law,’” and has articulated laws and policies consistent with that goal. It adds, though, that “[g]overnment officials retain enormous discretion . . . and existing legal mechanisms neither permit Chinese citizens to enforce their constitutional rights nor provide a consistent and reliable check on arbitrary administrative acts.”<sup>202</sup>

*E. The View From Below: Citizen Attitudes Toward Law*

Among many reasons for the “disappointing lack of effectiveness of enacted law” in China today, one knowledgeable observer of Chinese legal development has noted,

the concept and doctrines of legality, unlike the precepts of Confucianism, has never occupied a central role in traditional imperial China. There has not existed a legal culture with elements like officials’ fidelity to law or citizens’ consciousness of their legal rights, which provide the necessary conditions for the effective operation of a modern Western-style legal system.<sup>203</sup>

Although popular legal consciousness remains influenced by traditional attitudes that did not include insistence on legality, reform has brought about ongoing changes. More Chinese citizens are becoming aware of the possibilities for relying on the laws that the Party-state has given them in litigation to vindicate rights expressed in that legislation. Recent amendments to the Constitution raise the possibility of increased protection of rights. Legislation implementing those amendments has not yet appeared, but some, such as a draft nationwide property law, is under discussion. While the Chinese Constitution currently remains, as it has been throughout the history of the PRC, an aspirational document that is

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<sup>202</sup> CONG.-EXECUTIVE COMMISSION ON CHINA, ANNUAL REPORT 87 (2005). In discussions with LAO officials they have expressed their desire to raise the “consciousness” of various types of officials, such as mayors of major cities. The goal as expressed has been nothing less than changing the *legal culture* of the such officials through training that would included lectures by foreigners and study tours abroad.

<sup>203</sup> ALBERT HY CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE’S REPUBLIC OF CHINA 116 (3d ed., 2004).

not justiciable, enforcement of constitutional rights has become a topic of increasing interest.

Competing currents in Chinese legal culture are now discernible. While there is a lack of eagerness to promote reform from above, there are signs that from below, from Chinese society itself, citizens' attitudes toward the law are evolving. I offer an illustration from my own experience:

For over 35 years I have been traveling to China, and when I tell Chinese that I have been specializing in Chinese law for over 40 years, they often laugh because they think there is little to study. One day I had that kind of conversation with a taxi driver, who repeatedly exclaimed, "We don't have any real law." Our discussion continued during a lengthy ride to China's largest law school, and when we reached my destination, I asked him to wait while I went inside. When I returned to the taxi, he remarked that I had been gone a long time, more than an hour. When I reminded him that I had told him I would be gone that long, he said, "Yes, I knew I would have to wait, that's not a problem. My question is, since our country has so little law, how could you find enough to talk about for an hour?" We continued to talk, and at one point he said, "You don't understand. Do you know about campaigns?"

Yes, I said; there were often campaigns to enforce specific laws more strictly.

"No," he said, "you still don't understand. I am a taxi driver. If I steal from my company I should be punished. This month, the month of March, there is a 'Strike Hard' campaign going on to punish crime heavily. If I stole in February, before the campaign, I would have received a certain punishment. But if I steal this month, I would be punished more severely. That's not fair. The law should be the same in March as it is in February."

This taxi driver understood some basic concepts of the rule of law, and I have heard his sentiments echoed by many other ordinary citizens. Peasants and workers who have increasingly protested against arbitrary official behavior in recent years have often invoked published laws as the basis for their protests. Some Chinese legal scholars, officials and intellectuals have called for a truly national and autonomous judiciary that applies standards of procedural fairness. Some businesses in the non-state sector desire stronger protection of their transactions and property through rules enforced meaningfully and consistently by the power of the Chinese state. The Chinese media often discusses significant court cases and issues related to the law; there are also considerable influences from abroad conveyed by the foreign and domestic media, the Internet, and foreigners doing business. Additionally, foreign nongovernmental



organizations such as the Ford Foundation, The Asia Foundation, the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) and the Yale Center for Chinese Law organize foreign experts to advise on a range of law reform projects.

*F. Prospects*

1. The Near Term

Stepping back from the welter of reports and impressions that attempt to assess or summarize a confused picture, it is no surprise to find continuing disagreement among foreign observers. An investor characterized in a *Wall Street Journal* article as a “strong proponent of the coming China century” compared China today with the United States after the Civil War, when the U.S. “had no rule of law.”<sup>204</sup> Consistent with this view is a *Taipei Times* editorial, which noted that a group of Taiwanese businessmen “who have been defrauded, conned and swindled in China established an association to advocate their rights and rights of others who have shared similar fates.”<sup>205</sup>

At the same time, the perceptions of foreign investors and the problems they encounter in China are sometimes produced by their own ignorance. As one writer noted:

Where China is concerned, there is a long history of foreigners shedding their normal caution and being transported by heady visions of limitless gain. Where else, after all, offers so many opportunities to participate in such a phenomenal growth story? And whatever the risks of plunging in, how much greater are the risks of being left out?<sup>206</sup>

In my own experience in China since 1972, I have often been amazed at how little effort some clients and other businessmen made to educate themselves about problems encountered by foreign investors in China.<sup>207</sup> Other China specialists report that many new and current

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<sup>204</sup> Jeff D. Opdyke & Laura Santini, *Emerging Ways to Invest in the Wild, Wild East*, WALL ST. J., Mar. 9, 2005, at D1.

<sup>205</sup> Editorial, *Banding Together for Strength*, TAIPEI TIMES, July 18, 2003, at 8.

<sup>206</sup> Guy De Jonquieres, *Investors are Drawn to China in Spite of the Risks*, FIN. TIMES, Feb. 1, 2005, at 19.

<sup>207</sup> See, e.g., Stanley Lubman, *Through a Glass, Dimly: Perceptions of China in the American Business Community*, PROBLEMS OF POST-COMMUNISM, Mar.-Apr. 2000, at 34.

investors in China are equally as uninformed as their predecessors.<sup>208</sup> Such ignorance is only part of the superficiality of knowledge and caricaturization of China that is too common in the West.<sup>209</sup>

The combination of legal uncertainty and foreign unfamiliarity with the business environment led to an assessment in a survey of business in China in 2004 by *The Economist* that referred to risks

[f]or businesses already facing a host of challenges. China's developing capitalism is not solidly based on law, respect for property rights and free markets. It is unbalanced and potentially unstable. Multinational companies operating in China have often failed to produce an adequate return on their investment, or indeed a profit of any sort. That is partly their own fault, because they overestimated the market and underestimated the competition. With experience, more are getting it right. However, the business climate in China remains capricious and often corrupt.<sup>210</sup>

I would modify this judgment by weaving into it the conjecture that the near-term prospects seems to be the continuation of a *rolling uncertainty* that has marked the last twenty five years. The major causes that have been discussed here seem likely to maintain their influence. The development of FDI since 1979 suggests that as new or expanded forms of foreign business activity emerge and practice accumulates, uncertainty is restrained and reduced, although the regulation of FDI seems likely to continue to be marked by the problems that have been

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<sup>208</sup> It may be, too, that some foreign investors, if and as they become acquainted with the realities of business in China, decide that they would rather not take the risks they perceive. For an account of a transaction that led one prospective investor not to subject himself to the uncertainties of Chinese legal and business culture, see Nancy T. Avedissian, *Chinese M&A: Green Light or Red Flag?*, CHINA BUS. REV., Sept.-Oct. 2005, at 26. A US private equity firm walked away from a negotiation to acquire the assets of a Chinese manufacturer in Guangdong Province. It learned, among other things, that the site of the targeted company was not in compliance with zoning laws; that its long-term leases were due to expire but the seller felt no need to negotiate renewal of the leases; and that the company had not paid certain employment taxes, but was prepared to negotiate with the tax authorities if and when they raised the issue. The author of the article learned, she writes, that what is not an acceptable business risk is "not always entirely clear" in China, and that "the enforcement of laws can vary with the whims of local officials."

<sup>209</sup> See, e.g., Stanley Lubman, *The Dragon As Demon: Images of China on Capitol Hill*, 13 J. CONTEMP. CHINA 541 (2004); CHINA IN THE AMERICAN POLITICAL IMAGINATION (Carola McGiffert, ed. 2003).

<sup>210</sup> *Behind the Mask: A Survey of Business in China*, THE ECONOMIST, March 20, 2004, at 4 (the survey, an entire work with its own pagination, begins after page 60 of the regular issue).

discussed here, absent a deepening commitment by the Chinese Party-state to legal reform. In addition, the economic nationalism and backlash against FDI that have recently become noticeable continue to grow, so the problems faced by prospective foreign investors will reflect new difficulties.<sup>211</sup>

## 2. Beyond the Near Term

Further legal development depends on the future of the economic growth that underlies legal reform. Indefinite continuation of the torrid rate of the first twenty five years seems unlikely. Quite apart from this obvious uncertainty about the near term, however, are questions about the future path of general legal development in the years to come. Regardless of how many new institutions are created and new laws promulgated, whether for FDI or for wider application, a legal culture must evolve that will support consistent enforcement and application of laws, both new and old.

We cannot know now how deeply Chinese law in the future will bear the imprint of pre-Communist China's legal culture and the Maoist institutions and practices of the current Party-state that still exert strong influence. In particular, we cannot know the future trajectory of the rule of the CCP. One scholar has suggested that for the Chinese leadership to subject themselves to the rule of law they would have to "abandon beliefs, values, expectations and habits that have endured in China for over a millennium. In other words, they would have to abandon culture as well as self-interest."<sup>212</sup> It is not necessary to subscribe to this extreme view to take seriously the burden of history that rests on modern Chinese law.

Certainly the history of economic development in East Asia since WWII suggests that legal development will not follow a path similar to that of the West, and that we cannot presently predict the configuration of legal institutions that will become permanent. One scholar has suggested that "informal and non-state institutions may go a long way forward toward providing the predictability and security that investment

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<sup>211</sup> And, of course, the crisis in values that has been referred to and the social unrest that has become increasingly apparent in recent years could increase in seriousness and depth to the point that they affect both policy toward FDI and the concerns of prospective foreign investors.

<sup>212</sup> John O. Haley, *The Rule of Law in China: A Path Dependent (Pessimistic) View* 6 (May 12, 2006) (paper presented at conference on *The Rule of Law in China: Theory and Practice*, Promoting U.S. China Business Relations: A Forum, Washington University in St. Louis).

requires.”<sup>213</sup> While this view does not completely describe the Chinese system, it does call to mind the tactics that foreign investors and local governments have employed to fashion a degree of relative predictability and expectations ample enough to support sustained growth in foreign investment. Another scholar has commented that “contrary to some theory, less legal-rational means of market control may actually permit greater economic and social predictability, at least in the short-term.”<sup>214</sup>

But what might lie beyond the short term? It is easy to assume that a liberal-democratic rule of law is unlikely to evolve in China. But there is also evidence that Western concepts of law, even if they can be applied only with difficulty, are not irrelevant, either to the thinking of law reformers or the Chinese populace.

The search that I undertook forty years ago has changed, because China has undergone, and continues to be in the midst of, remarkable transformations. There is an impressive amount of Chinese law on the books now, and more will continue to appear. When I began, one question was whether law could ever be a lens that could be useful for viewing and deepening foreign understandings of China. The last twenty five years of Chinese history provide a ready answer, but another even more pointed question is present today: What is, and what will be, the significance of law in the governance of the Chinese Party-state? The challenge of that question is greater today than that posed by the earlier one, because China has itself now joined in the search for law.

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<sup>213</sup> Donald C. Clarke, *The Historical Legacy of China's Legal System*, in *THE RULE OF LAW: CHINESE LAW AND BUSINESS* 3 (May 11-13, 2005) (report of the presentations and discussions at a workshop held at Rhodes House, University of Oxford).

<sup>214</sup> Terence C. Halliday & Bruce G. Carruthers, *Legal Certainty, Market Certainty, and Social Instability: The Confounding Case of Stalled Bankruptcy Reform in China* 29 (May 30, 2004) (paper presented at the Law and Society Association annual conference, Chicago, Illinois).