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PROTECTION OF PERSONALITY RIGHTS UNDER KOREAN CIVIL LAW*

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* This is an English translation of Justice Kim's piece titled In-gyeog-gwon Ilban – Eonron-e Uihan In-gyeok-gwon Chimhaereul Jungsim-euro [*Personality Rights in General – Focusing on Infringement of Personality Rights by the Press*], which was originally published in Minsapanraeyeongu (XXI) (민사판례연구 (XXI)) [STUDIES OF CIVIL CASES (XXI)] 645 (1999). This abridged translation incorporates subsequent jurisprudence and academic literature released since the original publication. It has been translated with the author's permission to reprint.

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INTRODUCTION

In recent decades, the Republic of Korea has experienced a remarkable development in the field of information technology and digital electronics. The country is currently a world leader in internet and social media services market. While the Korean population enjoys the advent of an era marked with easy and fast access to mass communication, infringement of personality rights including honor,[1] privacy, and personal data has emerged as a serious issue of concern for the legal community.[2] In Korean courts and academia, disputes

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[1] In Korean law, the term "honor" (명예) means an objective social evaluation of one's character, virtues, and/or worth.

[2] The number of disputes involving infringement by the press of personality rights ("Press Disputes") has increased on an incremental basis since the 1980s. Press Disputes are primarily resolved through mediation or arbitration by the Press Arbitration Commission ("Commission") and also though court litigation. The trends of these Press Disputes over the years are discernible by probing the Commission statistics. Between the foundation of the Commission in 1981 and 2008, the number of mediations involving the Commission stood at 12,318, out of which 4,112 cases were settled. In 2006, the mechanism of press arbitration was first introduced, and a total of 31 arbitration requests were lodged with the Commission until 2008, with a decision reached on each requested case. The number of mediations was a meager 44 in 1981 and 55 in 1988, but began to climb in 1989; as a result, a total of 602 mediation requests were filed in 1998 and 951 in 2008, respectively. In 2005 and 2006, the Commission received more than 2,000 mediation requests combined. *See* Eonlonjungjaewiwonhoe (언론중재위원회) PRESS ARBITRATION COMMISSION, Yeondobyeol Jojeongsincheong Cheoli Hyeonhwang (연도별 조정신청 처리현황

surrounding personality rights are taking on new dimensions and unprecedented levels of complexity. The concept of personality rights is taking the center stage on its own, as Korean society shows an increased awareness on the issue of personality rights and looks for legislative guidance.

Reflecting on the past, when the Korean Civil Code ("Civil Code")[3] was enacted in 1958, only minimal attention was paid to the issue of personality rights. The legislature did not properly address the matter. After half a century, the Civil Code still consists of piecemeal provisions, lacking specific provisions focusing on personality rights. Although the Korean Criminal Code ("Criminal Code")[4] attempted to regulate certain aspects of personality rights by defining defamation and verbal insult as crimes, it failed to effectively regulate the area of privacy and unwarranted invasion.

Beginning in the 1980s, the Korean judiciary has attempted to flesh out personality rights by handing down trailblazing decisions. These decisions recognized a right to seek monetary damages and injunctive relief for violations of personality rights. Since the Civil Code is silent on personality rights, illegality of personality infringement was assessed in the context of freedom of expression. This judicial endeavor is embodied in the enactment of the Act on Press Arbitration and Remedies, etc. for Damages caused by Press Reports of 2005.[5]

The purpose of this article is to provide a general analysis on the protection of personality rights under Korean civil law. In particular, this article will examine problems regarding the press and other venues of expression. Towards this end, the meaning of pertinent constitutional and other legal provisions in relation to personality rights is discussed in Part I. The overall scope of legal protection accorded to personality rights is explored in Part II. Part III deals with the issue of conflict between personality rights and freedom of the press or freedom of arts[6] and the

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(1981 년~2008 년)) [STATUS OF ANNUAL MEDIATION REQUESTS PROCESSING (1981-2008)], http://bit.ly/2sISDQx. In 2013, 2,433 mediation cases were handled, and in the following year, in the aftermath of the *Sewol* ferry incident, the number of mediation requests literally skyrocketed, resulting in a total of 19,048 cases received and processed, which is the biggest number of mediations ever since the launch of the Commission. *See* Eonlonjungjaewiwonhoe (언론중재위원회) PRESS ARBITRATION COMMISSION, Eonlonjungjaewiwonhoe 2014 Nyeondoe Jojeongjungjae Cheoligyeolgwa (언론중재위, 2014 년도 조정중재 처리결과) [2014 MEDIATION PROCESSING RESULTS], http://bit.ly/2sJ0UEr.

[3] Minbeob [Civil Code], Act No. 471, Feb. 22, 1958, *amended by* Act No. 13710, Jan. 6, 2016 (S. Kor.).

[4] Hyeongbeob [Criminal Code], Act No. 293, Sep. 18, 1953, *amended by* Act No. 14178, May 29, 2016 (S. Kor.).

[5] Eonronjungjae Mit Pihaeguje Deung-e Gwanhan Beopryul [Act on Press Arbitration and Remedies, etc. for Damage caused by Press Reports], Act No.7370, July 28, 2005, *amended by* Act No. 10587, Apr. 14, 2011 (S. Kor.).

[6] Article 22.1 of the Korean Constitution guarantees freedom of arts (예술의 자유). DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION] art. 22 (S. Kor.). In this context, freedom of arts means one's freedom to exhibit, perform, and disseminate created works of art to the public. Constitutional Court. (Const. Ct.) 91Hun-Ba17, May 13, 1993 (S. Kor.).

significance of such friction in the context of civil liability in general. Part IV discusses the protection of personality rights of the dead, an area mostly unique to personality rights. I conclude with a brief summary with implications for future study.

I. THE MEANING OF PERSONALITY RIGHTS UNDER KOREAN CONSTITUTIONAL AND CIVIL LAW

In order to ascertain what position and status personality rights occupy in Korean civil law, it is first necessary to study the meaning of constitutional and other legal provisions governing personality rights.

A. Influence of the Constitution on Civil Law

Article 10 of the Korean Constitution provides "all citizens shall be assured of their human worth and dignity and shall have the right to pursue happiness," while Article 17 of the Constitution sets forth "the right to privacy of all citizens shall not be infringed."[7] Personality rights. which are largely premised on these constitutional norms, are acknowledged as the most basic and central of fundamental rights.[8]

The question of how the constitutional provisions have influenced personality rights under civil law may arise.[9] As will be seen below in Parts III and IV, the Constitution and related jurisprudence are significant for defining the contours and outer limits of personality rights in the context of Korean civil law.

B. Tort Liability under Civil Law

As will be illustrated below, tort liability under the Civil Code can play an influential role in protecting personality rights from infringement. First, Article 750 of the Civil Code provides that "(a)ny person who causes losses to or inflicts injuries on another person by an unlawful act, willfully or negligently, shall be bound to make compensation for damages arising therefrom," thereby providing a generic and broad prescription on the constitutive elements of a tort.[10] Accordingly, unlike the civil laws of Germany or Japan, a tort is deemed to have occurred as long as the element of illegality is present regardless of whether an absolute right such as property ownership is at stake.[11] According to the majority of

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[7] DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION] arts. 10, 17 (S. Kor.).

[8] *See* Constitutional Court [Const. Ct.], 89Hun-Ma82, Sep. 10, 1990 (S. Kor.)

[9] In Korean constitutional jurisprudence, this issue has been discussed as the effects of fundamental rights against other private parties or the effects of fundamental rights on private relations.

[10] Minbeob [Civil Code], Act No. 471, Feb. 22, 1958, *amended by* Act No. 13710, Jan. 6, 2016, art. 750 (S. Kor.).

[11] *See* Kim Gi Sun (金基善)'s commentary *in* Minbeobanuigyeonseo (民法案逐条書) [OPINIONS ON THE DRAFT CIVIL CODE] 199 (Minsabeobyeonguhoe (民事法硏究會) [Civil Law Research Group] eds., 1957).

legal scholars in Korea,[12] the presence of illegality is ascertained by taking into account the co-relation between the nature of infringing act and the type of right infringed, and personality rights are included in the ambit of rights protected under Article 750. Therefore, whether personality rights amount to rights of an absolute nature or not, Article 750 may apply where an infringement of personality rights or related interests has occurred. A more crucial query is usually how to assess the tortfeasor's negligence or willfulness and, if any, accompanying illegality in the context of a tort claim springing from the alleged infringement of personality rights.

Second, Article 751.1 of the Civil Code provides, "(a) person who has injured the person, liberty or fame of another or has inflicted any mental anguish to another person shall be liable to make good damages arising therefrom."[13] This provision confirms that harming one's honor or inflicting mental pain or anguish may be captured under Article 750, and affirms liability for non-property damages in such cases. Under the Korean civil law regime, therefore, personality rights can be protected with relative ease, since there is no significant legal barrier for awarding damages for actual infringement of said rights.

Third, Article 764 of the Civil Code provides, "(t)he court may, on the application of the injured party, order the person who has impaired another's honor to take suitable measures to restore the injured party's honor, either in lieu of, or together with damages."[14] Included among possible legal redresses to restore the afflicted party's honor is the right to request a corrective note,[15] retraction of a defamatory material, or a public apology. However, in a recent case, the Korean Constitutional Court ("Constitutional Court") held that ordering a public apology would be unconstitutional because it contravenes the freedom of conscience and personality rights in general.[16] On the other hand, there is a lower court

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[12] *See* Kwak Yoon Jik (郭潤直), Chegwongakron (債權各論) [THE SPECIAL PART OF THE LAW OF OBLIGATIONS] 709 (NEW ed. 1995) and *see also* Kim Cheung Han (金曾漢), Chegwongakron (債權各論) [THE SPECIAL PART OF THE LAW OF OBLIGATIONS] 464 (1988).

[13] Minbeob [Civil Code], Act No. 471, Feb. 22, 1958, *amended by* Act No. 13710, Jan. 6, 2016, art. 751.1 (S. Kor.).

[14] Minbeob [Civil Code], Act No. 471, Feb. 22, 1958, *amended by* Act No. 13710, Jan. 6, 2016, art. 764 (S. Kor.).

[15] *See*, inter alia, Supreme Court [S. Ct.], 96Da40998, 842, Feb. 24, 1998 (S. Kor.).

[16] In Constitutional Court [Const. Ct.], 89Hun-Ma160, Apr. 1, 1991, (3 KCCR 149) (S. Kor.), the Constitutional Court ruled that, in the context of defamation, it would be unconstitutional for a court to order the wrongdoer to place an advertisement of public apology and then enforce the order, as such a measure would be contrary to the freedom of conscience and personality rights in general. Following this ruling, there have been various discussions, one of which is, interestingly enough, that the scope of legal remedies for infringement on personality rights may be circumvented by none other than the perpetrator's own personality rights. Subsequently, while computing the quantum of damages for a corrective advertisement in Supreme Court [S. Ct.], 93Da40614, Apr. 12, 1996 (S. Kor.), the Court affirmed the Constitutional Court's position by acknowledging the

decision to the effect that, in a case involving infringement of personality rights other than defamation, restitutionary or other measures for the reasonable satisfaction of the victim may be ordered in addition to the usual award of money damages.[17]

There is a lingering question concerning whether it would be proper to use the term personality right as part of the Korean civil law lexicon. While legal academia as well as case laws recognize the term,[18] there is a minority view opposing the inclusion of personality rights into the general legal scheme. This view holds that Article 750 envisages formation of a tort in a broad way and that Article 751 provides "a person who has injured the honor of another person or has inflicted any mental anguish upon another person" shall be liable for damages.[19] As such, the minority view assert that whether a particular act or omission constitutes a tort may be determined in reference to Articles 750 and 751 alone, without recourse to the notion of personality rights.

Yet, while the primary mode of compensation for a tort is monetary damages, where infringement of personality rights is concerned, the complainant would also be entitled to seek injunctive relief along with the pecuniary compensation.[20] The availability of such injunctive relief and the right to seek retraction of an infringing publication evidences the

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decision of the court below that "albeit effective, an advertisement of public apology is not available to redress a negative advertisement."

[17] Seoul High Court [Seoul High Ct.], 92Na35846, Sep. 27, 1994 (S. Kor.).

[18] *See* Kwak Yoon Jik (郭潤直), Minbeopchoungchik (民法總則) [THE GENERAL PART OF CIVIL LAW] 51 (7TH ed. 2002); Kim Sang Yong (金相容), Bulbeophengwibeop (불법행위법) [THE LAW OF TORTS] 102 (1997); Park Chul Woo (朴哲雨), Chegwongakchik 債權各則(IV) [ANNOTATED SPECIAL PART OF THE LAW OF OBLIGATIONS (IV)] 118 (1987); Kang Nam Jin (姜南鎭), In-gyeog-gwon-ui Boho-e Daehan Hana-ui Je-an (人格權의 保護에 대한 하나의 提案) [ONE PROPOSAL FOR THE PROTECTION OF PERSONALITY RIGHTS], Minsabeophak (民事法學) [KOREAN J. OF CIVIL L.], no. 13/14, 1996 at 117; and Kim Jae Hyung (김재형), Eonron-ui Sasilbodoro Inhan In-gyeog-gwon-ui Chimhae (언론의 사실보도로 인한 인격권의 침해) [INFRINGEMENT BY THE PRESS UPON PERSONALITY RIGHTS VIA REPORTING OF FACTS], Seoul Daehakgyo Beobhak (서울대학교 法學) [SEOUL L. J.], no. 39, 1999 at 1. In terms of case law, *see* Supreme Court [S. Ct.], 79Da1883, Jan. 15, 1980 (S. Kor.) and Supreme Court [S. Ct.], 93Da40614, Apr. 12, 1996 (S. Kor.).

[19] *See* Lee Eun Young (李銀榮), Chegwongakron (債權各論) [THE SPECIAL PART OF THE LAW OF OBLIGATIONS] 733 (1995).

[20] *See* Supreme Court [S. Ct.], 93Da40614, Apr. 12, 1996 (S. Kor.). In this case, the appellate court ruled that the nature of personality rights is such that, once such rights have been infringed, it is difficult to ensure full restitution through after-the-fact relief (such as pecuniary compensation and reinstatement of honor) and to anticipate actual practicality of such relief. Consequently, the appellate court recognized a need for interlocutory relief, such as an injunction to thwart an actual or potential violation of personality rights, as a preventive measure, and the Court endorsed such judgment. *See also* Supreme Court [S. Ct.], 96Da17851, Oct. 24, 1997 (S. Kor.). Subsequently, the Constitutional Court ruled that this type of interlocutory relief in the context of defamation is not against the principle against censorship under the Korean Constitution. Namely, since said principle does not prohibit after-the-fact regulation of a legitimate nature following the publication of a piece of intellectual work, any ex post judicial ban on, for instance, playing of a film would not contravene the constitutional principle of anti-censorship. Const. Ct. 93Hun-Ga13 & 91Hun-Ba10 (consol.), Oct. 4, 1996 (S.Kor.).

exclusive and almost *in rem* nature of personality rights not unlike that of a property right.[21] Accordingly, the notion of personality rights provides rather useful guide in the Korean civil law regime.

C. *The Criminal Law and Copyright Law.*

First, Articles 307 through 312 of the Criminal Code proscribe the offense of defamation of character and offense of verbal insult. Protection of personality rights in the context of civil law is distinct from the protection of under the criminal law.[22] Nevertheless, the Criminal Code may come handy when it comes to resolving civil disputes concerning personality rights. Indeed, two provisions of the Criminal Code, namely Article 307.1, which states that a statement of fact may constitute defamation and Article 301, which states that an otherwise defamatory statement is not indictable if it should contain true facts solely for the public interest have been influential when determining if a civil defamation had occurred.[23]

Second, the Korea Copyright Act ("Copyright Act") contains detailed provisions on authors' moral rights. Where such rights are infringed, the author may seek a cease and desist order under the Copyright Act.[24] An author's moral rights are protected even after death.[25] Although these moral rights form a separate and independent legal concept from personality rights, they may be relevant where protecting the dead's personality rights is involved in the form of a cease and desist order. In this regard, the Copyright Act may be a more practical source for interpreting personality rights than the Civil Code itself.

D. *The Act on the Press*

It is increasingly common for personality rights to be regulated through individual enactments. Of these, the flagship legislation is

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[21] *See* Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] Mar. 14, 1970, (Showa 45) no. 586 HANREI JIHO [HANJI] 41 (Japan). On the other hand, a request for interlocutory relief based on personality rights is basically forward-looking in nature so as to prevent likely infringement of personality rights at some point in the immediate future. As such, unlike a claim for damages under Article 750 of the Civil Code, the element of willfulness or negligence may not factor in here. Yet where infringement of personality rights subsists even after the interlocutory relief has been granted, the perpetrator's negligence or willfulness may be extrapolated therefrom and found present. But when it comes to infringement by the press of personality rights, interlocutory relief should only be granted where the element of illegality is present and clear considering that interlocutory relief can put a far greater restraint on the freedom of expression than an award of money damages and that the Constitution prohibits pre-censorship in general.

[22] Hyeongbeob [Criminal Code], Act No. 293, Sep. 18, 1953, *amended by* Act No. 14178, May 29, 2016, art. 307-312 (S. Kor.).

[23] *Id.* arts. 307.1, 310.

[24] Jeojakgwonbeob [Copyright Act], Act No. 432, Jan. 28, 1957, *amended by* Act No. 14083, Mar. 22, 2016, arts. 11-15 (S. Kor.).

[25] *Id.* art. 128.

considered the Act on Press Arbitration and Remedies, etc. for Damages caused by Press Reports (the "Act on the Press"), which was enacted on January 27, 2005. The Act on the Press contains detailed provisions regarding infringement of personality rights by the press. In particular, Article 4.2 of the enactment provides that "(t)he press shall respect human dignity and worth and shall neither defame other persons nor infringe on their rights, public morals, and social ethics."[26] Article 5 then lays out the principles of redress for those who have been victimized by the press.[27] Namely, the press, any internet news service, or any internet multimedia broadcasting (collectively, the "Press") shall not infringe on other persons' personality rights, and, where the Press has infringed them, remedial measures will be undertaken promptly in accord with the procedure set forth in the Act on the Press.[28] The enactment goes on to cite two situations where no liability will attach to the Press for established acts of infringement. The first is where the victim voluntarily consented to infringement.[29] Another possible exception is where the Press did a report related to the public interest, and there is a justifiable ground that such report is true or is believed to be true.[30]

Arguably, the Act on the Press may function as a cure-all for infringement of personality rights involving the Press. Yet, outside the realm of the Press, it is virtually inapplicable. Thus, the Civil Code is an important, generic source of law on the protection of personality rights.

II. THE CONCEPT OF PERSONALITY RIGHTS AND ITS SCOPE OF PROTECTION

A. Concept of Personality Rights

The judiciary and legal scholars of Korea both acknowledge the concept of personality rights.[31] The notion of personality rights originated from the laws of Germany and the German word "*Persönlichkeitsrecht*." Use of personality rights is commonplace in most continental jurisdictions including Switzerland, Austria, and Japan. By contrast, such use is all but absent in the United States, where a more common approach involves the notion of privacy or slander and libel.

Personality rights are distinguishable from property rights. Korean civil law categorizes property rights into rights based on obligations (債權) and rights over things (物權). A person possesses rights over a variety of

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[26] Eonronjungjae Mit Pihaeguje Deung-e Gwanhan Beopryul [Act on Press Arbitration and Remedies, etc. for Damage caused by Press Reports]. Act No.7370, July 28, 2005, *amended by* Act No. 10587, Apr. 14, 2011, art. 4.2 (S. Kor.).

[27] *Id.* art. 5.

[28] *Id.* art. 5.1.

[29] *Id.* art. 5.2.

[30] *Id.*

[31] *See generally* the sources cited in note 18, *supra*.

subjects including life, liberty, body, health, honor, name, privacy and dialogue, to name just a few. The civil law system in Korea makes use of personality rights to allude to this spectrum of rights in a generic way. In the context of the Act on the Press, personality rights are defined as those pertaining to "life, liberty, body, health, honor, secrecy and freedom pertaining to privacy, portrait, name, voice, dialogue, works, personal documents, any other personal worth, and etc."[32]

B. Scope of Protection

The range of subjects protected by personality rights runs the gamut from life and liberty to portrait rights and privacy. Recently, the right to self-determination in the context of personal data also has made inroads into the range of what receives legal protection.[33]

1. Life, Liberty, Body, and Health

Infringing one's right to body, health, honor, name, portrait, private life, and other related interests may give rise to tortious liability. It is not in dispute that personality rights encompass such spectrum of rights. A right to life, liberty, body, and health are only recognizable in relation to natural persons, and not to corporate or non-incorporated entities.

2. Honor

The most frequent form of personality right violations involves defamation. Journalistic reporting of misleading facts would be a notable example.[34] In this context, honor or reputation denotes an objective social evaluation of one's character, virtues, and/or credit. It follows that defamation arguably involves objectively harming the overall societal assessment of a person. In order for defamation to be actionable, merely hurting a person's subjective sentiment or feeling for her reputation will not pass muster. Rather, what is required is a likelihood of inducing odium or contempt from an objective standpoint, as exemplified by a media outlet's reporting of false information,[35] such as publication of an essay with the false elements or character assassination.[36]

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[32]Eonronjungjae Mit Pihaeguje Deung-e Gwanhan Beopryul [Act on Press Arbitration and Remedies, etc. for Damage caused by Press Reports], Act No.7370, July 28, 2005, *amended by* Act No. 10587, Apr. 14, 2011, art. 5.1 (S. Kor.).

[33] In Supreme Court [S. Ct.], 2007Da27670, Nov. 20, 2008 (S. Kor.), the dissenting opinion noted that "(o)ne's right to body is the heart and soul of personality rights, and, as such, should be respected not only during one's lifetime but even afterwards to the fullest extent possible."

[34] *See* Supreme Court [S. Ct.], 85Da-Ka29, Oct. 11, 1988 (S. Kor.); *see also* Supreme Court [S. Ct.], 94Da33828, May 28, 1996 (S. Kor.).

[35] *See* Supreme Court [S. Ct.], 94Da33828, May 28, 1996 (S. Kor.).

[36] *See* Supreme Court [S. Ct.], 85Da-Ka29, Oct. 11, 1988 (S. Kor.).

In terms of relevant jurisprudence, the Korean Supreme Court ("Court") held that:

> (t)he term honor under Article 764 of the Civil Code means an objective social evaluation of one's character, virtue, fame, credit, and other related factors, and especially when it comes to corporation, corporate honor is equivalent to its good name and credit. Hurting honor is therefore to hurt how a person is socially perceived and assessed.[37]

The Court further held "the mere claim that one's own feeling of honor has been undermined does not amount to defamation of character per se."[38] In fact, in order for a cause of action for defamation to arise, there ought to be an objective likelihood of inducing the subject to contempt or abhorrence;[39] otherwise, a mere injury to one's subjective feeling or perception of honor would not readily bring about defamation.

Simultaneously, protection is warranted where one is subjugated to verbal insults by others for no good reason. Not unlike defamation, such situation calls for appropriate legal redress. In terms of possible criminal sanctions, where the wrongdoer made insulting or vilifying remarks without the buttress of supporting facts, such a statement may trigger the offense of insult. In terms of civil remedy, such statement could constitute the tort of verbal insult.[40]

3. Privacy

The concept of privacy originated in the United States, and it means the right to be let alone.[41] William L. Prosser categorized infringement of privacy into: 1) infringement or intrusion into one's spatial sphere of

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[37] Supreme Court [S. Ct.], 93Da40614, Apr. 12. 1996 (S. Kor.). This is also true in the case of unincorporated entities with standing as party to a civil suit such as a *Jong-jung* (宗中), i.e. a party consisting of the descendants of a common ancestor. *See also* Supreme Court [S. Ct.], 87Da-Ka1450, June 14, 1988 (S. Kor.), Supreme Court [S. Ct.], 89Da-Ka12775, Feb. 27, 1990 (S. Kor.), and Supreme Court [S. Ct.], 96Da17851, Oct. 24, 1997 (S. Kor.).

[38] In Supreme Court [S. Ct.], 92Da756, Oct. 27, 1992 (S. Kor.) and Supreme Court [S. Ct.], 97Ma634, July 9, 1997 (S. Kor.), both involving an injunction against the registration and publication of a family tree for alleged libel of a *Jong-jung*, the Court noted that "even when accepting the applicant *Jong-jung*'s cause of action at its face value, aside from the likelihood of the applicant's own sentiment of honor being injured or infringed, there is simply insufficient ground in this case to justify judicial intervention in order to protect the applicant's societal assessment from being somehow denigrated."

[39] Yang Chang Soo (梁彰洙), Jeongboh-wa Sahoe-wa Peuhraibeosi-ui Boho (情報化社會와 프라이버시의 保護) [INFORMATION SOCIETY AND PROTECTION OF PRIVACY], in Minbeopyeongu I (民法硏究 I) [STUDIES OF CIVIL LAW I] 513f. (1991). In this regard, defamation/libel is arguably distinguishable from the invasion of privacy.

[40] Kim Jae Hyung (김재형), In-gyeog-gwon-e Gwanhan Panrye-ui Donghyang (인격권에 관한 판례의 동향) [*Trends in the Case Law on Personality Rights*], Minsabeophak (民事法學) [KOREAN J. OF CIVIL L.], no. 3, 2005 at 362.

[41] S. Warren and L. Brandeis, *The Right to Privacy*, 4 Harvard L. Rev. 193 (1890).

solitude;[42] 2) disclosure of one's private life to the public;[43] 3) placing one in a false light publicly;[44] and 4) infringement of one's name and portrait or likeness, for economic advantages.[45] Prosser's categorization is considered highly useful.[46] In addition, privacy entails publicity, which is a right to commercially appropriate a famous person's name, portrait or profile. Because of its overall commercial trait, publicity is often seen as a proprietary dimension of privacy.

An individual possesses a right to prevent others from interfering with her privacy and to stop unauthorized exposure of privacy. When such a right is infringed, invasion of privacy is said to have occurred. Conceptually, privacy encompasses not only protection of an individual's private life, but also one's legitimate right and expectation to one's name and to one's portrait or image.[47]

In a case where the plaintiff, who had suffered certain side-effects following a breast augmentation surgery, consented to the broadcast of her privacy and portrait through a televised interview, but the interview subsequently aired in a way not meant by the plaintiff, the Court held that "a person has a legal interest not to be exposed to a third party in matters relating to the inmost secrets of her privacy."[48]

Defamation and invasion of privacy differ in several ways, the most salient of which are noted here. First, defamation involves infringement of how a person is socially evaluated, while privacy focuses on a person's

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[42] William L. Prosser, *Privacy*, 48 Cal. L. Rev. 383 (1960).

[43] *See generally id.* This includes trespass into a house or residence, illegal search of bags inside a store, wiretapping a conversation, and forced blood drawing.

[44] *See generally id.* This includes mentioning another's name as the author of a book or an editorial, drawing up a petition in someone's name without authorization, and inserting the plaintiff's picture in a book or thesis having no reasonable relationship to the plaintiff.

[45] This is referred to as "appropriation," and it includes using a person's name or portrait for the purposes of commercial advertisement without proper consent.

In Prosser, *supra* note 38, at 389, Prosser analyzed cases on privacy and concluded that they involved not merely a single tort, but an aggregate of four disparate torts. According to Prosser, these torts have nothing in common except for meddling with the right to be let alone. For further information, see W. PAGE KEETON & WILLIAM L. PROSSER, PROSSER AND KEETON ON TORTS 851-866 (W. Page Keeton et al. eds., 5th ed. 1984).

[46] RESTATEMENT (SECOND) OF TORTS § 652A (AM. LAW INST. 1977) also follows Prosser's categorization. But, in South Korea, where there is no disagreement on treating both Prosser's first two categories under the name of privacy, there has been no consensus on how to classify his third and fourth categories. For further details, see Yang, *supra* note 39, at 513f.

[47] Kim Jae Hyung (김재형), Ingyeoggwon Ilban – Eonron-e Uihan Ingyeokgwon Chimhae-reul Jungsim-euro (人格權 一般 – 언론에 의한 인격권 침해를 중심으로) [Personality Rights in General – Focusing on Infringement of Personality Rights by the Press], Minsapanraeyeongu (XXI) (민사판례연구 (XXI)) [STUDIES OF CIVIL CASES (XXI)] 645 (1999).

[48] Supreme Court [S. Ct.], 96Da11327, Sep. 4, 1998 (S. Kor.). In a similar vein, the Seoul Southern District Court affirmed liability for damages relating to a press report exceeding the boundaries of consent. *See* Seoul Southern District Court [Seoul Southern Dist. Ct.], 97Ka-Hap8022, Aug. 7, 1997 (S. Kor.).

inner emotions without taking the element of social assessment into account. Second, when it comes to defamation, proof of truth or of substantiality holds relevant significance. In fact, courts have held that actionable defamation does not arise if the alleged defamer can demonstrate there was a substantial reason to believe in the veracity of the statements made.[49] In contrast, for invasion of privacy, it is irrelevant whether the statement is actually true or if the party making the statement had a substantial reason to believe her statements to be accurate. In other words, an invasion of privacy may be found even where the perpetrator can prove veracity of the press coverage or a substantial reason for thinking the coverage to be truthful, as neither qualifies as a viable defense.

Third, while defamation of character may be pertinent to incorporated or unincorporated entities, invasion of privacy is not. On the other hand, both in defamation of character and invasion of privacy alike, when judging the tortious liability of the media entity involved, it is necessary to consider whether the coverage pertained to a public figure or to a public good. As will be explained more in Part IV, such consideration of public element is not necessarily identical in a defamation setting and in an invasion of privacy setting. Depending on the type of privacy involved, disparate theories of law may emerge and come into play in relation to the subject of public figure and interests.

4. Name and Portrait

One's right to a name means a right to self-determine whether to externally indicate her own name.[50] There are lower court decisions recognizing such a right.[51] And one's right to portrait or image is violated when, for instance, a photo taken without the subject's consent is made available publicly[52] or a picture is obtained and then posted without proper consent.[53] Even when there is consent to the taking of a photograph, there still can be an infringement of right to portrait when the photo is subsequently published in a way that exceeds the subject's expectation.[54]

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[49] *See, e.g.*, Supreme Court [S. Ct.], 85Da-Ka29, Oct. 11, 1988 (S. Kor.); Supreme Court [S. Ct.], 94Da33828, May 28, 1996 (S. Kor.); and Supreme Court [S. Ct.], 97Da24207, Sep. 30, 1997 (S. Kor.).

[50] Supreme Court [S. Ct.], 2007Da71, Sep. 10, 2009 (S. Kor.).

[51] Seoul District Court [Seoul Dist. Ct.], 95Ga-Hap60556, Apr. 25, 1996 (S. Kor.).

[52] Seoul Dist. Ct., 92Ga-Dan57989, July 8, 1993 (S. Kor.) and Seoul Dist. Ct., 93Na31886, Mar. 30, 1994 (S. Kor.).

[53] Seoul Dist. Ct., 96Ga-Hap31227, Feb. 26, 1997 (S. Kor.) and its appellate-level decision, Seoul High Ct., 97Na14240, Sep. 30, 1997 (S. Kor.).

[54] *See* Seoul High Ct., 88Na38770, Jan. 23, 1989 (HAJIP 1989-1, 148) (S. Kor.), Seoul Dist. Ct., 87Ga-Hap6032, Sep. 9, 1988 (S. Kor.), Seoul Dist. Ct., 88Ga-Hap31161, July 25, 1989 (S. Kor.), Seoul Dist. Ct., 92Ga-Hap12051, Sep. 22, 1992 (S. Kor.) and Seoul Eastern District Court, 89Ga-Hap13064, Jan. 25, 1990 (HAJIP 1990-1, 126) (S. Kor.).

5. Personal Data

Protection of personal information or data, which is a type of privacy, has been gaining momentum lately. The Court held that, "in a highly information-driven modern society, a person possesses a proactive right to self-regulate the information pertaining to himself."[55] Lawsuits for infringement of personal data are not uncommon when personal data such as name, resident registration number, and pictures are unlawfully disclosed or leaked.[56] The illegality of such unauthorized divulgence is made out if disclosing personal data without suitable consent may be evaluated as eroding the information owner's legally protected personality interests.[57] In Korea, the Protection of Personal Data Act was enacted on March 29, 2011 and came into effect as of September 30, 2011. Under the enactment, personal data is defined as "information that pertains to a living person, including the full name, resident registration number, images, etc., by which the individual in question can be identified, (including information by which the individual in question cannot be identified, but can be identified through simple combination with other information)."[58]

6. Voice and Dialogue

Infringing one's voice and dialogue may amount to an infringement of the victim's personality rights. There is a Court decision to the effect that direct transmission of an individual's voice may result in tortious liability.[59]

7. Right to Self-Determination

A medical doctor owes a duty to explain the benefits and risks of a procedure to her patient, which in turn forms a basis for recognizing the patient's right to bodily self-determination. Namely, when a physician performs surgery or other acts of medical import without properly discharging the duty to explain, the patient has arguably lost her opportunity to make an informed decision and to exercise the right to bodily self-determination in the process. Consequently, the patient may

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[55] *See* Supreme Court [S. Ct.], 96Da42789, July 24, 1998 (S. Kor.). This judgment affirms state liability for the intelligence service's act of spying on a group of civilians.

[56] Supreme Court [S. Ct.], 96Nu2439, May 23, 1997 (S. Kor.). In this case, the appellate court found that certain of the materials the plaintiff had asked to be disclosed, contained personal data and details related to property and were, therefore, not disclosable lest the other individual's secrets be revealed and freedom of privacy be violated. The Court subsequently endorsed this finding.

[57] Supreme Court [S. Ct.], 2008Da42430, Sep. 2, 2011 (S. Kor.).

[58] Gaeinjeongbobeob [Protection of Personal Data Act], Act no. 10465, Mar. 29, 2011, amended by Act No. 14107, Mar. 29, 2016 (S. Kor.).

[59] Supreme Court [S. Ct.], 96Da11327, Sep. 4, 1998 (S. Kor.).

choose to sue for pain and suffering.[60] Similarly, where a doctor administers blood transfusion without a proper explanation to the patient, such omission violates the patient's personality right to self-determination in relation to whether to receive any blood transfusion in the first place and also to the blood to be transfused.[61] Also, in its decision on physician assisted suicide, the Court decided that "[w]here a patient has reached the irrevocable phase of death, mercy killing may be permitted if the patient is exercising her right to bodily self-determination based on human dignity and value and on the right to pursue happiness, unless the circumstances overtly dictate otherwise."[62]

In *95Da39533*, the Court viewed sexual harassment as an infringement of personality rights.[63] Namely, "especially in a situation involving opposite sexes, an act of exhibiting sexual attraction may be natural and permissible, unless such act rises to the level of downgrading human dignity and of inflicting mental anguish and pain, at which point, the act becomes verboten and unlawful." Accordingly, sexual harassment is perceived as violating one's right to sexual self-determination, which is a tenet of personality rights. In a similar vein, the Constitutional Court held that, under Article 10 of the Constitution, all fundamental rights aim to guaranty individual personality rights and the right to pursue happiness which together form the backbone of human values, as the ultimate objective (or fundamental principle) of the guaranty and that an individual's personality rights and right to pursuit of happiness are predicated on the right to determine one's own fate, the right to which includes the right of choice when it comes to sexual intercourse and choice of a consenting partner.[64] There is also a Court decision that one's right to self-determination ensures volitional decisions by a capable human.[65] This right to self-determination arguably underpins personality rights encompassing life, body, liberty, fame, privacy, and personal data, as has been noted above.

8. Miscellaneous

There are numerous other instances where infringement on personality rights has been recognized. In a case[66] where four defendants A, B, C, and D covered up the torturing to death of the late

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[60] *See* Supreme Court [S. Ct.], 93Da60953, Apr. 15, 1994 (S. Kor.). In Supreme Court [S. Ct.], 2009Da95714, Mar. 25, 2010, the Court noted that a patient's consent to medical treatment is to ensure one's right to self-determination under individual personality rights and the right to pursue happiness as encapsulated in Article 10 of the Constitution. In this context, the patient retains a right to autonomously determine how to maintain life and bodily functions on her own and also to choose from a possibly array of medical treatment options.

[61] Supreme Court [S. Ct.], 96Da7854, Feb. 13, 1998 (S. Kor.).

[62] Supreme Court [S. Ct.], 2009Da17417, May 21, 2009 (S. Kor.).

[63] Supreme Court [S. Ct.], 95Da39533, Feb. 10, 1998 (S. Kor.).

[64] Constitutional Court [Const. Ct], 89, Hun-Ma82, Sep. 10, 1990 (S. Kor.).

[65] Supreme Court [S. Ct.], 2007Da27670, Nov. 20, 2008 (S. Kor.).

[66] Supreme Court [S. Ct.], 93Da41587, Nov. 7, 1995 (S. Kor.).

Jong-Chul Park, and attempted to make it appear as if defendants E and F were instead responsible for the death, the Court held that the act of cover up on the part of the defendants A through D had infringed the legally protected personality interests of the plaintiffs, who were the late *Park*'s parents and siblings. As a result, the four defendants coupled with the defendant Republic of Korea were ordered to make good the plaintiffs' pain and suffering. Given the facts of the case, this type of personality rights may not be categorized as falling within honor or privacy. Also, in 2008Da38288, the Court decided where the religious education of a parochial school exceeds the zone of tolerance under society's sound common sense and prevailing legal norms, it may result in a tort violating the aggrieved student's personality rights in relation to religion.[67] Further in 2009Da19864, the Court noted that:

> in the context of a social community including private organizations, a person is entitled to pursue various socioeconomic activities based on personal hopes and attainments, free from sexual discrimination, and such pursuit lies at the core of fulfilling one's right to personality. Violation of the right of equality may be discussed in concrete form as a violation of personality rights that are safeguarded in civil law under the general provisions of Article 750 of the Civil Code. Towards this end, a specific enactment governing the protection of right to equality among private relations is not a *quid pro quo*.[68]

C. Provisional Summary

Being very broad in scope, the concept of right to personality is also more or less ambiguous in nature, while the remit of protection for personality rights has been gradually broadening. On the other hand, as will be illustrated shortly, right to personality cases also entail the problem of defamation, invasion of privacy, or infringement of the right to portrait. These cases include where a powdered milk manufacturer had engaged in comparative advertising against its competition, which turned out to be a hoax, the competition's character, honor, and credit were adjudged to be injured thereby.[69] Where a news program did an exposé on the unfair trade practice of a luxury wedding dress rental business,

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[67] Supreme Court [S. Ct.], 2008Da38288, Apr. 22, 2010 (S. Kor.).

[68] Supreme Court [S. Ct.], 2009Da19864, Jan. 27, 2011 (S. Kor.).

[69] Supreme Court [S. Ct.], 93Da40614 & 40621 (consol.), Apr. 12, 1996 (S. Kor.). For a commentary on this case, *see* Kang Yong Hyun (姜容鉉), Bibanggwanggo-reul Han Ja-e daeha-yeo Sajeon-e Gwanggogeumji-reul Myeoung-haneun Panrye Mit Geu Pangyeoljeolcha-eseo Myeong-haneun Ganjeopgangje (誹謗廣告를 한 자에 대하여 事前에 廣告禁止를 명하는 判決 및 그 判決節次에서 명하는 間接强制) [CASE LAW ORDERING THE BEFORE-THE-FACT STOPPAGE OF COMPARATIVE ADVERTISING AND INDIRECT ENFORCEMENT OF THE ORDER IN THE CONTEXT OF CIVIL PROCEDURE], Daebeobwon Pangyul Haesul (大法院判例解說) [EXPOSITORY REV. OF SUPREME COURT [S. CT.] CASES], no. 25, 2006 at 69.

with the footage of a wedding wholly unrelated to such practice, the Seoul High Court recognized an occurrence of defamation, injury to honor, and violation of the right to portrait.[70] Lastly, where there was a rumor that an actress and her younger sister are not biologically related and a story was published with the innuendo that there might be a ring of truth after all to the rumor, the High Court found defamation and invasion of privacy, in the affirmative.[71]

Since the scope of legal protection for personality rights is fairly expansive, it may be futile to circumvent or limit its scope.[72] Rather, with the passage of time, the scope of protection is expected to enlarge with discovery and emergence of new spheres warranting legal protection. I am certain that there is a positive aspect to this generic and seemingly floating attribute of personality rights. But, at the same time, there is a concern that legal predictability and certainty may be at risk because it appears uncertain to decide under what specific circumstances, personality rights merit legal protection. As such, although confirming the particulars of personality rights is neither feasible nor necessarily desirable, there still may be a need to place personality rights in different categories and to ascertain the legal effects of each categorized right to personality.

III. THE PROBLEM OF THE CLASH BETWEEN PERSONALITY RIGHTS AND OTHER FUNDAMENTAL RIGHTS

An important trait of personality rights is that they may clash with other fundamental rights including freedom of the press and publication, freedom of arts, freedom of religion, as well as freedom of learning. The clash of fundamental rights in constitutional law also affects the protection of personality rights in private law: the Court determines in a given case if a violation of personality rights has occurred basically through a balancing test.[73]

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[70] Seoul High Ct., 96Na282, June 18, 1996 (S. Kor.).

[71] Seoul High Ct., 97Na14240, Sep. 30, 1997 (S. Kor.).

[72] The term "personality rights" is relatively ambiguous and so are "honor" and "privacy," each of which falls within the remit of protection of personality rights.

[73] For the subject of conflict of fundamental rights, see Kim Chul Soo (金哲洙), Hangeuk Heunbeobron (韓國憲法論) [AN INTRODUCTION TO THE KOREAN CONSTITUTION] 298 (New 10th ed. 1998) (Kor.); Young Huh, [KOREAN CONSTITUTIONAL JURISPRUDENCE] 258 (New 9th ed. 1998) (Kor.); Kwon Young Seong (權寧星), Hangeuk Heunbeobron (韓國憲法論) [KOREAN CONSTITUTIONAL JURISPRUDENCE] 303 (NEW ed. 1998) (Kor.); and Kwon Young Seong (權寧星), Gibongwon-ui Galdeung (基本權의 葛藤) [CONFLICT OF FUNDAMENTAL RIGHTS], Seoul Daehakgyo Beobhak (서울대학교 法學) [SEOUL L.J.], no. 36 1, 1995 at 45.

A. Conflict with the Freedom of Expression

1. Significance

Article 21.1 of the Constitution guarantees freedom of speech and of the press, and sub-article 4 of the same provision proscribes: "[t]he press or publishing companies should not infringe other's honor, right, public morality or social ethics. When the press or publishing companies infringe other's honor or rights, the aggrieved may request compensation for damages."[74] While freedom of speech and of the press is guaranteed, this constitutional guaranty is not without limit. On the contrary, when it comes to slander or libel, the Constitution provides for a victim's right to seek and recover damages. This is a highly unique constitutional provision the adequacy of which is in doubt. Nevertheless, as long as it stays part of the Constitution, the provision may not be glossed over. While the theory of the public figure in the United States is grounded upon the First Amendment to the U.S. Constitution, which prevents enactment of any legislation inhibiting freedom of expression, the Korean Constitution has trodden somewhat different path in that while it guarantees freedom of the press on one hand, it also considers compensation of damages arising from slander or libel as an equally important and valid constitutional value.

In South Korea, when determining infringement of personality rights, it becomes necessary to regulate conflicts of personality rights with freedom of expression in a given case. In this regard, the Court held:

> [a]ccording to Article 20 and the latter half proviso of Article 9 of the old Constitution (revised as of Dec. 27, 1980), freedom of expression should be protected to the utmost in a democratic society, but private legal interests such as personal honor and privacy deserve equal degrees of protection. So when two competing legal interests of protection of privacy as a personality right and of freedom of expression come to loggerheads, how to mediate such a juridical friction including the scope and methodology of proper redress, is best determined by comparing the various social values at stake in a case and then balancing the benefits and values to be derived from exercise of freedom of expression with the values attainable through the protection of personality rights.[75]

The Court's reasoning is equally sound when applied to cases where media coverage of facts results in an invasion of privacy. On the other

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[74] DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION], art. 10 (S. Kor.).

[75] Supreme Court [S. Ct.], 85Da-Ka29, Oct. 11, 1988 (S. Kor.). While ruling on the right to a correction notice, the Constitutional Court noted in another case that that "when personality rights, which form the origin and focal point of all rights, should collide with freedom of the press, efforts should be exerted to construe norms of the Constitution in a harmonious way, so as to rationally adapt and harmonize any discord." Constitutional Court [Const. Ct.], 89Hun-Ma165, Sep. 16, 1991.

hand, free expression of opinion generally, as opposed to media reporting and the coverage of facts it entails, should be encouraged and sufficiently guaranteed. But criticizing someone for vilification is not protected.

In what follows, I will divide the subject of conflict between personality rights and freedom of expression into cases involving defamation of character and invasion of privacy, respectively, and probe each in turn.

2. Defamation of Character

i. Media entities

1. According to many judgments of the Court, even where a person has defamed another, when such act of defamation relates to public interest with the sole purpose of furthering public good, no illegality will be deemed to be present if there is proof of truth or in the absence of such proof, if substantial reason can be adduced for the defamer to have believed in the veracity of the statement alleged.[76] This stance is a judicial adoption of a viable defense to the offense of criminal defamation in the context of determining civil liability, and it is undoubtedly one possible way of weighing the competing interests of freedom of speech and personality rights. But, of course, it is not the only way, and additional points of reference may well surface.

2. In relation to the Court's jurisprudence noted above, it is worthwhile to separate the category of "public good" from the category of "proof of truth or substantiality" and examine each identified category. In this context, "only when it is related to public good" denotes that, from an objective viewpoint, the facts conveyed are related to the public good, and the conveyor of the information must have done so for the interests of public good as well. And, in such a context, whether the facts bear on public good or not will be determined from the overall circumstance of the underlying expression including particulars of the facts, the range of audience to whom the facts were conveyed, and the means of expression, and then by balancing these elements against the possible extent of injury to the complainant's honor. In so far as alleged perpetrator's principal objective or motive was related to the public good, any incidental personal motive will not negate the overriding aim of public interest.[77] And where the complainant is a public figure, the substantive requirement that contents of the media coverage be connected to public interests or that the purpose of the coverage be for public good is likely to

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[76] *See, inter alia*, Supreme Court [S. Ct.], 85Da-Ka29, Oct. 11, 1988 (S. Kor.); Supreme Court [S. Ct.], 94Da33828, May 28, 1996 (S. Kor.); and Supreme Court [S. Ct.], 97Da24207, Sep. 30, 1997 (S. Kor.).

[77] Supreme Court [S. Ct.], 95Da36329, Oct. 11, 1996 (S. Kor.) and Supreme Court [S. Ct.], 96Da17257, July 14, 1998 (S. Kor.).

be met with relative ease. Simultaneously, while determining the substantiality of reason on the part of the defamer, the Court exhorted to consider whether speedy coverage was warranted given the nature of the story to be published, if the informant was reliable, and if there was a meaningful chance for face-to-face verification of facts involving the complainant.[78]

Recently, the Court handed down a decision about proving substantiality. In *97Da19038*, it held:

> even where a mass media entity injures one's honor by way of reporting facts, if such report is related to the public interest and its purpose is only for the good of the public, there will be no inherent illegality in the face of proof that reported facts are overall accurate and true. And even when there is no such proof, if the entity believed the report to be true and there was substantial reason buttressing that belief, the underlying act must be deemed void of *willful purpose or negligence*.[79]

So, unlike its precedents, *97Da19038* treats proof of substantiality as a question of negligence, as opposed to illegality,[80] which may have spawned controversy since its publication. But it cannot be ascertained if this decision embodies the unswerving position of the Court. This is because even after *97Da19038*, the Court has handed down cases mentioning proof of substantiality as a matter of determining in each instance the presence of illegality or lack thereof.[81]

3. When it comes to defaming public figures, there is a scholarly claim that a media entity ought to be liable for damages only where there is *actual malice* on the entity's part.[82] Such view is apparently in sync with the U.S. Supreme Court decision of *New York Times Co. v. Sullivan*.[83] The gist of the holding in this seminal decision may be summed up as, in a defamation case involving a public official, the official is required to prove that the defamatory statement was made with knowledge of falsity

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[78] Supreme Court [S. Ct.], 97Da24207, Sep. 30, 1997 (S. Kor.).

[79] Supreme Court [S. Ct.], 97Da19038, Feb. 27, 1998 (S. Kor.) (emphasis added) Similar Court decisions in the past include Supreme Court [S. Ct.], 94Da35718, June 16, 1995 (S. Kor.) and Supreme Court [S. Ct.], 96Da36395, May 8, 1998 (S. Kor.).

[80] This is almost identical to the position of the Japanese Supreme Court in Saikō Saibansho [Sup. Ct.] June 23, 1966 (Showa 41), no. 20, 5 SAIKŌ SAIBANSHO MINJI HANREISHŪ [MINSHŪ]1118 (Japan).

[81] Supreme Court [S. Ct.], 97Da34563, May 8, 1998 (S. Kor.). *See also* Supreme Court [S. Ct.], 97Da57689, May 22, 1998 (S. Kor.), dealing with the subject of administrative announcement.

[82] Kim Min Joong (김민중), Wongo-ui Sinbun-gwa Myeongyehweson Beopri-ui Jeogyong ("원고의 신분과 명예훼손법리의 적용") [THE STATUS OF PLAINTIFF AND APPLICATION OF THE LAW OF DEFAMATION], Eunronjoongjae (언론중재) [PRESS ARBITRATION], Summer, 2000, at 32. For an opposing view, *see* Han Wi Soo (韓渭洙), Gongjeok Jonjae-ui Jeongchijeok Inyeom-e Gwan-han Munjejegi-wa Myeongyehweson (公的 存在의 政治的 理念에 관한 問題提起와 名譽毁損) [TAKING ISSUE WITH THE POLITICAL BELIEFS OF A PUBLIC FIGURE AND DEFAMATION], in ASSORTED PROBLEMS OF CIVIL CASES V.11 611 (2002) (Kor.).

[83] *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964).

or with reckless disregard of whether the statement was false or not. The Court of Korea, however, has been reluctant to adopt the actual malice theory that has proliferated in the United States. The Court's position has been that, in a civil tort claim for defaming a public figure, the burden of proof is on the media entity, which engaged in an alleged act of defamation, to prove that its misstatements were not illegal.[84]

Ultimately, the Court attempts to resolve the problem of illegality case-by-case. But when it comes to public figures, freedom of the press ordinarily takes precedence. The Constitutional Court held that, in determining the presence of illegality in a criminal defamation context, a case involving a public figure merits a differing standard from that which is applicable in non-public figure proceedings.[85] The Court noted that, in defining boundaries between freedom of the press or publication on one hand and protection of honor on the other, no uniform standard may be applied. As there is a difference between something expressed pertaining to a private matter and something pertaining to a public matter, a more stringent standard is warranted when the allegation is related to the political beliefs of a public figure. When assessing if a subjective assessment of a defamatory expression is true or considering if there was substantial reason to believe the expression to be true, the usual standard of proof, which can be a bit stringent for the press, should not be required; rather, the standard of proof should be loosened and is considered satisfied when the media company adduces specific circumstances that raise doubts or provide a ground for subjective opinionated assessment. Lowering the evidentiary bar for the political beliefs of a public figure is certainly desirable for furthering the freedom of expression. And it would not be advisable for the judiciary to intervene in the arena of political debates and discourse in the form of imposing legal responsibility on a whim. This is because one's political beliefs are usually a hodgepodge of facts and opinions. As such, assessing them would be virtually impossible without engaging in ideological debates.[86]

Entering the 2000s, the Court began to hand down several decisions relating to public figures.[87] The Court's attitude is that it is willing to recognize and assure a broad range of grounds for critiquing a public figure's morality, integrity as well as propriety of work ethics. Accordingly, when it comes to a public figure's official duties, unlike media coverage for public interest, illegality would only be recognized for

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[84] *See* Supreme Court [S. Ct.], 97Da24207, Sep. 30, 1997 (S. Kor.), Supreme Court [S. Ct.], 97Da34563, May 8, 1998 (S. Kor.), and Supreme Court [S. Ct.], 2001Da53387, Feb. 27, 2004, (S. Kor.).

[85] Constitutional Court [Const. Ct.], 97Hun-Ma265, Jun. 24, 1999 (S. Kor.).

[86] *See* Kim, *supra* note 36, at 362.

[87] *See*, inter alia, Supreme Court [S. Ct.], 2007Da29379, Dec. 27, 2007 (S. Kor.), Supreme Court [S. Ct.], 2001Da53387, Feb. 27, 2004 (S. Kor.), Supreme Court [S. Ct.], 2002Da64384, July 8, 2003 (S. Kor.), Supreme Court [S. Ct.], 2002Da62494, July 22, 2003 (S. Kor.), and Supreme Court [S. Ct.], 2002Da63558, Sep. 2, 2003(S. Kor.).

a journalistic assailment that is "malicious or substantially beyond reason and convention."[88] Where a particular media coverage deviates from the range of ordinary media activities including sound oversight, criticism, and a check and a balance against the community of public officials and its individual constituents, and such deviation is considered a malicious or highly reckless attack that is patently out of proportion, the coverage may constitute libel. Towards this end, courts would consider a totality of circumstances, including particulars of the press coverage and its mode of expression, details of the issues under suspicion, extent of public interest, the degree to which the public figure's social honor has denigrated, how much effort was made to verify the facts covered, and other pertinent elements of interest.[89] Hence, it appears that, when it comes to public figures, courts are trying to produce a more refined and coherent set of legal theories and to apply them.

Also, when the expression in question pertains to a media entity, since media entities generally function as a critic of various social phenomenon backed by far-reaching freedom of the press, a broad zone of tolerance for valid criticism against the press is called for. Considering that media companies employ a built-in mechanism of rebuttal, which contributes to the prevention of distorted public opinion from spreading as a result of misinformation, and that assuring personality rights to one media company may well inhibit freedom of the press for another, the function of overseeing and criticizing the press should not be easily curtailed unless what is involved is a malicious or unwarranted attack. Compared to defamation of a private individual, even euphemistic exaggerations by a media company may be more widely tolerated given that related entities may rebut each other with relative ease and functional vehemence.[90]

4. Provisions on the Act on the Press. Adopting the relevant case law, article 5.2 of the Act on the Press provides that "where the press presents a report related to the public interest and there exists a justifiable ground that such report is true or is believed to be true," there will be no legal liability for infringement of personality rights.[91] To begin, the press

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[88] *See* Supreme Court [S. Ct.], 2005Da65494, Apr. 9, 2009 (S. Kor.). According to this judgment, it is not illegal per se to express a critical opinion about another person. Yet when the form and content of such an expression amounts to not only mere bluffing, but to an insulting and vilifying assassination of character and a distortion of truth which amounts to a public allegation resulting in infringement of the subject's personality rights, it may end up forming a sui generis tort that is distinguishable from defamation.

[89] *See*, inter alia, Supreme Court [S. Ct.], 2007Da29379, Dec. 27, 2007 (S. Kor.); Supreme Court [S. Ct.], 2001Da52216, Nov. 9, 2001 (S. Kor.); Supreme Court [S. Ct.], 2002Da63558, Sep. 2, 2003 (S. Kor.); and Supreme Court [S. Ct.], 2004Da35199, May 12, 2006 (S. Kor.).

[90] Supreme Court [S. Ct.], 2006Da53214, Apr. 24, 2008 (S. Kor.).

[91] Eonronjungjae Mit Pihaeguje Deung-e Gwanhan Beopryul [Act on the Press Arbitration and Remedies, etc. for Damage caused by Press Reports], Act No.7370, July 28, 2005, *amended by* Act No. 10587, Apr. 14, 2011, art. 5.2 (S.Kor.).

report in question ought to be related to interests of the public in order to meet the requirements of this provision. Yet, even if the report contains some ancillary content that is unrelated to the public interest, the report will still not violate the Act on the Press as long as the main content is for the public interest. In addition, the report must be true or there should be a justifiable reason for believing it to be true. Even though the Act on the Press is silent on published pieces questioning or critiquing a public official's morality, integrity or propriety of work ethics, the criterion of "justifiable reason" may be adopted by analogy. Namely, under the Act on the Press, a critical analysis of a public official's morality, for instance, will be adjudged illegal only if it comprises a malicious or substantially skewed attack.[92]

ii. Cases involving non-press actors

The theory of substantiality of truth is applicable where the police authorities had defamed a criminal suspect in the form of a press release containing the suspect's confession[93] or where a statement by a member of the National Assembly concerning the *Odaeyang* mass suicide incident came under defamation of character,[94] or in the case of injuring an individual's honor by disclosing the real name as part of a public administrative announcement (in the form of a press release) with a view to achieving certain administrative objectives.[95] But when it comes to judicial review of public administrative announcements for determining if there was sufficient reason to believe an announcement to be true, a more stringent standard would be generally required compared to a wholly private case. This is because administrative organs are capable of conducting thorough fact-finding through exercise of public authority, and the general populace tends to place high expectations and trust on the veracity of what a public body announces. Therefore, in the absence of objective and proper corroborative proof that the administrative organ's public announcement is true, it is not possible to ascertain if there were sufficiently substantial reasons for an announcement.[96]

On the contrary, religious expressions are strongly protected under freedom of religion. Namely, Article 20.1 of the Constitution provides

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[92] *See* Kim Jae Hyung (김재형), Eonron-e Uihan Myeongyae Deung Ingyeokgwon Chimhae-e Daehan Gujesudan-gwa Geu Jeolcha (언론에 의한 명예 등 인격권 침해에 대한 구제수단과 그 절차) [LEGAL REMEDIES AND RELATED PROCEDURE FOR VIOLATION BY THE PRESS OF PERSONALITY RIGHTS INCLUDING HONOR], Ingwon-gwa Jeongui (인권과 정의) [HUMAN RIGHTS AND JUSTICE], no. 399, 2009, at 90.

[93] Supreme Court [S. Ct.], 94Da29928, Aug. 20, 1996 (S. Kor.).

[94] Supreme Court [S. Ct.], 95Da36329, Oct. 11, 1996 (S. Kor.).

[95] Supreme Court [S. Ct.], 93Da18389, Nov. 26, 1993 (S. Kor.) and Supreme Court [S. Ct.], 97Da57689, May 22, 1998 (S. Kor.).

[96] *See* Supreme Court [S. Ct.], 93Da18389, Nov. 26, 1993 (S. Kor.); Supreme Court [S. Ct.], 97Da57689, May 22, 1998 (S. Kor.).

"[a]ll people have freedom of religion."[97] Such freedom includes freedom of missionary work to proclaim the religious principles of one's choice and to recruit new believers, which in turn subsumes freedom to criticize other belief systems and to suggest religious conversion. Religious proclamations or criticism of other beliefs is also covered by freedom of expression, in which case, by virtue of Article 20.1 of the Constitution on freedom of religion being a special provision vis-à-vis Article 21.1 of the Constitution dealing with freedom of expression, a publication for religious purposes would draw stronger protection than a publication for general purposes.[98] Therefore, one's freedom to criticize other religions or religious groups will be protected to the utmost. And in the event of infringing another's personality rights (including honor) while exercising such freedom, the problem of how to strike a balance between the guarantee of religious freedom and the protection of personal honor would be best resolved by weighing the totality of values to be gained by an act of religious criticism, the extent of religious proclamation, and the employed means of expression, against the degree to which the victim's honor is or is likely to be injured as a result of the criticism.[99]

3. Invasion of Privacy

Where the press reports on an individual's private life or matters, it may entail infringement on privacy, but there are times where protection of privacy can collide with freedom of speech. Therefore, what content is actually news or "press worthy" and therefore deserves protection under the freedom of speech and, in what circumstances, such content is nothing more than what kindles public curiosity, can raise thorny issues. And in relation to this problem, relying on the theory of public person may be productive. This theory is used to determine the outer limits of privacy according to the social status of a claimant who insists her right of privacy has been invaded.

In the United States, reporting on a public figure or for public interests does not constitute invasion of privacy as such.[100] This is to ensure freedom of speech on a broad scale and is certainly reflective of the peculiar situations of the United States. I believe that adopting the U.S. theory of public persons wholesale is inappropriate in the Korean context. But since media coverage of public persons may contain the element of public good on occasion, whether a particular coverage pertains to a public person or not, can be a significant consideration when determining infringement upon personality rights. In this context, the press may report on a public figure's private life or publish photographs

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[97] DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION], art. 20.1 (S. Kor.).
[98] DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION], arts. 20.1, 21.1 (S. Kor.).
[99] Supreme Court [S. Ct.], 96Da19246 & 19253 (consol.), Sep. 6, 1996 (S. Kor.).
[100] Prosser & Keeton, *supra* note 45, at 862.

of a public figure.[101] Yet in relation to recognized types of privacy, the theory of public persons would only apply to an act of "opening up privacy to the public" or of "giving distorted images (of a public figure) to the public." On the contrary, invading into the privacy of a public figure or using such figure's name or portrait for profit-making usually comes under invasion of privacy.[102]

B. Conflict with the Freedom of the Arts[103]

1. Introduction

In novels and films based on true stories or persons, any content degrading a featured character's social status or disclosing that character's private life may amount to infringement of personality rights relating to the person on whom the novel or film is modeled. In this regard, article 22.1 of the Constitution stipulates, "[a]ll people have freedom of study and arts."[104] An infringement of personality rights through novels and other works of literature may cause a collision of fundamental rights between personality rights on the one hand and freedom of expression and arts in general and freedom of literary creation in particular, on the other. In this part, the focus of my analysis is on novels based on real people and events, even though this inquiry may be equally applicable to films, plays,[105] cartoons,[106] television soap operas, and other equivalent genres.[107]

2. Specificity of the Victim

In order for infringement of personality rights by a work of literature such as novel to be actionable, a character appearing in the novel and alleged victim should be identical. This is alluded to as the specificity or identity of victim. Even where a novelist has penned a novel based on a real person, if the resulting literary character should differ from its real-life model, infringement of personality rights would be virtually a non-issue. But identity between the characters in the novel and the victim may be found not only where a similar or same name is used, but where, although there is no similarity in name, the novel's background, surrounding circumstances or overall storyline demonstrate identity or close semblance to real life.

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[101] *See id.* at 862.

[102] *Id.* at 859.

[103] For detailed information, *see* Kim Jae Hyung (김재형), Model Soseol-gwa Ingyeokgwon (모델小說과 人格權) [MODEL NOVELS AND PERSONALITY RIGHTS], Ingwon-gwa Jeongui (인권과 정의) [HUMAN RIGHTS AND JUSTICE], no. 241, at 44 (1997).

[104] DAEHANMINGUK HUNBEOB [HUNBEOB] [CONSTITUTION], art. 22.1 (S. Kor.).

[105] Kammergericht [Berlin High Court] July 13, 1928, JW 1928, 363.

[106] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] June 3, 1987, 1 BvR 313/85 (Ger.).

[107] In the United States and Japan, court decisions regarding infringement of personality rights involving novels or films have played a catalytic role in the development of personality rights law.

3. Standard for Determining Infringement of Personality Rights

As has been noted, where identity between a literary character and alleged victim is recognized, finding actual infringement of personality rights can be an issue. Even here a court will need balance the benefits of protecting freedom of arts against the competing interests of protecting personality rights, and, towards this end, some theoretical signposts will prove useful.

Infringement of personality rights has been found where, far from truth, a person is described as a sexual pervert and someone who resorts to abject means for success,[108] or where one's intimate sphere, such as a disgraceful past was divulged, or a person is inadvertently depicted as a delinquent.[109] In each such case, it can be said that the victim's personality rights were seriously violated judging by the shape and extent of infringement. Also, whether the author intended to defame the person on whom the novel is modeled may be a significant consideration.

But where a work of art is considered to form a realm of fiction of its own, there will be no infringement of personality rights. This is because, in such a case, while alleged infringement of personality rights is trivial, there is arguably a far greater need to promote and safeguard freedom of arts.[110]

And because the occurrence of infringement should be determined by an analysis of the work of art in question as a whole, even where such work contains defamatory details in part, it would not constitute an infringement of personality rights per se. In addition, that a certain expression of an artistic work should cause misunderstanding, in and of itself, may not be indisputable infringement of personality rights. For example, it is commonly understood that a satire or a cartoon almost always carries a risk of misunderstanding.[111]

Further, the nature of art work or contents of the right to personality often raises issues. For example, where an art work takes on the character of a factual record, the right to self-determination, a type of personality right, would arguably trump the freedom of arts.[112] Yet, when it comes to the right of publicity or the right of a party to use

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[108] See two German cases: Bundesgerichtshof [BGH] [Federal Court of Justice] Mar. 20.1968 (Ger.): Neue Juristische Wochenschrift [NJW] 1968, 1773 (Ger.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Feb. 21, 1971, 1 BvR 435/68 (Ger.).

[109] *See Melvin v. Reid*, 112 Cal. App. 285 (1931); *see also* Tokyo District Court's precedent of Tokyo Chihō Saibansho [Tokyo Dist. Ct.] Sep. 28, 1964 (Showa 39), no. 385 HANREI JIHO [HANJI] 12 (Japan).

[110] Seoul Dist. Ct., 94Ka-Hap9230, June 23, 1995 (S. Kor.).

[111] *See* the German case of Bundesgerichtshof [BGH] [Federal Court of Justice], June 8, 1982 BGHZ 84, 237 (Ger.) (Horten-Moritat case).

[112] *See* Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Feb. 14, 1973, 1 BvR 112/65 (Ger.).

elements of another's personality, such as that person's name or image. commercially for an art work, freedom of arts would normally trump the right to personality. Although from time to time artists cannot help drawing artistic inspiration from their quotidian reality. the extent of infringement of personality rights in such setting is considered de minimus.[113]

C. *Conflict with Other Rights*

When determining infringement of personality rights. the counterparty's rights are not always limited to freedom of expression or arts as such. For example. a suit was brought on if dismissing an employee because he had distributed fliers allegedly infringing personality rights can be justified. In this case, the Court took the occasion to note that even where a flyer is damaging to other's personality. credit, or honor or likely to foment such damage, and even if the flyer should contain a bit of misinformation or what it conveys is somewhat blown out of proportion or otherwise twisted. provided that the purpose of the flyer distribution was not to violate other's rights or legitimate entitlement but to maintain and improve labor conditions at large and to promote the improvement of workers' socioeconomic status and also that what the flyer avers is found overall true, distributing such flyer falls within the range of legitimate labor activities.[114] Here what was directly in dispute was the justness of a worker dismissal, but we can see that when determining on infringement of personality rights. an individual worker's rights or legal entitlement may be considered as suitable.

IV. INFRINGEMENT OF PERSONALITY RIGHTS OF THE DEAD

A. *Significance*

Article 3 of the Civil Code provides, "(a) person becomes the subject of rights and obligations while (s)he is alive."[115] So a dead person cannot become the subject of legal rights and obligations. This point is well-entrenched and overall axiomatic for property rights, but. when it comes

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[113] According to Larenz & Canaris. under German law, distribution of one's portrait or image is permitted without that person's consent if the distribution contributes to a higher artistic purpose. KARL LARENZ & CLAUS-WILHELM CANARIS, Lehrbuch des Schuldrecht Bd. II/2 [THE LAW OF OBLIGATIONS VOL. II/2] 527 (1994); Gesetz betreffend das Urheberrecht an Werken der bildenden Künste und der Photographie [KunstUrhG] [Act Concerning Copyright of Works of Fine Art and Photography] Sept. 1. 1907, as amended Feb. 16. 2002, art. 23.1 (Ger.), *available at* http://bit.ly/2x2QstS.

[114] Supreme Court [S. Ct.], 93Da13544. Dec. 28. 1993 (S.Kor.): Supreme Court [S. Ct.]. 96Nu11778, Dec. 23, 1997 (S.Kor.); Supreme Court [S. Ct.]. 98Da23654. May 22. 1998 (S.Kor.).

[115] Minbeob [Civil Act], Act No. 471, Feb. 22. 1958. amended by act No. 14409. art. 3 (S. Kor.)

to personality rights, it remains controversial. Article 308 of the Criminal Code prescribes the offense of defamation of the dead and, whether the bereaved may apply for a civil injunction to stop defamation against the dead, may raise a delicate problem.[116]

An act of defaming the dead is most likely to cause an injury to the honor of the bereaved as well. In that case, if the bereaved have been slandered or libeled to the same extent as the dead, there would be no point in taking issue with the dead's personality rights. This is because what is at stake here would be the personality rights of the living. But there may be cases where although the deceased's personality rights have been infringed, the bereaved's are not or because the infringement is so trivial that it appears counter-intuitive to obtain an injunction based on the bereaved's personality rights when balanced against to freedom of the press or arts. In such a case, arguing about the departed's personality rights may prove meaningful and efficient.

B. Recognition of the Personality Rights of the Dead

There has been much discussion in Japan and Germany relating to this subject. The judiciary and majority of legal scholars of Germany acknowledge personality rights of the dead. In Japan, while this topic has been hotly debated in the realm of legal academia, lower courts tend to resolve the issue in the form of protecting the bereaved's honor and their sentiment of commemoration. In South Korea, there are competing views so that while certain scholars maintain that the dead's personality rights must be acknowledged,[117] others take the opposing view that violating said rights can be resolved through a tort case brought by the bereaved.[118] And there are lower court decisions recognizing the dead's personality rights.[119] In a 2008 Court case, the dissenting opinion was likewise based

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[116] In so far as personality rights of the dead are concerned, what matters in terms of remedy is the right to interlocutory relief, not the award of monetary damages.

[117] Yang Sam Seung (梁三承), Minbeobjuhae (I) (民法注解 (I)) [ANNOTATED CIVIL CODE (I)] 256 (1992); Son Dong Kwon (손동권), Eonronbodo-wa Saja-ui Myeongyae Hweson (言論報道와 死者의 名譽毁損) [*Press Reports and Defamation of the Dead*], Eunronjoongjae (言論仲裁) [PRESS ARBITRATION], Spring 1992, at 9.

[118] *See* Ji Hong Won (池弘源), Ingyeokgwon-ui Chimhae (人格權의 侵害) [INFRINGEMENT OF PERSONALITY RIGHTS], Sabeobronjip (司法論集) [JOURNAL OF LEGAL STUDIES], no. 10. 1979 at 226. *See also* Han Wi Soo (韓渭洙), Myeongyae-ui Hweson-gwa Minsasang-ui Jemunje (名譽의 毁損과 民事上의 諸問題) [DEFAMATION OF CHARACTER AND RELATED ISSUES UNDER PRIVATE LAW], Sabeobronjip (司法論集) [JOURNAL OF LEGAL STUDIES], no. 24, at 401. 402 (1993). *See* also Lee Eun Young. *supra* note 15, at 740 where he asserts that. in certain cases, the dead's honor is meant to be protected through the law of torts as well not unlike that of the bereaved, but, since a legal right to claim emanating from defamation against the dead, is intended for and should be exercised by qualified beneficiaries or heirs in practice, in the strict sense of the word, only tortuous liability for the beneficiaries or heirs would thus arise.

[119] *See* Seoul Dist. Ct., 94Ka-Hap9230, June 23. 1995 (S. Kor.).

on recognition of personality rights of the dead.[120]

Traditionally in South Korea, people's expectation is such that social evaluation of a person during his or her lifetime would not be distorted even posthumously. Considering that, under copyright law, the moral rights of writers are protected well into death,[121] it would be irrational not to provide some form of legal protection for infringement of personality rights such as honor, involving the dead. And, as we have seen already, protecting the bereaved's honor or the spirit of commemoration alone will only offer a partial solution. In order to protect one's dignity and values under the Constitution effectively during an individual's lifetime, protective measures should come handy to prevent posthumous distortion, which in turn arguably provides a basis for recognizing personality rights of the deceased. In the meanwhile, it would be difficult, if not impossible, to pin down a period of protection for the dead's personality rights. Generally speaking, the longer time has elapsed from the point of death, the more arduous it will be to find an infringement of personality rights. And should the person in question become a historical figure through the passage of time, infringement of such figure's personality rights would be better left denied.[122]

C. Range and Enforcement the Dead's Personality Rights

The range of protection for the dead's personality rights is identical to the range for the living, in principle.[123] What is included in such range of juridical protection spans from defamation of character, personal distortion of the dead, and to the right of self-determination relating to information. For example, even where the press reported on the intimate details of a dead person truthfully, it may come under infringement on personality rights. In addition, disclosing the dead's correspondence or journal in a distorting way may lead to invocation of personality rights.

As a logical corollary to this inquiry, the question then becomes who is entitled to obtain injunctive relief to thwart infringement of personality rights on behalf of the dead, because, apparently, the dead are unable do it on their own. For this issue, a provision of the Copyright Act may be applied by analogy so that the bereaved (consisting of the surviving spouse, children, parents, grandchildren, grandparents, or siblings) or

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[120] *See* Supreme Court [S. Ct.], 2007Da27670, Nov.20, 2008 (S. Kor.).

[121] Article 14.2 of the Copyright Act provides, "(e)ven after the death of an author, *no* person who exploits the author's work shall commit an act that would have been damaging to the author's moral rights were the author alive, except that such an act is deemed to have not defamed the author if it is non-defamatory in view of the prevailing social norms considering the nature and extent of the act in question." And according to Article 96 and Article 14.2 of the Copyright Act, the bereaved can request reinstatement of honor under Article 95 for the reason that the dead author's honor has been injured. Yet the bereaved may not seek money damages on account of such injury.

[122] Supreme Court [S. Ct.], 97Da19038, Feb. 27, 1998 (S. Kor.).

[123] *See* LARENZ & CANARIS, *supra* note 113, at S. 533.

the executor of the deceased's will are granted standing to apply for and receive interlocutory relief in civil proceedings.[124]

CONCLUSION

In Korea today, personality rights are becoming established as a key set of rights. In a wide variety of social spheres, the protection of personality rights has begun to appear as a significant issue. Accordingly, it is time that more scholarly research is undertaken to define clearly the content and ambit of personality rights and their legal recognition. Despite this heightened status of personality rights in general, the Civil Code alone would offer incomplete solutions at best when it comes to civil disputes involving the interpretation and enforcement of personality rights. Thus, an amendment to the Civil Code is in order. This author has already suggested a specific recommendation for such an amendment. The concept of and protections for personality rights must be clearly defined in the law. A prophylactic measure in the form of a court order to ban and prevent specific invasion of personality rights should be made available. In addition to the remedies for injury, there should also be rules in place to allow the withdrawal of the aforementioned court ban by the injured party. Finally, there needs to be a clear demarcation of what situations are not included in the invasion of personality rights.

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[121] According to this particular provision of the Copyright Act, after the death of an author, the bereaved family (consisting of the surviving spouse, children, parents, grandchildren, grandparents, and/or siblings) or the executor of will may apply for remedies including injunctive relief under Article 123 against the wrongdoer who has violated or is likely to violate the provision of Article 14.2 with respect to the author's copyrighted work, or, in the alternative, apply for reinstatement of honor against a perpetrator who has infringed on the author's moral rights willfully or negligently or otherwise defamed the deceased author. See Jeojakgwonbeob [Copyright Act], Act No. 432, Jan. 28, 1957, *amended by* Act No. 14083, Mar. 22, 2016, arts. 14.2, 123 (S. Kor.).

ENGINEERING A VENTURE CAPITAL MARKET: LESSONS FROM CHINA

Lin Lin[*]

This article analyzes Professor Ronald Gilson's theory of "simultaneity" in engineering a venture capital market in the context of China. Based on both quantitative and qualitative data collected by the author, this article analyzes how China has created the fastest developing and the largest engineered venture capital market in the world within three decades. It concludes that the rise of venture capital in China is attributable to (1) increasing capital supply through various governmental programs, easing regulatory barriers towards institutional and foreign investors, providing tax incentives, and improving the exit environment; (2) enhancing the availability of financial intermediaries by introducing the limited partnership that creates an efficient relationship between venture capitalists and investors; and (3) encouraging entrepreneurship by improving the regulatory environment for small businesses. Through these measures, China has facilitated the simultaneous availability of capital with the appetite for high-risk, long-term investments and the emergence of a class of entrepreneurs with the skills and incentives to put that capital to work. One key factor of the rapid development of the Chinese market has been its increased reliance on market forces in allocating capital. On the other hand, a residual degree of bureaucratic involvement in capital allocation prevents the Chinese regime from being fully efficient. China serves as an (imperfect) model for other governments in the world where unfettered market forces have not brought about successful venture capital markets.

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INTRODUCTION

Venture capital ("VC") is widely recognized as a powerful engine that can drive a nation's innovation, job creation, knowledge economy, and macroeconomic growth.[1] As such, governments from various jurisdictions around the world, including Germany,[2] Australia,[3] Japan,[4]

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[1] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003). On the importance of VC, *see generally* Marco Da Rin et al., *The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project*, 7 EUR. BUS. ORG. L. REV. 525 (2006).

[2] *See* Gilson, *supra* note 1, at 1094-1096.

[3] *See* THE TREASURY AND THE DEPARTMENT OF INDUSTRY, INNOVATION, SCIENCE, RESEARCH AND TERTIARY EDUCATION OF AUSTRALIA, REVIEW OF VENTURE CAPITAL AND ENTREPRENEURIAL SKILLS (2012), *available at* http://bit.ly/2tIIz3c.

[4] *See* Zenichi Shishido, *Why Japanese Entrepreneurs Don't Give Up Control to Venture Capitalists* (Mar. 30, 2009) (unpublished manuscript), *available at* http://bit.ly/2w8JrdA.

Israel,[5] Chile,[6] Taiwan[7] and Singapore,[8] have all tried to promote the development of VC markets. Generally, government programs have not been especially successful.[9] However, China's efforts seem to have borne fruit. Over three decades, China has created the world's second largest VC market in terms of annual VC investment,[10] second only to the United States (U.S.). This article will explore the elements of China's experience in engineering a national VC market, as well as concerns about its continued growth of the market.

In a ground-breaking article, Professor Ronald Gilson explained that a VC market requires three key elements to thrive: (1) providers of capital with appetites for high-risk, high-return investments; (2) specialized financial intermediaries—VC firms—that properly incentivize all participants in the VC market; and (3) entrepreneurs.[11] This much is straightforward, but as he further explained, these three elements must emerge *simultaneously*. The simultaneous emergence of all three elements is difficult to envision with or without government involvement. For example, if there is no capital available in an economy for high-risk businesses, how will entrepreneurs emerge to form such businesses, and how will intermediaries emerge to identify the best of those entrepreneurs and channel investment funds to them? Gilson refers to this as the "simultaneity problem."[12] He attributes the success of the U.S. VC market in solving the simultaneity problem to private ordering,[13] explaining that the "U.S. VC market developed organically, largely without government assistance and certainly without government design."[14] Instead, it was the "idiosyncratic" history of the U.S. VC market that encouraged the simultaneous emergence of entrepreneurs, investors, and the right vehicles that served as the "nexus of a set of sophisticated contracts."[15]

This raises the question of whether it is possible for governments to successfully engineer VC markets. Most governments have tried to address the simultaneity problem by creating government programs to provide capital, encourage entrepreneurship, and attract knowledgeable

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[5] *See* Gilson, *supra* note 1, at 1097. *See also* JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED—AND WHAT TO DO ABOUT IT 42 (2009).

[6] *See* Gilson, *supra* note 1, at 1098.

[7] Christopher Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience*, 37 GEO. WASH. INT'L L. REV. 845 (2005).

[8] LERNER, *supra* note 5, at 42.

[9] Gilson, *supra* note 1, at 1070; LERNER, *supra* note 5, at 192.

[10] *See* ERNST & YOUNG, BACK TO REALITY: GLOBAL VENTURE CAPITAL TRENDS 2015 3, 10-12 (2016), *available at* https://go.ey.com/1QifExd [hereinafter BACK TO REALITY].

[11] Gilson, *supra* note 1, at 1076-78, 1093.

[12] *Id.* at 1093.

[13] *Id.* at 1069, 1093.

[14] *See id. at* 1070.

[15] *Id.* at 1069, 1093.

financial intermediaries. For the most part, however, these programs failed because they could not adequately respond to the problems inherent in VC financing: uncertainty, information asymmetry, and agency cost.[16]

China offers a fascinating case study of how a VC market can be engineered: its VC market is one of the fastest developing and largest engineered markets in the world.[17] Before 1985, VC did not exist in China.[18] But after three decades of development, China now receives the second largest annual VC investment in the world.[19] In 2016, 636 new VC funds were set up in China, collectively raising more than USD 50 billion of fresh capital for investment. This represented a 79.46% increase over the previous year.[20] Additionally, there were 3,683 VC investment deals closed in 2016, an increase of 6.91% from 2015, and of 91.2% from 2014.[21] Total VC investment in China was USD 48.9 billion, surpassing VC investment in the entirety of Europe combined.[22] Also, of the top five VC deals worldwide in 2015, three were made in China.[23] While the United States dominated global VC activity by deal quantity and value in 2015 with 3916 investment deals (in total valued at USD 72.3 billion), two out of three top deals were China-based.[24] VC exits were also impressive, with the amount raised from exits via IPO and M&A reaching USD 8.2 billion and USD 11.5 billion respectively, in 2015.[25] For context, VC exits via IPO and M&A in the United States raised USD 6 billion and USD 54 billion respectively in the same period.[26] As of the end of 2014, VC investments contributed directly and indirectly to 9.3% of China's GDP.[27] These figures underline the

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[16] *Id.* at 1070.

[17] Anette Jönsson, *Venture Capital Continues to Flow into Chinese Startups*, WALL ST. J. (Apr. 28, 2015), http://www.wsj.com/articles/venture-capital-continues-to-flow-into-chinese-startups-1430244889. *Venture Capital Soars and Investor Expectations Follow*, NIKKEI ASIAN REV. (Feb. 18, 2016), http://asia.nikkei.com/Politics-Economy/Economy/Venture-capital-soars-and-investor-expectations-follow; Lucinda Shen, *China is the Biggest Venture Capital Firm in the World*, FORTUNE (Mar. 9, 2016), http://for.tn/2tZyM0S.

[18] *See* text accompanying note 59, *infra*.

[19] *See* BACK TO REALITY, *supra* note 10, at 3, 10-12.

[20] Qingke Yanjiu Zhongxin (清科研究中心) [Zero2IPO Research Center], Qingke Yanjiu Niandu JuZhi (清科研究年度巨制) [*Zero2IPO's Yearly Mangum Opus*], Touzijie (投资界) [PEDAILY] (Jan. 21, 2017), http://bit.ly/2sZtjFD.

[21] *See* Zero2IPO Research Center, *Venture Capital Annual Report 2014*, ZERO2IPO PUBLISHER (2015), http://research.pedaily.cn/report/free/1301.shtml.

[22] *See* BACK TO REALITY, *supra* note 10, at 3, 10-12.

[23] *Id.* at 10.

[24] *Id.* at 3.

[25] *Id.* at 10.

[26] *Id.* at 6.

[27] Niu Fulian (牛福莲) & Wang Jingjing (王晶晶), Jujiao Xin Changtai Xia Fengxian Touzi Gaige Yu Chuangxin (Xia) (聚焦新常态下风险投资改革与创新(下)) [*Focusing on the Reform and Innovation of Venture Capital under the New Normal (Part II)*], Zhongguo Jingji Shibao (中国经济时报) [CHINA ECONOMIC TIMES] (Jul 10, 2015), http://bit.ly/2ujIISe.

significance of the Chinese VC market and its influence on China's economy.

The growth of the VC market in China over the past decade is without precedent. In the U.K., VC investments peaked in 2007 and have remained relatively stagnant,[28] totaling USD 4.8 billion in 2015 (0.168% of U.K.'s 2015 GDP).[29] The value of VC investments in Germany and France amounted to USD 2.9 billion (0.086% of GDP) and USD 1.9 billion (0.078% of GDP) respectively in 2015.[30] In stark contrast, China's VC market has maintained rapid growth since 2002, with fund raising, investments, and exits reaching a record high in 2015 (0.450% of GDP).[31]

In contrast to the U.S., China's VC market did not emerge as a result of market forces alone, but was instead consciously and strategically designed by the state from the outset. Specifically, governmental policies and actions facilitated the development of the VC market in order to encourage innovation and technological development, and to stimulate structural reforms of the economy. China's fascinating experience challenges the orthodox view that top-down governmental efforts to promote VC are unlikely to be successful. Moreover, despite doubt as to the effectiveness of private ordering in China[32] due to its weak investor protection[33] and lack of judicial independence,[34] China has succeeded in building a VC market. The pivotal question is: how did China manage to create the second largest VC market in the world despite its immature legal infrastructure?

Based on quantitative and qualitative data,[35] this article analyzes

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[28] *Annual Value of Venture Capital Investments on the UK Market from 2007 to 2015*, STATISTA, http://bit.ly/2s3499m (last visited May 24, 2017).

[29] BACK TO REALITY, *supra* note 10, at 3, 10-12.

[30] *Id.* at 9.

[31] Zero2IPO Research Center, *supra* note 20.

[32] *See generally* Jiangyu Wang, *China: Legal Reform in an Emerging Socialist Market Economy*, *in* LAW AND LEGAL INSTITUTIONS OF ASIA: TRADITIONS, ADAPTATIONS AND INNOVATIONS (E. Ann Black & Gary F. Bell eds. 2011); Donald Clarke, Peter Murrell, & Susan Whiting, *The Role of Law in China's Economic Development*, *in* CHINA'S GREAT ECONOMIC TRANSFORMATION (Loren Brandt & Thomas G. Rawski eds. 2008).

[33] *See generally* Nicholas C. Howson & Vikramaditya S. Khanna, *The Development of Modern Corporate Governance in China and India*, *in* CHINA, INDIA AND THE INTERNATIONAL ECONOMIC ORDER (Muthucumarasawamy Sornarajah & Jiangyu Wang eds., 2010) (on investor protection).

[34] *See generally* Chapter 4 of JIANFU CHEN, LEGAL INSTITUTIONS IN CHINESE LAW: CONTEXT AND TRANSFORMATION 147-70 (2008).

[35] The empirical study consists of: (I) a study on a sample of fifty VC agreements. These agreements are obtained from leading law firms and VC firms, i.e. Banyan Capital, Jubilee Capital, Shenzhen Cedar Capital, Shiyue Hualong Capital, Songhe Yuanwang Capital, Chengwei Capital, Island Peak Innovation, King & Wood Mallesons (Beijing, Shanghai and Shenzhen offices), Fangda Law Firm (Beijing and Shanghai offices), Zhong Lun Law Firm (Beijing and Shenzhen offices), Global Law Firm (Beijing office), Jincheng Tongda & Neal Law Firm (Beijing office), Chongqing Zhonghao Law Firm, Yuan Tai Law Offices, Deheng Law Firm (Shenzhen office), and Shenzhen Huashang Law Firm; (II) interviews with sixty venture capitalists, legal counsels, representatives of institutional

how China has addressed the simultaneity problem. The Chinese government has helped solve the problem by laying down the necessary legal and institutional infrastructure for a VC market, including: (1) providing public capital through various government programs and increasing private capital by easing regulatory barriers towards institutional investors, providing tax incentives, and improving the exit environment; (2) enhancing the availability of financial intermediaries and fund raising by introducing the limited partnership, a new and popular business vehicle that creates an efficient relationship between venture capitalists and investors; and (3) encouraging entrepreneurship by revising the country's corporate and securities laws and streamlining the process of establishing businesses and doing business.

The Chinese government's role in allocating capital, however, is not without flaws. The VC market's rapid growth stemmed largely from the fact that the central government has laid down the institutional and legislative infrastructure to increase the role of market forces in the capital allocation process. But there are institutional obstacles, including the flawed cadre appointment system and flawed incentives for government officials, that prevent local governments from achieving the delicate balance of allowing local government funding to operate based on market forces while concurrently pursuing the governments' policy goals.

The lesson to be learned from the Chinese experience is that the optimal role of a government in engineering a VC market should be to provide the necessary enablers, while playing only a limited role in the capital allocation process by simply providing seed funding and leaving specific capital allocation decisions such as selection of portfolio companies and designing investment strategies to private VC firms with the right incentives. This is a lesson that could be valuable to other countries, such as Japan[36] and Germany,[37] that have attempted to promote the development of a VC market without significant success, and to other countries that are attempting to promote the formation and growth of a VC sector.

The remaining parts of this article are structured as follows. Part I examines the Chinese experience of engineering a VC market. Part II identifies the institutional impediments in China and suggests room for future reforms. Part III critically discusses the lessons learned from

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investors and entrepreneurs. The interviewees come from the six cities that are the major places of VC in China, namely Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou; (III) a study of official data published by the leading service providers, i.e. the annual reports published by the Zero2IPO Research Center, the *China Venture Capital Yearbook* published by China Venture Capital Research Institution, and the annual reports published by the VentureChina.cn.

[36] *See* Shishido, *supra* note 4.

[37] *See* Ronald J. Gilson & Bernard S. Black, *Does Venture Capital Require an Active Stock Market?*, J. APPLIED CORP. FIN. 36, 36-48 (1999).

China for other jurisdictions. A brief conclusion follows.

I. TACKLING THE SIMULTANEITY PROBLEM IN CHINA

A. *The Difficulty Overseas*

The key challenge for governments seeking to engineer a VC market is ensuring the simultaneous availability of three factors—a challenge that Gilson termed the "simultaneity problem." The first factor is investment capital. Venture capitalists provide a special type of capital for early-stage, high-growth, high-risk, often high-technology firms that need equity capital to finance product development or growth.[38] Because of venture capitalists' appetite for high-risk, high-return investments, and because of their managerial skills and industrial connections, venture capital plays an important role in commercializing cutting-edge science and innovation.[39]

The second factor is the availability of specialized financial intermediaries that serve as the "nexus of a set of sophisticated contracts" and that implement an effective incentive structure in a VC cycle.[40] There are two main contracts that place financial intermediaries between sources of capital and innovative businesses. The first contract arises at the fund-raising stage between the investor and the VC fund, which is typically organized in the U.S. as a limited partnership. This contract alleviates the agency costs between the investor and fund manager and incentivizes the latter through mechanisms such as a fixed term, mandatory distributions, and structuring of the fund manager's compensation.[41] The second contract arises between the VC fund and the portfolio company. This contract addresses the uncertainty, information asymmetry and agency costs between the VC fund and entrepreneurs and incentivizes both participants through mechanisms such as staged financing, allocation of control to the fund, structuring of the entrepreneur's compensation and incentivizing exit. [42] The interaction, or "braiding," of the two contracts enhances the efficiency of each in terms of incentivizing exit and constraining opportunistic behavior by the VC fund against entrepreneurs.[43]

The last essential factor for creating a national VC market is the availability of entrepreneurs. Gilson assumes that the supply of entrepreneurs is the "sole function" of the availability of capital and

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[38] *Id.* at 36.

[39] Gilson, *supra* note 1, at 1068. *See also*, LERNER, *supra* note 5, at 181-182 (emphasizing the importance of a large domestic market with investors willing to take risks with younger firms in the development of a VC market).

[40] Gilson, *supra* note 1, at 1069, 1093.

[41] *Id.* at 1087-90.

[42] *Id.* at 1078-87.

[43] *Id.* at 1091-92.

specialized financial intermediaries. In his view, by providing *funding* through the right contractual *vehicle*, government can encourage a supply of *entrepreneurs*.[44]

International experience reveals that resolving the simultaneity problem is not an easy task. Over recent years, many governments have sought to engineer a VC market but have encountered difficulties to varying extents.

In Germany, funding remains the major issue for start-ups, and governmental efforts at resolving the issue have not been sufficient. [45] Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG")[46] proved a failure due to the interference by the government: capital allocation was determined by WFG's board committee, which was largely comprised of bureaucrats. [47] It also failed to incentivize venture capitalists to choose portfolio companies because the government provided a guarantee and insured up to 75% of WFG's losses and because profits were limited by the entrepreneur's call option. [48] Further, WFG personnel were not incentivized to provide technological or management assistance to portfolio companies because of the restriction of profits placed on WFG.[49]

The Indian government has faced challenges in ensuring the availability of capital and specialized financial intermediaries. Although VC fund regulations were enacted in India to encourage the funding of early-stage companies, this goal has been compromised because VC funds have primarily been used as a vehicle to invest in more mature companies, rather than start-ups. [50] Further, VC funds in India are typically organized as trusts because the limited partnership vehicle is not available.[51] Participants in the Indian VC market are thus unable to

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[44] *Id.* at 1102-03.

[45] MARTIN SELTER & THOMAS PRUEVER, LIQUIDITY MEETS PERSPECTIVE: VENTURE CAPITAL AND START-UPS IN GERMANY 36 (VC TRENDS INITIATIVE BY EY 2015) https://go.ey.com/2tljvd8. *See also* Gilson, *supra* note 1, at 1094-1097. As of 2013, the average VC investment in Germany stands at merely €780,000, compared to €6m in America. *See A Slow Climb*, The Economist (Oct. 15, 2013), http://econ.st/1sYYdea.

[46] Deutsche Wagnisfinanzierungsgesellschaft "translates roughly to 'German Venture Financing Fund." *Gilson*, supra note 1, at 1094 n.66 (citing Ralf Becker & Thomas Hellmann, *The Genesis of Venture Capital: Lessons from the German Experience, in* VENTURE CAPITAL, ENTREPRENEURSHIP, AND PUBLIC POLICY 33 (Vesa Kanniainen & Christian Keuschnigg eds., 2005)).

[47] See *id.* at 1094-97.

[48] *Id.*

[49] *Id. See also* Ralf Becker & Thomas Hellmann, *The Genesis of Venture Capital: Lessons from the German Experience, in* VENTURE CAPITAL, ENTREPRENEURSHIP, AND PUBLIC POLICY 33 (Vesa Kanniainen & Christian Keuschnigg eds., 2005).

[50] Akil Hirani, *India, in* GLOBAL VENTURE CAPITAL TRANSACTIONS: A PRACTICAL APPROACH 229 (Beat Brechubul & Robert J. Wooder eds., 2004).

[51] Abhinav Surana & Apurva Kanvinde, *Private Equity in India: Market and Regulatory Review*, WESTLAW UNITED KINGDOM, http://tmsnrt.rs/2tlKuoT (last updated Nov. 1, 2016).

take advantage of the efficient contracting structure for specialized financial intermediaries prevalent in the U.S.

While the government of Singapore has enhanced the availability of funding for start-ups through various programs and introduced the limited partnership to provide a new business vehicle for venture capitalists and investors, concerns have been raised about the government's significant role in the capital allocation process.[52] The imposition of various eligibility requirements on the entrepreneurs, types of portfolio companies, and industries may dampen incentives for participants in the VC market.[53] There is also a "lack of a large base of entrepreneurs" due to the perceived high opportunity costs of becoming an entrepreneur in Singapore.[54]

Nevertheless, some government programs, such as the Israeli Yozma Program and the Chilean Corporation for the Incentive of Production ("CORFU") Program, have achieved a certain degree of success.[55] These successes highlight the shortcomings of other countries and are consistent with the success of the Chinese government's efforts. For example, the Israeli Yozma program did not make investment decisions and provided no guarantee against loss.[56] These investments were made by highly incentivized private fund managers who bore the investment's risk and possessed the control rights to directly monitor the portfolio companies.[57]

VC has had a much shorter history in China than in the U.S.[58] The concept of VC was first officially introduced in China in 1985 in the central government's *Decision to Reform the Science and Technology System*.[59] The industry only began to emerge in the same year when the first VC firm, the China New Technology Venture Capital Company (*zhongguo xinjishu chuangye touzi gongsi*) was set up as a government-initiated project.[60] Prior to that, and before the launch of the open-door

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[52] Newley Purnell, *Singapore Aims to Become Southeast Asia's Silicon Valley*, WALL ST. J. (Feb. 26, 2014), http://on.wsj.com/1IcA35S.

[53] *See id. See also* interview with Mr. K, company founder of a Singaporean start-up, in Singapore (Sept. 9, 2016).

[54] Winston T.H. Koh & Poh Kam Wong, *The Venture Capital Industry in Singapore: A Comparative Study with Taiwan and Israel on the Government's Role* 25 (National University of Singapore Entrepreneurship Centre Working Papers, Paper No. WP2005-09, 2005), http://bit.ly/2tqafVF.

[55] *See* Gilson, *supra* note 1, at 1097-99.

[56] *Id.* at 1097.

[57] *Id.*

[58] *See* LERNER, *supra* note 5, at 8. The United States has over 70 years of experience in VC.

[59] Zhonggong Zhongyang Guanyu Kexue Jishu Tizhi Gaige de Jueding (中共中央关于科学技术体制改革的决定) [*The Decision to Reform the Science and Technology Systems*], Renmin Ribao (人民日报) [People's Daily] (Mar. 13, 1985), http://bit.ly/2snLfJC.

[60] *See* Zhu Shaoping & Ge Yi (朱少平 & 葛毅), Zhonghua Renmin Gonghe Guo Hehuo Qiye Fa de Xiuding: Lifa Jincheng Ziliao Huibian (《中华人民共和国合伙企业法》的修订:立法进程资料汇编) [COLLECTION OF MATERIALS RELATING TO THE AMENDMENT OF THE

policy and economic reform (*gaige kaifang*) in 1978, there were no private enterprises, let alone start-ups or VC. The Chinese VC market developed slowly and was dominated by state-owned VC firms and VC funds in the 1980s and 1990s due to the lack of a developed stock market and unfamiliarity with the new concept,[61] as well as the limited choices of business vehicles available at that time.[62] The market began to develop rapidly only after 1998 when Cheng Siwei, then vice chairman of the National People's Congress Standing Committee, presented a groundbreaking "No.1 Proposal" urging the development of a VC market.[63] After the proposal, a series of policies and laws were promulgated, including the Strategy of Invigorating China through Science and Education (*kejiao xingguo*) and the Law on Promoting the Transformation of Scientific and Technological Achievements.[64]

As discussed below, the Chinese government has helped to tackle the simultaneity problem effectively within three decades.[65]

B. Capital

1. The Need for Venture Capital in China

Today, there is a strong demand for high-risk, high return VC in China, with the increased number of small businesses and the improved innovation and IT infrastructure. In the first nine months of 2015, over 3 million small businesses were registered, accounting for 96.62% of the total number of new registered businesses.[66] In Beijing's Zhongguancun district, the so-called "Chinese Silicon Valley," an average of 7 new companies were registered every minute from March 2014 to May 2015.[67] Beijing has become Asia's largest hub for entrepreneurship.[68]

PARTNERSHIP ENTERPRISE LAW] 4 (2004). *See also* Lu Haitian et al., *Venture Capital and the Law in China*, 37 HONG KONG L.J. 229 (2007).

[61] *See* Lin Lin, *Venture Capital Exits and the Structure of Stock Markets: Lessons from China*, 12 Asian J. Comparative L. 1, 7 (2017).

[62] Limited Partnership was not available under Chinese law in this period.

[63] Cheng Siwei (成思危), Zhongguo Fengxian Touzi de Lishi yu Xianzhuang (中国风险投资的历史与现状) [*The History and Status Quo of China's Venture Capital*], in Cheng Siwei Lun Fengxian Touzi (成思危论风险投资) [CHENG SIWEI ON VENTURE CAPITAL] (2008).

[64] *See* Appendix 2, *infra*.

[65] *See* Part I.B.E, *infra*.

[66] Press Release, Zhonghua Renmin Gongheguo Guojia Gongshang Xingzheng Guanli Zongju(中华人民共和国国家工商行政管理总局) [State Administration for Industry and Commerce], Gongshang Zongju: Quanguo Xin Dengji Qiye Baochi Gaowei Zengjiang (工商总局：全国新登记企业保持高位增长) [State Administration for Industry and Commerce: Country-Wide, Newly-Registered Businesses Maintain High Levels of Growth], (Oct. 15, 2015), http://bit.ly/2snfq3H.

[67] Zhang Lulu, *China's Startup Boom: 7 New Firms Every Minute*, CHINA.ORG.CN (Jun 9, 2015), http://on.china.cn/1B2Rt59.

[68] Zheng Lipeng (郑利鹏), Na Shenme Zhengjiu Ni: Zai Tanlan Zhong bei Wanhuai de Zhongchou Nazhi Zhu (拿什么拯救你：在贪婪中被玩坏的众筹那只猪) [*How to Rescue ECF?*

However, the growth of start-ups and small and medium size firms ("SME") has long been constrained by a substantial capital gap in China as China's stock markets are unable to serve as viable financing channels for SMEs. Apart from dealing with the prohibitively high costs and long waiting times (caused by the current approval system) involved in an IPO, start-ups and SMEs, by virtue of their youth or size, also face difficulties meeting the stringent listing requirements set by the two Main Boards.[69]

Moreover, unlike state-owned enterprises ("SOEs",) that are able to receive low-interest loans from state-owned banks (in part due to administrative influence), private companies face enormous difficulties in securing bank loans.[70] Statistics show that among 56 million micro and small enterprises in China's industrial and commercial areas, only 11.9% are able to obtain loans from banks.[71] Further, these micro and small enterprises receive less than 25% of the loans extended by state-owned commercial banks.[72] Such problems with securing debt financing are exacerbated for start-ups, which typically have insufficient collateral to offer as security.[73] This inadvertently contributed to a high demand for VC as an important means of start-up financing.

In addition, China's Gross Domestic Product ("GDP") growth rate fell from 10.4% in 2010 to 6.918% in 2015,[74] with traditional economic sectors such as manufacturing and real estate showing signs of weakening.[75] Also, with a population of 1.3 billion and a labor force of 900 million, China faces strong pressure to address an increasingly significant unemployment issue.[76] It is thus imperative for the government to foster the development of high-technology industries and a knowledge-based economy to enhance competitiveness and promote

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The Industry Spoilted by Greed], Pintu Shangye Pinglun (品途商业评论) [PINTU360.COM] (Feb. 1, 2016), http://bit.ly/2si4NUu.

[69] Lin, *supra* note 61, at 18-19.

[70] *See* Lan Yuping (蓝裕平), Fengxian Touzi ke Youxiao Jiejue Zhongxiao Qiye Rongzi Nan (风险投资可有效解决中小企业融资难) [*Venture Capital can Effectively Solve the Problem of Capital Financing of Small and Medium Enterprises*], Guoji Rongzi (国际融资) [INTERNATIONAL FINANCING] (Sep. 8, 2010), http://bit.ly/2x2QstS.

[71] Jiedai Bao Qiye Ban Heng Kong Chu Shi, Zhong Xiao Wei Qiye Rongzinan Youwang Chedi Pojie (借贷宝企业版横空出世 中小微企业融资难有望彻底破解) [*With The Launch of Jiedaibao, SMEs' Financial Gaps May be Solved*], Meiri Toutiao (每日头条) [KKNEWS.CC] (Mar. 1, 2016), http://bit.ly/2v55Yoa.

[72] *Id.*

[73] Lin Lin, *Managing the Risks of Equity Crowdfunding: Lessons from China*, 2 J. CORP. LEGAL STUD. 327, 329 (2017).

[74] *GDP Growth (Annual %)*, WORLD BANK, http://bit.ly/2tpOaGw (last visited May 24, 2017).

[75] Mark Magnier, *As Growth Slows, China Highlights Transition from Manufacturing to Service*, WALL ST. J. (Jan 19, 2016), http://on.wsj.com/1KpyCk5.

[76] Press Release, Guowuyuan (国务院) [State Council], Guowuyuan Guanyu Dali Tuijin Dazhong Chuangye Wanzhong Chuangxin Ruoga Zhengce Cuoshi de Yijian (国务院关于大力推进大众创业万众创新若干政策措施的意见) [Views of the State Council on Policy Measures Relating to Mass Entrepreneurship] (June 16, 2015), http://bit.ly/2t1Q9Oh.

sustainable growth. Developing a national VC market is therefore high on the agenda of the Chinese government.

2. Increasing Capital Supply via Government Guidance Funds

Funds for VC investment can be divided into two types depending on their source: government funding[77] and private funding. Government funding has been recognized as one of the most important sources of funding for fueling entrepreneurship across countries, after bank credit.[78] Many countries have issued various government programs to support entrepreneurial businesses, typically through setting up government-sponsored funds to make investments in start-ups. Recent examples include New Zealand's Venture Investment Fund ("NZVIF")[79] and Singapore's Early Stage Venture Fund ("ESVF") program.[80]

In China, VC funding has been provided to tech start-ups through government-sponsored programs, particularly through Government Guidance Funds ("GGF") (*zhengfu yindao jijin*), which are designed to increase the supply of VC to early-stage enterprises and implement national industrial policy by directing capital into government encouraged innovative industries.[81]

The size of the government program is important to VC financing. A public program that is too small would hardly have any impact on a large and diverse economy, while a program that is too large might crowd out private funding and obstruct market forces in the allocation of start-up financing.[82] Also, small firms typically face great difficulties in raising capital, due to information asymmetry between entrepreneurs and investors.[83] Government funds are advantageous as they have an "add-on effect" in raising capital: with proper structuring, investors are willing to invest in such funds once government investors have taken the lead.[84]

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[77] In this article, government funding typically refers to the capital provided by central and local governments.

[78] *See The EY G20 Entrepreneurship Barometer 2013*, ERNST & YOUNG (2013), https://go.ey.com/2uqMw7b. *See also* ERNST & YOUNG, ADAPTING AND EVOLVING: GLOBAL VENTURE CAPITAL INSIGHTS AND TRENDS 2014 (2014), at 14, *available at* https://go.ey.com/1gw404b [hereinafter ERNST & YOUNG – TRENDS 2014].

[79] For a detailed analysis of the program, see JOSH LERNER ET AL., A STUDY OF NEW ZEALAND VENTURE CAPITAL AND PRIVATE EQUITY MARKET AND IMPLICATIONS FOR PUBLIC POLICY (LECG 2005), *available at* http://bit.ly/2ujnHqt.

[80] Terence Lee, *Singapore Government to Pump $48 Million into Six Venture Capital Funds*, TECHINASIA (Apr. 22, 2014), http://bit.ly/2ujlpGU.

[81] *See* Guanyu Changye Touzi Yindao Jijin Guifan Shelin Yu Yunzuo de Zhidao YiJian (关于创业投资引导基金规范设立与运作的指导意见) [Opinion on Venture Capital Fund Specifications and Operational Guidance] (promulgated by the St. Admin. for Industry and Commerce, Oct. 18, 2008), http://bit.ly/2s3806c.

[82] LERNER, *supra* note 5, at 117-19.

[83] *Id.* at 69.

[84] *Id.* at 70.

As shown in Figure 1 and Table 1, the size of the Chinese GGF program arguably used to be too small—only 2% of the total investable amount was contributed by GGFs. This problem was more pronounced in rural areas, where GGFs were so lacking in size that they could not play effective roles in guiding capital flow to start-ups.[85]

To resolve this problem, there has been a new wave of GGFs established at both the central and local levels since 2015. As can be seen from Figure 1, in 2015 alone, 297 GGFs were established with a combined investment amount of RMB 1.5 trillion, which was 5.24 times the amount raised in 2014.[86] As of the end of 2015, there were 780 GGFs in China, managing RMB 2183.447 billion (USD 319.7 billion).[87]

Significantly, at the central government level, a RMB 40 billion (USD 6.5 billion) State Venture Capital Investment Guidance Fund ("SVCIGF") (*guojia xinxingchanye chuangyetouzi yindao jijin*) was set up in 2016 to support start-ups in emerging industries and foster innovation.[88] A National SME Development Fund (*guojia zhongxiao qiye fazhan jijin*) with 60 billion RMB was also set up in the same year to promote the development of SMEs.[89] These two national funds, together with a number of local GGFs, are likely to leverage government funding to attract private investors to participate in the funds.[90]

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[85] Qingke Yanjiu Zhongxin (清科研究中心) [Zero2IPO Research Center], Qingke Paiming: 2016 Zhengfu Yindao Jijin Paiming Qidong Zaiji, Jiemi Wanyi Guimo Yindao Jijin Shichang Geju (清科排名：2016 政府引导基金排名启动在即，解密万亿规模引导基金市场格局) [*Zero2IPO Ranking: 2016 Government Guided Fund Ranking About to Launch, Decipher The Market Structure of Thousand-billion Level Guided Fund*], Touzijie (投资界) [PEDAILY] (Jan. 28, 2015), http://bit.ly/2siKMNF. *See also* Guojia Xinxing Chanye Chuangye Touzi Yindao Jijin Jiang Zhengshi Touru Yunzuo (国家新兴产业创业投资引导基金将正式投入运作) [*SVCIGF Will Be Operating Soon*], Fujian Ribao (福建日报) [FUJIAN DAILY], Aug. 26, 2016 at 7, *available at* http://bit.ly/2s2Z6Wu.

[86] Zerp2IPO Research Center, *supra* note 85.

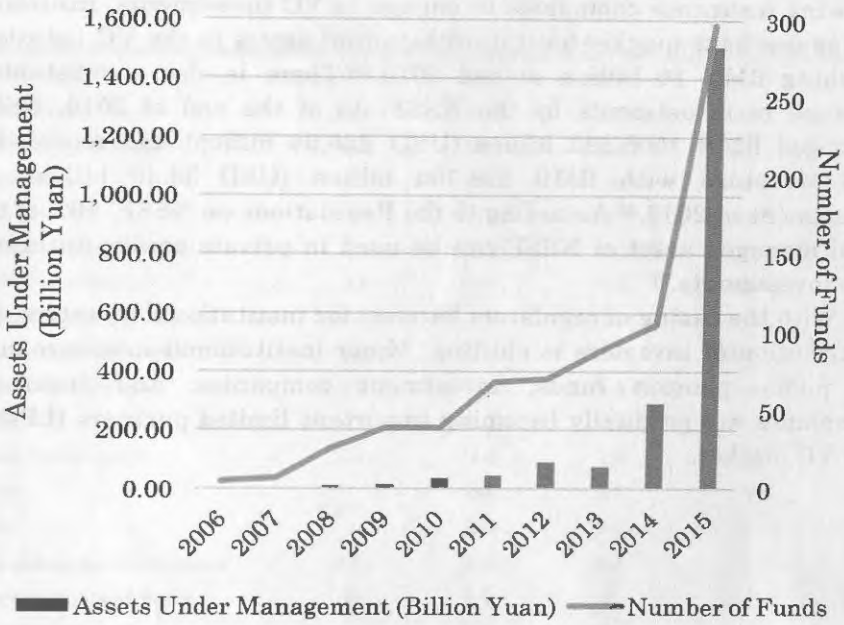
[87] *Id.*

[88] *Id.*

[89] Guojia Zhongxiao Qiye Fazhan Jijin Shouzhi Shiti Jijin Guimo Da 60 Yiyuan (国家中小企业发展基金首支实体基金规模达 60 亿元) [*First National SME Development Fund Reaching 6 Billion in Fund Size*], Zhongguo Xinwen Wang (中国新闻网) [CHINA NEWS.COM] (Aug. 29, 2016), http://bit.ly/2s38cSY.

[90] *See* Zero2IPO Research Center, *supra* note 85.

FIGURE 1: GOVERNMENT GUIDANCE FUNDS IN CHINA (2006-2015)[91]



3. Increasing Capital Supply from Institutional Investors

Institutional investors such as commercial banks, insurance companies, trust companies, and pension funds have long been prohibited from making equity investments due to policy constraints under previous regulations.[92] This has contributed to a predominance of wealthy individuals and families in the VC market, as highlighted in Table 2.

Recognizing the importance of institutional investors as a source of investable capital in long-term and high-risk investments, and in light of recent success stories in Israel and Singapore, which have had attracted global investors to their VC industries,[93] China's regulators have made efforts to promote VC investment from qualified institutional investors and foreign investors.

Regulators – notably including the China Securities Regulatory Commission ("CSRC"), China Insurance Regulatory Commission ("CIRC"), and China Banking Regulatory Commission ("CBRC") – have since 2008 begun to remove restrictions preventing the National Social

[91] Zero2IPO Research Center, *supra* note 81.

[92] *See* Appendix 2, *infra*.

[93] LERNER, *supra* note 5, at 101.

Security Fund ("NSSF"), insurance companies, commercial banks, investment funds, and trust companies from making equity investments.[94] For example, after the CIRC issued a set of guidelines allowing insurance companies to engage in VC investments, insurance companies have quickly built up substantial assets in the VC industry, reaching RMB 10 billion at end 2014.[95] There is also a substantial increase in investments by the NSSF. As of the end of 2015, NSSF managed RMB 1508.592 billion (USD 226.94 billion) and recorded a 15.14% return with RMB 228.704 billion (USD 34.40 billion) on investment in 2015.[96] According to the Regulations on NSSF, 10% of the total managed asset of NSSF can be used in private equity (including VC) investments.[97]

With the easing of regulatory barriers for institutional investors, the distribution of investors is shifting. Major institutional investors such as public pension funds, investment companies, and insurance companies are gradually becoming important limited partners (LPs) in the VC market.

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[91] Since 2008, the NSSF has been permitted to make equity investments in certain funds. Since 2010, insurance companies were allowed to make equity investments. Since 2014, insurance companies were permitted to make investments in VC funds. *See* Appendix 2, *infra*.

[96] Gui Jieying (桂洁英) 2015 Yi Jidu Huoyue LP Zengzhi, 14, 337 Jia, Xianzi, Yindao Jijin Qianzai Guimo Pangda (2015 一季度活跃 LP 增至 14, 337 家，险资、引导基金潜在规模庞大) [*For the First Quarter of 2015, Active LPs have Increased to 14,337; Insurance Companies and Government Guidance Funds are Potentially the Largest Investors*], Touzijie (投资界) [PEDAILY] (Apr. 28, 2015), http://bit.ly/2tZcvA0.

[96] Baidu Baijia GPLP (百度百家 GPLP), Shebao Jijin: Jiemi Touziquan Da BOSS Xuanxiu PE de Biaozhun (社保基金：揭秘投资圈大 BOSS 选秀 PE 的标准) [*Social Security Fund: Revealing the Big Boss' Standards of Drafting PE*], Touzijie (投资界) [PEDAILY] (May 9, 2016), http://pe.pedaily.cn/201605/20160509396982.shtml.

[97] Quanguo Shehui Baozhang Jijin Tiaoli (全国社会保障基金条例) [Regulations of National Social Security Fund], (promulgated by the State Council, Mar. 26, 2016, effective Apr. 1, 2016), http://bit.ly/2s377ur.

TABLE 1: PERCENTAGE OF CAPITAL RAISED BY LPS IN CHINA'S VENTURE CAPITAL AND PRIVATE EQUITY MARKET (BY INVESTABLE AMOUNT) (2011-2015)

	2011(%)[98]	2012(%)[99]	2013(%)[100]	2014(%)[101]	2015(%)[102]
Listed companies	28.7	26.3	26.3	25.0	24.5
Public pension funds	20.4	20.7	20.3	19.2	17.8
Sovereign wealth funds	19.0	19.1	18.7	17.5	16.0
Enterprises[103]	3.5	3.4	3.6	4.5	4.5
Fund of funds	5.9	6.4	6.3	6.1	5.6
Investment companies	2.8	4.0	4.1	4.5	4.7
VC PE institutions	3.7	3.2	3.3	3.8	3.8
Enterprise annuity fund	4.3	4.1	4.0	3.7	3.4
Governmental agencies	0.4	0.9	1.0	3.4	5.9
Wealthy families and individuals	0.7	1.1	1.3	1.5	1.6
Private family funds	1.4	1.4	1.3	1.2	1.1
Trusts	3.8[104]	0.2	0.3	0.4	0.5
Banks		3.0	2.9	2.8	4.0
Asset management companies	1.7	2.3	2.3	2.3	2.4
Government-guided funds	1.8	2.1	2.1	2.0	2.0
Endowment funds	—	0.1	0.1	0.1	0.1
Insurance institutions	1.1	1.0	1.1	1.1	1.1
University endowment funds	0.8	0.7	0.7	0.7	0.6
Others	—	0.2	0.2	0.2	0.3
Total	100.0	100.0	100.0	100.0	100.0

[98] 2011 Nian Zhongguo Simu Guquan Touzi Shichang LP Niandu Yanjiu Baogao Jianban (2011 年中国私募股权投资市场 LP 年度研究报告简版) [*Summary of Private Equity Market LP Yearly Research Report 2011*], Touzijie (投资界) [PEDAILY], http://bit.ly/2uCGxtV.

[99] 2012 Nian Zhongguo Simu Guquan Touzi Shichang LP Niandu Yanjiu Baogao Jianban (2012 年中国私募股权投资市场 LP 年度研究报告简版) [*Summary of Private Equity Market LP Yearly Research Report 2012*], Touzijie (投资界) [PEDAILY], http://bit.ly/2sZlejV.

[100] 2013 Nian Zhongguo Simu Guquan Touzi Shichang LP Niandu Yanjiu Baogao Jianban (2013 年中国私募股权投资市场 LP 年度研究报告简版) [*Summary of Private Equity Market LP Yearly Research Report 2013*], Touzijie (投资界) [PEDAILY], http://bit.ly/2sShJ3Q.

[101] 2014 Nian Zhongguo Simu Guquan Touzi Shichang LP Niandu Yanjiu Baogao Jianban (2014 年中国私募股权投资市场 LP 年度研究报告简版) [*Summary of Private Equity Market LP Yearly Research Report 2014*], Touzijie (投资界) [PEDAILY], http://bit.ly/2sZwGfH.

[102] Qingke Nianbao: Simutong Shoulu LP Zengzhi 15,849 Jia, Zhengfu Yindao Jijin, Shangshi Gongsi, Xianzi Cheng 2015 Zui Ri Jigou LP (清科年报：私募通收录 LP 增至 15,849 家，政府引导基金、上市公司、险资成 2015 最热机构 LP) [*Year 2015: Qingke Annual Report: PE LPs increase to 15,849, Government Guidance Funds, Listed Companies, Insurance Institutions are the most popular institutional LPs*], Touzijie (投资界) [PEDAILY] (Feb. 01, 2016), http://bit.ly/2tBwQf9.

[103] Enterprises excludes listed companies.

[104] In 2011, Trusts and Banks were counted together. *Summary of Private Equity Investment Market LP Yearly Research Report 2011*, *supra* note 98.

TABLE 2: PERCENTAGE OF TYPES OF LIMITED PARTNERS IN CHINA'S VENTURE CAPITAL AND PRIVATE EQUITY MARKET (BY NUMBER) (2011-2015)

	2011(%)[105]	2012(%)[106]	2013(%)[107]	2014(%)[108]	2015(%)[109]
Wealthy families and individuals	46.1	50.2	50.8	54.4	53.0
Enterprises[110]	19.5	17.2	16.6	14.9	14.6
VC/PE institutions	7.0	6.3	6.3	6.2	6.2
Investment companies	4.7	5.9	6.1	8.5	9.4
Government-guided funds	3.7	2.8	2.7	2.0	2.1
Listed companies	3.0	4.3	4.2	3.9	4.7
Asset management companies	3.1	2.3	2.1	1.7	1.7
Governmental agencies	3.0	3.2	3.9	3.1	3.0
Trusts	3.6[111]	0.6	0.7	0.5	0.5
Banks		1.3	1.1	0.8	0.7
Public pension funds	1.9	1.3	1.1	0.8	0.7
Fund of funds	1.8	1.5	1.5	1.3	1.5
University endowment funds	1.0	0.5	0.4	0.3	0.3
Insurance institutions	0.6	0.6	0.6	0.4	0.4
Private family funds	0.5	0.3	0.3	0.2	0.2
Sovereign wealth funds	0.4	0.3	0.3	0.2	0.1
Enterprise annuity fund	0.1	0.1	0.1	0.1	0.1
Endowment funds	--	0.3	0.3	0.2	0.2
Others	--	1.0	1.0	0.9	0.8
Total	100.0	100.0	100.0	100.0	100.0

[105] *Summary of Private Equity Investment Market LP Yearly Research Report 2011*, *supra* note 98.

[106] *Summary of Private Equity Investment Market LP Yearly Research Report 2012*, *supra* note 99.

[107] *Summary of Private Equity Investment Market LP Yearly Research Report 2013*, *supra* note 100.

[108] *Summary of Private Equity Investment Market LP Yearly Research Report 2014*, *supra* note 101.

[109] *Year 2015: Qingke Annual Report: PE LPs increase to 15,849, Government Guidance Funds, Listed Companies, Insurance Institutions are the most popular institutional LPs*, *supra* note 102.

[110] Enterprises exclude listed companies.

[111] In 2011, Trusts and Banks were counted together. *Summary of Private Equity Investment Market LP Yearly Research Report 2011*, *supra* note 98.

TABLE 3: PERCENTAGE OF CAPITAL RAISED IN THE U.S. VENTURE CAPITAL MARKET[112] (BY AMOUNT)

U.S.	2014(%)	2015(%)
Wealthy investors and family offices	8	10
Corporations	5	1
Public pension funds	32	31
Corporate pension funds	6	10
Union pension funds	1	2
Insurance companies	6	10
Endowments	5	7
Sovereign wealth funds	12	6
Funds of funds	6	3
Discretionary advisers	1	2
GP contributions	1	2
Bank/financial services	9	2
Others	8	15
Total	100	101 (due to rounding)

4. Increasing Capital Supply from Foreign Investors

Since 1995, China has promulgated regulations aimed at promoting the establishment of foreign funds. For example, the *Administrative Measures on Foreign-Established Industry Investment Funds* allows Chinese firms to raise funding overseas together with foreign firms,[113] and the *Regulations on the Administration of Foreign Invested Venture Capital Enterprises* allowed foreigners intending to invest in the Chinese market to do so by setting up a Foreign Invested Venture Capital Enterprise ("FIVCIE").[114]

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[112] LAURA KREUTZER, PENSIONS ARE STILL LP TOP DOGS, BUT WEALTHY INVESTORS GAIN GROUND 18 (2015), http://bit.ly/2vcOHtl.

[113] Sheli Jingwai Zhongguo Chanye Touzi Jijin Guanli Banfa (设立境外中国产业投资基金管理办法) [Procedures for the Management of China's Industrial Investment Funds Abroad] (promulgated by the People's Bank of China, Sept. 6, 1995, effective Sept. 6, 1995) http://bit.ly/2u4009D. This regulation has since repealed. Feizhi de Guizhang he Guifanxing Wenjian (废止的规章和规范性文件) [Repealed Regulations and Standards] (promulgated by the People's Bank of China, Jan. 5, 2007, effective Jan. 5, 2007), art. 36, http://bit.ly/2u3tBA9.

[114] Waishang Touzi Chuangye Touzi Qiye Guanli Guiding (外商投资创业投资企业管理规定) [Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises] (promulgated by the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science & Technology, the State Administration for Industry and Commerce, the State Administration of Taxation and the State Administration of Foreign

Since 2011, Shanghai, Beijing, Tianjin, Chongqing, and Shenzhen have promulgated regional Qualified Foreign Limited Partner ("QFLP") programs to attract foreign qualified institutional investors to make equity investments in their regions.[115] Under the QFLP, foreign-invested funds and fund management companies are permitted to convert their foreign currency capital into RMB in order to invest into RMB funds.[116] In 2012, the Renminbi Qualified Foreign Limited Partner ("RQFLP") program was launched by Shanghai to broaden the scope of foreign investors eligible to make VC investments.[117] Under RQFLP, qualified foreign fund managers are permitted to raise offshore RMB from offshore investors to invest in RMB funds set up in Shanghai.[118]

5. Tax Incentives

A favorable tax environment is an important factor in increasing the supply of private capital in a VC market.[119] Many local Chinese governments have implemented preferential tax policies for VC firms that serve as general partners (GPs), and for their investors who serve as the limited partners (LPs) in VC funds (see Table 4).[120]

Today, individuals and families form the majority of LPs (by number) in the market. As of 2015, 53% of LPs in China are wealthy individuals and families,[121] 14.6% are private enterprises, and 9.4% are investment companies.[122] As of 2014, China had the largest population of high-net-worth individuals in Asia (890,000), holding a combined wealth of USD 4.5 trillion, a 19.3% increase from the previous year.[123] Further, the majority of leading VC firms are also both private and foreign.[124] There is also a growing number of VC funds set up by non-

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Exchange, Jan. 30, 2003, effective Mar. 1, 2003, revised Oct. 28, 2015), art. 2, http://bit.ly/2tlDhVP.

[115] Ming Wang et al, CHINA'S FINANCIAL MARKETS: ISSUES AND OPPORTUNITIES 128 (2014).

[116] Sheppard Mullin Richter & Hampton LLP, *Renminbi Qualified Foreign Limited Partner: An Incremental Step Toward RMB Internationalization in the Private Equity Industry*, LEXOLOGY (MAY 20, 2013), http://bit.ly/2t23BBN.

[117] Mayer Brown LLP, *Shanghai Launches New RQFLP Programme*, LEXOLOGY (JAN. 14, 2013), http://bit.ly/2s2PZEX.

[118] *Id.*

[119] John Armour & Douglas Cumming, *The Legislative Road to Silicon Valley*, 58 OXFORD ECON. PAPERS 598, 603-13, 617-26 (2006).

[120] Gui Jieying, *Cancellation of PE Tax Incentives Causes a Stir amid the Trend of Market Innovation and Mass Entrepreneurship*, PEDAILY.CN (Apr. 10, 2015), http://bit.ly/2tlZ6Eb.

[121] The number of wealthy individual and families is big while the fund size they raise is small (1.6% in year 2015). *See* Table 2, *supra*.

[122] *See* Table 2, *supra*.

[123] *Annual World Wealth Report*, CAPGEMINI & RBC WEALTH MANAGEMENT (2015), http://bit.ly/2tqfwwa (last visited May 24, 2017).

[124] *See The Top 50 VC Firms of the Year 2015* (ranked by Zero2ipo), PEDAILY.CN (Dec. 4, 2015), http://bit.ly/2snlpW0.

state owned companies,[125] including Chinese internet giants Tencent and Alibaba.[126] Interviewees have stated that these tax incentives have greatly increased their interests in making VC investments.[127]

TABLE 4: TAX RULES FOR PRIVATE EQUITY/VC FUNDS AT SELECTED LOCATIONS IN CHINA[128]

Region	Tax Regulations[129]
Beijing	GPs and LPs pay individual income tax at a rate of 20%.[130]
Tianjin	Individual GPs and LPs pay individual income tax at a rate of 20%. Within the Tianjin Economic-Technological Development Area, individual partners receive 100% subsidies for tax on income beyond the 20% individual income tax of individual partners.[131]
Shanghai	Individual GPs pay individual income tax at a rate of 35% for income above RMB 50,000; LPs pay individual income tax at a rate of 20% for equity investment income.[132]
Chongqing	Individual GPs pay individual income tax at progressive tax rates ranging from 5-35%; LPs pay individual income tax at a rate of 20%. Pursuant to China's Western Development program, funds organized as companies are subject to corporate income tax at a rate of 15%.[133]
Shenzhen	Individual GPs pay individual income tax at a progressive tax rate ranging from 5-35%; LPs pay individual income tax at a rate of 20%.[134]

6. Improving Exit Environment

The establishment of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) in 1990 offered new exit channels for

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[125] *See* ERNST & YOUNG – 2014 - TRENDS, *supra* note 78, at 20.

[126] Tencent and Alibaba are two top Chinese e-commerce companies.

[127] Interview with Mr. Tian (anonymity requested), Partner, Songhe Yuanwang Capital, in Singapore (Dec. 30, 2016).

[128] Gui, *supra* note 120.

[129] The private equity funds in this table also include VC funds.

[130] Liu Tianyong (刘天永), Simu Guquan Jijin Caiyong Shenme Zuzhi Xingshi Zui Jie Shui? (私募股权基金采用什么组织形式最节税?) [*What is the most tax-efficient structure for Private Equity Funds?*], Zhongguo Kuaji Shiye (中国会计视野) [CHINA ACCOUNTING VISION] (Oct. 18, 2016), http://bit.ly/2sni4Gx.

[131] *Id.*

[132] *Id.*

[133] Chen Zhonghua & Chai Nan (程中华 & 柴楠), Simu Guquan Touzi Jijin Shuishou Zhengce Daibipin (私募股权投资基金税收政策大比拼) [*Comparison of Tax Policies for Private Equity Funds*], Xinlang Caijing (新浪财经) [SINA FINANCE] (May 23, 2017), http://bit.ly/2sS9tiq.

[134] Liu, *supra* note 130.

VC investments. Before that, VC-backed firms were unable to exit via IPOs. In 2016, 148 VC and private equity backed companies were listed on China's stock markets via IPO.[135] In October 2009, the exit environment was further improved by the launch of a new NASDAQ-like secondary board ChiNext.[136] ChiNext provides more relaxed listing requirements as compared to the two main boards, i.e. the SSE and SZSE.[137] The launch of ChiNext has indeed facilitated VC-backed exits. In the five-year span after ChiNext's launch, 519 exits were made via ChiNext, with a market return of RMB 743.4 billion.[138] As of October 23, 2014, 519 companies that were backed by VC or private equity were listed on ChiNext.[139]

In 2013, the nation-wide expansion of the National Equities Exchange and Quotation ("NEEQ") system (also known as the "New Third Board") also provided an important exit vehicle for VC-backed firms.[140] Unlike the Main Boards and ChiNext, all of which employ the merits-based approval system for IPOs, the NEEQ uses the filing system, under which board listings are not subject to CSRC approvals.[141] Such a filing system involves largely reduced listing costs for the applicants.[142] Moreover, the relatively low listing requirements and shorter listing timelines have greatly expedited financing for SMEs and start-ups, especially for the companies that were unable to meet the listing standards of the Main Boards or ChiNext.[143] In the year 2016 alone, 1230 VC-backed companies were quoted on the NEEQ, accounting for 61.5% of the total exits in 2016.[144]

C. Investment Vehicle

In order to create the right incentives for investment in attractive technologies and businesses, a business vehicle that appropriately allocates legal rights and obligations must be available. The limited partnership has been the predominant vehicle for collecting investment funds in the U.S. since the 1970s.[145] The limited partnership, managed by a venture capital firm, collects and holds funds for future investment

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[135] Zero2IPO Research Center, *supra* note 20.

[136] *ChiNext, China's Nasdaq*, PEOPLE'S DAILY, http://bit.ly/2tlIMnm.

[137] Lin, *supra* note 61, at 17.

[138] *Id.*

[139] *See* Zuo Yonggang (左永刚), Chuangyeban Wunian VC/PE Cheng Zuida Yingjia (创业板五年 VC/PE 成最大赢家) [*Five Years of GEB: VC/PE is the Biggest Winner*], Zhengquan Ribao (证券日报) [SECURITIES DAILY] (Oct. 23, 2014), http://bit.ly/2tZmtBz.

[140] Lin, *supra* note 61, at 24.

[141] *Id.*

[142] *Id.*

[143] *Id.*

[144] Zero2IPO Research Center, *supra* note 20. For further information on the correlation between the stock market and the VC market in China, see Lin, *supra* note 61, at 17.

[145] *See* LERNER, *supra* note 5, at 10.

and the shares of start-ups in which it has invested. In recent years, a number of jurisdictions, including Singapore, [146] New Zealand, [147] Taiwan, [148] Japan, [149] and Switzerland, [150] have introduced the limited partnership into their business menus to attract more equity investment in their regions. Other jurisdictions that already have the limited partnership vehicle, such as the United Kingdom [151] and Australia, [152] have also recently amended their limited partnership regimes in order to encourage the growth of VC investment.

The central concept characterizing the limited partnership is that there are two types of partners. LPs who make capital contributions to the firm enjoy a limited liability shield and have no right to participate in its management, whereas GPs have the right to manage the firm and bear unlimited liability for the debts and obligation of the firm. [153] The combination of limited liability and general liability, and the prohibition of LPs to take part in the management of the firm, is particularly attractive to investors who want to delegate management of their funds to professional venture capitalists. [154] The limited partnership is governed by a partnership agreement that offers flexibility for the partners to customize terms to align the interests of the investors and the venture capitalists. [155]

Further, as compared to companies, limited partnerships enjoy a greater degree of confidentiality over their financial information—an attractive feature for investors who do not wish to disclose their

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[146] Singapore Limited Partnerships Act 2008 (Cap. 163B). The act came into operation on May 4, 2009. *Id.*

[147] Limited Partnerships Act 2008 (N.Z.). The act came into force on May 2, 2008. *Id.* at s. 2.

[148] Taiwan's Limited Partnership Law was passed on June 24, 2015. Youxian Hehuo Fa (有限合夥法) [Limited Partnership Law] (Taiwan).

[149] Tōshi jigyō yūgen sekinin kumiai keiyaku ni kansuru hōritsu [Limited Partnership Act for Investment], Law No. 90 of 1998 (Japan).

[150] A special form of limited partnership, designed for collective investments in alternative investment area, was introduced into Swiss law in 2007. *See* Hannes Glaus, *New Partnership*, INT'L. FIN. L. REV., June 2007, at 54, 54.

[151] The British Government announced in 2006 that it would reform the Limited Partnership Act 1907 to clarify and modernize the law relating to limited partnerships. Certain changes based on these recommendations were brought forward in a Legislative Reform Order (LRO) in June 2009.

[152] In 2007, a Tax Laws Amendment (2007 Measures No. 2) Bill was introduced to Australia in order to relax the eligibility requirements for foreign residents investing in VC LPs and Australian VC funds. *See* Press Release, Minister for Revenue and the Assistant Treasurer, Government to Make Further Improvements to the Tax System (Mar. 29, 2007) *available at* http://bit.ly/2t23o1q.

[153] *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-101 et seq. (West 2010); Singapore Limited Partnerships Act 2008 (Cap. 163B), s 6; Limited Partnerships Act 2008, ss 25-31 (N.Z.).

[154] It must be noted that when the GP is organized as a corporation, the issue of unlimited liability has effectively been sidestepped.

[155] Joseph McCahery & Erik Vermeulen, *Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form*, 5 EUR. BUS. ORG. L. REV. 61, 72 (2004).

investment.[156] Limited partnerships also generally enjoy considerably lower formality costs as compared to corporations,[157] as well as pass-through tax treatment.[158]

1. Adoption of the Limited Partnership and Its Popularity

Recognizing the importance of limited partnerships to venture capital, the Chinese legislature has also introduced this new business vehicle in China[159] under the revised Partnership Enterprise Law ("PEL").[160] The adoption of the limited partnership was part of the government's strategy to develop scientific innovation as articulated in its 11th Five-Year Plan (2006-2010),[161] which identified the promotion of VC investment as a critical element for achieving "independent innovation" and sustainable economic progress.[162]

Shortly after the enactment of the revised PEL, the first Chinese limited partnership was set up on June 27, 2007.[163] Today, the limited partnership has become the most popular business vehicle among newly raised VC funds in China.[164]

Consistent with the benefits of limited partnerships elsewhere in the world, the Chinese limited partnership regime also have two types of partners: GPs, who are jointly and severally liable for the debts and liabilities of the firm, and LPs, who are only liable to the extent of their capital contributions.[165] LPs are not permitted to "carry out partnership affairs", while GPs have the right to conduct the day-to-day management of the firm.[166] The PEL also provides a "safe-harbor" list of

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[156] UK LAW COMMISSION & SCOTTISH LAW COMMISSION, LIMITED PARTNERSHIPS ACT 1907: A JOINT CONSULTATION PAPER 3 (CONSULTATION PAPER NO. 161; DISCUSSION PAPER NO. 118, 2001), *available at* http://bit.ly/2s2NGlz.

[157] *Features of a Limited Liability Partnership*, ACCOUNTING AND CORPORATE REGULATORY AUTHORITY, http://bit.ly/2uujfFA.

[158] UK LAW COMMISSION & SCOTTISH LAW COMMISSION, *supra* note 156, para. 1.5-1.6.

[159] Yan Yixun (严义埙), Hehuo Qiye Fa Xiuding de Liyou (合伙企业法修订的理由) [*Reasons of Revising the Partnership Enterprise Law*], Zhongguo Renda Wang (中国人大网) [NPC.GOV.CN] (May 8, 2006), http://bit.ly/2t1Sglp.

[160] Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) [hereinafter Partnership Enterprise Law], http://bit.ly/2siBv8s.

[161] *See* Guomin Jingji he Shehui Fazhan Di Shiyi Ge Wunian Guihua Gangyao (国民经济和社会发展第十一个五年规划纲要) [Outline for the Eleventh Five-year Plan for the National Economic and Social Development] (promulgated by the Standing Comm. Na'l People's Cong., Mar. 14, 2006), http://bit.ly/2sno8P6.

[162] *See* Yan, *supra* note 159.

[163] Li Jingying (李静颖), Wenzhou Shoujia PE Banlu Zheyi Donghai Chuangtou Zhuanru Huanya Chuangtou (温州首家 PE 半路折翼东海创投转入环亚创投) [*The First Venture Capital Limited Partnership in Wenzhou Donghai Venture Capital is Now a Subsidiary of Huanya Chuangtou*], Diyi Caijing Ribao (第一财经日报) [FIRST SECURITIES DAILY] (May 8, 2008), http://bit.ly/2tlNAsy.

[164] *See* Table 5, *infra*.

[165] Partnership Enterprise Law, *supra* note 126, at art. 2.

[166] *See id.*, arts. 2, 67, and 68.

the activities in which LPs may engage without being viewed as "carrying out the partnership affairs," in order to assist LPs in demarcating the legitimate scope of their participation in the firm's activities.[167]

In addition, the Chinese limited partnership provides an efficient contract between the GP and the LPs.[168] First, in contrast to England[169] and Singapore[170] which adopt the aggregate approach towards limited partnership and do not consider the limited partnership as a separate legal entity, the Chinese regime does possess entity features and does have certain attributes which are consistent with separate legal personality, such as the right to hold assets,[171] to sue, and be sued.[172] Furthermore, the limited partnership is not dissolved upon the dissociation of partners,[173] and a creditor's recourse against the GP is postponed until he has exhausted his remedies against partnership assets.[174] The entity approach adopted by the Chinese law helps to facilitate the continuity of the limited partnership. Second, apart from allowing limited partnerships to enjoy pass-through tax treatment at the entity level in China, there are also a number of preferential tax policies for LPs and GPs in VC funds provided by the local governments.[175]

Prior to the introduction of limited partnership, the major business forms for domestic venture capitalists to raise funds were the Limited Liability Company ("LLC"), the Joint Stock Company ("JSC"), the general partnership, and trust. These types of entities had disadvantages that discouraged investment. LLCs and JSCs faced double tax treatment, substantial formation costs and substantial financial disclosure requirements,[176] while general partnerships gave rise to unlimited liability for all partners and a similarly harsh tax

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[167] *See id.*, arts. 68.

[168] *See generally* ZHU & GE *supra* note 60.

[169] Martin Palmer, *UK: English Limited Partnership Registration*, MONDAQ.COM (May 11, 2016), http://bit.ly/2t2aVPv.

[170] ACCOUNTING AND CORPORATE REGULATORY AUTHORITY, *supra* note 157.

[171] Partnership Enterprise Law, *supra* note 126, at arts. 20, 21, 22.

[172] *See* Minshi Susong Fa (民事诉讼法) [Civil Procedure Law] (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug 31, 2012, effective Jan. 1, 2013), art. 49, WESTLAW CHINA, *available at* http://bit.ly/2tlSqGV.

[173] Partnership Enterprise Law, *supra* 126, at art. 48.

[174] *Id.* at art. 38.

[175] *See* Table 4, *infra*.

[176] Before the revision of the PRC Company Law 2005, it was not easy to incorporate a company in China as the minimum capital required for the Limited Liability Company and the Joint Stock Company was RMB 30,000 and RMB 5 million respectively. *See* Jichun Shi, How Chinese Enterprises to Live to Freedom and Competition: Further Integration of the Corporate Law and Competition Law of China with Global Standards 13-14 (NYU Global Fellows Program, Oct. 25, 2006), http://bit.ly/2tZlXn4. For tax issues, see NANCY MARSH ET AL, PARTNERSHIPS IN CHINA: THE NEW FRONTIER, par. 5.1 (2008), http://bit.ly/2tlF78Q.

burden.[177] As for the trust-type fund,[178] although it also enjoys pass-through tax treatment,[179] due to the complex structure, insufficient protection to investors,[180] as well as the lack of registration regime,[181] it has not been a popular business form for fund raising in China.[182]

TABLE 5: PROPORTION OF DIFFERENT TYPES OF BUSINESS FORMS USED FOR NEWLY RAISED VC FUNDS (2008-2013) [183]

	Limited Partnership	Company	Trust	Others	Total
2013	68.96%	24.14%	0.00%	6.90%	100%
2012	57.50%	35.00%	5.00%	2.50%	100%
2011	69.64%	28.57%	0.00%	1.79%	100%
2010	46.56%	45.80%	1.53%	6.11%	100%
2009	25.20%	67.48%	3.25%	4.07%	100%
2008	51.19%	39.29%	4.76%	4.76%	100%

[177] MARSH, supra note 176. Before 2000, the PRC partnership enterprise was subject to taxation both at the enterprise level and upon distribution. Since 2000, the partnership enterprise has become tax transparent.

[178] The trust-type fund emerged in China in 2008. It is regulated by Xintuo Gongsi Siren Guquan Touzi Xintuo Yewu Caozuo Zhiyin (信托公司私人股权投资信托业务操作指引) [Operational Guidelines for Private Equity Investment Business Trust Companies] (promulgated by the China Banking Reg. Comm., June 25, 2008, effective, June 25, 2008), http://bit.ly/2tXNF68.

[179] Deloitte, *New Belgium-China Income Tax Treaty Applicable as of 1 January 2014*, 2 (Jan. 27, 2014), http://bit.ly/1iQU98h.

[180] For example, in contrast with GPs, trustee companies do not bear unlimited liability. Such companies only bear unlimited liability in specific situations, such as illegal activities or breach of the trust agreement, while bearing no liability for any failures under ordinary operating situations. As such, the accountability of the trustee company towards the fund is limited. See Jianbo Lou, An Overview of PRC Trust Law and Trust Business, 6-7 (unpublished manuscript), http://bit.ly/2tmcyrX.

[181] As the trust regime lacks a compulsory public registry, the identity of the beneficiaries cannot be determined, and this becomes an obstacle when the portfolio company of the trust-type VC fund wants to conduct an IPO in China. CSRC requires pre-listed companies to retire any shares held by trustee companies. *See* Zhongguo Xintuo Yexiehui (中国信托业协会) [China Trust Industry Association], Hangye Fazhan Baogao Zhi Chanpin Pian: Siren Guquan Touzi Xintuo (行业发展报告之产品篇：私人股权投资信托) [*Industry Development Report on Products: Private Equity Investment Trust*], Xinlang Caijing (新浪财经) [SINA FINANCE] (NOV. 10, 2016), http://bit.ly/2tvgk2z.

[182] *See* Table 5, *infra*.

[183] *See* CHINA CONSTRUCTION PRESS, CHINA VENTURE CAPITAL ANNUAL REPORTS 2008-2013 (on file with author). The sample size for the years 2008 to 2013 is 84, 123, 131, 112, 40 and 29 respectively.

2. Introduction of Foreign-Invested Limited Partnership

To allow foreign investors to use the limited partnership in raising funds, the State Council issued a new measure to allow foreign venture capitalists and investors to set up a foreign invested limited partnership (FILP).[184] It offers a new business vehicle for foreigners to raise VC funds in China.

Prior to this, one of the popular business vehicles used by foreigners to raise funds was the FIVCIE.[185] As stated above, the FIVCIE was an important legal innovation in its time, but it had flaws. Compared to the FIVCIE,[186] the FILP is subject to fewer procedural requirements in its establishment and operation. For example, unlike the FIVCIE which requires the fund's manager to satisfy certain capital and experience requirements,[187] there is no such requirement under the FILP. Further, unlike the FIVCIE regime which requires the fund manager to contribute at least 1% of the total capital,[188] the fund's manager under the FILP is not required to make a minimum contribution and is allowed to contribute in the form of services.[189] Also, FILPs can be registered and may reduce their capital without obtaining governmental approval.[190] They are not required to make up for accumulated losses or to allocate part of their profits to a reserve fund.[191] They enjoy flexibility in the structuring of profit distributions without reference to capital contribution.[192] In the FILP, the Chinese partners may be designated as LPs, while foreign investors may serve as GPs, giving them greater control over the fund.[193]

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[184] Waiguo Qiye Huozhe Geren zai Zhongguo Jingnei Sheli Hehuo Qiye Guanli Banfa (外国企业或者个人在中国境内设立合伙企业管理办法) [Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals] (promulgated by. St. Council, Nov. 25, 2009, effective Mar. 1, 2010), http://bit.ly/2tlSxC9.

[185] Waishang Touzi Chuangye Touzi Qiye Guanli Guiding (外商投资创业投资企业管理规定) [Provisions Concerning the Administration of Foreign-Funded Venture Investment Enterprises] (promulgated by the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science & Technology, the State Administration for Industry and Commerce, the State Administration of Taxation, and the State Administration of Foreign Exchange. Jan. 30, 2003. effective Mar. 1, 2003), *available at* http://bit.ly/2s2FXDT.

[186] *See* text accompanying note 113, *supra*.

[187] Provisions Concerning the Administration of Foreign-Funded Venture Investment Enterprises, *supra* note 176, art. 7(2) (providing that the mandatory investor (i.e. the fund manager) must have managed assets to the value of at least USD 100m in the most recent 3 years before the application).

[188] *Id.*, art. 7(6).

[189] Baker & McKenzie, *China Issues Foreign-invested Partnership Rules* 1 (Dec. 2009), http://bit.ly/2sSfKux.

[190] Samuel H. Shaddox, *China's Foreign Invested Partnership Enterprise Law: The Lifeless or Sleeping Dragon?* 22 PACIFIC RIM L. & POL. J. 469, 473-474 (2013). *See also* Appendix 2, *infra*.

[191] *Shaddox, supra* note 182, at 471-74.

[192] *Id.*

[193] *Id.*

D. Entrepreneurs

The last essential factor for creating a VC market is the availability of entrepreneurs. This presents a "chicken and egg" challenge. Without entrepreneurs there will be no capital to fund them, and without capital to fund them, there will be no entrepreneurs—even if individuals with the requisite qualities are available.

1. Policies and Tax Reliefs to Strengthen Entrepreneurship

First, as indicated in Appendix 2, since 1978, a large number of substantive laws and policies were promulgated to serve the mission of the "Four Modernizations" Policy and the "Strategy of Invigorating China through Science and Education" (*ke jiao xing guo*). Since May 2013, the central government has issued at least 22 documents, including two fundamental opinions issued by the State Council to embark on the *Mass Entrepreneurship and Innovation* reform.[194] This was followed by several specific measures that aimed to improve institutional mechanisms to facilitate entrepreneurship and innovation, for instance, by deepening business system reforms, strengthening intellectual property protection and establishing a mechanism for the training and hiring of talented professionals.[195]

These policies resulted in the emergence of young entrepreneurs in China's VC market.[196] It is reported that 2.3% of the university graduates of 2013 have chosen to start businesses.[197] There are also an increasing number of overseas returnees (*haigui*)[198] who have started businesses with their technological knowhow and overseas resources. As of 2014, the number of overseas returnees stood at 1.8 million, accounting for 51.4% of total overseas graduates.[199] In an interview conducted with 913 overseas returnees, 78.4% of whom had returned after 2010,[200] more than half indicated that their decisions to return to China was largely based on the attractive entrepreneurial environment,[201] reflecting the positive effect of government policies in

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[194] Views of the State Council on Policy Measures relating to Mass Entrepreneurship, *supra* note 76.

[195] *Id.*

[196] *See, e.g., id.*

[197] Chen Zhengfei (陈正飞), 90hou "Chuangke" Jueqi: Tiansheng de Chuangyejia (90后"创客"崛起：天生的创业家) [*Post-90s Entrepreneurs: Genius Entrepreneurs*], Juece Wang (决策网) [JUECE.NET.CN] (May 4, 2015), http://bit.ly/2snteef.

[198] Haigui (海归) is a Chinese language slang term for Chinese people who have returned to mainland China after having studied abroad for several years.

[199] Quanqiuhua Zhiku (全球化智库) [CENTER FOR CHINA & GLOBALIZATION], Zhongguo Haigui Jiuye Chuangye Diaocha Baogao 2015 (2015 中国海归就业创业调查报告) [2015 CHINA OVERSEAS RETURNEES ENTREPRENEURSHIP REPORT] (2015), *available at* http://bit.ly/2uW8egn. The number of overseas returnees in 2014 was 3.2% more than the number in 2013, and almost 10% more than that in 2012.

[200] *Id.*

[201] *Id.*

encouraging entrepreneurship.

Second, various forms of tax relief have been provided to national scientific parks and incubators to encourage innovation.[202] For example, qualified incubators are exempted from paying real estate taxes and taxes on using urban land.[203] They are also exempted from business taxes for income received from renting work sites, housing, and incubation services provided to incubated companies.[204] Such developments have caused a nationwide surge in the number of incubators, from 534 in 2005 to 896 in 2010, and then to 1500 in 2015.[205] As of March 2015, there were more than 1,600 incubators supporting more than 80,000 start-ups.[206] In 2015, China saw 1,102,000 invention patent applications, which was 18.7% more than the previous year, with 359,000 being authorized.[207]

2. Entrepreneur-Friendly Company Law Reforms

Various company law reforms to promote entrepreneurship have been recently carried out in a number of jurisdictions, including several EU states,[208] Taiwan,[209] and Singapore.[210] These reforms typically focus

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[202] The 2006 *Outline of the National Program for Long- and Medium-Term Scientific and Technological Development* mentioned that "qualified science and tech incubators and National University Science Parks will be exempt from corporate tax, income tax, property tax, and urban land use tax for a specified period of time".

[203] Under the Notice on Issues concerning the Taxation Policy of the National University Science Park 2007, "real estate and land may be used by qualifying incubators for their own purposes or be offered to incubated companies for free or for a rent. Such real estate and land shall be exempted from real estate taxes and land use taxes." Guanyu Guojia Daxue Kejiyuan youguan Shuishou Zhengce Wenti de Tongzhi (关于国家大学科技园有关税收政策问题的通知) [Notice on Issues concerning the Taxation Policy of the National University Science Park] (issued by the Minstry of Finance & State Administration of Taxation, Aug. 20, 2007), http://bit.ly/2tpOl4N.

[204] In 2013, the Ministry of Finance and the State Administration of Taxation extended the abovementioned policy to 31 December 2015. *See* Press Release, State Administration of Taxation of The People's Republic of China, MOF, SAT Issue Circulars on Preferential Tax Policies for Incubators and University Science Parks 2014, (Jan. 15, 2013), http://bit.ly/2snnP7d.

[205] Wan Ge (万格), Touzhong Guandian: Guonei Fuhuaqi Fazhan Shitou Xunmeng, Zijin Yali cheng Zhuyao Pingjing (投中观点：国内孵化器发展势头迅猛 资金压力成主要瓶颈)[*China Venture Viewpoint: domestic incubators are developing rapidly, and pressure to raise capital is becoming the major bottleneck*], 投中网 [CHINAVENTURE.CN] (Jan. 27, 2014), http://bit.ly/2tm7YcW.

[206] *See* Keji Buzhang Wan Gang Da Jizhe Wen (科技部长万钢答记者问) *Science and Technology Minister Wan Gang Answers Reporters' Questions*, 中国网 [CHINA.ORG.CN] (May 30, 2015), http://bit.ly/2snoYvm.

[207] Press Release, State Intellectual Property Office of the PRC, China Received over 1 Million Invention Patent Applications in 2015 (Jan. 20, 2016), http://bit.ly/2fJpqUc.

[208] Mette Neville & Karsten Engsig Sorensen, *Promoting Entrepreneurship - The New Company Law Agenda*, 15 EUR. BUS. ORG. L. REV. 545 (2014).

[209] In 2015, Taiwan introduced a new corporate form, the Closely-Held Company Limited by Shares, to provide flexibility for fund-raising for start-ups. *See* Joseph P.Y. Tseng & Jacqueline Fu, *Amendment to Taiwan's Company Act Establishes 'Closely-Held*

on updating existing corporate forms, introducing new types of private companies, reducing capital requirements and procedures for setting up companies, as well as providing more flexibility in share transfer and corporate governance. While some may argue that company law reforms alone do not strengthen enterprises and entrepreneurship, empirical studies have found that fine-tuning regulations for companies can have a positive effect on entrepreneurship,[211] in particular reducing the minimum capital requirement.[212]

The LLC is a prominent business form for portfolio companies (i.e. start-up firms) in the Chinese VC market. In recent years, important amendments have been made to the PRC Company Law to modernize the corporate regime, to reduce the costs in setting up a business, and to facilitate the development of VC.

First, one of the most significant company law reforms was the abolition of certain registered capital requirements for domestic and foreign companies in 2013.[213] Prior to this revision, LLCs were required to have a minimum registered capital of at least RMB 30,000 (USD 4,800). [214] Also, domestic and foreign investors were required to contribute the first installment of registered capital within 90 days from the date of incorporation, and the remainder within two years. The amendment removes this statutory threshold. Since March 1, 2014, investors have been free to decide the amount of registered capital in their companies. Companies are no longer required to appoint an accounting firm to verify mandatory capital contributions and register the paid-in capital amount with the company registration agency.

Second, the newly introduced "three-in-one" business registration reform is another noteworthy improvement in the ease of starting business in China. Starting from October 1, 2015, there is no need for different government agencies to issue business certificates separately for enterprises applying for registration. Unified registration procedures, numbering, and coding rules have been put into practice nationwide.[215]

Third, an additional important reform is the launch of a new annual

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Company Limited by Shares' to Provide Flexibility on Fund-Raising for Startups, K&L GATES (Jul 27, 2015), http://bit.ly/2ujnAv2.

[210] *See* Lin Lin & Michael Ewing-Chow, *The Doing Business Indicators in Minority Investor Protection: The Case of Singapore*, 1 SING. J. LEGAL STUD. 46 (2016).

[211] *See* Neville & Sorensen, *supra* note 208, at 584 ("there is little doubt that legislation on companies can contribute to promoting entrepreneurship.").

[212] *Id.*

[213] On December 28, 2013, the Standing Committee of the National People's Congress passed certain amendments to the PRC Company Law of 2006, effective as of March 1, 2014. *See* Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2005, effective Mar. 1, 2006, last revised Dec. 28, 2014), http://bit.ly/2tZcpby.

[214] *Id.*, art. 26.

[215] Press Release, State Administration of Taxation of The People's Republic of China, *supra* note 204.

reporting system in 2014.[216] Under the new system, companies are no longer required to submit annual reports. Instead, the regulator will conduct random reviews of the contents of a company's public reports.

These initiatives have greatly reduced the cost and procedures involved in setting up and doing business. China's ranking on the World Bank's Ease of Doing Business Index has also gradually increased from No. 99 in 2013 to No. 78 in 2017.[217]

In 2016, 16,513,000 new businesses were registered in China, a 11.6% rise from the same period the previous year.[218] This increasing number of registered businesses could be attributed, to a certain extent, to fundamental changes in the domestic business regulatory environment.

E. The Venture Capital Response to Governmental Actions

As discussed in this part, the Chinese government at both the central and local levels has helped to tackle the simultaneity problem by establishing legislative and institutional infrastructure conducive to VC development.[219] A significant amount of legislation has been promulgated to facilitate the different stages of the VC cycle, including fundraising, investment, and exit. Specifically, and with reference to the hierarchy of laws, there have been: (1) national laws[220] ranging from the Company Law to the Partnership Enterprise Law;[221] (2) administrative regulations[222] ranging from the Interim Measures for Administration of Start-up Investment Enterprises[223] to the newly promulgated Interim Measures for Supervision and Administration of Private Investment Funds;[224] and (3) various local regulations governing issues such as

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[216] On February 14, 2014, the SAIC published the *Notice on Ceasing the Annual Inspection of Enterprises*. Gongshang Zongju: Qiye Nianjian 3 Yue 1 Ri Qi Quxiao (工商总局：企业年检 3 月 1 日起取消) [*Notice on Ceasing the Annual Inspection of Enterprises*], Remin Ribao (人民日报) [PEOPLE'S DAILY] (Feb. 20, 2014), http://bit.ly/2siPSt7.

[217] *Doing Business Reports on China*, WORLD BANK GROUP, http://bit.ly/1fY9Qsj (last visited Aug. 21, 2017).

[218] Press Release, Gongshang Zongju Xiang Meiti Jieshao 2016 Nian Quanguo Shichang Zhuti Fazhan Deng Xiangguan Qingkuang (工商总局向媒体介绍2016年全国市场主体发展等相关情况) [The State Administration for Industry and Commerce Introduced the Development of National Market Entities in 2016] (Jan. 20, 2017), http://bit.ly/2tlJqAS.

[219] *See* Appendix 1 and Appendix 2, *infra*.

[220] National laws are promulgated by the National People's Congress and its Standing Committee.

[221] Zhengquan Touzi Jijin Fa (证券投资基金法) [Securities Investment Fund Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2003, revised Dec. 28, 2012, effective June 1, 2013), *available at* http://bit.ly/2si7HZu.

[222] Administrative regulations are promulgated by the State Council and the ministries under the State Council.

[223] Chuangye Touzi Qiye Guanli Zhanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for Administration of Start-up Investment Enterprises] (promulgated by the St. Dev. & Reform Comm'n, et al., Nov. 15, 2005, effective Mar. 1, 2006), http://bit.ly/2tZcQ5G.

[224] *See* Guojia Fazhan Gaigewei Bangongting Guanyu Jinyibu Guifan Shidian Diqu Guquan Touzi Qiye Fazhan he Beian Guanli Gongzuo de Tongzhi (国家发展改革委办公厅关于进一步规范试点地区股权投资企业发展和备案管理工作的通知) [Notice of the General Office

establishment of funds and tax.

In particular, the legislation and policies described above have contributed to the effective engineering of China's VC framework: (1) providing public funding through GGFs and increasing private funding by easing regulatory barriers towards institutional investors and foreign investors; (2) enhancing the availability of financial intermediaries through introducing a new and popular business vehicle – the limited partnership – for VC fundraising; and (3) facilitating the establishment and operation of entrepreneurial firms through supportive industrial policies, tax relief, and revisions to the corporate legal regime.

As Figure 2 and Figure 3 demonstrate, from 2002 to 2015, China's VC market experienced steady growth in the total amount of funds raised. Figure 2 provides a timeline for the development of the market and illustrates how the development of the VC market is largely influenced by regulatory policies and laws. For example, although the number and volume of funds raised dipped in 2009 due to the global financial crisis, both the number of newly established venture funds and the amounts raised increased two-fold in 2011. As explained above, this VC boom can be attributed to the launch of the new NASDAQ-like secondary board ChiNext, new measures allowing more institutional investors and foreign investors to make equity investments,[225] and the substantial increase in investments by the NSSF (of more than RMB 6 billion). Also, although the suspension of the IPO process by CSRC from November 2012 to January 2014 negatively affected fundraising in both 2012 and 2013, the 2013 nationwide expansion of the NEEQ system, which offered a new exit channel for VC-backed companies, was followed by a sharp increase in new VC commitments.[226]

Further, with regard to investor composition, although the Chinese market was dominated by state-owned VC firms and funds in the 1980s and 1990s, it has since seen a rapid emergence of private firms and funds. Today the majority of leading VC firms in China are both private and foreign.[227] Private funding primarily from listed companies and

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of the National Development and Reform Commission on Further Regulating the Development and Filing Management of Equity Investment Enterprises in Pilot Areas] (effective Jan. 31, 2011), http://bit.ly/2v0lGiX; Guojia Fazhan Gaigewei Bangongting Guanyu Cujin Guquan Touzi Qiye Guifan Fazhan de Tongzhi (国家发展改革委办公厅关于促进股权投资企业规范发展的通知) [Notice on Promoting Regulation and Development of Equity Investment Enterprises] (Nov. 23, 2011), http://bit.ly/2tlVzq7; Simu Touzi Jijin Guanliren Dengji he Jijin Beian Banfa (shixing) (私募投资基金管理人登记和基金备案办法(试行)) [Measures on the Registration of Private Investment Fund Managers and Filing of Private Investment Funds (for Trial Implementation)] (promulgated by the Asset Management Association of China, Jan 17, 2014, effective Feb. 7, 2014), http://bit.ly/2sSvTQL.

[225] *See* Appendix 2, *infra*.

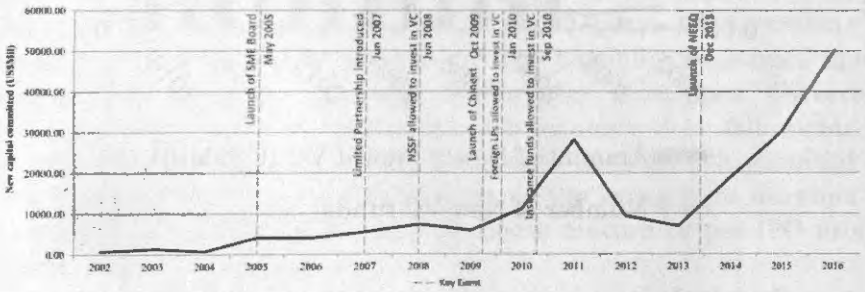
[226] Lin, *supra* note 61, at 16-17, 24-26.

[227] *See* Qingke-2015 Zhongguo Guquan Touzi Niandu VC Jigou Pingxuan Paiming (清科-2015 中国股权投资年度 VC 机构评选排名) [*Zero2IPO-China Top 50 Venture Capital*

investment companies has become a major source capital to the VC market in China.[228] Although their average investment is smaller, private individual and families form the majority of investors.[229]

Finally, with supportive policies and an improving regulatory environment, China's entrepreneurial culture is also evolving. A new generation of entrepreneurs – the "post-90s" generation of entrepreneurs – has emerged.[230] Unlike their parents, these second-generation entrepreneurs are more inclined to pursue their dreams by setting up their own businesses.[231] Having received good educations and having grown up in the age of the Internet and the rise of China, they tend to be less afraid of failure. They are also able to adapt quickly to changes in the business environment.[232]

FIGURE 2: NEW VENTURE CAPITAL COMMITMENTS AND MAJOR LEGISLATIVE AND POLICY CHANGES (2002-2016)[233]



Institutions in 2015], Touzijie (投资界) [PEDAILY] (Dec 4, 2015, 7:02 PM), http://bit.ly/2snlpW0.

[228] *See* Table 1, *supra*.

[229] *See* Table 1, *supra* (noting that government guidance funds only account for 2% of all investors on average).

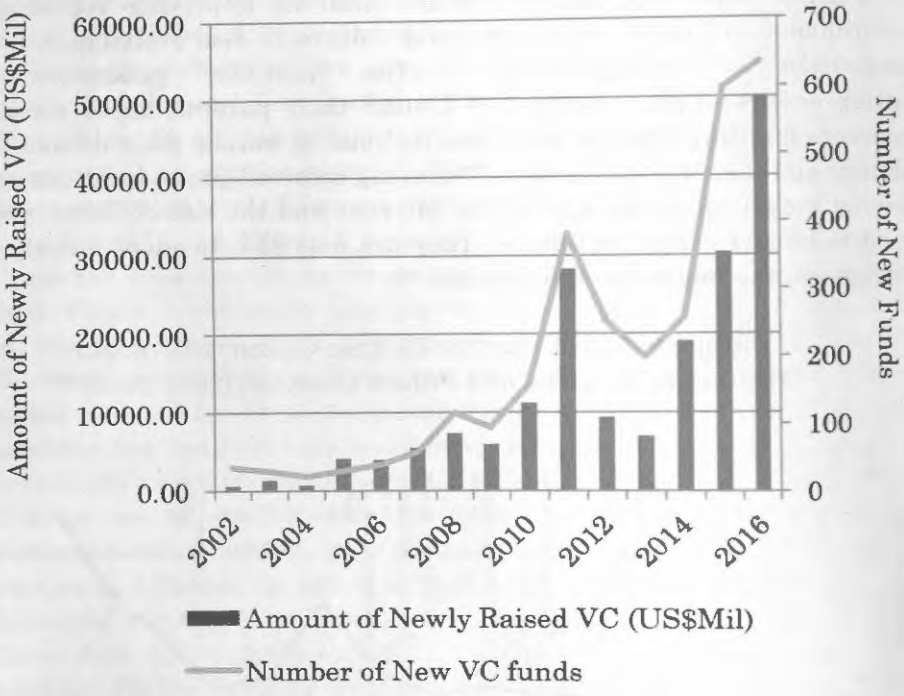
[230] Interview with Ms. S, Vice President, Banyan Capital, in Beijing, China (Oct. 2015). Interview with Mr. Zhu, partner, Island Peak Innovation, in Singapore (Dec. 16, 2016)

[231] *Id.*

[232] *Id.*

[233] This graph is drawn from the contents of Appendix 2, *infra*.

FIGURE 3: NEW VENTURE CAPITAL COMMITMENTS AGAINST NEW VENTURE CAPITAL FUNDS 2002-2016 (USD MILLION)[234]



II. ROOM FOR IMPROVEMENT AND SUGGESTIONS

Although China has solved the simultaneity problem with a certain degree of success, institutional impediments may nonetheless prevent the Chinese VC industry from realizing its full potential. This part discusses how the Chinese government can improve on what it has done to facilitate even greater growth of VC.

A. Problems with Public Funding

GGFs have not been unproblematic despite positive progress and swift development. There are GGFs at both the central and local levels. National GGFs are set up by the central government, while local GGFs are set up by local governments at different levels (i.e. province, city, and county). As of December 2015, 417 GGFs were city-level GGFs, and they managed an investment amount of RMB 824.3 billion, while there

[234] This graph is based on data from *Summary of Private Equity Investment Market LP Yearly Research Report 2012*, supra note 99 (2002-2012) and *Year 2015: Qingke Annual Report: PE LPs increase to 15,849, Government Guidance Funds, Listed Companies, Insurance Institutions are the most popular institutional LPs*, *supra* note 102 (2005-2016).

were only 9 national-level GGFs, managing RMB 274.85 billion.[235] While most of these GGFs were recently established and it is still too early to test their roles in the VC market empirically, there are several flaws in the structure of the local GGFs and the rules by which they operate.

First, local government intervention is prevalent within local GGFs. Local governments often mandate the sectors, companies, or locations to be funded.[236] In particular, it is common for a local government to require a VC firm to inject GGF funding in certain companies within the region.[237] This could lead to conflicts between the GGF and the VC firm, resulting in disincentives to the latter in finding promising projects and causing it to be less willing to receive funding from GGFs in future projects.

There are also problematic local regulations that unduly restrict the duration of investments and size of the portfolio companies. For example, Jiangsu province specifies that the maximum duration of the GGF investment is five years,[238] which is inconsistent with the international practice of between 7 to 10 years.[239] Restricting the duration of investments and size of the portfolio companies ignores market force in the selection of portfolio companies. Investment managers may have to choose those companies that fall within the restricted categories but not the companies with growth potential and are in need of venture capital. Shortening the investment duration will encourage investment managers to choose mature or pre-IPO projects instead of early-stage start-ups.

Second, the selection of managers in some local GGFs is flawed. For instance, the manager of the Shanghai Angel Investment Guidance Fund (AIGF) is not selected from the private sector, but is statutorily

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[235] Zero2IPO Research Center, *supra* note 85.

[236] For example, Article 6(5) of the Implementation Rules for Shanghai Angel Investments Guidance Fund states that the investor is to invest mainly in companies within Shanghai. Shanghaishi Tianshi Tozi Yindao Jijin Guanli Shishi Xize (上海市天使投资引导基金管理实施细则), [Implementation Rules of the Shanghai Angel Investment Guidance Fund] (promulgated by the Shanghai Municipal Development and Reform Commission, Dec. 16, 2014, effective Dec. 16, 2014), art. 6(5) HUKEHE [2014] No. 49 http://bit.ly/2t1V5CN.

[237] Article 8 of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, *supra* note 236, states that investments by the Shanghai Angel Investments Guidance Fund into each portfolio company shall be between RMB 5 million – 30 million RMB and that this amount shall not exceed 50% of the total subscribed capital of the portfolio company.

[238] Article 41 of the Measures of the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund states that the duration of investments made by the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund shall not exceed 5 years unless approval is sought from the fund's management committee. Jiangsusheng Xinxing Chanye Chuangye Touzi Yindao Jijin Guanli Banfa (江苏省新兴产业创业投资引导基金管理办法) [Measures of the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund] (promulgated May 20, 2013, effective May 20, 2013), http://bit.ly/2tZzn2D.

[239] LERNER, *supra* note 5.

appointed. The manager currently appointed is a subsidiary [240] of another government-backed fund, the Shanghai Technology Entrepreneurship Foundation for Graduates ("EFG"), [241] that "shall exercise the rights as the investors of the Shanghai AIGF." [242] Two questions naturally follow: First, how would EFG "exercise the rights as an investor" and operate the fund effectively since it does not hold any equity interests in the fund? Second, how would the EFG monitor the fund effectively when the fund is being operated by its subsidiary? Also, unlike the ordinary VC limited partnership model where a professional VC firm serves as the GP and is subject to various legal and contractual constraints (e.g. unlimited liability for the debts of the fund, fiduciary duties, and the LPs' derivative action mechanism), there is no effective mechanism to constrain the behavior of the Shanghai AIGF's statutorily mandated fund manager.

Moreover, under the Shanghai AIGF Measures, [243] a steering committee comprising the deputy mayor of Shanghai and other government bureaucrats is in charge of the policy-making and supervision of the fund. [244] The lack of open selection mechanism for local cadres in charge of the GGFs may lead to problems including bureaucratic red-tape and a lack of expertise and professionalism within the GGFs.

Further, the Shanghai AIGF Measures mandate the establishment of a separate investment committee comprised of external experts and government representatives to review and vote for investment proposals. [245] These officials may intervene directly in the decision-making process of the fund, thus causing internal conflicts. Also, while the GP of a limited-partnership type VC fund in the United States and the United Kingdom is constrained by fiduciary duties and potential

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[240] Shanghai Venture Capital Jieli Technology Financing Group *(shanghai chuangye jieli keji jinrong jituan).*

[241] This Foundation was established by the Shanghai government as a not-for-profit organization in 2006.

[242] Implementation Rules of the Shanghai Angel Investment Guidance Fund, *supra* note 236, at art. 3.

[243] Article 3 states that the steering committee is the highest management institution for the Shanghai AIGF and is responsible for the policymaking and supervision of the fund. *Id.* Public information reveals that the steering committee is led by the deputy mayor of the Shanghai and includes bureaucrats from 12 departments of the Shanghai government. *See* Liang Jialin (梁嘉琳), Xunzhao "Xiao Ali" Shanghai Chengli Guonei Shouge Zhengfu Tianshi Yindao Jijin (寻找"小阿里" 上海成立国内首个政府天使引导基金) [*Looking for "small Ali" Shanghai set up the First Domestic Government Angel Guide Fund*], Jingji Guancha Bao (经济观察网) [ECONOMIC OBSERVER] (Dec 24, 2014), http://bit.ly/2siFqlz.

[244] Liang, *supra* note 243.

[245] Article 12 of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, *supra* note 236, states that the fund must set up an independent investment review committee to review investment proposals. The committee will comprise experts and representatives from relevant government agencies. *Id.*

personal liability,[246] officials in this committee are not penalized for decisions made by the committee. Consequently, ensuring that these officials do not misuse resources of the fund to obtain personal benefits remains a difficult task.

Third, local governments or GGFs often guarantee investment losses suffered by VC firms, resulting in flawed incentives for the VC firm and the entrepreneurs. Examples include the GGFs of Beijing,[247] Jiangsu,[248] Guangzhou,[249] and Shanghai.[250] For example, the Shanghai government guarantees and compensates VC firms for up to 60% of their actual losses caused by investments in scientific and technological enterprises at the seed stage or up to 30% at the start-up stage,[251] as well as RMB 3 million of their actual losses for each investment project and RMB 6 million for annual investments by each investment firm.[252]

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[246] Kenneth Jacobson, *Fiduciary Duty Considerations in Choosing between Limited Partnerships and Limited Liability Companies*, 36 Real Prop. Prob. Trust J. 1, 6 (2001); Larry E Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927, 939 (2004).

[247] Special subsidies exist for VC investments in Zhongguancun, an area in Beijing with a high concentration of technology firms. Zhongguancun Guojia Zizhu Chuangxin Shifanqu Youxiu Rencai Zhichi Zijin Guanli Banfa (中关村国家自主创新示范区优秀人才支持资金管理办法) [Measures on the Zhongguancun Talent Attraction Investment Fund], ZHONGKEYUAN FA [2013] No. 40 (promulgated by the Zhongguancun Science and Technology Park Management Committee, Nov. 18, 2013, effective Nov. 18, 2013), http://bit.ly/2s3k4Ek.

[248] The Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund, Jiangsu Development and Reform Commission states that angel investment firms would be compensated for up to 50% of the losses they incur from investments into seed or early-stage technology-based enterprisea, provided that these losses were incurred within three years from the time the relevant investments were made, up to a limit of RMB 3 million. Jiangsusheng Xinxing Chanye Chuangye Touzi Yindao Jijin Guanli Banfa (江苏省新兴产业创业投资引导基金管理办法) [Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund] (promulgated by the Jiangsu Development and Reform Commission, May 20, 2013, effective May 20, 2013), http://bit.ly/2tZzn2D.

[249] The Trial Measures for the Technology Enterprises Incubator Venture Capital and Credit Risk Compensation Fund of Guangdong Province states that VC firms will be compensated for up to 50% of the losses they incur from investments made into early-stage enterprises in the Guangdong Province Technology Enterprises Incubator, up to a limit of RMB 2 million. Guangdongsheng Kexue Jishu Ting Guangdongsheng Caizheng Ting Guanyu Keji Qiye Fuhuaqi Chuangye Touzi ji Xindai Fengxian Buchang Zijin Shixing Xize (广东省科学技术厅广东省财政厅关于科技企业孵化器创业投资及信贷风险补偿资金试行细则) [Trial Measures for the Technology Enterprises Incubator Venture Capital and Credit Risk Compensation Fund of Guangdong Province] (jointly promulgated by the Guangdong Provincial Office of Science and Technology and the Guangdong Provincial Department of Finance, Feb. 15, 2015, effective Apr. 1, 2015), http://bit.ly/2sSymL1.

[250] Shanghaishi Tianshi Touzi Fengxian Buchang Guanli Zhaxing Banfa (上海市天使投资风险补偿管理暂行办法) [Shanghai Angel Investment Risk Compensation Interim Measures], (promulgated by Shanghai Sci. & Tech. Comm., Shanghai Fin. Bureau, and Shanghai Dev. & Reform Comm'n, Dec. 29, 2015, effective Feb. 1, 2016), http://bit.ly/2ujSS5k.

[251] *Id.*, art. 9.

[252] *Id.*, art. 10.

Such VC firms are less incentivized to perform effectively and work in the best interests of the funds. Guarantee schemes that are funded by taxpayers' money also may create public grievances towards the GGFs, as the very nature of VC investments is high-risk. Guarantee schemes are also problematic because they are usually implemented by officials who may not possess sufficient expertise in calculating the losses suffered and who may prefer to compensate VC firms that are government-backed. For example, the Shanghai AIGF Measures state that a steering group comprising government officials is responsible for the implementation of the compensation scheme.[253] Statistics show that many of the VC firms that received compensation for their investment losses were indeed government-backed firms.[254]

Fourth, GGFs often negotiate for smaller compensation packages for GGF-backed VC firms than for private VC firms, resulting in worse incentives for GPs of GGF-backed VC firms. Typically, the most popular distribution of the GP's compensation is the so-called "2/20 Rule."[255] The GP receives an annual management fee for its services comprising 2 to 2.5% of the committed capital, and a carried interest of 20 to 25% of the profits realized by the fund.[256] This is, however, not always the case in China. Local governments are often overly protective of the taxpayers' money while negotiating profit allocation, resulting in the VC firm being paid less than a 20% carried interest,[257] or in the GGFs being given priority in the distribution of profits over the VC firm.[258] Meanwhile, there is a lack of clear and detailed rules on the evaluation of the fund and the appraisal system of the GP in some local GGFs.[259]

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[253] *Id.*, art. 11.

[254] *Id.*, art. 8 (specifing that applicants for compensation shall make a filing with the relevant registrar in charge of VC investments). Statistics show that out of more than 110 VC firms which had made filings for compensation as of January 2016, most were state-owned VC firms. *See* Fengxian Touzi Shihai, Pingshenme Zhengfu Lai Tieqian (风险投资失败，凭什么政府来贴钱) [*Why Should the Government Be Subsidizing Venture Capital Investment Failures*], Jinri Huati (今日话题) [IN TOUCH TODAY] (Jan. 27, 2016), http://bit.ly/2tq6PC8.

[255] Under this rule, the venture capitalists are entitled to a flat 2% of total asset value as a management fee and an additional 20% of any profits earned as carried interest. *See* PAUL GOMPERS & JOSH LERNERK, THE VENTURE CAPITAL CYCLE 91-126 (2nd ed., 2004).

[256] Kate Litvak, *Venture Capital Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161 (2009).

[257] Zero2IPO, *supra* note 85.

[258] Qidi Zhengfu Yindao Jijin: Sida Wenti Lanlu VS Sida Qushi "Guanfeng" (起底政府引导基金：四大问题拦路 VS 四大趋势"观风") [*Uncover Government Guide Fund: Four Problems VS Four Trends*], Touzijie (投资界) [PEDAILY] (May 12, 2016), http://bit.ly/2tqdk89.

[259] Article 23 of the Implementation Rules for Shanghai Angel Investments Guidance Fund, *supra* note 236, states generally that the steering committee and its office are responsible for the supervision and evaluation of government guidance funds, but provides no specific evaluation criteria. Article 30 of the Interim Measures of the Government Investment Fund simply specifies that the GGF should set up an evaluation system for the fund, but provides no detailed rules on how the assessment should be made. *See* Zhengfu Touzi Jijin Zanxing Guanli Banfa (政府投资基金暂行管理办法) [Interim Measures

Lastly and most importantly, there are two institutional obstacles that prevent local governments from allowing local GGFs to operate based on market forces. The first is the flawed cadre appointment system in China. Since the early years of the Chinese Communist Party, China's cadres have always been appointed by higher-level supervisors.[260] Also, under the cadre responsibility system (*gangwei zerenzhi*), appointed cadres are personally held responsible for achieving certain targets and policies laid down by higher-ups.[261] In the context of GGFs, these systems have led to the inevitable intervention of local governments in the selection of the portfolio companies. In order to make sure that public capital is properly used and that the officials in charge have some form of personal responsibility, municipal governments typically mandate the mayor of the city to be the chairman of the steering committee of the GGF.[262] The second institutional obstacle is the flawed incentive mechanisms of government officials. In China, GDP growth remains one of the key performance indicators of the municipal government.[263] This has encouraged many local GGFs to mandate that the fund invest only in certain industries and companies in their region that have already gained significant market success.[264]

Nevertheless, these problems have not prevented the growth of the VC market. The negative impact caused by the flawed structure of the local GGFs appears not to have been significant economically. The most likely reason may be that the size of GGF has been small: it accounts for only 2% of the total investment amount in the market.[265] The figure was much smaller before 2011[266] and is even smaller for local GGFs.[267] Another reason may be the fact that most of the local GGFs were established in 2015, so for now the negative impact caused by the guarantees and problematic compensation is still limited.

Moreover, cognizant of the problems within the local GGFs discussed above, the Chinese central government and many local governments have begun to move towards a *market-oriented approach*

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on Government Investment Funds], (promulgated by the Ministry of Finance), art. 30, CAIYU [2015] No. 210, http://bit.ly/2tm19J1.

[260] Hu Wei, G. Zhiyong Lan, & Liu Songbo, *Innovations in Cadres Selection and Promotion in China: The Case of Mudanjiang City*, 8 BUS. PUB. ADMIN. STUD. 48 (2014).

[261] Maria Edin, *Remaking the Communist Party-State: The Cadre Responsibility System at the Local Level in China*, 1 CHINA: INT. J. 1 (2003).

[262] *See* text accompanying note 243, *supra*. *See also* Implementation Rules of the Shanghai Angel Investments Guidance Fund, *supra* note 236.

[263] Telephone interview with Mr. W, Head of the General Office of Human Resource Department, Guangdong Branch of the Communist Party of China (Aug. 19, 2016); Telephone interview with Mr. Z, Deputy Head of Panyu District of Guangzhou City, Guangdong Province (Aug. 20, 2016).

[264] See text accompanying notes 237-238, *supra*; Implementation Rules of the Shanghai Angel Investments Guidance Fund, *supra* note 236.

[265] *See* Figure 1, *supra*.

[266] Zero2IPO Research Center, *supra* note 85.

[267] *See* Figure 1, *supra*.

in the provision of funding for VC.[268] This involves *attracting more private investors and reducing government intervention* in the operation of the GGFs.[269] Since 2015, government agencies including the National Development and Reform Commission (NDRC) and Ministry of Finance, as well as many local governments have issued measures to reduce government intervention in the fundraising and operation of local GGFs and mandate the market-oriented approach among GGFs.[270] For example, the Interim Measures of the Government Investment Fund 2015, which govern GGFs, specify that GGFs should operate based on market forces and the fund should be managed by professional GPs instead of the government.[271] The NDRC Interim Measures for Management of Government Funded Industrial Investment Fund 2016 also specified that the government investment funds shall operate based on market forces and the government who provides capital "shall not participate in the daily operation of the funds."[272] This would allow venture capitalists and entrepreneurs to work more effectively and achieve positive results in a venture capital cycle that is driven primarily by market forces.

Notably, the national-level SVCIGF is also a positive step forward on both points.[273] The SVCIGF comprises 40 billion RMB of capital funding, with 10-15 billion RMB coming from the government and the remaining 25-30 billion RMB from other investors such as private enterprises and institutional investors.[274] With a target of 40 billion RMB, together with a number of forthcoming local GGFs, the SVCIGF tackles the problem of the old GGFs being too small to make a difference in guiding capital flow to start-ups. Moreover, by allowing more than half the funding to originate from the private sector, government interference is mitigated, and the fund is likely to rely chiefly on the market for guidance. Fund managers can make more informed commercial decisions on capital allocation.[275] Furthermore, investment-wise, the SVCIGF will invite public tenders from professional fund managers and give priority for returns to private investors.[276]

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[268] *Id.*

[269] *See* Zero2IPO, *supra* note 85.

[270] *See* Appendix 2, *infra*.

[271] *See, e.g.*, Interim Measures on Government Investment Funds, *supra* note 259, art. 11.

[272] Zhengfu Chuzi Chanye Touzi Jijin Guanli Zanxing Banfa (政府出资产业投资基金管理暂行办法) [Interim Measures for Government Funded Industrial Investment Fund Management] (promulgated by the Nat'l Dev. and Reform Comm. Dec. 30, 2016, effective Apr. 1, 2017) art. 6., http://bit.ly/2tZxTVJ.

[273] See Diagram 1, *infra* (outlining the structure and capital flows of the SVCIGF).

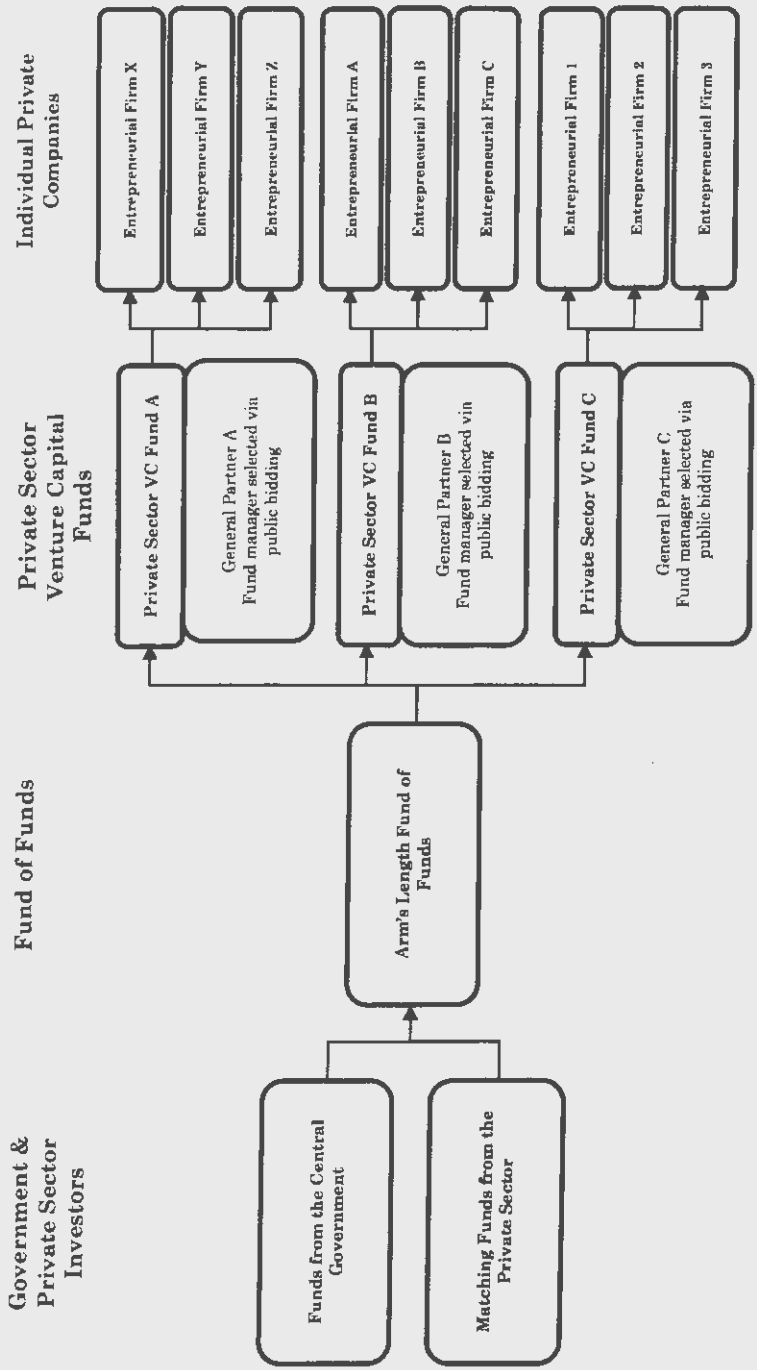
[274] 400 Yi Guojia Chuangtou Jijin Dingceng Fangan Sheji yi Jiben Wancheng (400亿国家创投基金顶层方案设计已基本完成) [*The Design of the 40 billion State Venture Capital Investment Fund is almost completed*], Xinlang Caijing (新浪财经) [SINA FINANCE] (Mar 30, 2015), http://bit.ly/2tqft3E.

[275] *Id.*

[276] *Id.*

Nevertheless, as the SVCIGF was just launched, it remains to be seen whether it will be implemented effectively according to the announced guidelines.

DIAGRAM 1: STATE VENTURE CAPITAL INVESTMENT GUIDANCE FUND (SVCIGF) 2015



In light of the public nature of the GGFs, the unique party-state system, and protectionism at the local level, I suggest the following ways to improve government participation in GGFs.

First, the government ceding control to market forces would mitigate operational inefficiencies arising from the incompetence and lack of professional experience on the part of government authorities.[277] Requiring matching funds from the private sector would help to reduce the dangers of uninformed decisions and political interference.[278] Local governments should avoid intervention in the selection of portfolio companies and fund managers. Funding should be provided to early-stage start-ups that are in high demand of capital, instead of later-stage, government-linked companies that allow for the creation of quick returns.

Second, the impact of government-sponsored funds "depends not only on the design of the program but also on the selection of the" managers. [279] Instead of appointing government-linked VC firms, governments should select experienced, professional, and independent VC firms to manage the funds.

Third, a well-designed appraisal and compensation system (such as the 2/20 rule[280]) should be established to provide incentives to the fund's manager. Also, more detailed rules should be provided on the evaluation, regular reporting, and auditing of the GGFs to fill the legislative gap in the existing regulations governing GGFs.[281]

Fourth, the structure of the GGFs should be simplified to reduce bureaucracy and transaction costs. A "fund of funds" (FOF) approach taken by the SVCIGF seems more desirable for GGFs.[282] Under this model, the consolidated fund will make investments in a number of other funds, and each of these funds will invest in a portfolio of companies. By doing so, the consolidated fund enjoys broader exposure to the industry and diversification of the risks associated with a single investment, in contrast to GGFs of old, in which a local fund is usually restricted to only one project.[283]

Fifth, under various local regulations, there are no detailed rules governing the stage wherein investments are made into portfolio companies.[284] Giving the funds disproportionate representation or even

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[277] *See* LERNER, *supra* note 5, at 128-133.

[278] *Id.*

[279] Douglas Cumming & Sofia Johan, *Pre-Seed Government Venture Capital Funds*, 7 J. INT'L ENTREPEURSHIP 26, 26-27 (2009).

[280] *See* the explanation in note 255, *supra*.

[281] *See, e.g.*, Implementation Rules of the Shanghai Angel Investment Guidance Fund], *supra* note 236; Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund, *supra* note 248. Various local regulations governing GGFs do not provide rules on these issues.

[282] *See* Diagram 1, *supra*.

[283] *See* Diagram 1, *supra*.

[284] *See* Diagram 1, *supra*.

control of the portfolio company's board of directors could help reduce agency costs at the financing stage.[285] I suggest that the GGF should appoint a representative to serve as a director on the board of the portfolio company to restrict the entrepreneur's discretion and behavior in using the GGF funding. The GGFs may also require veto rights in important matters or the power to replace the entrepreneur as the portfolio company's chief executive officer.

B. Problems with Investment Vehicle

Although there is little doubt that the adoption of the limited partnership in China has contributed to a more favorable environment for the VC industry and reduced transaction costs in the fundraising process, there are some special features that require further legislative attention.

First, unlike other jurisdictions such as US-Delaware,[286] the U.K.,[287] and Singapore,[288] which do not impose an upper limit on the number of partners in the limited partnership, the Chinese limited partnership has a requirement of at least two and a maximum of fifty partners.[289] The maximum number of partners may unduly constrain the size of the fund and is inconsistent with international practice. As such, I suggest that the restriction on the number of partners be removed.

Second, partners are allowed to transfer their partnership shares to outsiders (subject to various requirements) under the PEL.[290] An assignee of a GP will become a GP himself and be subject to rights and obligations in accordance with the amended agreement and the PEL.[291] This stands in stark contrast to the assignee's position under U.S. law, where a transfer in whole or in part of a partner's transferable interest in the partnership does not entitle the transferee to participate in the

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[285] Gilson, *supra* note 1, at 1082.

[286] DEL. CODE ANN. tit. 6, § 17-101(9) (West 2010) ("limited partnership" means "a partnership formed under the laws of the State of Delaware consisting of 2 or more persons and having 1 or more general partners and 1 or more limited partners"). *See also* GOVERNMENT OF SINGAPORE, STUDY TEAM ON LIMITED PARTNERSHIPS AND LIMITED LIABILITY PARTNERSHIPS, REPORT OF THE STUDY TEAM ON LIMITED PARTNERSHIPS, par. 8.4.1 (2007), *available at* http://bit.ly/2tIIs8o.

[287] Although the UK used to impose an upper limit on the number of partners, there is no longer such a limit for all types of partnerships since 2001. GOVERNMENT OF SINGAPORE, STUDY TEAM ON LIMITED PARTNERSHIPS AND LIMITED LIABILITY PARTNERSHIPS, *supra* note 241, at para. 8.4.1. Section 4(2) of Limited Partnerships Act 1907 now states "[a] limited partnership must consist of one or more persons called general partners, ..., and one or more persons to be called limited partners..." Limited Partnerships Act 1907, 7 Edw. 7 c 24, § 4(2) (Grt. Br.).

[288] s 3(2) of Limited Partnership Act (Chapter 163B) states that "A limited partnership must consist of (a) one or more of general partners; and (b) one or more of limited partners." Singapore Limited Partnerships Act 2008 (Cap. 163B) s 3(2).

[289] Partnership Enterprise Law, *supra* note 126, art. 61.

[290] *Id.* at arts. 22, 73.

[291] *Id.* at art. 24.

management of the partnership business.[292] Arguably, any change of the GP is likely to result in serious consequences for a fund, particularly with regard to the LPs' interests since they rely on the expertise of the GP when deciding to invest in the fund. Therefore, the PEL should not entitle the transferee, during the continuance of the partnership, to participate in the fund's management.

Third, unlike the Delaware code, the PEL does not provide any rules specifying how an existing company or partnership may convert into a limited partnership or *vice versa*.[293] There is a practical need for VC limited partnerships to be able to convert into companies, especially when the limited partnership-type funds would like to expand their business.[294] Currently, funds must deregister as limited partnerships and re-establish themselves as companies in order to convert to companies. Ideally, the Chinese legislature would provide a seamless process for the conversion of limited partnerships to companies.

Fourth, Delaware and the UPA do not require newly admitted partners, whether general or limited, to be personally liable for the prior obligations of the partnership.[295] Logically, the newly admitted partner ought not to bear any liability for the prior debts of the firm, since he was not a partner then and was not involved in any form of management of the firm. However, similar to a GP in a German limited partnership,[296] a GP in a Chinese limited partnership will assume joint liability with the existing partners for debts incurred by the firm before he joined the firm. Correspondingly, a new LP will bear liability to the extent of his capital contribution even if the partnership's debts were incurred before he joined the firm.[297] This restriction would reduce the attractiveness of the limited partnership to the venture capitalists and investors. I suggest that the PEL not require newly admitted GPs or LPs to be personally liable for the prior obligations of the partnership.

Lastly, another distinctive feature of the PEL is the requirement that limited partnerships be dissolved in the event that the limited partnership is left with only LPs.[298] The limited partnership should be

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[292] UNIF. PARTNERSHIP ACT §503 (Nat'l Conference of Comm'rs on Unif. State Laws 1997).

[293] *See* DEL. CODE ANN. tit. 6, §17-217 (West 2013).

[294] Yang Guang (阳光), Renminbi Jijin Bianlian: GP Gaobili Chuzi Ji Huigui Gongsizhi Cheng Qushi (人民币基金变脸 GP 高比例出资及回归公司制成趋势) [*RMB Funds Change Faces: Trends of Converting Back to Companies and Increasing Capital Contributions by GP*], Tou Zhong Wang (投中网) [CHINESE VENTURE] (Jun. 2, 2009), http://bit.ly/2sScNKr.

[295] *See* DEL. CODE ANN. tit. 6, § 15-306 (West 2011); UNIF. PARTNERSHIP ACT §306.

[296] The German Commercial Code §130 provides that a new partner is liable as the other partners for partnership obligations incurred before he joined. HANDELSGESETZBUCH [HGB] [COMMERCIAL CODE], § 130. The German Commercial Code also provides that a new limited partner shall be liable for partnership obligations incurred before he joined. *Id. at* § 173.

[297] Partnership Enterprise Law, *supra* note 126, at arts. 44, 77.

[298] *Id.* at art. 75.

converted into a general partnership if it is left with only GPs.[299] Equivalent provisions are not found in the PEL's German, French, and U.S. counterparts. A Chinese limited partnership with only LPs should be allowed to continue operating as a limited partnership over a grace period so as to explore possible options and attract incoming GPs. Also, as a typical VC fund usually lasts for ten years and makes long-term investments in a number of companies, forcing a limited partnership to be dissolved would create unnecessary costs and adversely affect the operation of the investee portfolio companies, which largely rely on the funding and management of the VC fund.

C. Problems with Entrepreneurs

Despite the effective policies and mechanisms put in place to promote the growth of entrepreneurs and entrepreneurial firms as discussed in the last part, more gaps in legislation must be filled to continue to address the issue of entrepreneurship in China, particularly in enhancing the protection of intellectual property rights. Interviewees stated that insufficient intellectual property protection has been a main concern for entrepreneurs and venture capitalists in China.[300]

Moreover, there is a lack of personal bankruptcy laws in China. In China, there are several sanctions for debtors that default on loans: (1) the debtor will be included in the *List of Dishonest Persons Subject to Enforcement* and will face a series of penalties; [301] (2) the debtor may be subject to expenditure limits [302] and restrictions on international travel;[303] (3) depending on the severity of the situation, courts may fine or impose custodial sentences on the debtor; [304] (4) if elements of criminal offences are met, the debtor may be prosecuted for his refusal

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[299] *Id.*

[300] Telephone interview with Mr. G, Partner, Chengwei Capital, Shanghai (Aug. 1, 2016).

[301] This is of particular relevance to a corporate debtor who may face more restrictions in its subsequent business operations. *See* Zuigao Renmin Fayuan Guanyu Gongbu Shixin Beizhixing Ren Mingdan de Ruogan Guiding (最高人民法院关于公布失信被执行人名单信息的若干规定) [Several Provisions of the Supreme People's Court on Announcement of the List of Dishonest Persons subject to Enforcement] (promulgated by the Supreme People's Court, Jul. 16, 2013), art. 1, http://bit.ly/2ujY2OD.

[302] Zuigao Renmin Fayuan Guanyu Xianzhi Beizhixing Ren Gao Xiaofei de Ruogan Guiding (最高人民法院关于限制被执行人高消费的若干规定) [Several Provisions of the Supreme People's Court on Restricting High Consumption of Judgment Debtors] (issued by Supreme People's Court, Jul. 01, 2010), art. 1, http://bit.ly/2tm8DeO.

[303] Guanyu Shiyong Zhonghua Renmin Gonghe Guo Minshi Susong Fa Zhixing Chengxu Ruogan Wenti de Jieshi (关于适用《中华人民共和国民事诉讼法》执行程序若干问题的解释) [Interpretation of the Supreme People's Court of Several Issues concerning the Enforcement Procedures in the Application of the Civil Procedure Law of the People's Republic of China], (Issued by Supreme People's Court, Nov. 03, 2008), art. 37, http://bit.ly/2snzKC3.

[304] Minshi Susong Fa (民事诉讼法) [Civil Procedure Law], (promulgated by the Nat'l People's Cong, Apr. 9, 1991, effective Apr. 9, 1991), art. 241, http://bit.ly/2tZfvfI.

to comply with payment judgments.[305] As noted by Armour and Cumming, a liberal personal bankruptcy regime has a positive impact on the success of a VC market.[306] Conversely, a stricter bankruptcy regime discourages potential entrepreneurs from taking risks and failed entrepreneurs from re-engaging in business.[307] Given the high-risk nature of VC, it is crucial to provide an appropriate exit mechanism for individuals who have failed in their entrepreneurial venture. Personal bankruptcy laws should allow them to start afresh, while at the same time ensuring that creditors can obtain a fair share of the bankrupt's assets.

Further, although there is an increasing number of second-generation entrepreneurs in China, these entrepreneurs are still relatively new and inexperienced in the VC market. The future challenge would likely be to attract skilled venture capitalists and experienced mentors who have the necessary start-up management expertise and the willingness to nurture young entrepreneurs. Indeed, observers have reflected that there is and will likely remain a gap between China and U.S. in terms of entrepreneurial culture.[308]

III. LESSONS LEARNED

Economic theory suggests two main rationales for public intervention to encourage entrepreneurship and favor start-ups.[309] The spillover hypothesis argues that public intervention should subsidize young, entrepreneurial firms that have to spend substantial research and development (R&D) expenditure but only receive limited private returns in the early stage of their life cycles.[310] In contrast, the market failure hypothesis explains that governments may rectify market

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[305] Article 313 of China's Criminal Law states that "Whoever refuses to carry out a decision or order made by a people's court while he is able to carry it out is to be sentenced to not more than three years of fixed-term imprisonment, criminal detention, or be fined. If circumstances are particularly severe, he may be fined and sentenced to a fixed-term of imprisonment of more than three years and less than seven years." Zhongguo Renmin Gongheguo Xingfa (中华人民共和国刑法) [Criminal Law of the People's Republic of China], (promulgated by the Standing Comm. Nat'l People's Congress, July 1, 1979, last revised Aug. 29, 2015, effective Nov. 1, 2015), art. 313, http://bit.ly/2tZwb6Z.

[306] Armour & Cumming, *supra* note 119, 617-26, 628. *See also* John Armour, *Personal Insolvency Law and the Demand for Venture Capital*, 5 Eur. Bus. Org. L. Rev. 2004 87 (2004).

[307] Armour & Cumming, *supra* note 119, at 601-03.

[308] Zhongmei Liangguo Nianqingren Changye Huanjing Chayi Da (中美两国年轻人创业环境差异大) [*Large Disparity in Entrepreneurial Environments for Chinese and American Youngsters*] (Mar. 1, 2012), Xinlang Caijing (新浪财经) [SINA FINANCE], http://bit.ly/2tbPtWS.

[309] Marina di Giacomo, Public Support to Entrepreneurial Firms: An Assessment of the Role of Venture Capital in the European Experience, 8 J. Private Equity, no. 1, Winter 2004, at 22, 25.

[310] *Id.* (citing Zvi Griliches, *The Search for R&D Spillover*, 94 Scandinavian J. Econ. 29 (1992).

imperfections by fostering legal and fiscal environments that are conducive to private investors and entrepreneurs to operate (e.g. tax relief, bankruptcy process facilitating reorganization, a stock market that facilitates SME exits).[311]

As discussed in Part I, governments face difficulties in resolving the simultaneity problem in engineering a robust VC market. Several governments, such as those of Germany, India and Singapore, have attempted to tackle this problem but it has proven to be a difficult task. However, there is evidence to show that the three essential determinants have been gradually addressed by China. This part will discuss specifically the lessons that other countries could learn from China in tackling the simultaneity problem, as well as examine similar flaws present in the Chinese and other countries' models, which will require more attention in future legal and policy reforms.

A. Capital

1. Increased Domestic and Foreign Capital Supply

First, as to domestic private capital, China has gradually removed regulatory barriers to allow more institutional investors to invest in the VC market.[312] Arguably, this liberalization of the financial markets can be easily replicated by other countries.

Second, in terms of foreign capital, China has launched various programs for foreign investors to raise funds and make equity investments.[313] Other countries can learn from China's attempt to create a foreign investor friendly regulatory environment and engage in capital control liberalization. However, this may be subject to the specific political, economic and legal environments of a nation. For example, in Brazil, while FMIEEs (*Fundos Mutuos de Investimento em Empresas Emergentes*) are made available to serve as special investment vehicles for VC investments, the FMIEEs' unpopularity shows that the Brazilian government has yet to provide sufficient regulatory incentives that would encourage investors to take advantage of this structure.[314] Brazil also discourages foreign investment by imposing a financial transactions tax on foreign capital inflows[315]—a macroeconomic policy measure intended to prevent excessive inflation,

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[311] Josh Lerner, When Bureaucrats Meet Entrepreneurs: The Design of Effective Public Venture Capital Programmes, 112 ECON. J. F73 (2002).

[312] *See* Part I.B.3, *supra*.

[313] Part I.B.4, *infra*.

[314] Shannon Guy, *Private Equity in Brazil: Industry Overview and Regulatory Environment*, 2 MICH. BUS. & ENTREPRENEURIAL L. REV. 155, 173 (2013).

[315] On Brazil's taxing of financial transactions see Marcos Chamon & Marcio Garcias, *Capital Control in Brazil: Effective?* 6 (Paper presented at the 15th Jacques Polak Annual Research Conference of the International Monetary Fund, Nov. 13-14, 2014), http://bit.ly/2tmc7O4.

reduce risks of asset price bubbles, and curb strong exchange rate appreciation, which may hurt Brazil's export competitiveness.[316]

Third, with regard to public funding, China's establishment of various government programs[317] has substantially increased the supply of funding to the VC market. The reality is that countries have differing availability of public funds. Lackluster economic growth and fiscal profligacy in the boom years may cause a government to be burdened with dwindling public funds and face budgetary constraints. Germany's WFG program, for example, was only funded 50 million DM (approximately 81 million USD using 1990 rates).[318] Though the WFG program was conducted from 1976 to 1991[319] and inflation must be accounted for, its modest size provides less of an "add-on effect" in raising capital.

Public fund size, however, is not the only determining factor.[320] Many other factors affect the success and effectiveness of government programs, including the duration of the programs,[321] their flexibility,[322] the presence of incentives for a financial intermediary to monitor portfolio companies,[323] and the implementation process.[324] Notably, China's new SVCIGF program has taken a market-oriented approach, by allowing, *inter alia*, matching of more than half of the funding from the private sector, appointment of GPs via public bidding, and use of FOF structure to diversify investment risks. Regulations have also been issued to reduce government intervention in the capital allocation of government funds.[325]

Nevertheless, there are similar flaws found within China's local GGFs and other countries' public programs. For instance, like Germany's WFG, some of China's local GGFs guarantee investment losses suffered by VC firms, resulting in a lack of incentives for venture

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[316] *Id.* at 2. Brazil's justification that strict capital control is necessary to maintain economic and financial stability, however, is not entirely sound. Its short crash and boom cycles, rapidly fluctuating currency, and high inflation are just symptoms of multiple political problems (such as corruption, paralysis of policymaking process, lack of implementation of structural economic reform) that it faces.

[317] *See* Part I.B.2, *supra*.

[318] Gilson, *supra* note 1, at 1095.

[319] PAUL JOWETT & FRANCOISE JOWETT, PRIVATE EQUITY: THE GERMAN EXPERIENCE 15 (2011).

[320] LERNER, *supra* note 5, at 117-23 (arguing that either too small or too large a government initiative can pose profound difficulties).

[321] *Id.* at 112-16 (arguing that encouraging entrepreneurship requires a long-term commitment on the part of public officials).

[322] *Id.* at 124-27 (suggesting that government officials must appreciate the need for the flexibility in VC investment and rely more on market forces in selecting portfolio companies).

[323] *See* Gilson, *supra* note 1, at 1099-1100.

[324] LERNER, *supra* note 5. The implementation process refers to whether the fund distribution is driven by market forces or whether there is an excessive amount of government interference.

[325] *See* text accompanying notes 269-275, *supra*.

capitalists to monitor the portfolio companies. Further, there was government intervention in the selection of the portfolio companies in WFG and China's local GGFs due to the flawed incentive and appointment structure of GPs.[326]

Therefore, when emulating China's VC public funding system, other countries should take note to avoid the similar structural deficiencies present in some local GGFs and instead refer to the newly launched SVCIFG's market-oriented design. The government's role in the fund-raising process should be limited to being a LP who does not participate in the management of the fund. By doing so, the government leaves capital allocation decisions to market forces.

2. Tax Incentives

Multiple Chinese local governments have offered significant tax exemptions to both GPs and LPs in VC funds.[327] These tax exemptions increase investment profitability, thereby encouraging the supply of the VC to the industry. Various forms of tax relief are also provided to scientific parks and incubators to encourage innovation.

However, it could be difficult for certain states to follow China's example of greatly reducing tax rates. France, for instance, imposes a progressive income and capital gains tax rate up to 45%.[328] The high tax rates limit returns to a successful entrepreneurial venture and put a damper on VC activity. While individual investors may claim an exemption from income tax on investment income and capital gains derived through FCPI (*Fonds Communs de Placements dans l'Innovation*), in order to qualify for these tax exemptions, they must hold their shares for 5 years, immediately reinvest all fund distributions, and hold no more than 25% of the portfolio company's shares.[329] Such onerous exemption requirements reduce the effectiveness of the tax policy in encouraging VC investments.[330]

In contrast, Japanese tax law's hostility to the use of equity as an incentive means that additional cash-flow rights cannot be used by venture capitalists to encourage entrepreneurs to give up management

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[326] *See* text accompanying notes 239-271, *supra*.

[327] *See* Part I.B.5, *supra*.

[328] DELOITTE, FRANCE 2016 HIGHLIGHTS 22 (2016), *available at* http://bit.ly/2t2ggES.

[329] DECHERT LLP, PRIVATE EQUITY 2010 VOLUME 2: VENTURE CAPITAL: COUNTRY Q&A FRANCE 54 (2010), http://bit.ly/2s3s6x4.

[330] Ann Baker et al, *Venture Capital Investment in France: Market and Regulatory Overview*, WESTLAW UNITED KINDOM, http://tmsnrt.rs/2ttCjWJ.

control.[331] Japan's ambiguous and unfriendly tax rules thus present a real hindrance to the development of its VC industry.[332]

Ultimately, policymakers should strike a right balance when providing tax breaks. If a policymaker is of the view that the benefits of encouraging VC shall outweigh the potential loss in tax revenue, it may introduce a more favorable tax regime to boost the VC sector. However, excessive tax incentives would distort the efficacy of market forces in allocating capital and may allow poor performing VC firms to survive on tax incentives and government subsidies.

3. Active Stock Market

Through the launch of the national OTC market – NEEQ and the NASDAQ-like ChiNext Board with lowered listing requirements, China has greatly improved the IPO exit options for VC-backed firms.[333] Arguably, the establishment of SME-specific Board and the reduction of listing requirements can be copied by other stock market-centered countries to foster VC if those countries are willing to bear the high legislative costs. Moreover, the effectiveness of new stock exchanges is affected by the existing structure of the financial market. Given their longstanding and well-established bank-centered systems, countries like Japan and Germany[334] may face difficulties in attempting to develop into market-centered systems without far reaching reforms. Path dependency may present a thorny problem for institutional change.

B. Investment Vehicle

The Chinese limited partnership vehicle is made available for both domestic and foreign investors, and remarkably provides the twin benefits of separate legal personality and tax transparent treatment at the entity level.[335]

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[331] Shishido, *supra* note 4. Sweat equity may be challenged by the Japanese National Tax Agency as a gift and entrepreneurs will have to pay gift tax.

[332] Hajime Tanahashi et al, *Venture Capital Financing in Japan: A Combination of the Familiar and the Unique* IN PRIVATE EQUITY 2010 VOLUME 2: VENTURE CAPITAL 15, 15 (2010), http://bit.ly/2s36XmL.

[333] Lin, *supra* note 61, at 17.

[334] *See* Gilson & Black, *supra* note 37 (discussing the correlation between stock market and VC market in bank-centered systems). *See also* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998) (same).

[335] *See* Part I.C, *supra*. If a foreigner individual or enterprise establishes a limited partnership in China, it is subject to additional regulations including the Provisions on the Registration of Foreign-funded Partnership Enterprises and the Measures for the Formation of Partnership Enterprises inside China by Foreign Enterprises or Individuals. Waishang Touzi Hehuo Qiye Dengji Guanli Guiding (外商投资合伙企业登记管理规定) [Provisions on the Registration of Foreign-funded Partnership Enterprises], promulgated by State Administration for Industry and Commerce, Jan. 29, 2010, effective Mar. 1, 2010), http://bit.ly/2sdwb1N; Waiguo Qiye Huozhe Geren Zai Zhongguo Jinei Sheli Hefuo Qiye

In Taiwan, the recently introduced limited partnership is not seen as a viable investment vehicle for venture capitalists. The limited partnership is taxed the same way as a Taiwanese company and the lack of tax transparent treatment severely limits its functionality.[336] In the U.K. and Singapore, limited partnerships do not have separate legal personality as they are based on the common law aggregate approach on partnership. Singapore's drafter specifically highlighted the concern that overseas tax authorities may treat the Singapore limited partnership as an opaque entity for tax purposes if it has a separate legal personality. In turn, this would affect the adoption rate of the limited partnership in Singapore.[337] However, the tax transparency benefit arguably does not need to be inevitably intertwined with the absence of separate legal personality. The entity approach will ensure the continuity of partnerships by conferring perpetual succession and providing a more ideal business vehicle for investors.[338]

India, on the other hand, has no limited partnership and VC funds largely rely on the trust structure. Investors become trust beneficiaries and contractually retain the ability to exercise restricted passive control over the GP's investment decisions via the Contribution Agreement.[339] The trust offers organizational flexibility, limited liability for investors, and tax transparency.[340] However, notwithstanding the Indian trust's ability to reasonably govern the investment relations between the managers and investors, the trust's lack of separate legal personality remains a drawback.

Arguably, if the jurisdiction has preexisting business forms that are functionally similar to the limited partnership, there is then less pressing need to enact limited partnership legislation. Moreover, if governments wish to introduce the limited partnership, they must be willing to provide the vehicle with sufficient benefits and attributes to meet the business needs of potential users; failure to do so will result in waste of legislative resources.

Guanli Banfa (外国企业或者个人在中国境内设立合伙企业管理办法) [Measures for the Formation of Partnership Enterprises inside China by Foreign Enterprises or Individuals], (promulgated by the State Council, Aug. 19, 2009, effective Mar. 1, 2010), http://bit.ly/2ssOC77.

[336] Cheryl H.L. Hsieh, *M&A Alert: Introduction of the Taiwan Limited Partnership Act*, K&L GATES (July 27, 2015), http://bit.ly/2sS8vDb.

[337] Government of Singapore, Study Team on Limited Partnerships and Limited Liability Partnerships, *supra* note 286, at paras. 7.1.5–7.1.7.

[338] The U.K. has considered changing the aggregate approach to the entity approach on partnerships. See law Commission & Scottish Law Commission, Partnership Law: Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965 (2003), http://bit.ly/2s34Yid.

[339] *See* Purvi Kapadia & Poorvi Sanjanwala, *Venture Capital Investment in India: Market and Regulatory Overview*, THOMSEN REUTERS PRACTICAL LAW (2013), http://tmsnrt.rs/2whmOUm (last visited Aug. 19, 2017).

[340] Nishith Desai Associates, *India*, *in* PRIVATE EQUITY 209, 210 (Charles Martin ed., 2010).

C. Entrepreneurship

To encourage entrepreneurship, China engaged in a series of entrepreneur-friendly company law reforms.[341] These reforms can be easily learned by other jurisdictions. Taiwan, for example, is also currently undergoing company law reform to streamline the business incorporation and operation process.[342]

China also provided numerous policy incentives and tax reliefs to improve innovation, legislative and institutional infrastructure for the VC industry.[343] The *continuous* nature of these policy incentives is key to the rapid development of the Chinese VC market.

The importance of continual government support may also be seen in Taiwan's example where investors in high-tech start-ups were historically granted a hefty income tax deduction. While this tax relief policy brought about substantial capital injection in the VC sector from 1995 to 2000, it was subsequently abolished in 2000.[344] The termination of policy incentives directly contributed to the Taiwanese VC industry's decline in recent years, proving that governmental promotion of entrepreneurship requires consistent and long-term effort.[345]

CONCLUSION

China, as an experimentalist in law and development, offers an important example of how a government can engineer a VC market. This article finds that the Chinese government has played an important role in helping the nation to establish the three key elements of a VC market, when one had not developed organically.

This article has shown the important role of the government in creating a VC market through law and policy. One characteristic of the Chinese VC market is that it is created and led by governments, both on central and local levels, through *continuous* law and policy reforms. Meanwhile, although China's market is established by governments, a key reason for its rise is the central government's efforts at adopting a more market-oriented approach towards capital allocation. This is reflected in three ways: First, the newly established SVCIGF and the new regulations governing the GGFs to reduce government intervention. Second, the changing role of the central government: from a direct

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[341] *See* Part I.D, *supra*.

[342] Tseng & Fu, *supra* note 209.

[343] *See* Appendix 2, *infra*.

[344] *See* Zhang Yuning (张育宁), Weishenme Zai Taiwan Chuangye Nabudao Chuangtou de Qian? Su Shizhong: Taiwan rang Zaoqi Touzizhe Dou Bian Bendan (为什么在台湾创业拿不到创投的钱？苏拾忠：台湾让早期投资者都变笨蛋) [*Why Taiwan Entrepreneurs Cannot Receive Venture Capital funding? Su Shizhong: Taiwan Made a Fool Out of Early-Stage Investors*], Keji Baoju (科技报桔) [TECHORANGE] (Apr. 15, 2013), http://bit.ly/2tlNqSl.

[345] *Id.*

financial intermediary that decides how exactly capital is to be allocated to a mere facilitator and provider of capital. Third, that private capital is becoming the major source of VC[346] with the eased regulatory regime, the more liberal regulatory framework governing the VC market, the predominance of the limited partnership, and the increased number of private VC firms, start-ups and entrepreneurs. By providing the legislative and institutional infrastructure for the VC market, the government can facilitate the increased role of market forces, especially in the area of capital allocation.

The Chinese experience offers several lessons to other countries: First, governments can help solve the three-factor simultaneity problem—by providing public *funds* through the well-designed government programs; by introducing business-friendly legal *vehicles*; and by improving the regulatory environment for fund raising, investments, and exits, governments can encourage capital supply, boost *entrepreneur participation,* and attract knowledgeable financial intermediaries to the market. Second, governments can facilitate the creation of a market premised on market forces and private contracting by restricting its own participation to being a LP, and leaving capital allocation decisions to private-sector parties with right incentives.[347] Failure to do so would prevent the industry from attaining sustainable growth.

Nevertheless, there is substantial room for improvement in China. Various institutional impediments within each factor, as highlighted above, may prevent the industry from realizing its true potential. Moreover, in light of China's unique party-state system, conflicts between the central and local governments, the flawed cadre appointment system, and the flawed incentive mechanisms of government officials, it is difficult to ensure that local governments completely do not intervene in the capital allocation process. I suggest that the design of the government programs should be improved to keep such intervention to a minimum, while ensuring that the government's policy goals are still realized.

Additionally, the next big challenge for the government is to further develop a VC market based on private contracting. In this regard, one key task is to ensure the effective enforcement of the various contracts covering the entire VC cycle. As the effect of private ordering in China may not be known for years to come, considerable future research will be required before meaningful suggestions can be offered.

Lastly, the engineering of a venture capital market is highly specific to the context of each country. On top of capital, specialized financial intermediaries and entrepreneurs, an effective VC market also requires

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[346] *See* Table 1, *supra*.

[347] *See generally* Gilson, *supra* note 1.

a wide range of complex social, legal, and economic institutions[348]: robust stock markets,[349] sophisticated auditing and legal professions, strong investor protection,[350] effective judicial enforcement of contracts, liberal bankruptcy laws,[351] and an effective reputation market.

Further research must be done in these particular areas for there to be a comprehensive examination of how the relationship between the government and the free market should be balanced and how the effectiveness of contractual design can be maximized. Ultimately, it remains to be seen whether the Chinese VC market can replicate the success of the U.S. market in the long run.

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[348] Armour & Cumming, *supra* note 119.

[349] I address the correlation between the stock market and the venture capital market in Lin, *supra* note 61.

[350] Armour & Cumming, *supra* note 119 at 597. Armour and Cumming's empirical findings show that the "investor friendliness" of a country's legal and fiscal environment is a significant determinant of the supply of venture capital investment to entrepreneurial firms.

[351] *Id.* (arguing that a more liberal personal bankruptcy law stimulates demand for venture capital finance). However, as there is no personal bankruptcy law in China, this article will not address this issue in the context of China.

APPENDIXES

APPENDIX 1: LEGISLATIVE EFFORTS AT TACKLING THE SIMULTANEITY PROBLEM IN CHINA

	Legislative efforts	**Existing & Potential Problems**	**Suggestions**
Capital	Private capital: (1) Removed regulatory restrictions that prevented certain institutional investors from investing in VC funds, thus broadening the investor base; (2) Tax incentives to attract private capital in VC investments; (3) Foreign investors were progressively permitted to make equity investments through various special schemes; (4) Regulatory environment for exits was improved to attract venture capital investments. Public capital: (1) A large number of GGFs were set up to inject capital into the market, with the intention of attracting matching capital from the private sector; (2) The SVCIGF scheme supports a market-oriented approach to capital allocation.	Public capital: (1) Certain local governments' heavy intervention in the management of the fund and allocation of capital; (2) Governmental guarantees of investment losses; (3) Complicated internal structure of local GGFs.	Public capital: (1) Governmental guarantees of investment losses should be abolished; (2) Governmental intervention in the selection of portfolio companies and funds' managers should be restricted; (3) The structure of the local GGFs should be simplified to reduce bureaucracy; (4) A well-designed appraisal and compensation system should be established to provide right incentives; (5) Continuous education of government officials on the nature of the VC industry.

	Legislative efforts	Existing & Potential Problems	Suggestions
Specialized Financial intermediaries	(1) The limited partnership was introduced; (2) Various foreign investment vehicles were introduced to attract foreign capital.	(1) Regulatory problems concerning the limited partnership; (2) Private ordering problems for limited partnerships: LP activism and internal conflicts.	Addressing regulatory problems concerning the limited partnership vehicle such as by removing the maximum number of partners and providing more detailed statutory rules on partners' duties and LPs' derivative action.
Entrepreneurship	(1) The government has embarked on a policy of encouraging mass entrepreneurship and mass innovation through institutional measures; (2) The company law, tax law and securities law were revised to facilitate setting up and doing business; (3) A large number of substantive laws were promulgated or revised to improve IT infrastructure.	(1) Excessive tax preference treatment is given at the local level; (2) A lack of personal bankruptcy law and a lack of dual class structure; (3) A lack of dual-class stock structure under Chinese corporate law; (4) IP rights are insufficiently protected.	(1) Consider promulgating personal bankruptcy law to ensure that honest failed entrepreneurs are protected and given a fresh start; (2) Consider adopting the dual-class stock structure; (3) IP rights protection should be enhanced.

APPENDIX 2: LEGAL DEVELOPMENTS AND THE GOVERNMENT'S ROLE IN DEVELOPING THE VENTURE CAPITAL MARKET OF CHINA 1978-2016[352]

Dates	Law/Policy	Implications for VC Market
	CAPITAL	
Feb. 9, 2006	"Outline of the National Medium and Long-Term Science and Technology Development Plan" (2006-2020) published.[353]	Encouraged setting up guidance funds to support start-ups in the seed stage.
July 6, 2007	"Interim Measures for the Management of Venture Capital Guidance Funds which support Science and Technology-based Small and Medium Enterprises" published.[354]	Introduced institutional mechanisms to encourage innovation and support high-tech start-ups.
June 5, 2008	National Social Security Fund was allowed to make equity investments.[355]	Greatly increased the VC funding.
Oct. 18, 2008	"Guidance on the Establishment and Operation of the Venture Capital Guidance Funds" published.[356]	Provided clear guidance on the guidance funds.
Sept. 5, 2010	"Interim Measures for Equity Investment with Insurance Funds" issued.[357]	Insurance funds were allowed to invest in VC funds.

[352] This table seeks to highlight the most important legal developments in relation to the development of the VC market in China.

[353] Guojia Zhongchangqi Kexue he Jishu Fazhan Guiha Gangyao (2006 – 2020 Nian) (国家中长期科学和技术发展规划纲要 (2006-2020 年)) [National Medium and Long Term Development Plan for Science and Technology (2006 – 2020)] (promulgated by the Nat'l Assembly, Feb. 9, 2006, effective Feb. 9, 2006), http://bit.ly/2ssxTR2.

[354] Kejixing Zhongxiao Qiye Chuangye Touzi Yindao Jijin Guanli Zanxing Banfa (科技型中小企业创业投资引导基金管理暂行办法) [Interim Measures for Administration of Technological SME Venture Capital Guidance Funds] (jointly promulgated by Ministry of Finance of the PRC and Ministry of Science and Technology of the PRC, Jul. 6, 2007, effective Jul. 6, 2007, http://bit.ly/2tbMGwU.

[355] Wang Mengmeng (王萌萌), Jigou LP de PE Touzi Xianzhuang – Quanguo Shebao Jijin Baoxian Jijin (机构 LP 的 PE 投资现状—全国社保基金 保险基金) [*Current Investment Status of PE Institutional LPs – National Social Security Fund Insurance Funds*] (Aug. 8, 2014), Tou Zhong Wang (投中网) [CHINA VENTURE], http://bit.ly/2tBt9Jj.

[356] Guanyu Chuangye Touzi Yindao Jijin Guifan Sheli yu Yunzuo Zhidao Yijian (关于创业投资引导基金规范设立与运作指导意见) [Guiding Opinions on Establishment and Operation of Venture Capital Guidance Funds] (promulgated by State Council Office, Oct. 18, 2008, effective Oct. 18, 2008), http://bit.ly/2sxP7HS.

[357] Baoxian Zijin Touzi Guquan Zanxing Banfa (保险资金投资股权暂行办法) [Interim Measures for Insurance Funds Making Equity Investments] (promulgated by China

Dates	Law/Policy	Implications for VC Market
Jan. 24, 2011	Shanghai published the "Implementation Measures on the Pilot Program for Development of Foreign-invested Equity Investment Enterprises".[358]	Foreign-LPs are permitted to convert foreign currency capital into RMB to invest into RMB funds.
May 2011	First batch of Qualified Foreign Limited Partner (QFLP) funds set up under Chongqing QFLP Pilot Program.[359]	Encouraged foreign capital to make equity investments in Chongqing.
July 16, 2012	"Notice on Issues Relating to Equity and Real Estate Investments by Insurance Funds" issued.[360]	Expanded the scope of permissible equity investments by insurance funds.
Feb. 18, 2013	"Interim Provisions on the Management of Securities Investment Funds by Asset Management Institutions" issued.[361]	More institutional investors, such as social security funds, insurance funds, and fund companies were permitted to make equity investment.
Aug. 13, 2014	The State Council issued "Several Opinions of the State Council on Accelerating the Development of Modern Insurance Service Industry".[362]	Expanded the industries for insurance companies to make equity investments.

Insurance Regulatory Comm., Sep. 5, 2010, effective Sep. 5, 2010), http://bit.ly/2ssvWnK.

[358] Guanyu Benshi Kaizhan Waishang Touzi Guquan Touzi Qiye Shidian Gongzuo de Shishi Banfa (关于本市开展外商投资股权投资企业试点工作的实施办法) [Measures for Implementing the Municipal Pilot Project of Foreign Investment Equity Investment Enterprises] (jointly promulgated by Shanghai Financial Services Office, Shanghai Municipal Commission of Commerce and Shanghai Administration for Industry and Commerce, Dec. 24, 2010, effective Jan. 24, 2011), http://bit.ly/2tvOS4P.

[359] Liu Xue (刘雪), QFLP Zhengce Kuorong Hu Jing Jin Yu Sidi Shidian (QFLP 政策扩容 沪京津渝四地试点) [*QFLP Policy Expansion: Shanghai, Beijing, Tianjin, Chongqing being the Four Pilot Cities*] (Sep. 6, 2011), Xinhua 08 (新华 08) [XINHUA 08], http://bit.ly/2uakVod.

[360] Guanyu Baoxian Zijin Touzi Guquan he Budongchan Youguan Wenti de Tongzhi (关于保险资金投资股权和不动产有关问题的通知) [Notice on Insurance Funds Investing into Equity and Real Estate] (promulgated by China Insurance Regulatory Commission, Jul. 16, 2012, effective Jul. 16, 2012), http://bit.ly/2sycoJL.

[361] Zichan Guanli Jigou Kaizhan Gongmu Zhengquan Touzi Jijin Guanli Yewu Zanxing Guiding (资产管理机构开展公募证券投资基金管理业务暂行规定) [Interim Provisions on the Management of Public Securities Investment Funds by Asset Management Institutions] (promulgated by China Securities Regulatory Commission, Feb. 18, 2013, effective Jun. 1, 2013), http://bit.ly/2tc4fN1.

[362] Guowuyuan Guanyu Jiakuai Fazhan Xiandai Baoxian Fuwuye de Ruogan Yijian (国务院关于加快发展现代保险服务业的若干意见) [The State Council's Several Opinions on

Dates	Law/Policy	Implications for VC Market
Dec. 12, 2014	Notice of the China Insurance Regulatory Commission on Matters concerning the Investment of Insurance Funds in Venture Capital Funds[363]	Allowed insurance funds to invest into venture capital funds
Nov. 12, 2015	Ministry of Finance issued the Interim Measures for Government investment fund *(zhengfu touzi jijin zhanxing guanli banfa)*[364]	Regulated the government investment funds
Dec. 25, 2015	Ministry of Finance issued the Guiding Opinions of the Ministry of Finance on Injecting Fiscal Funds into Government Investment Funds to Support Industry Development *(guanyu caizheng zijin zhuzi zhengfu touzi jijin zhichi chanye fazhan de zhidao yijian)*[365]	Specified on how to use the fiscal fund in supporting industry developments
May. 11, 2016	CSRC issued a pilot scheme to grant ten banks access to VC investments following the removal of a legal bar on banks holding equity in non-financial companies they lend money to.[366]	Allowed banks to make VC investments.

Accelerating Development of the Modern Insurance Service Sector] (promulgated by State Council, Aug. 13, 2014), http://hit.ly/2uvMOXf.

[363] Zhongguo Baojianhui Guanyu Baoxian Zijin Touzi Chuangye Touzi Jijin Youguan Shixiang de Tongzhi (中国保监会关于保险资金投资创业投资基金有关事项的通知) [Notice of the CIRC on the Relevant Matters Concerning Insurance Funds Investing into Venture Capital Funds] (promulgated by China Insurance Regulatory Comm., Dec. 12, 2014, effective Dec. 12, 2014), http://bit.ly/2tBNPRn.

[364] Interim Measures on Government Investment Funds, *supra* note 259.

[365] Caizhengbu Guanyu Caizheng Zijin Zhuzi Zhengfu Touzi Jijin Zhichi Chanye Fazhan de Zhidao Yijian (财政部关于财政资金注资政府投资基金支持产业发展的指导意见) [Ministry of Finance's Guidance Opinions on Financial Capital Injection into Government Investment Funds to Support Industry Development] (promulgated Dec. 25, 2015), http://bit.ly/2uvMNTo.

[366] Zhu Xiaoshan (朱筱珊), 2016 Nian Chuangtou Hangye Shida Guanjianci (2016年创投行业十大关键词) [*VC Industry's Top 10 Key Words for 2016*] (Dec. 30, 2016), Zhengquan Shibao Wang (证券时报网) [STCN.COM], http://bit.ly/2tvLfeZ.

Dates	Law/Policy	Implications for VC Market
Dec. 30, 2016	The National Development and Reform Commission issued Interim Measures for government funded industrial investment fund management *(zhengfu chuzi chanye touzi jijin zhanxing guanli banfa)*[367]	Regulated fund raising, registration, approval, investments, disclosure of information, evaluation and other issues relating to government funded industrial investment fund.
	FINANCIAL INTERMEDIARIES	
Oct. 31, 2002	"Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises" was passed.[368]	Regulated foreign invested enterprises.
Oct. 27, 2005	PRC Company Law was revised.[369]	Introduced the one-person company and streamline the process of setting up a company.
March 1, 2006	"Interim Measures for Administration of Start-up Investment Enterprises 2005" came into force.[370]	Regulated domestic VC enterprises and provided tax incentives to foreign invested VC enterprises.
Aug. 27, 2006	PRC Partnership Enterprise Law was passed.[371]	Introduced the limited partnership.
June 1, 2007	"Circular on Tax Policies Promoting Development of Venture Capital Enterprises" came into force.[372]	Provided tax incentives to VC Invested Enterprises.

[367] Interim Measures for Government Funded Industrial Investment Fund Management, *supra* note 272.

[368] Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises, *supra* note 114.

[369] Cao Kangtai (曹康泰), Guanyu "Zhonghua Renmin Gongheguo Gongsi Fa (Xiuding Cao'an) de Shuoming (关于《中华人民共和国公司法(修订草案)》的说明) [Explanation of Draft Revisions of the Company Law of the People's Republic of China], Address to the Nat'l People's Cong. (Feb. 25, 2005), http://bit.ly/2tuyEor.

[370] Interim Measures for Administration of Start-up Investment Enterprises, *supra* note 223.

[371] Partnership Enterprise Law, *supra* note 160.

[372] Guanyu Cujin Chuangye Touzi Qiye Fazhan Youguan Shuishou Zhengce de Tongzhi (关于促进创业投资企业发展有关税收政策的通知) [Notice on Relevant Tax Policies for Promoting Development of Venture Capital Industry], jointly issued by Ministry of Finance and State Administration of Taxation, Feb. 7, 2007, effective Jan. 1, 2006, http://bit.ly/2sdyAcK.

Dates	Law/Policy	Implications for VC Market
June 25, 2008	"Operational Guidelines for the Private Equity Investment Trust Business of Trust Companies 2008" came into force.[373]	Regulated trust-type funds.
Oct. 18, 2008	"Guiding Opinions on the Normalized Establishment and Operation of the Venture Capital Guiding Fund Made by the Departments Including the Development Reform Commission" was issued.[374]	Provided clearer guidance on the operation of the funds.
Nov. 23, 2009	Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals was published.[375]	Provided a new foreign-invested vehicle for foreigners.
Dec. 28, 2013	Amendments to the PRC Company Law, effective on March 1 2014.[376]	Abolished the requirement of minimum registered capital.
Sept. 2015	China's business registration system reform on integrating "three certificates into one" with unified credit codes.[377]	Streamlining the registration process of starting a business.
	ENTREPRENEURSHIP	
Mar. 1986	Launch of National High Technology Research and Development Program of China (863 Program).[378]	Aimed to improve the country's innovation ability and development of cutting-edge technology.

[373] Operational Guidelines for Private Equity Investment Business Trust Companies, *supra* note 178.

[374] Opinion on Venture Capital Fund Specifications and Operational Guidance, *supra* note 81.

[375] Provisions on the Registration of Foreign-funded Partnership Enterprises, *supra* note 335.

[376] Gongsifa Xiugai Yian Huo Tongguo Zhuce Renjiaozhi Queli (公司法修改议案获通过 注册认缴制确立) [*Company Law Amendment Bill has passed Registration System is confirmed*] (Dec. 29, 2013), Caixin (财新) [CAIXIN.COM], http://bit.ly/2twtxbi.

[377] Guowuyuan Bangongting Guanyu Jiakuai Tuijin "San Zheng He Yi" Dengji Zhidu Gaige de Yijian (国务院办公厅关于加快推进"三证合一"登记制度改革的意见) [Opinions of General Office of the State Council on Accelerating the Reform of the "Unification of Three Certificates" Registration System] (promulgated Jun. 29, 2015), http://bit.ly/2tyh5rt.

[378] Press Release, Keji Bu (科技部) [Ministry of Science and Technology], Guojia Gaojishu Yanjiu Fazhan Jihua (863 Jihua) Jiandu Weiyuanhui Chengli (国家高技术研究发展计划 (863 计划) 监督委员会成立) [Supervisory Committee Established for National High Technology Research and Development Program (863 Program)] (Aug. 30, 2002), http://bit.ly/2ty6DjC.

Dates	Law/Policy	Implications for VC Market
Aug. 1988	The Torch Plan was launched.[379]	A guiding plan for the development of high tech industries.
May 4, 1998	Project 985 was launched.[380]	Aimed to develop world-class universities.
Nov. 20, 2014	"Opinions of the State Council on Supporting the Sound Development of Micro and Small Enterprises" introduced.[381]	Introduced policy measures to support SMEs through financial support, tax incentives, etc.
Mar. 2, 2015	"Opinions of the State Council on the Expansion of the Space for Mass Entrepreneurship and the Promotion of Mass Entrepreneurship" issued.[382]	Promoted market-orientated mass innovation.

[379] Huoju Jihua Xiangmu (火炬计划项目) [*Torch Project*], Kexue Jishubu Huoju Gaojishu Chanye Kaifa Zhongxin (科学技术部火炬高技术产业开发中心) [*Torch High Technology Industry Development Center, Ministry of Science & Technology*], http://bit.ly/2tcQsGd.

[380] Press Release, Jiaoyu Bu (教育部) [Ministry of Education], "985 Gongcheng" Jianjie ("985 工程"简介) [Introduction to "985 Project"], http://bit.ly/2t3dCao.

[381] Guwuyuan Guanyu Fuchi Xiaoxing Weixing Qiye Jiankang Fazhan de Yijian (国务院关于扶持小型微型企业健康发展的意见) [Opinions of State Council on Supporting Healthy Development of Small and Micro-enterprises] (promulgated Nov. 20, 2014), http://bit.ly/2ubtr6u.

[382] Guowuyuan Bangongting Guanyu Fazhan Zhongchuang Kongjian Tuijin Dazhong Chuangxin Chuangye de Zhidao Yijian (国务院办公厅关于发展众创空间推进大众创新创业的指导意见) [Office of State Council's Guidance Opinions on the Development of Puhlic Space to Promote Innovation and Entrepreneurship] (promulgated Mar. 11, 2015), http://bit.ly/2twDTZ1.

ROCKING THE BOAT: THE PARACELS, THE SPRATLYS, AND THE SOUTH CHINA SEA ARBITRATION

Kirsten Sellars[*]

On July 12, 2016, the Permanent Court of Arbitration found overwhelmingly in favor of the Philippines in its dispute with the People's Republic of China over maritime entitlements in the South China Sea. This piece appraises the decision in light of the events leading up to the current controversy over the Paracel and Spratly groups.

To investigate the source of the conflict, one does not have to go back very far. In 1974, during the final stages of the Vietnam War, China ejected South Vietnam from the Paracel Islands—a group of tiny maritime features in the South China Sea claimed by both nations. After a classic "weekend war," China tried to dampen down the affair by swiftly releasing the prisoners and refusing to be drawn into an international debate.

Within days, though, there was more activity, when South Vietnam dispatched forces to occupy five features in the Spratly Islands, a larger group further to the south of the South China Sea. During this period, South Vietnam, the Philippines, and Taiwan all engaged in the fortification of their respective features—reinforcing garrisons, installing military hardware, building runways, and shooting at interlopers. The militarization of the Spratlys had begun; and well before China, the focus of the current arbitration, established a physical presence on the reefs in the vicinity.

By drawing on these earlier events, examined through the lens of United States' diplomatic correspondence of the time, it is possible to both construct a legal path to the arbitration based on the parties' claims to the Spratlys, and critically appraise the Tribunal's reasoning on its jurisdiction over the Philippines' claims against China.

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INTRODUCTION

On July 12, 2016, the Permanent Court of Arbitration found overwhelmingly in favor of the Philippines in its dispute with the People's Republic of China over maritime entitlements in the South China Sea.[1] This piece appraises the decision in light of the events leading up to the current controversy over the Paracel and Spratly groups.

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This piece examines the unfolding of the Paracels and Spratlys disputes through the lens of the United States' diplomatic correspondence between the State Department and its missions in Asia.

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[1] *South China Sea Arbitration* (Phil. v. China), PCA Case No. 2013-19, Award, ¶ 1203 (Perm. Ct. Arb. 2016) [hereinafter Arbitration], http://bit.ly/2twyRL7.

When the controversy ignited in 1974, the U.S. was still trying to disentangle itself from Vietnam, and had no intention of being inveigled by its Asian allies into commitments in the South China Sea. Consequently, it struck a determinedly neutral stance, stating that it took no position; a stance to which it formally adhered until 2016. But declared disinterest did not mean lack of interest, and behind the scenes, Washington played an active though little known role in trying to contain the conflict, by discouraging Saigon from pressing its Paracels claims in the Security Council, and trying to deter American oil companies from exploring Reed Bank.

This diplomatic correspondence, which the Permanent Court of Arbitration does not appear to have examined, casts a strong light on the interests and legal positions of the players in the South China Sea—interests which continue to govern the actions of China, the Philippines, Taiwan and Vietnam today. When chronicling the initial phases of the current disputes, American officials not only set out the parties' legal justifications for their actions, but also provided assessments of the merits of some of these positions. In the process, they also offered early insights into a central jurisdictional question addressed by the Tribunal: whether the Spratlys features should be defined as "islands" or "rocks" under Article 121 of the U.N. Convention on the Law of the Sea—the matter on which we shall conclude.

I. CHINA, THE VIETNAMS, AND THE PARACELS CLASH

A. China Grasps the Nettle

In January 1974, fifteen months before the end of the Vietnam War, the Republic of Vietnam (South Vietnam) accused the People's Republic of China (P.R.C.) of illegally occupying a marine feature in the Paracels group.[2] Beijing responded with a statement condemning Saigon's "brazen announcement"[3] and declaring that the attempt to incorporate the Paracels into South Vietnam was "illegal and null and void."[4] It also claimed that the Paracels (Hsisha), Spratlys (Nansha), Pratas (Tungsha) and Macclesfield Bank (Chungsha) were part of China's

[2] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: EA Press Summary, par. 2 (Jan. 17, 1974) (National Archives Records Administration (NARA), Access to Archives Database (AAD) Document No. 1974STATE010818).

[3] *Id.*

[4] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: RVN/PRC Dispute over South China Seas Islands, par. 4 (Jan. 18, 1974) (1974HONGK00751).

territory,[5] and that it would "never tolerate" an infringement on its territorial integrity.[6]

A week later, South Vietnamese troops reportedly opened fire on men trying to raise a Chinese flag on Robert Island.[7] Things rapidly escalated. The South Vietnamese issued a statement giving their version of events just after the clash:

> On January 19th, 1974, at 0829 hours, Chinese troops opened fire on the Vietnamese troops on the island of Quang Hoa (also known as Duncan Island). At the same time, communist Chinese vessels engaged Vietnamese vessels stationed in the area, causing heavy casualties and material damages. On January 20th, 1974, communist Chinese warplanes which had been overflying the area on previous days, joined the action and bombed Vietnamese positions on the islands of Hoang Sa (Pattle) Cam Tuyen (Robert) and Vinh Lac (Money). By the evening of January 20th, 1974, Chinese troops ha[d] landed on all the islands of the Hoang Sa archipelago.[8]

Beijing claimed it had acted in self-defense. Within hours of the clash, the Foreign Ministry issued a statement declaring that the South Vietnamese had invaded Chinese islands, rammed Chinese fishing boats, killed Chinese fishermen, and opened fire on Chinese naval vessels,[9] and that it was only then that "[d]riven beyond the limits of forbearance, our naval units, fishermen and militiamen fought back heroically in self-defense, meting out due punishment to the invading enemy."[10] Not only that, Beijing added, but the South Vietnamese were deploying the tactic of "the guilty party filing the suit first" by claiming that China's had made a "sudden challenge" to Vietnam's proclaimed sovereignty over the Paracels when, "as is known to all, Hsisha, as well as Nansha, Chungsha and Tungsha islands, have always been China's territory."[11]

Two months later, the Chinese newspapers published an epic poem by Chang Yung-mei entitled "The Paracels War," which once again

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[5] Cable from State Department, Subj: EA Press Summary, par. 2 (Jan. 17, 1974) (1974STATE010818).

[6] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: RVN/PRC Dispute over South China Seas Islands, par. 4 (Jan. 18, 1974) (1974HONGK00751).

[7] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Weekly Wrap-up on East Asian Affairs, par. 8 (Feb. 2, 1974) (1974STATE022409). For press reports see, *e.g.*, Cable from State Department, Subj: EA Press Summary, par. 1 (Jan. 18, 1974) (1974STATE012431).

[8] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: PRC-GVN Clash in Paracels, p. 2 (Jan. 21, 1974) (1974SAIGON00945).

[9] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: PRC Letter to Security Council on Paracel Islands, p. 2 (Jan. 23, 1974) (1974USUNN00232).

[10] *Id.*

[11] *Id.*

portrayed China as the aggrieved party.[12] In this poetic account of the battle, a Chinese fishing boat warned a South Vietnamese warship to leave the Paracels area; but instead of doing so, the South Vietnamese ship, now joined by a second, tried to ram the fishing boat. When a Chinese naval vessel intervened, it was harassed and then fired on by four Vietnamese warships. After a half-hour battle, the Chinese sunk a Vietnamese ship with hand grenades, "writing a new chapter in the history of people's war at sea."[13] (The poet, with some ingenuity, even managed to work in a denial that the Chinese had used Komar-class vessels or Styx missiles during the engagement.[14])

American officials, who pored over the poem, commented that its portrayal of the Chinese as the underdogs in the battle "appears aimed at deflecting the image of China bullying a small neighbor," as well as providing a suitable setting for displays of heroism and guerrilla tactics.[15] They also noted that,

> The poet reaffirms the PRC claim to the Paracel, the Spratly, and the Pratas island groups, calling them all Chinese fishing areas and asking rhetorically how China can allow them to be occupied by bandits. He also reiterates China's determination not to give up 'an inch of its land nor a drop of its water,' while disavowing any Chinese desire for the territory of others or a willingness to attack unless attacked.[16]

B. Beijing's Motives

Aside from self-defense, an American official in Hong Kong speculated on other possible Chinese motives for taking action in the Paracels, and came up with three: "Spiraling interest in the oil potential of the East Asian shelf area, concern that the communist Vietnamese might affirm Vietnam's claim, and the long-term strategic potential of the islands."[17] Each one of these issues was indeed significant in the grand scheme of things, but only one proved to be decisive at the time.

Regarding the potential oil deposits, China had on numerous occasions before the Paracels incident publicly pronounced both its desire to exploit the natural resources in the seas adjacent to its coastline, and its resolve to prevent other states from encroaching on these resources. On December 29, 1970, a *Renmin Ribao* (*People's Daily*) editorial entitled 'On China's seabed and subsoil resources' stated:

Taiwan Province and the islands appertaining thereto, including

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[12] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking Celebrates its Paracels Victory with an Epic Poem, par. 1 (Mar. 19, 1974) (1974HONGK03095).

[13] *Id.* par. 3.

[14] *Id.*

[15] *Id.* par. 4.

[16] *Id.* par. 2.

[17] U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking's Calculations in the Paracels War, pp. 1-2 (Jan. 30, 1974) (1974HONGK01036).

> the Tiaoyu ... Huangwei, Chihwei, Nanhsiao, Peihsiao and other islands, are China's sacred territories. The resources of the sea-bed and subsoil of the seas around these islands and of the shallow seas adjacent to other parts of China all belong to China, their owner, and we will never permit others to lay their hands on them.[18]

China was just as vocal at an April 1974 U.N. Economic Commission for Asia and the Far East (ECAFE) meeting, convened a few months after the incident. The Chinese delegate complained that since the 1960s, the superpowers had "dispatched planes and surveying ships everywhere to barge at will into offshore areas of developing countries for prospecting sea-bed resources and stealing much resources intelligence."[19] Furthermore, he said, "certain countries" (i.e. Japan and South Korea) were encroaching on Chinese sovereignty by unilaterally declaring marine "joint development zones," while the "Chiang Kai-shek clique in Taiwan" had been concluding illegal deals with foreign states and enterprises.[20] China's sovereignty, he insisted, was not just over the seas adjacent to its coast, but also the seas adjacent to its islands:

> The delegation of the People's Republic of China hereby reiterates that all the seabed resources in China's coastal sea areas and those off her islands belong to China. China alone has the right to prospect and exploit these sea-bed resources ... prospecting and drilling activities carried out at will in China's coastal sea areas and those off her islands in disregard of China's sover[ei]gnty are illegal.[21]

Regarding the Paracels, one purpose of China's intervention was thus to warn off both the maritime superpowers and local rival claimants to resources in the South and East China seas. As an American official based in Hong Kong noted, "by brushing the hapless Vietnamese off their perches in the Paracels, Peking has cautioned claimants to other disputed territory on the shelf (including South Korea and Japan) to refrain from unilateral steps to advance or to exploit their positions."[22] China's message to one neighbor was clear: we *have* seized the Paracels, and we *can* seize the Senkakus.

The next possible motive for the intervention related to the strategic value of the Paracels themselves. On one hand, the Chinese obviously had much to gain from stepping up their presence in areas adjacent to

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[18] *On China's Seabed and Subsoil Resources*, Renmin Ribao [PEOPLE'S DAILY], Dec. 29,1970, (quoted in WINBERG CHAI, THE FOREIGN RELATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 325 (1972)). The islands referred to were part of the Diaoyu/Senkaku group in the East China Sea.

[19] Cable from U.S. Embassy Colombo to U.S. State Department, Subj: Paracel/Spratly Islands Dispute, p. 2 (Apr. 3, 1974) (1974COLOMB00907).

[20] *Id.* pp. 2-3.

[21] *Id.* p. 2.

[22] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking's Calculations in the Paracels War, par. 2 (Jan. 30, 1974) (1974HONGK01036).

the sea-lanes running through the South China Sea. On the other, some speculated that they feared the Soviet Pacific Fleet's further encroachment into the South China Sea at the invitation of North Vietnam,[23] and occupied the Paracels as a deterrent.

After the clash, the Chinese certainly moved fast to consolidate their hold. A documentary made three months after the incident showed docks, weather balloons, radar and other defense installations—and an oil drilling rig.[24] Later reports indicated that they were further expanding their military facilities, as well as building wharves, harbors, breakwaters, offices,[25] warehouses, meteorological stations, and marine products processing plants.[26] At around the same time, the Chinese reported that they had unearthed items dating back to the Tang and Song dynasties in archaeological digs,[27] which were presented as evidence to support their claim to historic rights to the Paracels.[28]

Yet it is the final argument, relating to Vietnam's claims to the Paracels, which goes furthest in explaining why—and even more significantly, *when*—Beijing took action. China was unlikely to have picked a fight with South Vietnam over the Paracels while the American forces were still on the scene. It was only after 1973, once the Americans had mostly removed themselves, leaving Saigon to fight its own battles, that the risks to China diminished. Moreover, the intervention could not have taken place *later* than it did, because it was clearly only a matter of time before the North Vietnamese forces defeated the South Vietnamese and made their own claim to the Paracels. Beijing had to take advantage of the narrow window of opportunity that presented itself between the Americans' exit and the North Vietnamese assuming power.

So China grasped the nettle, spurred by economic and strategic motives, but also by political expediency—it was more internationally palatable for them to eject their unpopular South Vietnamese enemies than their erstwhile North Vietnamese friends. When it came, the military intervention was decisive, and its diplomatic follow-up was forthright: in a public statement issued just after the incident, Beijing declared that the Saigon authorities had intruded into "China's

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[23] Cable from U.S. Embassy Manila to State Department, Subj: Philippine Reaction to Chinese Seizure of Paracels, par. 4 (Jan. 22, 1974) (1974MANILA00775). The Soviets dismissed rumours that the North Vietnamese would offer them a base at Cam Ranh Bay as "a Chinese fabrication." Cable from U.S. Embassy Moscow to U.S. State Department, Subj: Soviet Views of China, par. 9 (Jun. 27, 1975) (1975MOSCOW08994).

[24] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Oil Rig on Paracel Islands, p. 1 (Jun. 11, 1974) (1974HONGK06572).

[25] Cable from U.S. State Department to All East Asian and Pacific Diplomatic Posts, Subj. EA Press Summary, p. 8 (Jan. 2, 1975) (1975STATE000668).

[26] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: People's Republic of China—Economic Review 2, par. 6 (Jan. 26, 1975) (1975HONGK00976).

[27] *Id.*

[28] Cable from U.S. State Department to All East Asian and Pacific Diplomatic Posts, Subj: EA Press Summary, p. 5 (Dec. 11, 1974) (1974STATE271136).

territorial waters and air space around and over the Hsisha Islands," and would "eat their own bitter fruit" if they attempted to take further action.[29]

Having secured the Paracels and having warned off Saigon, China then acted with equal dispatch to draw a line under the issue. It promptly returned the prisoners captured during the clash, decreased the air and naval operations in the vicinity of the Paracels, stopped air and naval operations around the Spratlys, and refrained, at least in the short term, from making propaganda statements about the success of the operation.[30] As far as Beijing was concerned, the matter was closed.

C. Saigon's Perspective

Needless to say, South Vietnam took a rather different view of the matter. The Paracels were theirs, not China's, and it was Saigon, not Beijing, which was acting in self-defense. "As a small nation unjustly attacked by a big military power," the Foreign Ministry stated on 20 February, "the Republic of Vietnam appeals to all justice- and peace-loving nations of the world to resolutely condemn the brutal acts of war by communist China."[31]

Just days before the clash, the South Vietnamese authorities had declared that the Paracels (as well as the Spratlys) were an integral part of South Vietnam. This was based on two grounds: "geographical propinquity," and long-standing "continuous and peaceful display of state authority."[32] The Foreign Minister, Vuong Van Bac, stated that Vietnam's claims to the Paracels dated back to 1802, when Emperor Gia Long set up the Hoang Sa Company to exploit resources in the vicinity.[33] Further, these claims were reaffirmed in 1932 by the French Governor-General, Pierre Pasquier (who integrated the Paracels into the Thua Thien provincial administration); confirmed in 1938 by Emperor Bao Dai; and decreed in 1961 by South Vietnam's first president, Ngo Dinh Diem.[34] Such actions, Bac concluded, "were not challenged by any country, including communist China."[35]

The Foreign Minister also argued that the Vietnamese had rights by

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[29] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: NCNA Reports PRC Clashes with South Vietnamese, p. 2 (Jan. 20, 1974) (1974HONGK00769).

[30] Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: Position with Respect to Spratley Islands (Jan. 29,1974) (1974PEKING00178).

[31] Cable from U.S. Embassy Saigon to U.S. State Department: Subj: PRC-GVN Clash in Paracels, par. 9 (Jan. 20, 1974) (1974SAIGON00866).

[32] Cable from U.S. Embassy Saigon to U.S. State Department: Subj: PRC-GVN Clash in Paracels, p. 2 (Jan. 21, 1974) (1974SAIGON00945).

[33] Cable from U.S. Mission to the United Nations, to U.S. State Department, Subj: Texts of GVN Letter, p. 3 (Jan. 18, 1974) (1974USUNN00175).

[34] *Id.*

[35] *Id.* Bac also claimed that none of the fifty-one countries attending the 1951 San Francisco Conference, which set the Allies' peace terms with Japan, "raised any objection" to Vietnam's claim to sovereignty over the Paracels after Japan's surrender. *Id.* p. 4.

virtue of the fact that they occupied the Paracels. The authorities had, he stated, "consistently stationed troops and exercised administrative control over those archipelagos, and the Vietnam Navy regularly patrols and supervises navigational security in the area."[36] Yet the situation was by no means clear-cut. The U.S. State Department's Bureau of Intelligence and Research reported, for example, that Robert Island seemed to have changed hands since the war, with a Chinese presence on it in the 1950s, and the South Vietnamese occupying it in the early 1970s.[37] Even then, South Vietnam did not have the Paracels to itself: the Chinese had stationed personnel on Woody and Lincoln islands, and "PRC naval vessels [were] frequently seen in the area carrying out re-supply of its personnel and maneuvers in the open water between the Paracels and Hainan Island."[38]

D. Hanoi's Silence

The South Vietnamese were not the only ones wrong-footed by the incident. The North Vietnamese also saw the Paracels as being part of Vietnamese territory, but could do nothing to stop them from falling into China's hands. As one diplomatic observer noted, they were "now irretrievably lost."[39] To make things worse, Hanoi then faced the unpalatable choice of either backing their enemy in Saigon over what they considered to be a rightful claim, or yielding to their patron in Beijing over what they saw as an illegal annexation. Surrendering to the inevitable, they chose the latter option, privately communicating their displeasure to the Chinese, but rarely commenting publicly on the issue—although when they did, they pointedly observed that territorial disputes should be settled by negotiation.[40]

The South Vietnamese, noting Hanoi's public silence on the issue, chided the North Vietnamese for failing to defend Vietnam's sovereignty. They issued a communiqué accusing its leaders of denying their "Vietnamese ancestral roots" by declining to take joint action against China,[41] while the Saigon media lambasted them for being "running dogs" and of "humbly bowing to ... their bosses, the Red Chinese."[42] The communist Provisional Revolutionary Government

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[36] *Id.*

[37] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: RVN/PRC Dispute over South China Seas Islands, par. 2 (Jan. 18, 1974) (1974HONGK00751).

[38] *Id.* par. 3.

[39] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Reaction to Chinese Seizure of Paracels, par. 3 (Jan. 22, 1974), (1974MANILA00775).

[40] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking's Calculations in the Paracels War, par. 3 (Jan. 30, 1974) (1974HONGK01036).

[41] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: EA Press Summary, par. 3 (Jan. 30 1974) (1974STATE019887).

[42] Cable from U.S. Embassy Saigon to State Department, Subj: Saigon Media Treatment of Paracels Issue, par. 7 (Jan. 21, 1974) (1974SAIGON00944).

based in South Vietnam got the same treatment.[43] This needling was apparently successful, causing embarrassment to Vietnamese communists in both the north and south.[44]

II. INTERNATIONAL REACTIONS TO THE INCIDENT

A. The West Disengages

Further afield, the United States, the United Kingdom, and France, each adopted a strictly hands-off approach to the affair.

The Americans' aim was to extract themselves from Indochina in an orderly fashion, and they had no appetite for a row with China over the Paracels. As soon as reports of the clash came through, they turned down Vietnamese requests for aerial reconnaissance,[45] instructed the US Navy to stay well away from the area,[46] and initially declined to take part in the search for survivors.[47] In Saigon, Graham Martin, the U.S. Ambassador, tried to calm the situation. In the midst of the crisis he cabled Washington to explain that he was impressing on South Vietnamese officials: "(1) necessity to play it cool (2) avoid any action that would lead to escalation (3) try to move conflict immediately to diplomatic arena such as UNSC [U.N. Security Council] and (4) that under no foreseeable circumstances could we foresee the possibility of U.S. military force involvement in any way."[48] According to the State Department, the incident was the "last thing" they needed during their withdrawal from Vietnam.[49]

As events unfolded, the Americans worked out a three-point message designed to show that they had played no part in the conflict, and had no intention of doing so. Their first and oft-repeated point was that the United States government "takes no position on conflicting claims to Paracels, but strongly desires peaceful resolution of dispute."[50] The second and third points were flat denials: "We do not know circumstances under which present clash arose," and "US military forces are not involved."[51] There was a fly in the ointment, though. Gerald Kosh, an American member of a defense attaché's staff in

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[43] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: GVN Chides "PRG" for Statement on the Paracels/Spratleys, p. 4 (Feb. 11, 1974) (1974SAIGON01851).

[44] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: Embassy Saigon's Mission Weekly Feb 7-13, 1974, p. 4 (Feb 13, 1974) (1974SAIGON01966).

[45] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: PRC-GVN Clash in Paracels (Jan. 20, 1974) (1974SAIGON00862).

[46] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: PRC-GVN Clash in Paracels, par. 1 (Jan. 19, 1974) (1974STATE012641).

[47] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: PRC-GVN Clash in Paracels, par. 1 (Jan. 20, 1974) (1974SAIGON00862).

[48] *Id.*

[49] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: PRC-GVN Clash in Paracels, par. 4 (Jan. 19, 1974) (1974STATE012641).

[50] *Id.* par. 3.

[51] *Id.*

Danang, happened to be travelling on one of the Vietnamese vessels caught up in the clash, and was captured by the Chinese. (A telegram from Saigon to the State Department said, "We do not know why he is there."[52]) Whatever the reason, Kosh complicated the affair, especially when the press picked up on him after the Chinese released him to the Americans via International Committee of the Red Cross intermediaries in Hong Kong eleven days later.[53]

While this was taking place, State Department officials, having worked out their line on the issue, did what they could to encourage the South Vietnamese to pursue the conflict through legal and diplomatic channels. They instructed Ambassador Martin to inform President Nguyen Van Thieu or Foreign Minister Bac that it was in the interests of neither Saigon nor Washington to exacerbate the conflict, which might draw China into the Vietnam war: "We do not suggest that GVN [Government of Vietnam] take actions prejudicial to their legal position on sovereignty of the Paracels or fail to defend themselves, but we believe that further naval clashes should, if possible, be avoided."[54] Instead, they suggested that Saigon take its grievances to the United Nations, the International Court of Justice, or the U.N. Conference on the Law of the Sea, scheduled to reconvene later in the year.[55] After a few days they backed this up with a threat to Saigon that further military action against China would "work directly against our efforts to secure sufficient military and economic assistance for Vietnam from [U.S.] Congress."[56] In short, both Beijing *and* Washington were instructing Saigon to back down.

In the meantime, those European colonial powers who had earlier laid claim to the South China Sea also chose to remain neutral on the issue. The British kept their mouths shut (one press report suggested that they were worried about retaliatory Chinese pressure on Hong Kong[57]). The French also declined to give an opinion, stating that the competing claims were "very complicated," that there would never be a "clear case," and that they were "very reluctant to take any position on the dispute."[58]

Shortly after the incident, the South Vietnamese Ambassador called on the Quai d'Orsay's directeur d'Asie-Océanie, Henri Froment-Meurice,

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[52] *Id.* par.1.

[53] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking Decision to Effect Mass Release of SVN Prisoners, par. 1 (Feb. 16, 1974) (1974HONGK01746).

[54] Cable from U.S. State Department to U.S. Commander-in-Chief Pacific Fleet (CINCPAC), Subj: GVN/PRC Dispute in Paracels, par. 3 (Jan. 26, 1974) (1974STATE012653).

[55] *Id.*

[56] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Paracel Islands, par. 3 (Jan. 28, 1974) (1974STATE018390).

[57] Cable from U.S. State Department to All East Asian and Pacific Diplomatic Posts, Subj: EA Press Summary, par. 19 (Feb. 7, 1974) (1974STATE025982).

[58] Cable from U.S. Embassy Paris to U.S. State Department, Subj: French Position Concerning Paracels and Spratleys, par. 3 (Jan. 25, 1974) (1974PARIS02298).

to request French support for inscribing the issue on the Security Council agenda. Froment-Meurice said he would "reflect on" the question[59] (later events indicate that the outcome of the reflection was "no"). The Ambassador also asked for access to the French archives to help establish their Paracels claim, but the Quai flannelled: opening the archives would not be easy because the files in their Saigon embassy were in a mess, and the files back in France were in several different locations.[60]

When the Americans questioned the French about their position, sous-directeur Asie Henri Bolle stated that France, as the one-time "protecting" power of Indochina, had merely "espoused the views of the Annamite empire, which had continually held that Paracels and Spratleys were Vietnamese territory."[61] This comment suggests either that France was merely acting as an agent for the Annamite royal family during the colonial era, or that its officials were retrospectively rewriting history.

B. The Sino-Soviet Rift

This brings us to another major third party: the Soviet Union. China's relations with the United States had improved during the *détente* years, but its relations with the Soviet Union had worsened. After armed border clashes between China and the Soviets in 1969, tensions between them showed no signs of abating.

On January 19, 1974, on the same weekend as the Paracels clash, the Chinese declared five Beijing-based Soviet diplomats *personae non gratae* for handing over radio equipment and for receiving "counterrevolutionary" papers from a Chinese contact.[62] (The Soviets counterclaimed that the five had been trapped in an elaborate Chinese sting involving klieg lights, movie cameras, and pre-positioned crowds of people.[63])

The same day, the Soviet newspaper *Izvestia* berated China for, among other things, opposing *détente*, recognizing Pinochet's regime, undermining Soviet disarmament efforts, resisting Asian collective security, succoring Western European reactionaries, and letting down

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[59] *Id.* par. 2.

[60] *Id.*

[61] *Id.* par. 3.

[62] Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: Expulsion of Soviet Diplomats, par. 1 (Jan. 21, 1974) (1974PEKING00131).

[63] Cable from U.S. Embassy Moscow to U.S. State Department, Subj: Soviet Reactions to PRC Expulsion of Diplomats and to PRC-GVN Clash, par. 2 (Jan. 22, 1974) (1974MOSCOW01036). Speculating on the reason behind the expulsions, the U.S. Liaison Office in Beijing suggested that the Chinese might simply have had enough of "heavy-handed Soviet efforts to collect intelligence here," such as an earlier attempt to "drive off with Chinese mailbox ripped off a wall." Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: Expulsion of Soviet Diplomats, par. 3 (Jan. 21, 1974) (1974PEKING00131).

the Arabs.[64] On 24 January, *Renmin Ribao* responded in kind, accusing the Soviets of fomenting "counterrevolutionary opinion," purveying neo-Confucianism, and targeting China as "a colony of Soviet-revisionist social-imperialism."[65]

Given all this, it is unsurprising that the Soviets criticized China for its intervention in the Paracels: according to *Pravda*, this incident demonstrated Beijing's desire to dominate Asia and distract attention from its domestic problems.[66] But they could not say much more than that. First, they had a problem casting the Saigon regime—which they had long derided as an American stooge—as the hapless victim of Chinese aggression.[67] And second, they seemed to have recognized China's claim to the Paracels by labelling maps with the Chinese name: "Hsisha (Paracel)."[68] (A Soviet source claimed later that the maps were a mere technicality, and that they considered the status of the Paracels to be "undetermined."[69])

Drawing together the strands of the Sino-Soviet relationship, William Sullivan, the U.S. Ambassador in Manila, suggested that "Peking's persistent paranoia about Moscow" was a strong motive for China's action in the Paracels.[70] The Americans were withdrawing from Indochina, the Soviet Pacific Fleet was growing fast, and the North Vietnamese were on the brink of victory. Sullivan speculated that China's intervention was a doubly pre-emptive move: "the first preemption may have been against a North Vietnamese occupation of the islands (using newly acquired Soviet-built naval craft); and the second preemption may have been against the ultimate Soviet use of the island cluster as a support facility for the Soviet fleet, which Moscow would expect to arrange with a grateful Hanoi leadership."[71]

Whether or not this scenario was seriously contemplated, the Chinese attempts to prevent the Soviet Pacific Fleet from establishing a foothold in the South China Sea also assisted the Americans. As Sullivan noted:

> [O]ur private reaction to the Chinese move [in the Paracels] may have to be somewhat different from our ritual pious public

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[64] Cable from U.S. Embassy Moscow to U.S. State Department, Subj: Soviet Press Mum on Chinese Expulsion of Soviet Diplomats But Not on Hsisha Incident, par.1 (Mar. 21, 1974), (1974MOSCOW00955).

[65] Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: PRC Anti-Confucius Campaign Turns Spearhead against Soviets, par. 1 (Jan. 29, 1974) (1974PEKING00175).

[66] Cable from U.S. Embassy Moscow to U.S. State Department, Subj: Soviets Skirt Pitfalls in Heavy Press Treatment of Paracels Dispute, par. 1 (Jan. 28, 1974) (1974MOSCOW01321).

[67] *Id.* par. 2.

[68] *Id.*

[69] Cable from U.S. Embassy Moscow to U.S. State Department, Subj: Soviet Views of China, par. 1 (Jun. 27, 1975) (1975MOSCOW08994).

[70] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Reaction to Chinese Seizure of Paracels, par. 4 (Jan. 22, 1974) (1974MANILA00775).

[71] *Id.*

> protestations against peace-breakers. It could mean, at least in the short run, that a significantly useful facility for a major hostile navy has been turned into a relatively insignificant island outpost for a minor hostile navy.[72]

This might explain, at least in part, why the Americans gave the South Vietnamese so little support when they tried to take their complaint about the Paracels to the Security Council.

C. Security Council Dead-end

In the midst of the crisis, South Vietnam's Foreign Minister Bac instructed its observers at the United Nations to lodge a formal request for a Security Council meeting on the Paracels to consider whether China had engaged in "aggression" and to contemplate "urgent action to correct the situation." [73] On hearing this news, the American Ambassador to the U.N., John Scali, cabled the State Department from New York:

> GVN plan to take Paracels issue to SC [Security Council] raises obvious and serious complications for us. Vietnamese would seem to have no chance of favorable SC decision and little prospect of any kind of advantage. The further they press the[ir] case the greater the likelihood of Vietnamese humiliation and of problems for us. Our situation would be extremely a[w]kward even if Vietnamese had clear legal title to disputed islands.[74]

Shortly afterwards, Gonzalo Facio Segreda, the Security Council President, began to take soundings among members as to whether the meeting should be inscribed on the Security Council agenda. When the Chinese delegation was informed, their U.N. Permanent Representative, Huang Hua, called on Facio to express his displeasure. [75] According to William Bennett, the American deputy representative, Huang was in "high dudgeon," insisting to Facio that the Paracels were an "exclusively internal matter of China" and that Facio's consultation with Security Council members was a "violation of Chinese sovereignty."[76] Facio stood his ground over the consultations and later privately expressed his annoyance over the "heavy-handed Chinese attempt to pressure him."[77]

In Washington, meanwhile, Tran Kim Phuong, the South Vietnamese Ambassador, visited Assistant Secretary of State for East Asian and Pacific Affairs Arthur Hummel and his deputy Monteagle

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[72] *Id.* par. 5.

[73] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council, p. 1 (Jan. 20, 1974) (1974USUNN00188).

[74] *Id.* p. 2.

[75] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council: China, par. 1 (Jan. 21, 1974) (1974USUNN00203).

[76] *Id.*

[77] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council, par. 4 (Jan. 22, 1974) (1974USUNN00219).

Stearns at the State Department. Phuong stated that his government "wished to bring to public light this 'clear case of violence' by a superpower and permanent SC member against a small neighbor."[78] Hummel and Stearns responded that they were not asking the Vietnamese to withdraw the request, but they had "considerable doubt" as to what a meeting would accomplish: the Chinese would claim provocations over the Paracels, and other Security Council members might rebuff South Vietnam's claims.[79]

South Vietnam would have gained an especially unsympathetic hearing in the 1974 session of the United Nations. In order to even inscribe the meeting under the terms of Article 27(2) of the U.N. Charter, it would have had to gain nine affirmative votes[80] out of fifteen, with abstentions being counted as negative votes.[81] The chance of winning sufficient votes was slim. At least one permanent member, China, was expected to vote against inscription, while more non-permanent members were expected to follow suit.[82] As the Americans explained, the Council's makeup in that session was "especially unfortunate" to the West because:

> India, which was occasionally helpful, has been replaced by Iraq. Sudan which despite its radical orientation has had responsible SC rep, is replaced by Mauritania. Yugoslavia, which has occasionally been very unhelpful but still played independent role, has been replaced by Byelorussia.[83]

Of the remaining non-permanent members, four more—Cameroon, Indonesia, Kenya and Peru—were non-aligned states, which, while not necessarily approving China's conduct against a smaller state, were not likely to affirmatively support South Vietnam.[84]

Facio's consultations with Security Council members confirmed this lack of support. The Soviet representative admitted it would be "awkward" for the U.S.S.R. to back China, given their bad relations, but thought that the United States would also have trouble choosing "between its old ally and its new friend."[85] The Indonesian representative said the issue was "a most delicate one for Jakarta" and that Hanoi's view would have to be taken into account along with Saigon's.[86] The Australian and Austrian representatives doubted a

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[78] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Security Council Consideration of Paracels Issue, par. 2 (Jan 21, 1974) (1974STATE013405).

[79] *Id.*

[80] *See* U.N. Charter art. 27, ¶ 2.

[81] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Prospects for SC Meeting on Paracels, par. 4 (Jan. 21, 1974) (1974STATE013407).

[82] *Id.* par. 3.

[83] *Id.* par. 2.

[84] *Id.* par. 3.

[85] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council, par. 3 (Jan. 22, 1974) (1974USUNN00208).

[86] *Id.*

meeting would be "fruitful."[87] The British representative hoped the problem would go away.[88] The French representative was vague and evasive.[89] The Peruvian representative had little to say.[90] Four representatives—from Britain, Indonesia, Iraq and Peru—questioned whether South Vietnam had the right to raise an issue before the Security Council when it was not "seated" as a member of the United Nations.[91] Several others, Indonesia included, speculated on whether South Vietnam was the true representative of Vietnam.[92]

Based on these soundings, Facio concluded that five members would vote for the meeting's inscription (Australia, Austria, Costa Rica, United Kingdom, United States); five would vote against (Byelorussia, China, Indonesia, Iraq, U.S.S.R.); and five would abstain (Cameroon, France, Kenya, Mauritania, Peru).[93] So, in Facio's words, South Vietnam "will not get anywhere."[94] When this information was relayed back to Saigon, President Thieu pulled the plug on the proposal.[95]

The South Vietnamese then switched their attention to another institution—the Southeast Asia Treaty Organization (SEATO)—which elicited a "strongly negative" response from the Americans.[96] The proposal to bring the case to the International Court of Justice never got off the ground. There was nothing more they could do to raise their case in the international arena.

D. The Price of the Paracels

What, then, was the significance of China's action in the Paracels? None of the players emerged unscathed. South Vietnam staked its claim and lost. North Vietnam stayed silent. The United States kept out—it aspired only to a clean break from Indochina. The Soviet Union could endorse neither China nor South Vietnam. The old colonial powers looked the other way. Even the main beneficiary, China, paid a price: its carefully cultivated image as an advocate of peace in the region drowned in the South China Sea.

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[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] *Id.*

[93] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council, par. 3 (Jan. 3, 1974) (1974USUNN00219).

[94] Cable from U.S. Mission to the United Nations to U.S. State Department, Subj: Paracels in Security Council, par. 1 (Jan. 22, 1974) (1974USUNN00208).

[95] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: Paracels in the Security Council (Jan. 24, 1974) (1974SAIGON01040).

[96] Cable from U.S. State Department to U.S. Embassies Bangkok and Saigon, Subj: GVN Request that SEATO Consider Paracel Issue, par. 1 (Jan. 24, 1974) (1974STATE015405).

III. THE FOCUS SHIFTS TO THE SPRATLYS

A. *New Controversies Brew*

Even before the furor over the Paracels had died down, official attention shifted across to the Spratlys, the loose cluster of islets, cays, and submerged reefs scattered across the southeastern corner of the South China Sea. The question was: after the Paracels incident, would China strike next at this group, to which it also laid claim? If it did so, it would have to contend with other claimants, whose military forces already occupied some of the features.

Among these was Taiwan, which had since 1956 taken possession of the largest feature in the Spratlys—Itu Aba (Taiping)—as well as the Pratas group further to the north.[97] In the intervening decades, it had built various installations on Itu Aba,[98] including, it was rumored, an airstrip.[99] By the 1970s, it garrisoned some 200-300 soldiers there,[100] who were rotated and supplied by ships from Taiwan every three months.[101] In other words, Itu Aba, like the Pratas group, was (and still is) a Taiwanese garrison within a closed military area.[102]

Yet although Taipei and Beijing were at loggerheads on most issues, they saw eye-to-eye over Chinese sovereignty in the South China Sea. Under the "one-China" principle, they jointly claimed possession of the Paracels, Spratlys, the Pratas group, and Macclesfield Bank on behalf of a united China. And it was for this reason that Taipei made every effort to cool down the Paracels controversy. As the Walter McConaughy, U.S. Ambassador to Taiwan, reported,

> [I]n ROC [Republic of China] view, Paracels (as Spratleys and Pratas, of course) are [i]ndisputably Chinese territory ... ROC has also avoided using Paracels clash as example of PRC "bloodthirstiness" or "warlike disposition." With sole exception of [newspaper] *Lieh Ho Pao*, ROC media have carefully downplayed Paracels news, and *Lien Ho Pao* was given very stiff reprimand for front-paging story.[103]

Even so, one problem Taiwan faced was that it was not the sole occupant of the Spratlys: the Philippines and South Vietnam were also

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[97] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: RVN/PRC Dispute over South China Seas Islands, par. 2 (Jan. 18, 1974) (1974HONGK00751).

[98] *Id.*

[99] Cable from U.S. Embassy Taipei to U.S. Embassy Manila, Subj: Medevac from Itu Aba, par. 4 (Nov. 7, 1975) (1975TAIPEI07195).

[100] Cable from U.S. Embassy Taipei to State Department, Subj: Conflicting Claims to Spratleys, par. 1 (Jan. 26, 1974) (1974TAIPEI00508).

[101] Cable from U.S. Embassy Taipei to State Department, Subj: ROC Navy Resupply Mission to Spratleys, par. 2 (Feb. 5, 1974) (1974TAIPEI00751).

[102] Cable from U.S. Embassy Taipei to U.S. Embassy Belgrade, Subj: Emergency Visas for Republic of China, par. 5 (Oct. 18, 1974) (1974TAIPEI06378).

[103] Cable from U.S. Embassy Taipei to U.S. State Department, Subj: ROC Views on the Islands Controversy, p. 2 (Jan. 30, 1974) (1974TAIPEI00602).

in the mix. Another problem was that immediately after the Paracels clash, the latter had occupied five more Spratlys features. This development was of great concern to Taiwan: if China responded militarily to South Vietnam (which was one of Taiwan's few anti-communist allies in the region), it too might be drawn into a confrontation with China.[104] So in a move designed to placate Beijing, Taipei had proclaimed:

> [T]he government of the Republic of China has lodged a strong protest with the Vietnamese government, and reaffirmed its position to the effect that these [Spratly] islands are inherently part of the territories of the Republic of China and that the Republic of China's sovereignty over them is not to be doubted ... These islands had been occupied by Japan during the Second World War. They were restored to the Republic of China, when, after the war, in December 1946, the Chinese government despatched a naval contingent to take them over from the Japanese.[105]

This statement is significant because it refers to the Spratlys being "*inherently* part of the territories of the Republic of China"—meaning the Republic of China in existence *before* the 1949 split between the two Chinas. (This point is reiterated in the final sentence, which states that the Spratlys were restored to the Republic of China in December 1946, three years before the split.) The emollient message to Beijing was clear: after 1949 *both* the People's Republic of China and Taiwan inherited the Spratlys under the "one-China" principle.

Even so, Taiwan's Premier Jiang Jingguo thought it best to keep troops on alert, and, according to Ambassador McConaughy, cancelled both the resupply ship to the Paracels[106] and the "regularly scheduled post-Lunar New Year 'comfort mission' to Pratas."[107] It can be surmised that the Taiwanese troops stationed on the features commenced the new year without their usual celebrations.

B. The Philippines' Trusteeship Argument

The unsettled situation in the South China Sea compelled the various claimants to articulate their legal claims to the Spratlys. In 1974, the treaty regime governing the law of the sea was a work in progress. The U.N. had already convened two conferences: the first conference, held in 1958, produced treaties governing the territorial sea, continental shelf, high seas, and fishing, but reached no agreement on

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[104] *Id.*

[105] Cable from U.S. Embassy Taipei to State Department, Subj: [ ]ROC Reiterates Claim to Spratleys, pars. 2-3 (Feb. 8, 1974) (1974TAIPEI00807).

[106] Cable from U.S. Embassy Taipei to U.S. State Department, Subj: ROC Navy Resupply Mission to Spratleys, par. 2 (Feb. 5, 1974) (1974TAIPEI00751).

[107] Cable from U.S. Embassy Taipei to U.S. State Department, Subj: ROC Views on the Islands Controversy, par. 3 (Jan. 30, 1974) (1974TAIPEI00602).

the width of the territorial sea and fishing limits; the second conference, held in 1960, was convened to answer these outstanding questions, but collapsed.[108] The crucial third conference, which began considering substantive issues in June 1974, eventually produced the all-encompassing U.N. Convention on the Law of the Sea (UNCLOS),[109] but this would not enter into force until November 1994.[110] Consequently, the Spratly claimants had to reach for pre-UNCLOS law of the sea doctrines to make their case.

A curtain-raiser for the Spratlys controversy took place in 1971 when the Philippines protested about Taiwan's military presence on Itu Aba. In Manila on July 10, President Ferdinand Marcos emerged from a National Security Council meeting about the Spratlys, and read out a Presidential *communiqué* to the assembled press: "The Council has verified that one of these islands—the island of Itu Aba, known to us as Ligaw—is now under occupation by Nationalist Chinese forces who have fortified the island with gun emplacement and who have on a number of occasions, fired warning shots on reconnaissance aircraft and maritime vessels."[111] This, Marcos added, was a serious threat to the Philippines' national security.[112]

The Filipinos then set out the first of their legal arguments against China's and Taiwan's claims to the Spratlys. They looked to the Peace Treaty with Japan, concluded in San Francisco on September 8, 1951, which stated in Article 2(f) that Japan would renounce "all right, title and claim to the Spratly Islands and to the Paracel Islands."[113] The treaty did not specify that the Paracels and Spratlys, once renounced by Japan, should be passed to another recipient. The Filipinos offered their own interpretation: that both groups fell instead under "the de facto trusteeship of the Allied powers" that had signed the treaty.[114] (Note: the Philippines was a party to the Peace Treaty, whereas China and Taiwan were not.[115])

The Filipinos had first used this "trusteeship" argument in 1957, shortly after Taiwan had established a permanent garrison on Itu Aba,

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[108] For an overview and documentation arising from the first two U.N. Law of the Sea conferences, see *United Nations Law of the Sea Conference, 1958*, UNITED NATIONS http://bit.ly/1p9R06q; and *Second United Nations Conference on the Law of the Sea, 1960*, UNITED NATIONS, http://bit.ly/1kHbwqW.

[109] United Nations Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 397 [hereinafter *UNCLOS*].

[110] For an overview and documentation arising from the third U.N. Law of the Sea conference, see *Third United Nations Conference on the Law of the Sea, 1973-1980*, UNITED NATIONS, http://bit.ly/2jZMVWk.

[111] U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 2 (Jan. 23, 1973) (1973MANILA00858).

[112] *Id.* par. 3.

[113] Treaty of Peace with Japan, art. 2, ¶ f, Sept. 8, 1951, 3 U.S.T.S 3161, 136 U.N.T.S 45.

[114] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 5 (Jan. 23, 1973) (1973MANILA00858).

[115] Treaty of Peace with Japan, *supra* note 113, pmbl., n.1.

when they issued a statement affirming that the Spratlys remained under Allied trusteeship.[116] They used it again in 1971, when Marcos issued the aforementioned Presidential *communiqué* reiterating that by virtue of the trusteeship conferred by the peace treaty, "no one may introduce troops on any of these islands without the permission and consent of the allied powers,"[117] and that Taiwan should withdraw its troops.[118] They used it once more in 1974, again in protest against the Taiwanese at Itu Aba (and Vietnamese elsewhere in the Spratlys), urging that this matter be brought to the attention of the Allied signatories or the United Nations.[119]

C. The Status of "Kalayaan"

As well as protesting Taiwan's occupation of Itu Aba, the Philippines itself claimed a number of features in an area covering the northeast of the Spratlys, which it dubbed "Kalayaan" (Freedomland). This brings us to the Filipinos' second legal argument relating to the South China Sea. "Kalayaan," they claimed, was a "53 island group" comprising islands, islets, reefs, cays and banks "which Filipino explorer Tomas Cloma explored and occupied from 1950 to 1974."[120] These features, Marcos said at his 1971 press conference, "are regarded as *res nullius* and may be acquired according to the modes of acquisition recognized under international law—among which is occupation and effective administration."[121] At the time, he said, the Philippines were in effective occupation and control of Nanshan Island (in Tagalog, Lawak), Thitu (Pagasa), and Flat Island (Patag).[122] Over the next two-and-a-half years, they expanded their occupation to five features: Nanshan Island, Thitu, West York Island (Likas), Northeast Cay (Parola), and Loaita Island (Kota).[123] By February 1974, they had constructed a weather station on Thitu and a lighthouse on Northeast Cay,[124] and reportedly stationed around thirty troops on each feature.[125]

In early 1974, they took a firmer line over the occupation of the features in the South China Sea than they had done previously, while

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[116] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 5 (Jan. 23, 1973) (1973MANILA00858).

[117] *Id.*

[118] *Id.* par. 6.

[119] Cable from U.S. Embassy Manila to U.S. State Department, Subj: GOP Protests ROC and GVN Show of Force in Spratleys, par. 6 (Feb. 6, 1974) (1974MANILA01389).

[120] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 8 (Jan. 23, 1973) (1973MANILA00858).

[121] *Id.*

[122] *Id.* par. 9.

[123] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratlys, p. 2 (Feb. 28, 1974) (1974MANILA02335).

[124] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratlys, par. 1 (Feb. 14, 1974) (1974MANILA01730).

[125] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: EA Press Summary, par. 7 (Mar. 28, 1974) (1974STATE062701).

embellishing their arguments on trusteeship and *res nullius*. They made a careful distinction between the Spratlys, which they claimed were still under Allied trusteeship, and "Kalayaan," which they claimed was governed by customary international law permitting the occupation of unclaimed territory—although the physical division between the two entities was left deliberately vague.[126]

On January 30, 1974, Foreign Secretary Carlos Romulo produced an *aide memoire* contending that "Kalayaan" was *res nullius* because it was made up of new volcanic and coral outcrops that had appeared after older features that, historically, had been seen as constituting the Spratlys.[127] Eight days later, Juan Arreglado, former Legal Counsel for the Department of Foreign Affairs, produced a different argument, claiming that the Spratlys should be held *res communis* for all the Allied signatories, and that the Philippines, as a signatory, had the right to occupy them without obtaining permission from any nation.[128] Six days after that, Alejandro Melchor, Executive Secretary, produced still more arguments, stating that the Philippines had claimed the islands based on the fact of their occupation, and that they had "assumed an international obligation" with respect to the "safe navigation of commerce" in the South China Sea.[129]

As well as some of these more legalistic claims, Manila also presented more straightforward arguments based economics and security: one was that "Kalayaan" might produce petroleum and oil, which would resolve the Philippines' energy crisis; another (alluding to the fact that Japan had used the features as a staging area for their 1941 invasion of the Philippines) was that its occupation could provide a buffer against hostile forces.[130]

The "trusteeship" and "*res nullius*" arguments for the Philippines' occupation of some features in the Spratlys was given short shrift by Washington. As the State Department made clear, the U.S. government "does not rpt [repeat] not consider that Spratleys were placed under 'de facto trusteeship of the Allied powers' as a result of provisions of 1951 treaty with Japan."[131] It continued:

> Peace Treaty does not rpt not however decide question of sovereignty, since Allied agreement was not possible. As [John Foster] Dulles said at San Francisco Peace Conference in 1951 it was necessary to let the future resolve doubts such as this "by

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[126] Cable from U.S. Embassy Manila to U.S. State Department, Subj: GOP Claims to Spratlys and Kalayaans, par. 3 (8 Feb. 8, 1974) (1974MANILA01478).

[127] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Position with Respect to Spratley [Is]lands, par. 2 (Jan. 30, 1974) (1974MANILA01114).

[128] Cable from U.S. Embassy Manila to U.S. State Department, Subj: GOP Claims to Spratlys and Kalayaans, par. 1 (Feb. 8, 1974) (1974MANILA01478).

[129] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratlys, pars. 2, 5 (Feb. 15, 1974) (1974MANILA01792).

[130] *Id.* pars. 2, 6.

[131] Cable from U.S. State Department to U.S. Consulate General Hong Kong, Subj: Spratley Islands, par. 2 (Feb. 8, 1974) (1974STATE017663).

invoking international solvents other than this treaty." While final disposition of sovereignty issue should be left to decision by Allied powers, no trusteeship as such was created.[132]

That said, the State Department was of the view that the Philippines was not precluded from expanding its territory in the Spratlys by legitimate means, but this expansion would have to meet certain requirements. A memo observed that, "Continuous, effective and uncontested occupation and administration of territory is a primary foundation for establishing sovereignty in absence of international settlement."[133] However, it also noted that "Phil occupation could hardly be termed uncontested in face of claims and protests of Chinese and Vietnamese."[134]

D. Manila's Treaty-based Claims

The Americans were not the only ones paying attention to the Philippines' legal arguments. The Chinese were following them too, and, unsurprisingly, they rejected them.

In 1974, Chinese officials invited Sven Hirdman, the Swedish Deputy Chief of Mission in Beijing, to visit the International Organization and Treaty Law Department of the Chinese Ministry of Foreign Affairs.[135] There, these officials communicated their concerns to him about the implications of the Filipino claims that "Kalayaan" was not part of the Spratlys.[136] They argued that the 1898 Treaty of Paris between the United States and Spain, and the 1946 amended Constitution of the Philippines—which both defined the territory of the Philippines—placed these features outside its territorial limits.[137] The Chinese also rejected the Filipino claims to the features by virtue of occupancy, stating that Chinese ships had visited them long before anyone else, and that they had Ming Dynasty records to prove it.[138] Hirdman was reportedly "impressed" by these arguments.[139]

The Chinese may not have been aware of it, but Washington had arrived at the same conclusion about the legal status of the Philippines' claims. They agreed, for example, that the Spratly marine features "all fall outside Philippine territory as ceded to U.S. by 1898 Treaty with Spain."[140] They also agreed that post-war treaties setting out the

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[132] *Id.*

[133] Cable from U.S. State Department to U.S. Embassy Manila, Subj: US MDT Commitment and Spratlys, par. 5 (Jun. 9, 1975) (1975STATE133765).

[134] *Id.*

[135] Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: PRC View on Philippine Claim to Spratlys, par. 1 (Mar. 1, 1974) (1974PEKING00352).

[136] *Id.*

[137] *Id.*

[138] *Id.* par. 2.

[139] *Id.* par. 3.

[140] Cable from U.S. State Department to U.S. Embassy Manila, Subj: US MDT Commitment and Spratlys, par. 3 (Jun. 9, 1975) (1975STATE133765).

territorial limits of the Philippines did not include the Spratlys.

The Americans focused their attention on the Mutual Defense Treaty (MDT), which it had agreed with the Philippines in October 1951, just a month after the conclusion of the Peace Treaty with Japan. The State Department noted that when the MDT was signed,

> GOP [Government of Philippines] had asserted no claim to any of Spratly Islands, and had protested neither Vietnamese nor Chinese claims, which had been reiterated at time of negotiation of 1951 Japanese Peace Treaty. USG [U.S. Government] announced publicly at that time it considered sovereignty question undetermined. Furthermore ... USG maps accompanying presentation of MDT also exclude Spratlys from territories covered by MDT.[141]

Under Article 5 of the MDT, the United States and the Philippines were committed to mutual defense in the event of armed attack on "the metropolitan territory of either of the Parties, or on the island territories under its jurisdiction in the Pacific, or on its armed forces, public vessels or aircraft in the Pacific."[142]

With respect to the first element, the Americans concluded that the Spratlys could not be considered to be "metropolitan territory" as they were not part of the Philippines' uncontested sovereign jurisdiction and did not appear on the maps used during the negotiations.[143] With respect to the second element, the Spratlys could not be regarded as "island territories under its jurisdiction in the Pacific" because, the Americans argued, this provision was designed at the time to cover territories administered by a party under an international agreement, such as the U.S.-administered U.N. Trust Territories or Okinawa.[144] The Philippines did not administer islands under these conditions because the "US does not consider [the] Japanese Peace Treaty [to have] created de facto Allied power trusteeship over Spratlys, and we would not regard the Spratlys as thus being islands under jurisdiction of either party (or both)."[145] Finally, on the third element regarding attacks on "armed forces, public vessels and aircraft in the Pacific," the Americans decided that the MDT "does not obligate us to support this type of deployment in event of armed attack" because it had not recognized either the Philippines' or the other states' claims to the Spratlys.[146]

Referring back to the treaty negotiations, they stated that they had "found nothing ... to indicate that treaty protection of armed forces of party in Pacific was intended to extend to such forces as may be

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[141] *Id.*

[142] *Id.* par. 2; Mutual Defense Treaty between the Republic of the Philippines and the United States of America, Aug. 30, 1951, 3 U.S.T. 3947.

[143] Cable from U.S. State Department to U.S. Embassy Manila, Subj: US MDT Commitment and Spratlys, par. 3 (Jun. 9, 1975) (1975STATE133765).

[144] *Id.* par. 4.

[145] *Id.*

[146] *Id.* par. 9.

stationed in notoriously disputed territories such as Spratleys for purpose of establishing or enforcing claim to that disputed territory."[147] They also noted that the MDT had to be interpreted in light of Article 1, which obliged them to refrain from the "threat or use of force in any manner inconsistent with U.N. Charter."[148] Looking forward, the United States wanted to avoid creating a precedent for a situation in which "Phils ever tried to invoke MDT with respect to Sabah" or "NATO were invoked by either side in Greece-Turkey territorial disputes."[149]

In conclusion, the United States' commitment to the Philippines could not be "boot-strapped into commitment for defense of territory not included in first two categories" of Article 5,[150] especially if it had the effect of propelling them into "a military confrontation with the PRC or Vietnam ... [when] they were merely countering Philippine acts against territories to which they have strong claims."[151]

The Americans did not accept the Filipino *res nullius* argument either. During the negotiations over the renewal of the MDT in 1976, the issue of contested claims came up in an exchange between Ambassador Sullivan and the Filipino negotiators, Senator Emmanuel Pelaez and General Romeo Espino, over the Philippines-occupied features in the northeast Spratlys, including the reef area known as Reed Bank.[152] In the hasty transcription of the meeting, Sullivan, referring to Thitu, stated:

> "The occupation of the islands themselves—I guess you have the biggest one—the one where you have your airstrip ..."
> Senator Pelaez – "The Reed Bank however, is not so much ... is not in the Spratlys."
> Amb. Sullivan – "Well, that depends on who defines the Spratly."
> Gen Espino – [ ] "That is a different group["]
> Amb. Sullivan – "The Chinese say it is Nan Sha and has been theirs since 1412."[153]

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[147] Cable from U.S. Secretary of State to U.S. Consulate General Hong Kong, Subj: Spratley Islands, par. 1 (Feb. 8, 1974) (1974STATE017663).

[148] Cable from U.S. State Department to U.S. Embassy Manila, Subj: US MDT Commitment and Spratlys, par. 6 (Jun. 9, 1975) (1975STATE133765) (quoting Mutual Defense Treaty between the Republic of the Philippines and the United States of America, Aug. 30, 1951, 3 U.S.T. 3947).

[149] *Id.* par. 11.

[150] *Id.* par. 10.

[151] Cable from U.S. State Department to U.S. Delegation, Subj: Briefing Memorandum: Philippine Aide Memoire on the US Commitment, par. 12 (Aug. 8, 1976) (1976STATE196878).

[152] Cable from U.S. Embassy Manila to U.S. State Department et al., Subj: Mutual Defense Treaty—Reed Bank, p. 2 (Jul. 30, 1976) (1976MANILA11299).

[153] *Id.* (ellipses in original).

IV. THE SPRATLYS CARVE-UP BEGINS

A. Vietnam Moves In

From 1971 onwards, the Philippines occupied a number of features in the northeast of the group, and then, from 1973 onwards, the South Vietnamese occupied a number of others. The scramble for the Spratlys had begun.

In August 1973, Saigon stationed 64 men on Namyit Island (in Vietnamese, Nam Yet).[154] Then on January 30, 1974, just ten days after the Paracels clash, it dispatched a new task force reportedly consisting of a cutter, a patrol craft escort, and an LSM carrying 136 men to occupy five more features in the Spratlys: Sin Cowe Island (Sinh Ton), Spratly Island (Truong Sa), Amboyna Cay (An Bang), Southwest Cay (Song Tu Tay) and Sand Cay (Son Ca).[155] Of the men on the LSM, 17 were to relieve some of the troops already stationed on Namyit and the rest were to be distributed in groups of 20 to 30 around the five features.[156] Ambassador Martin reported to Washington that the task force commander had been ordered to occupy only unoccupied features, and "not to engage in any hostile action toward any forces which might be in the area and not to attempt to land troops on any occupied islands."[157] The press speculated on Saigon's motives: to find offshore oil, to pre-empt China from occupying them (or handing them over to Hanoi), to ignite anti-Chinese nationalist sentiment, to distract attention from domestic problems, and to embarrass the North Vietnamese and the PRG.[158]

These newly occupied features were low-lying reefs or sandbars, some of them shaped like "inner-tubes" enclosing shallow lagoons.[159] According to an official report, the South Vietnamese headquarters were located on Namyit Island, under the command of First Lieutenant Doan Cam Tiem, and the troops were divided between Namyit and four other features (but not Amboyna Cay, as originally reported, because it was only two hectares and barely a metre above sea level).[160] The troops took with them weapons, shelters, bedding, sampans, and gear with which to catch food[161] (mainly sea-life and birds). The following month, Saigon

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[154] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: Spratly Islands, par. 3 (Jan. 31,1974) (1974SAIGON01347).

[155] *Id.* The UPI report incorrectly listed "Southwest Cay" (Song Tu Tay) as Philippines-occupied "Northeast Cay."

[156] *Id.*

[157] *Id.* par. 4.

[158] Cable from U.S. State Department to All East Asian Diplomatic Posts, Subj: EA Press Summary, par. 1 (Feb. 6, 1974) (1974STATE024979).

[159] Cable from U.S. Embassy Bangkok to U.S. State Department, Subj: Chinese Seizure of the Paracels, par. 2 (Feb. 4, 1974) (1974BANGKO01573).

[160] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: GVN Announcement of Garrisoning of Spratly Islands, par. 5 (Feb. 23, 1974) (1974SAIGON02411).

[161] *Id.* par. 7.

reportedly sent 500 tons of construction materials out to the features, along with engineers to assist with the building of bunkers and permanent housing.[162]

All this shows that the Spratlys already had been "invaded" in recent years before China got in on the act. The largest feature, Itu Aba, had been occupied by Taiwan in 1956, and ten more features had been occupied by the Philippines and South Vietnam between 1971 and 1974. All three nations constructed defense facilities and housing, as well as piers, lighthouses, weather stations, and airstrips. And all three mounted patrols: in March 1974, for example, it was reported that the South Vietnamese kept two warships and the Taiwanese kept three warships in the area.[163] All these parties kept one eye on each other and the other on the not-so-sleepy Chinese giant.

B. The Big Question

How would China respond to Saigon's latest moves in the South China Sea? On 4 February 1974, the Foreign Ministry in Beijing gave its answer. It warned that it would "not tolerate infringement on China's territorial integrity" in the Spratlys[164]—but, crucially, it did not threaten immediate action.

Even so, the various occupants of the Spratlys were jittery, and attempted to engage the United States in the discussion about the implications of a Chinese strike at the Spratlys. South Vietnam's Ambassador Phuong told the Americans that if China took action, it would be "a more serious situation than in the Paracels" because it would "place the PRC in a busy ocean area with potential for economic exploitation" and "cast doubt on the possibility of detente in Southeast Asia."[165] The Filipinos, meanwhile, made clear to the Americans their concerns about China inserting itself into the area of shipping lanes through the South China Sea.[166]

The Americans refused to be drawn. The State Department line was to say nothing, or, if really pressed, to say only that "the U.S. takes no position on the sovereignty of these islands."[167] (The American delegate to ECAFE was told to avoid referring even to a "dispute" over the Spratlys, as it would "likely occasion sharp PRC retort."[168]) When

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[162] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: EA Press Summary, par. 1 (Mar. 12, 1974) (1974STATE049497).

[163] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: EA Press Summary, par. 7 (Mar. 28, 1974) (1974STATE062701).

[164] Cable from U.S. State Department to U.S. Embassy Kuala Lumpur, Subj: Weekly Round-up on Easy Asian Affairs, par 17 (Feb. 11, 1974) (1974STATE027235).

[165] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Paracels/Spratlys, par. 6 (Feb. 7, 1974) (1974STATE025541).

[166] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Position with Respect to Spratley [ ]Islands, par. 6 (Jan. 30, 1974) (1974MANILA01114).

[167] Cable from U.S. State Department to US Embassy Colombo, Subj: Paracels/Spratly Islands Dispute, par. 3 (Apr. 2, 1974) (1974STATE065649).

[168] *Id.*

Deputy Assistant Secretary Stearns met Phuong just after China's statement, he suggested that Saigon should focus on defeating the North Vietnamese rather than baiting the Chinese out of "wounded national pride."[169] Stearns continued:

> Quite aside from obvious disadvantages Saigon would have in a shoving contest with Peking, [he] thought that dispute could badly damage prospects for getting additional military and economic aid for Vietnam from Congress. Even those on [Capitol] Hill who generally favored our efforts to help GVN defend itself against North Vietnam would be unenthusiastic about strengthening Saigon for further gun-boat skirmishes with Chinese.[170]

Behind the scenes, the Americans did not believe that China was considering an assault on the Spratlys.[171] This assessment was based on three calculations. First, they assumed that China would not want to embroil itself in a dispute with Taiwan, the Philippines, and other Southeast Asian states during the delicate period of transition following the United States' withdrawal from the region.[172] Second, they predicted that the Chinese would find it even more difficult to make a legal case for self-defense in the Spratlys than they had in the Paracels.[173] Finally, they calculated that the Chinese lacked the military reach to sustain an assault on the Spratlys: while the Paracels incident had shown that they could carry out short-range air operations using antique IL-28s,[174] the distances between China's air bases on Hainan and Liuchow peninsula and the Spratlys "may be such as to limit PRC use of airpower (Mig-15s, 17s, 19s and IL-28s), if not rule it out entirely."[175]

C. Hanoi Ousts Saigon

In April 1975, another event rocked the region: the disintegration of the South Vietnamese regime. Just weeks before a North Vietnamese tank famously ripped the gates off the Presidential Palace in Saigon, Hanoi dispatched naval vessels across the South China Sea to wrest the Spratly features from their South Vietnamese occupants. On 14 April, they launched an amphibious assault on Southwest Cay, which was occupied at the time by 29 South Vietnamese soldiers and four radio

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[169] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Paracel/Spratley Islands Secret, par.2 (Feb. 6, 1974) (1974STATE025259).

[170] *Id.*

[171] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Weekly Wrap-Up on East Asian Affairs, par. 9 (Feb 2, 1974) (1974STATE022409).

[172] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking and the Spratlys, par. 4 (Feb. 2, 1974) (1974HONGK01194).

[173] Cable from U.S. State Department to U.S. Embassy Saigon, Subj: Paracels/Spratlys, par. 4 (Feb, 7, 1974) (1974STATE025541).

[174] *Id.* par. 2.

[175] Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: Position with Respect to Spratley Islands, par. 2 (Jan. 29, 1974) (1974PEKING00178).

and weather station operators.[176] According to Filipino reports from a salvage vessel and marine units in the vicinity:

> An unidentified craft was observed discharging UDT team on Southwest Cay. Shortly thereafter, an explosion was heard, and an NLF [National Liberation Front] flag was observed flying on the island. Radio contact with the island was also lost on or about that time.[177]

Southwest Cay was only 3,000 meters away from Northeast Cay, which was occupied by the Philippines. One member of the South Vietnamese force swam from one feature to the other, and "defected" to the Filipino side.[178] The North Vietnamese reportedly shipped the rest of the South Vietnamese as prisoners back to Danang, and started to build up fortifications on Southwest Cay.[179] By May 7, the new Vietnamese government proclaimed the liberation of all the features from the South Vietnamese.[180]

Meanwhile, back on Northeast Cay and Southwest Cay, the Vietnamese and Filipinos surveyed each other across the water. To prevent a clash, the Philippines decided to withdraw their marines on Northeast Cay under the cover of darkness, leaving just the Filipino flag flying to signal its claim to the feature.[181] The absence of any daytime activity would soon have become apparent to the Vietnamese, camped just a short distance away, and, as Ambassador Sullivan dryly noted in Manila, "I would ... expect that, in [a] short while, Vietnamese will occupy Parola and demonstrate their warm feelings of fellowship with their Philippine neighbors."[182]

The Vietnamese did indeed land on Northeast Cay, and they hauled down the Filipino flag, but then, contrary to Sullivan's expectation, they departed again.[183] This suggests that while the Socialist Republic of Vietnam was keen to claim the features previously occupied by South Vietnam, it did not intend to pick a fight with the other claimants to the Spratlys. The Filipino marines soon returned to Northeast Cay,[184] and they remain there to this day.[185]

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[176] Cable from U.S. Embassy Saigon to U.S. State Department, Subj: Disputed Territories in South China Sea, par. 1 (Apr. 18, 1975) (1975SAIGON05275).

[177] *Id.*

[178] Cable from U.S. Embassy Manila to U.S. State Department, Subj: GOP Concern over NVN Incursion into Spratley Area, par. 3 (Apr. 24, 1975) (1975MANILA05250).

[179] *Id.*

[180] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratly Islands, par. 1 (May 7, 1975) (1975MANILA06055).

[181] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 2 (May 27, 1975) (1975MANILA07196).

[182] *Id.* par 4.

[183] Cable from U.S. Embassy Manila to U.S. State Department, Subj: GOP Action in Spratly Island Area, par.1 (Aug. 27, 1975) (1975MANILA11980).

[184] *Id.*

[185] Arbitration, *supra* note 1, ¶ 405.

D. Activity on Reed Bank

This brings us to some final episodes relating to the South China Sea in the mid-1970s, which revolved around the area of the Spratlys known as Reed Bank. Located in the vicinity of the Filipino-occupied Nanshan and Flat islands (Lawak and Patag), this was a vast bank of reefs and shoals some 180 nautical miles off the coast of Palawan in the Philippines. Like the rest of the Spratlys, Reed Bank fell outside the aforementioned 1898 Treaty of Paris which defined the territorial limits of the Philippines, but within the area that Manila claimed as "Kalayaan."[186] Bearing in mind that UNCLOS (which specified that an exclusive economic zone extended to 200 nautical miles) was still in the process of being negotiated, the Philippines claimed Reed Bank on two other grounds: first, its proximity to the Philippines, and second, as part of its continental shelf.[187]

From 1972 onwards, the Philippines quietly began to divide up Reed Bank—some two million hectares—and solicit applications for oil exploration concessions.[188] By August 1975, a number of oil companies, including American companies, had applied. [189] Ambassador Sullivan proposed warning the American companies of the risks of engaging in commercial activities in disputed waters: "We have in mind perhaps a warning of the type previously issued to Gulf, inter alia, respecting the Senkakus." [190] The State Department agreed, recommending he tell them that "because of the conflicting international claims in the Reed Bank area USG will continue strongly to advise American companies against participating in oil exploration or drilling there."[191]

According to the cables, Sullivan thus warned two American outfits—Brinkerhoff Maritime Drilling Corporation and Salen Group—that the United States could not provide protection for American personnel or vessels operating in the area.[192] Both apparently ignored the advice, and Brinkerhoff started spudding a well at Reed Bank in April 1976.[193] Manila was aware that Sullivan was warning off U.S. companies,[194] and stepped up its protection of the Brinkerhoff/Salen operation on Reed Bank, providing air and marine surveillance, and

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[186] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Petroleum Concessions and the Spratly Dispute, par. 1 (Feb. 8, 1974) (1974MANILA01524).

[187] *Id.* par. 3.

[188] *Id.* par 1.

[189] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Melchor's Call on SecDef Tokyo, par. 7 (Aug. 28, 1975) (1975MANILA12020).

[190] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Petroleum Concessions in the Spratly Areas, par. 7 (Sep. 5, 1975) (1975MANILA12464).

[191] *Id.* par. 1.

[192] Cable from U.S. State Department to US Embassy Manila, Subj: American Drilling in Reed Bank Area, par. 2 (Apr. 24, 1976) (1976STATE099563).

[193] *Id.* par. 1; Cable from U.S. Embassy Manila to U.S. State Department, Subj: American Drilling in Reed Bank Area, par. 1 (May 4, 1976) (1976MANILA06164).

[194] *Id.* par. 4.

anchoring a patrol boat adjacent to the Brinkerhoff drilling barge.[195] Sullivan bad no doubt that the Philippines' involvement with Brinkerhoff was calculated: the Manila government, he wrote, "had previously attempted [to] interest two fairly large U.S. petroleum companies in exploration of Reed Bank area, partly because U.S. has only available commercial technology for operating in this environment and partly because Marcos wants U.S. to have a direct interest in this confrontation."[196]

At the same time, the Philippines also stepped up its activities on the features it already occupied, and by 1976, it had constructed an airfield and stationed artillery on Thitu.[197] As Sullivan commented, the major weakness in the Philippines' posture hitherto had been its inability to move its forces around except by sea: the construction of the airstrip was "presumably designed to meet need for ability to move forces rapidly on and—more likely—rapidly off islands in event of conflict."[198] This airstrip soon proved useful for other reasons. According to intelligence received by the Americans, the Filipinos were flying small armed T-28s from Palawan out to Thitu. These aircraft were then carrying out aerial photographic reconnaissance missions over the Vietnamese garrison on Southwest Cay and the Taiwanese garrison on Itu Aba.[199] This activity did not go unnoticed, and on May 14, 1976, the Vietnamese on Southwest Cay fired on a Filipino T-28 carrying out one of these sorties.[200] The arrival of the oil companies on Reed Bank threatened to ignite what was already a combustible situation.

E. The Mutual Defense Treaty Bluff

All of this posed a conundrum for the United States—a conundrum that would be exploited by Manila during negotiations over the renewal of the MDT, which included the decision on whether to renew the leases on the Americans' Clark Air Base and Subic Bay Naval Base on Luzon in the Philippines. At issue was the commitment of each party of the MDT to meet the "common dangers" provision set out in Article 4.[201] Would the United States take action alongside the Philippines to protect its own forces at Clark and Subic Bay against "common dangers" posed by a third state to the Philippines? Yes, of course it would. And would

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[195] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratly Islands, par. 2 (May 6, 1976) (1976MANILA06304).

[196] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Involvement in Spratly Islands, par. 6 (May 24, 1976) (1976MANILA07149).

[197] Cable from U.S. State Department to U.S. Embassy Manila and CINCPAC, Subj: [P]hilippine Involvement in Spratly Islands, par. 1 (May 21, 1976) (1976STATE124807).

[198] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Interest in Spratleys, par. 3 (Jan. 12, 1976) (1976MANILA00571).

[199] Cable from U.S. State Department to U.S. Embassy Manila and CINCPAC, Subj: [P]hilippine Involvement in Spratly Islands, par. 1 (May 21, 1976) (1976STATE124807).

[200] *Id.* par. 2.

[201] Mutual Defense Treaty between the Republic of the Philippines and the United States of America, *supra* note 142, art. 4.

the United States take action alongside the Philippines to protect Reed Bank against "common dangers" posed by another claimant to the Spratlys? No, it would not. This was held up by the Philippines as an example of bad faith: the United States was prepared to defend only what was important to itself, not to the Philippines, and this, as Sullivan noted, would have "strong negative consequences on our base talks."[202]

Throughout the summer of 1976, Manila pressed Washington for an explicit statement about the United States' obligations to the Philippines over Reed Bank under Articles 4 and 5 of the MDT in the event of an "emergency."[203] President Marcos got involved, stating that progress on the negotiations over the military bases was directly related to a satisfactory American response to the Philippines' Reed Bank claims.[204] Without this clarification, the Philippines would demand that the Americans pay rent or compensation for the bases, on the grounds that there was no genuine mutuality in the United States-Philippines alliance.[205]

This was a bluff, and both parties knew it. The Americans took the view that the Filipinos, who feared an assault from a rival claimant to the Spratlys, adopted this tactic to strengthen, rather than weaken ties with the United States. They wanted the Americans to go on record as saying that they were willing to defend the Philippines' claims to the Spratlys—thereby gaining "maximum insurance from [the] U.S." in the event of an attack by the militarily superior Chinese or Vietnamese forces.[206]

The Americans pushed back. During the MDT negotiations, Sullivan (as he reported back to Washington), explained repeatedly to the Filipino negotiators:

> (1) that US and Phils have differing interpretations of the status of the claimed areas west of the Palawan Trench—the Reed Bank and the Spratlys;
>
> (2) that we have a differing interpretation on the continental shelf, viewing the Palawan Trench as a derogation of the continuity of the continental shelf;
>
> (3) that we are aware of the claims in this area of the Philippines, Vietnam, the PRC, the Republic of China, and perhaps France, and consider this a d[i]sputed area;
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> (4) that we will do nothing that might diminish the Philippine

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[202] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Involvement in Spratly Islands, par. 7 (May 24, 1976) (1976MANILA07149).

[203] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippines Base Negotiations: Daily Summary No. 10, par. 5 (Jul. 3, 1976) (1976MANILA09675).

[204] Cable from U.S. State Department to U.S. Delegation Secretary, Subj: Marcos-Robinson meeting, par. 2 (Aug. 6, 1976) (1976STATE195292).

[205] Cable from U.S. Embassy Manila to U.S. Embassy Canberra, Subj: U.S. Defense Commitment to the Philippines, par. 4 (Aug. 2, 1976) (1976MANILA11355).

[206] *Id.*

claim and that we would hope that there can be a peaceful solution among the various claimants.[207]

F. The Continental Shelf Question

Sullivan's reference to the Palawan Trench was of particular interest, given the contemporaneous debates taking place at the U.N. Conference on the Law of the Sea. The Filipinos claimed that Reed Bank was part of their continental shelf, and thus part of the territory covered by defense obligations set out by the MDT.[208] They were seemingly undeterred by the fact that the shelf was split lengthways by the 1,600-meter-deep Palawan Trench, which ran between Palawan in the Philippines and Reed Bank beyond it: Solicitor General Estelito Menoza claimed that the trench was part of the shelf—not a boundary to it.[209]

To support this claim, the Philippines apparently relied on Article 1 of the 1958 Geneva Convention on the Continental Shelf (to which it was not a party), which stated that the term "continental shelf" referred to "the seabed and subsoil of the submarine areas adjacent to the coast but outside the area of the territorial sea, to a depth of 200 metres or, beyond that limit, to where the depth of the superjacent waters admits of the exploitation of the natural resources of the said areas."[210] Although the Philippines had no demonstrable plans to plumb the depths of the Palawan Trench for resources,[211] its ground for treating it as part of its continental shelf was based on the existing state practice, which suggested that trenches were not regarded as terminating the continental shelf.[212]

The Americans countered by arguing that the Palawan Trench interrupted the contiguity of the Philippine continental shelf, placing Reed Bank beyond the Philippines' territorial jurisdiction, and thus beyond the remit of the MDT.[213] Between themselves, though, the Americans admitted that this legal position was not conclusive.[214]

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[207] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippines Base Negotiations: Daily Summary No. 10, par. 5 (Jul. 3, 1976) (1976MANILA09675).

[208] Cable from U.S. Embassy Manila to U.S. State Department, Subj: U.S. Obligations under Mutual Defense Treaty, pars. 1, 4 (Jul. 29, 1976) (1976MANILA11209).

[209] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Petroleum Concessions and the Spratly Dispute, par. 3 (Feb. 8, 1974) (1974MANILA01524).

[210] Convention on the Continental Shelf, art. 1, Apr. 29, 1958, 15 U.S.T. 471, 499 U.N.T.S. 311.

[211] Cable from U.S. State Department to U.S. Embassy Manila, Subj: Visit of DepSec Robinson: Briefing Papers—Spratly Islands and Reed Bank, par. 6 (Aug. 4, 1976) (1976STATE193353).

[212] *Id.*

[213] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippines Base Negotiations: Daily Summary No. 10, par. 5 (Jul. 3, 1976) (1976MANILA09675).

[214] Cable from U.S. State Department to U.S. Embassy Manila, Subj: Visit of DepSec Robinson: Briefing Papers—Spratly Islands and Reed Bank, pars. 4, 7 (Aug. 4, 1976) (1976STATE193353).

Referring to Article 6 of the aforementioned Convention, they acknowledged the long-held U.S. view that the boundaries of continental shelves between neighboring states should be determined *by agreement* in accordance with equitable principles.[215] When coming to agreement:

> We recognize it as possible that states may agree to disregard trenches in the shelf between them, or that equitable principles may support a state's desire to leap a nearby trench. An example of an agreement to disregard a trench is that between Norway and Great Britain where the trench falls just off Norway's coast. We ourselves have disregarded trenches off the Pacific coast, and are involved currently in a complex dispute with Canada over the Gulf of Maine, in which we argue that equitable principles should be a major determining factor in delimitation of the shelf.[216]

Moreover, Article 6(2) of the Convention provided for circumstances when agreement between neighboring states was absent, stating that "unless another boundary line is justified by *special circumstances*, the boundary shall be determined by application of the principle of *equidistance*."[217] If the Philippines had been party to the Convention, and another state—say, China—exercised sovereign jurisdiction over the Spratlys, the Philippines could claim Reed Bank on the basis of either equidistance or "special circumstances."[218] But the Philippines was bound by neither treaty nor custom (as "the Convention in this regard is not regarded as binding customary international law") and this allowed it to adopt an "even more aggressive stance on the right to part of Reed Bank."[219]

While this debate was unfolding, Marcos travelled to Beijing to meet Mao Zedong and senior Chinese ministers. A year later, in 1976, he recounted parts of their conversation back to the Americans. Among other things, he said he had reminded the Chinese that several countries occupied the Spratlys, and had enquired whether they intended to "chase Chinese Nationalists out of Itu Aba."[220] Deng Xiaoping had apparently replied that the Nationalists also still occupied Taiwan, "which was of more importance to Peking than Itu Aba."[221] When Marcos pressed the matter, Deng had suggested that at least for the time being, the "status quo could continue even though [the] PRC

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[215] *Id.* par. 4.

[216] *Id.*

[217] Convention on the Continental Shelf, *supra* note 210, art. 6(2) (emphases added).

[218] Cable from U.S. State Department to U.S. Embassy Manila, Subj: Visit of DepSec Robinson: Briefing Papers—Spratly Islands and Reed Bank, par. 5 (Aug. 4, 1976) (1976STATE193353).

[219] *Id.*

[220] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratly Islands Dispute, par. 3 (Aug. 9, 1976) (1976MANILA11802).

[221] *Id.*

regarded all the islands as Chinese."[222] Marcos reportedly took this to be a tacit agreement that the Chinese would turn a blind eye to the Filipinos' occupation of the Spratlys features.[223]

Back in Manila, Sullivan, considering this exchange, concluded that Marcos's ultimate goal in the Spratlys was to carve out a space for the Philippines that was focused less on the small land features and more on the potentially petroleum-rich seabeds and subaqueous formations in the vicinity of Reed Bank and elsewhere.[224] Marcos would "take whatever he can get," he said, "but his game ... is apparently to advance claims to as much as he can credibly encompass, so that he can fall back to a North Sea type seabed partition which will give him something west of the Palawan Trench."[225] This tactic is still being pursued today.

V. THE TRIBUNAL STEPS IN

A. *Maintaining the* Status Quo

Back in the 1970s, it was widely expected that China would follow up the take-over of the Paracels with an invasion of the Spratlys—but as it turned out, it did not. Observers speculated that the cost to China of antagonizing the members of SEATO or the Association of Southeast Asian Nations (ASEAN) was simply too great, and suggested that China lacked the capacity to extend its air cover or sustain a victory over the Spratlys.[226] The most likely reason, though, was that China felt that it had made its point forcefully enough in the Paracels, and was prepared to tolerate the *status quo* in the Spratlys provided that no other claimant rocked the boat.[227]

If this was the case, then it raises a vital point about the recent award made by the Permanent Court of Arbitration, to which we now turn.

B. *A Question of Jurisdiction*

When bringing its case at The Hague, the Philippines mounted a four-pronged challenge to China's activities within the Spratlys. It asked the Tribunal to declare that China's claim to the South China Sea

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[222] *Id.*

[223] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Philippine Involvement in Spratley Islands, par. 3 (May 24, 1976) (1976MANILA07149).

[224] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratly Islands Dispute, par. 6 (Aug. 9, 1976) (1976MANILA11802).

[225] *Id.*

[226] See, for example, Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking and the Spratlys, pars. 2, 4 (Feb. 2, 1974) (1974HONGK01194); Cable from U.S. Liaison Office Peking to U.S. State Department, Subj: Position with Respect to Spratley Islands, par. 2 (Jan. 29, 1974) (1974PEKING00178).

[227] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Peking's Calculations in the Paracels War, par. 5 (Jan. 30, 1974) (1974HONGK01036).

within the "nine-dash line" exceeded its UNCLOS entitlements;[228] that the disputed Scarborough Shoal and certain Spratlys features did not generate any marine entitlements;[229] that China was interfering with the Philippines' maritime fishing, oil exploration, navigation, and construction activities;[230] and that China was both "failing to protect" and "inflicting severe harm" on the marine environment.[231]

All the elements of the drama that has been unfolding since the 1970s were present here: the contested claims to the Spratlys area, the militarization of the South China Sea, the aerial surveillance of rivals' features—even the exploratory activity on Reed Bank.[232] Yet the Philippines also gave a new environmentalist twist to the proceedings with its claims that China had damaged reef ecosystems and the marine environment by, among other things, building artificial islands on reefs and acquiescing to the harvesting of giant clams.[233]

As is well known, China rejected the Philippines' move to arbitration and did not participate in or accept the outcome of the proceedings.[234]

When responding to the Philippines' requests, the Tribunal was operating under two jurisdictional restraints. First, UNCLOS does not deal with land territory, so the Tribunal could not decide a state's sovereignty over the Spratlys features themselves; it could only consider the maritime zones that surrounded them.[235] Second, China had in 2006 made a declaration to UNCLOS precluding international court decisions about sea boundary delimitation, in accordance with Article 298(1)(a)(i).[236] Consequently, the Tribunal could not make a decision about *overlapping* maritime claims, as this would have involved sea boundary delimitation. It could only make a decision about claimed entitlements if there were *no* overlap: "where—for instance—a State claims maritime zones in an area understood by other States to form part of the high seas or the Area for the purposes of the Convention."[237]

Of particular interest were the Philippines' requests for declarations on the status of reefs occupied by China near or within the Philippines' exclusive economic zone, and, connected to that, the entitlement of these reefs to certain maritime zones—namely, exclusive economic zones and continental shelves.[238]

Even if the Tribunal found that none of the reefs generated these

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[228] Arbitration, *supra* note 1, ¶ 7.

[229] *Id.* ¶ 8

[230] *Id.* ¶ 9.

[231] *Id.*

[232] *Id.* ¶¶ 656-657.

[233] *Id.* ¶¶ 9, 764.

[234] *Id.* ¶¶ 11.

[235] *Id.* ¶ 5.

[236] *Id.* ¶¶ 6, 202-203; UNCLOS, *supra* note 109, art. 298.

[237] *Id.* ¶ 155 (citing *South China Sea Arbitration* (Phil. v. China), PCA Case No. 2013-19, Award on Jurisdiction and Admissibility, ¶ 156 (Perm. Ct. Arb. 2015), http://bit.ly/2aDybcN).

[238] *Id.* ¶¶ 643-647 (on Submissions 3, 5, 6, 7), ¶¶ 303-304 (on Submissions 4, 6).

maritime zones—and it did so find[239]—this was not the end of it. If any *other* feature claimed by China and entitled to maritime zones was situated within 200 nautical miles of certain reefs, "the resulting overlap and the exclusion of boundary delimitation from the Tribunal's jurisdiction by Article 298" [240] would prevent the Tribunal from addressing the majority of the fifteen submissions—namely, submissions 3, 4, 5, 6, 7, 8, 9, 12(a) and (c), and 15. In other words, the Tribunal's jurisdiction over these would be triggered *only* if there were no maritime-zone-generating features within the entire Spratlys group—which, as we recall, was claimed in its entirety by China.

C. "Islands" and "Rocks"

This brings us to Article 121 UNCLOS, which defines "islands," which generate maritime zones, and non-islands—"rocks"—which do not. It states:

> 1. An island is a naturally formed area of land, surrounded by water, which is above water at high tide.
> 2. Except as provided for in paragraph 3, the territorial sea, the contiguous zone, the exclusive economic zone and the continental shelf of an island are determined in accordance with the provisions of this Convention applicable to other land territory.
> 3. Rocks which cannot sustain *human habitation or economic life of their own* shall have no exclusive economic zone or continental shelf.[241]

In other words, Article 121 first defines an island; second, provides a rule about islands (they generate the same maritime zones as other land territory); and third, sets out an exclusion—namely, rocks. The Tribunal addressed the exclusion. As indicated by Article 121(3), rocks cannot sustain "human habitation or economic life of their own" and do not generate the aforementioned maritime zones. It reasoned inversely—and without much reflection—that islands *must* therefore be able to sustain "human habitation or economic life of their own" in order to generate the maritime zones.[242] The Tribunal applied this formula to all of the Spratlys features, including its largest, Itu Aba, occupied by Taiwan, and concluded that "neither Itu Aba, nor any other high-tide feature in the Spratly Islands, is a fully entitled island for the purposes of Article 121 of the Convention."[243]

Was this reasoning persuasive? Taking as its starting point the phrase "human habitation," the Tribunal began to construct a far

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[239] *Id.* ¶ 1203B.

[240] *Id.* ¶¶ 630, 1203A.

[241] UNCLOS, *supra* note 109, art. 121 (emphasis added).

[242] It asserts, for example, that "if a feature is capable of sustaining either human habitation or an economic life of its own, it will qualify as a fully entitled island." Arbitration, *supra* note 1, ¶ 494.

[243] *Id.* ¶ 632.

narrower definition of an island than appeared in Article 121. To meet the standard, it would have to have "non-transient inhabitation ... by a stable community of persons who have chosen to stay and reside on the feature in a settled manner,"[244] or, put another way, inhabitation by a "stable community of people for whom the feature constitutes a home and on which they can remain."[245] These descriptions encompass three ideas: that humans inhabit an island voluntarily, that they are constituted as a "community," and that this community is "stable," "settled," and "non-transient." (The Tribunal adds to this rather rigid concept of community the caveat that it "need not necessarily be large, and in remote atolls a few individuals or family groups could well suffice."[246])

This adds a lot of baggage to two plain words, "human habitation"—and goes beyond the UNCLOS drafters' intent. The drafters, after all, were simply discussing the *absence* of human habitation from a rock, which is easy to establish (did people live there or not?). The Tribunal, by contrast, was not merely considering the *presence* of human habitation on an island (did people live there or not?) but further, specifying that such presence had to be *voluntary*, *communal* and *non-transient*.

The Tribunal's more selective approach was apparent when it rejected the idea that humans who lived on the features but did not meet all three conditions could constitute "human habitation." It thus stated that the fishermen who reportedly occupied the features at one time or other were not the "natural" population of the Spratlys, but mere itinerants, because they were not described as being "of Itu Aba" or "of Thitu" and were not accompanied by their families.[247] It also declared that garrisoned soldiers— on, say, Itu Aba or Thitu—were not there of their own accord, but only because they were performing their military duties, and would not stay on "if the official need for their presence were to dissipate."[248] Finally, it also stated that civilians, recently arrived on the features, were only present courtesy of the governments concerned, for reasons "motivated by official considerations" connected with the disputes over the features' sovereignty.[249] Whether true or not (these assertions are not supported by sources), the Tribunal appears to be straining towards the classification of the features as rocks rather than as islands.

D. Inhabitants and "Habitation"

What, then, are the prerequisites for "human habitation"? Drawing

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[244] *Id.* ¶ 618.
[245] *Id.* ¶ 542.
[246] *Id.*
[247] *Id.* ¶ 618.
[248] *Id.* ¶ 620.
[249] *Id.*

on the Tribunal's own cited sources as well as some of the previously cited U.S. cable traffic from the 1970s and earlier, we will focus on Itu Aba, the largest feature in the Spratlys. The record may not be complete, but it is detailed enough to present a picture of near-continuous habitation over the last century. The Tribunal notes that from the early 1920s to 1929, a Japanese guano mining company occupied Itu Aba, stationing up to 600 people there in 1927.[250] After that, two more Japanese companies re-occupied it in the late 1930s, stationing 130 people on the feature.[251] In 1939, the Japanese government assumed direct control of Itu Aba[252] and held it until the end of the war, after which they relinquished it under the terms of the Peace Treaty.[253] From 1946 to 1950, according to Filipino sources cited by the Tribunal, Taiwan took over the occupancy of Itu Aba.[254] Then, from 1956 onwards, according to American sources not cited by the Tribunal, Taiwan occupied it on a more permanent basis[255] (prompting the Philippines to pointedly declare in 1957 that the Spratlys fell under the *de facto* power of the Allied signatories of the Peace Treaty with Japan).[256] In 1974, the Americans indicated that some 200-300 Taiwanese troops were stationed on Itu Aba.[257]

In other words, save for some missing years in the 1930s and 1950s, this particular feature has been continuously inhabited for almost a century.

Could these occupying companies or garrisons have sustained at least some of their personnel on the feature's own supply of food and water—thus indicating habitability? The answer seems to be: yes, they could. The Tribunal considered evidence indicating that fresh potable water is available on Itu Aba: two reports from 1919 and 1994 suggested that water on the feature was of good quality (although a third stated that the underground water was salty).[258] As well as sea-catch, the feature is capable of supporting agriculture: one 1919 report indicated that there was an abundance of banana trees, while another from 1933 suggested that papaya trees planted by the Japanese had seeded across the feature, and there were also "fine palm fields, pineapple fields and sugar cane fields."[259] Photographs taken of the feature in 1951 showed it

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[250] *Id.* ¶¶ 602, 606.

[251] *Id.* ¶ 602.

[252] *Id.* ¶¶ 361, 602.

[253] Treaty of Peace with Japan, *supra* note 113, at 50.

[254] Arbitration, *supra* note 1, ¶ 430.

[255] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: RVN/PRC Dispute over South China Seas Islands, par. 2 (Jan. 18, 1974) (1974HONGK00751).

[256] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, pars. 5-6 (Jan. 23, 1973) (1973MANILA00858).

[257] Cable from U.S. Embassy Taipei to U.S. State Department, Subj: Conflicting Claims to Spratleys, par. 1 (Jan. 26, 1974) (1974TAIPEI00508).

[258] Arbitration, *supra* note 1, ¶ 583.

[259] *Id.* ¶ 586.

to be "thickly wooded,"[260] while modern satellite images—even Google Maps—show what looks to be extensive vegetation and tree cover.[261]

The Tribunal acknowledged that this evidence suggests that Itu Aba could support at least some people:

> There is historical evidence of potable water, although of varying quality, that could be combined with rainwater collection and storage. There is also naturally occurring vegetation capable of providing shelter and the possibility of at least limited agriculture to supplement the food resources of the surrounding waters. The record indicates that small numbers of fishermen, mainly from Hainan, have historically been present on Itu Aba ... and appear to have survived principally on the basis of the resources at hand ...[262]

That provides strong evidence of Itu Aba's habitability. Yet, the Tribunal fails to conclude that it is an island. Instead it makes a logical jump from this paragraph to the next one, which suggests that Itu Aba, as a "principle feature" of the Spratlys, is not habitable after all:

> The principal features of the Spratly Islands ... are *not obviously habitable*, and *their capacity even to enable human survival appears to be distinctly limited*. In these circumstances, and with features that fall close to the line in terms of their capacity to sustain human habitation, the Tribunal considers that *the physical characteristics of the features do not definitively indicate the capacity of the features*. Accordingly, the Tribunal is called upon to consider the historical evidence of human habitation and economic life on the Spratly Islands and the implications of such evidence for the natural capacity of the features.[263]

Given that the Tribunal linked the "rocks" or "islands" status of the features to its jurisdiction, one might have expected that it would have expressed itself more clearly in this passage, which attempts to explain why, in the Tribunal's view, the Spratlys features were uninhabitable "rocks." Instead, the paragraph invites challenge.

It begins by stating that the features are "not obviously habitable"—despite the fact that at least one, Itu Aba, clearly *is* habitable, because of the presence of water and food sources, as well as populations numbering several hundred people. Then it raises the bar, claiming that the features' "capacity even to enable human survival appears to be distinctly limited"—which raises the question: if a feature such as Itu

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[260] *Id.* ¶ 592.

[261] *See* Taiping Island, GOOGLE MAPS, http://bit.ly/2tZVbgG. On the quality of these images, see Taiwan's complaint that Google Maps showed its Itu Aba military installations too clearly, and asked for them to be blurred: Christopher Mele, *For Taiwan, Google Images of Disputed Island Are Too Clear*, N.Y. TIMES (Sept. 23, 2016), http://nyti.ms/2u03zNg.

[262] Arbitration, *supra* note 1, ¶ 615.

[263] *Id.* ¶ 616 (emphases added).

Aba is demonstrably habitable, it must also be survivable. (The phrase, "distinctly limited" clarifies nothing, because it is not clear whether the limit refers to the *duration* of human life on a feature, or the *number* of people the feature might support.)

The first two sentences of the passage are also notable for the number of qualifying words and phrases: "obviously," "close to," "appears to be," "not definitively." These suggest that the Tribunal was equivocating.

Still, one should ask why, despite the presence of water and food, humans have not *settled* on the Spratlys. While the Tribunal goes some way towards answering this question, it does not take the final step, which would lead to a different conclusion than the one it actually reached.

It argues that other than a feature's physical attributes, the most reliable marker of an island's capacity to support human habitation "will usually be the historical use to which it has been put." Thus,

> In such circumstances, the Tribunal should consider whether there is evidence that human habitation has been prevented or ended by forces that are separate from the intrinsic capacity of the feature. *War, pollution, and environmental harm* could all lead to the *depopulation*, for a prolonged period, of a feature that, in its natural state, was capable of sustaining human habitation. In the absence of such intervening forces, however, the Tribunal can reasonably conclude that a feature that has never historically sustained a human community lacks the capacity to sustain human habitation.[264]

Let us apply this to formula to Itu Aba. Although the feature has been populated almost continuously since the early 1920s, and by substantial numbers of people, there have been no *settled* populations—the phosphate workers[265] may have been recruited or dragooned from Japan's then-colony of Formosa (later Taiwan), and were probably present for only a few years; the troops[266] were recruited or conscripted by Taiwan's armed forces and served on rotation. The question, then, is why others did not make Itu Aba their home.

The Tribunal lists some of the historical reasons for populations not taking root—"War, pollution, and environmental harm"—and we will take "war" as our example. During armed conflict, humans may not be able to settle an island "for a prolonged period" because it is occupied by military forces prepared to take lethal action to defend it. Now apply this to the Spratlys. Although there has been no full-blown war in the immediate vicinity since 1945, the situation has been identical in every other respect so far as settlement goes. Humans have not been able to

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[264] *Id.* ¶ 549 (emphases added).

[265] See, for example, the reference to "Formosan" labourers at *id.* ¶ 619.

[266] Cable from U.S. Embassy Taipei to State Department, Subj: ROC Navy Resupply Mission to Spratleys, par. 2 (Feb. 5, 1974) (1974TAIPEI00751).

set up home in, say, Itu Aba, *even had they wanted to*, for the simple reason that it is a garrisoned island within a military zone, occupied by forces not averse to firing on interlopers: recall, for example, Marcos's allegation in 1971 about shots being fired at aircraft and vessels.[267] If potential inhabitants had shown up within its territorial waters, they would have been swiftly escorted out of the area—at gunpoint. *That* is why Itu Aba has not been settled.

It may thus be argued that the Tribunal should have found Itu Aba, and perhaps a few other features, to be an island, generating an exclusive economic zone and a continental shelf. This would have allowed for a less overloaded interpretation of Article 121 on the question of "human habitation." But as we know, a finding of even *a single island* in the Spratlys would have entailed the Tribunal renouncing its jurisdiction over many of the Philippines' submissions because of the consequent overlap of maritime zones. In the event, it decided not to exercise this restraint, and arrived at a decision that not only delivered a decisive blow to China, but also clipped Vietnam and Taiwan in the backswing. In short, it altered the *status quo* in the South China Sea.

CONCLUSION

The current disputes can be traced back to the mid-1970s, when China's intervention against South Vietnam in the Paracels rippled across the South China Sea to the Spratlys. While not wishing to underplay the dangers of the militarization of the area, some perspective is important: the world is now witnessing the latest stage of a process, not a dramatic new event. So, when the *South China Morning Post* carried a story earlier this year, based on American sources, about Beijing "beefing up" its military presence in the Paracels,[268] it was not reporting anything particularly unusual: it was simply echoing the themes of the aforementioned Chinese documentary, broadcast on local television some 43 years earlier, which told much the same story.[269] Not only that, but China, although a very significant player in the Spratlys, is far from being the only player. It is one thing to note, as have innumerable editorials, that China is constructing runways and military installations on the reefs; it is quite another to add, as is rarely done, that Taiwan, the Philippines and Vietnam have been doing precisely this on the features for four decades or more.

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[267] Cable from U.S. Embassy Manila to U.S. State Department, Subj: Spratley Islands, par. 2 (Jan. 23, 1973) (1973MANILA00858).

[268] Kristin Huang, *China "Beefing Up Military" on Disputed Islands in the South China Sea, Says US Think Tank*, SOUTH CHINA MORNING POST (Feb. 10, 2017), http://bit.ly/2twF9KG.

[269] Cable from U.S. Consulate General Hong Kong to U.S. State Department, Subj: Oil Rig on Paracel Islands, p. 1 (Jun. 11, 1974) (1974HONGK06572).

By focusing on the South China Sea disputes as a process, it is possible to identify both the continuities and discontinuities in the claimants' legal positions over the years. One of the most notable aspects of the events of the 1970s was the parties' attempts to invoke the law to justify their respective claims, based, variously, on historic rights, *res nullius*, the Treaty of Peace with Japan, and the Mutual Defense Treaty. Observers in Washington, who then occupied a ringside seat to the disputes by dint of their patronage of regimes in Saigon, Taipei, and Manila, occasionally let slip their views of the claimants' arguments, despite the United States' avowed neutrality.[270] In 1976, for example, one high-level State Department cable dispatched during the MDT negotiations stated:

> [W]e take no position on merits of the various claimants cases concerning the Spratlys. You should know, however, that as a technical legal matter the Philippines claim is probably the least convincing of the lot.[271]

Be that as it may, the entry into force of UNCLOS in 1994 provided the claimants with new opportunities to advance different and perhaps more compelling legal claims. This eventually led one of them, the Philippines, to the door of the Permanent Court of Arbitration. It was a path worth taking, because the Tribunal's award, handed down in July 2016, gave Manila almost everything it had asked for. That said, it was notable how, just four months after the decision, President Rodrigo Duterte, when invited to Beijing on a state visit, declared that the arbitration would "take a back seat" during his talks with the Chinese.[272] The law is one thing; politics is quite another.

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[270] Cable from U.S. State Department to U.S Embassy Saigon, Subj: PRC-GVN Clash in Paracels, par. 3 (Jan. 19, 1974) (1974STATE012641).

[271] Cable from U.S. State Department to U.S. Embassy Manila, Subj: Visit of DepSec Robinson: Briefing Papers—Spratly Islands and Reed Bank, par. 2 (Aug. 4, 1976) (1976STATE193353).

[272] Charmaine Deogracias, *Duterte Allows Xi to Take Lead on South China Sea Issue*, PHILIPPINES STAR (Oct. 20, 2016), http://bit.ly/2tVTGkk.