

Regulation of Foreign Investment In Chinese Law

by Xiaoqing Yan

A thesis submitted to the Faculty of Graduate Studies and
Research in partial fulfilment of the requirements for the
degree of Master of Laws (L.L.M.)

Institute of Comparative Law

March 1992

McGill University

Copy Number 1

ABSTRACT

Prior to 1979, the legal system of the People's Republic of China (PRC) did not provide any mechanism for foreign direct investment (FDI). China's decision to accept FDI came with the arrival of a new political leadership set upon the pursuit of radically different economic policies following the Cultural Revolution. This new leadership sought to take China on the quickest route to modernization while still remaining loyal to the socialist state. Therefore, while the Chinese Constitution insists on public ownership as the basis of the economy, it also recognizes and encourages other forms of economic activity which benefit the national economy. This reform process led to an enlarged private sector and considerable FDI. That process continues today as the Chinese legal system moves further towards the promotion and protection of foreign investment and international norms of economic behaviour.

This thesis examines the development of China's legal regime regarding foreign investment. It will highlight distinctive features of that regime such as the enactment of laws by both national and regional governments.

The thesis will also examine how the opening to FDI has resulted in increased interest in international law by the Chinese government. With considerable speed, China has recognized and adhered to international treaties regarding foreign investment since the end of the Cultural Revolution.

Finally, this thesis will analyze the many difficulties surrounding FDI in China today. Managing foreign investment in a centrally planned economy has led to many legal,

political, social, and economic problems. The focus of this analysis will be on legal difficulties concerning FDI which are of particular concern to foreign investors.

RESUMMÉ

Avant 1979, le système légal de la République Populaire de Chine ne contenait aucun mécanisme de régulation de l'investissement direct étranger (IDÉ). La décision de la Chine d'accepter l'IDÉ est survenue avec l'arrivée d'un nouveau leadership dont les objectifs économiques étaient radicalement différents de ceux poursuivis avec la Révolution Culturelle. Ce nouveau leadership désirait que la Chine prenne le plus rapide chemin vers la modernization tout en demeurant fidèle aux principes d'un État Socialiste. Ainsi, alors que la Consitution de la Chine insiste sur la propriété publique comme base de l'économie, Elle reconnaît et encourage également d'autres formes d'activités économiques qui peuvent être bénéfiques à l'économie nationale. Ce processus de réforme a élargi considérablement le secteur privé et les IDÉ en Chine. Ce processus continue aujourd'hui alors que le système légal chinois progresse vers la promotion et une protection accrue des IDÉ et des normes économiques internationales de conduite.

Ce mémoire examine le développement du système légal de la Chine sur les investissements étrangers. Il met en relief les caractéristiques distinctives de ce régime qui sont dans les lois mises en place par les gouvernements régionaux et le gouvernement national.

Ce mémoire étudie également comment l'ouverture aux IDÉ a provoqué un intérêt croissant envers le droit international par le gouvernement chinois. La Chine a

rapidement reconnue et adhéree aux traités régissant l'investissement étranger depuis la fin de la Révolution Culturelle.

Enfin, ce mémoire analyse les nombreuses embûches qui affectent les IDÉ en Chine aujourd'hui. La gestion des investissements étrangers dans une économie centralement planifiée a causé plusieurs problèmes légaux, politiques, sociaux et économiques. Le centre de cette analyse sera sur les difficultés juridiques relatives aux IDÉ qui sont d'intérêt pour les investisseurs étrangers.

Acknowledgement

I would like to take this opportunity to express my sincere appreciation to Professor David Stevens for not just supervising my thesis, but also for introducing me to, and cultivating my interest in the field of business law. There are few who could have taught me better.

I also wish to thank my teachers at McGill University for the help they offered me in my attempting to understand international business law.

Finally, I would like to thank all of my classmates and friends at the Institute of Comparative Law for making my stay the most enjoyable and stimulating academic experience in my life.

Xiaoqing Yan

ABBREVIATIONS

BITs	Bilateral Investment Protection Treaties
CIETAC	China International Economic and Trade Arbitration Commission
CCPIT	Chinese Council for the Promotion of International Trade
CITIC	China International Trust and Investment Corporation
CJL	<u>Contractual Joint Venture Law</u>
ECL	<u>Economic Contract Law</u>
FECL	<u>Foreign Economic Contract Law</u>
WFOL	<u>The Law on Wholly Foreign Owned Enterprises</u>
ICSID	International Centre For the Settlement of Investment Disputes
JVL	<u>Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment</u>
MOFERT	Ministry of Foreign Economic Relations and Trade
NPC	National People's Congress
SEZs	Special Economic Zones
SAIC	State Administration for Industry and Commerce
SAEC	State Administration for Exchange Control
TICR	<u>Regulation of the P.R.C. on the Administration of Technology Import Contracts</u>

Table of Contents

ABSTRACT	i
Résumé	iii
ACKNOWLEDGEMENTS	v
LIST OF ABBREVIATIONS	vi
Chapter I Introduction: Overviews	1
A. Distribution of Legislative Power.....	2
B. Foreign Direct Investment in China.....	5
C. Special Economic Zones and Open Coast Cities.....	11
Chapter II Institutional Framework For Foreign Investment	19
A. China's Economic Reforms	19
B. Institutional Framework For Foreign Investors- Government Institutions.....	22
1. Ministry of Foreign Economic Relations and Trade.....	23
2. Industry Ministries	24
3. Regional Foreign Trade Bodies.....	24
4. State Administration of Exchange Control (SAEC)	25
5. The Bank of China.....	25
6. The China International Trust and Investment Corporation (CITIC).....	26
Chapter III Foreign Investment Laws	27
A. Legislation Concerning Equity Joint Ventures.....	27
1. Legal Status.....	28
2. Establishment and Registration.....	29
3. Investment Contributions.....	31
4. Control and Management.....	32
5. Termination.....	33
B. Contractual Joint Venture Law.....	35
1. Legal Status.....	35
2. Establishment and Registration.....	36
3. Capital.....	36
4. Management	37

5. Operation.....	37
6. Termination	37
C. The Law on Wholly Foreign Owned Enterprises	38
1. Legal Status.....	39
2. Establishment and Registration.....	39
3. Investment Contributions... ..	41
4. Management	41
5. Operation.....	42
6. Termination.....	43
Chapter IV China's Civil Code.....	45
A. Legal Person.....	46
B. Contract.....	48
C. The Law of Agency.....	53
D. Property Right.....	55
E. Foreign Civil Relationship.....	59
Chapter V Technology Transfer	61
A. Ascertaining Authority of the Chinese Party.....	61
B. Legal Framework for Technology Transfer.....	63
1. The <u>Regulation of the P.R.C. on the Administration of</u> <u>Technology Import Contract</u>	64
2. The <u>Patent Law of the PRC</u>	72
3. The <u>Trademark Law of the PRC</u>	76
Chapter VI Chinese Tax Law and Chinese Bilateral Tax Treaties.....	81
A. Individual Income tax.....	81
B. Consolidated Industrial and Commercial Tax.....	82
C. Income Tax of Foreign Funded Enterprises.....	83
D. Customs Duties.....	86

E. Urban Real Estate Tax.....	89
F. Vehicle and Ship License Tax.....	90
G. Bilateral Tax Treaties	91
1. Double Taxation and General Rules of International Law.....	91
2. Chinese Bilateral Tax Treaty Program	91
Chapter VII Foreign Exchange Control.....	98
A. Non-Convertibility of the RMB.....	98
B. The Laws and Regulations Concerning Foreign Exchange Control.....	99
Chapter VIII China's Bilateral Investment Protection Treaty Program	105
A. Friendship Commerce and Navigation (FCN) Treaties, Bilateral Investment Insurance Agreements and Bilateral Investment Protection Treaties.....	105
1. FCN Treaties.....	105
2. Bilateral Investment Treaties.....	106
B. Chinese Bilateral Investment Treaty Program.....	107
1. Investment Protected.....	107
2. Treatment of Investment	110
3. Financial Transfer.....	111
4. Expropriation and Nationalization.....	112
5. Dispute Settlement	114
Chapter IX Dispute Settlement Mechanisms.....	118
A. Mediation.....	118
B. Arbitration.....	119
1. Arbitration Situs.....	121
2. Procedural Rules.....	123
3. Applicable Law.....	124
4. Enforceability of Arbitral Awards.....	126
C. Litigation	133

Chapter X Conclusion	136
Selected Bibliography	139

Chapter I Introduction: Overviews

Since the implementation of the open door policy in 1979, China has been absorbing and utilizing foreign direct investment by setting up various forms of enterprises. On July 8, 1979, the Law of the People's Republic of China on Chinese Foreign Joint Venture ¹ was promulgated and went into effect. Since that date China has enacted many laws and regulations which have created a comprehensive legal system governing foreign investment.

To understand this system, to study its content, nature and structure, is an important task, not only for practising lawyers and government officers but also for businessmen.

This thesis will focus on the legal changes arising out of the economic reforms and open door policy to help explain the Chinese legal system concerning foreign direct investment. The thesis itself is divided into four main parts. The first part (Chapters I and II) provides a general overview, both factual and legal, of foreign direct investment in China. The regulatory mechanisms that the Chinese government employs to promote and control foreign investment are introduced. The second part (chapters III, IV, V, VI and VII) focuses on the laws which directly

¹ The Law of the People's Republic of China on Joint Venture Using Chinese and Foreign Investment [hereinafter JVL] was adopted on July 1, 1979 at the Second Session of the Fifth National People's Congress, and promulgated on July 8, 1979. English translation can be found in the Collection of Laws and Regulations of the People's Republic of China Concerning Economic Affairs Vol.I (Beijing: the Department of Treaties and Law of the Ministry of Foreign Economic Relations and Trade of the P.R.C., 1985) p.42.

concern foreign direct investment: foreign investment laws, the regime of private property, the regulation of technology transfer, China's investment treaties, foreign exchange control and China's tax laws. The third part (chapter VIII) analyzes China's bilateral investment treaty program from a public international law point of view. Finally, the fourth part (Chapter IX) discusses dispute settlement mechanisms available to foreign investors in China.

Throughout the thesis, distinctive aspects of China's legal regime concerning foreign investment are highlighted. Another preoccupation running through the paper is to show how the opening to FDI has resulted in an increased interest in international law on the part of the Chinese authorities. Finally, the thesis points to remaining problems in Chinese law regarding FDI.

The laws reviewed in this thesis are as of December 1991.

A. Distribution of Legislative Power

The law applying to foreign investment in China can be divided into domestic law and treaties. Both are subordinate to the Constitution of P.R.C. which embodies the fundamental guidelines for all legislation applicable to foreign investment in China.

In China, the legislative power of the PRC is vested in the National People's Congress and its Standing Committee². The National People's Congress

² According to the Constitution of P.R.C. which was adopted on Dec. 4 1982, the National People's Congress and its Standing Committee exercises the legislative power of the state.(art. 58) English translation can be found in Beijing Review No. 52 Dec. 27, 1982. Regarding Chinese legislative power, see also Ralph H. Folsom & John H. Minan eds Law in the People's Republic of China

has the power to amend the Constitution, to supervise the enforcement of the Constitution, and to enact and amend basic statutes dealing with criminal offenses, civil affairs, state organs and other matters³.

The State Council has authority to adopt administrative measures and to enact administrative rules and regulations, in accordance with the constitution and the laws.⁴

The ministries and commissions issue orders and regulations within the jurisdiction of their respective departments and in accordance with the statutes and

(Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1989) p.30-39. The National People's Congress consists of about 3,000 delegates, elected every 5 years from all over the country. No discussion of law in the P.R.C. would be complete without examining the relationship between the communist party and the legal system. The Chinese Communist Party Central Committee has significant influence over the legislative process. The Constitution of P.R.C. is based on the "four fundamental principles", one of which is the leadership of the Chinese Communist Party. Many fundamental policy decisions that eventually lead to the enactment of laws originate with the Chinese Communist Party Central Committee. The Chinese leaders in charge of the key legislative organs such as the State Council and the Standing Committee of the National People's Congress are usually members of the party's politburo.

³ Ibid. the Constitution of the P.R.C. art. 62.

⁴ The Central Government of the PRC- State Council which is the executive body of the highest organ of state power, it is the highest organ of state administration. The term of office of the State Council is the same as that of the National People's Congress (5 years). The State Council is composed of: the Premier; the Vice-Premiers; the State Councillors; the Ministers in charge of ministries; the Ministers in charge of commissions; the Auditor-General; the Secretary-General. The Premier, Vice -Premiers and State Councillors shall serve no more than two consecutive terms. The State Council enacts administrative laws and regulations in accordance with the Constitution and laws. The Constitution arts. 86,87, and 89.

the administrative rules and regulations issued by the State Council.⁵

Local governments, in accordance with the Constitution, may enact regulations to reflect local conditions.⁶ Since China has established a system of Special Economic Zones [hereinafter SEZs] and applies a separate policy to fourteen open coastal cities which attract a substantial portion of foreign investment, the local legislation of foreign investment plays an important role in the overall scheme.

The Standing Committee of the National People's Congress also exercises the power to decide on the ratification and abrogation of treaties concluded with other countries⁷.

Generally speaking, there are three categories of treaties relating to foreign economic relations in China. The most important category concerns the bilateral promotion and mutual protection of foreign investment. China has signed many such agreements with the major investing countries of the world.⁸ The second sort of

⁵ Supra, note 2, the Constitution art. 90.

⁶ Supra, note 2 the Constitution art. 100.

⁷ The National People's Congress elects, and has the power to recall, the members on its Standing Committee. The Standing Committee is elected for the same term as the National People's Congress; it exercises its functions and powers until a new standing committee is elected by the succeeding National People's Congress. It is composed of the Chairman, the Vice-Chairmen, the secretary-General, and members. The Constitution arts. 65, 66 and 67.

⁸ The P.R.C. signed its first BIT with Sweden in 1982. Since then, some 20 more treaties have been concluded with other countries. To date, China has concluded BITs with Romania (1983), the Federal Republic of Germany (1983), France (1984), Belgium-Luxembourg (1984), Finland, Australia (1988), Austria, Denmark,

treaties concern taxation. These treaties are usually agreements for the avoidance of double taxation and the prevention of tax evasion. China has signed such treaties with the United States (1984), Japan (1983) and Canada (1986). The last sort of treaty deals with a wider variety of issues including for example, foreign trade arrangements as well as accords relating to industrial and technological cooperation. China has signed such agreements with Japan (1984), the United States (1979), EEC (1978).

B. Foreign Direct Investment In China

China's decision to accept FDI was the result of a fundamental shift in political leadership and, consequently, economic policy that began after the Cultural Revolution⁹. Mao's successor Deng Xiaoping strongly criticized the Cultural Revolution (1966-1976) and its impact upon China. Deng embarked on a more

Italy, Kuwait, Malaysia, the Netherlands, New Zealand, Norway, Pakistan, Singapore, Sri Lanka, Switzerland, Great Britain, Thailand and Japan (1988). The P.R.C. now has bilateral investment protection treaties with every major industrialized country, except the United States and Canada. See, Laurence W. Bates, "Protecting Foreign Investment In China: the Sino-Japanese Bilateral Investment Treaty" (1988) Vol. 10. Iss:12 East Asian Executive Reports at.9

⁹ The Great Proletarian Cultural Revolution was an attack by Mao on capitalists. The true purpose, in fact, was to dispose of Mao's rivals. The Revolution began in May 1966 and ended in October 1976, one month after Mao's death. The Cultural Revolution produced a ten year period of turmoil in China. Many schools and universities were closed and, in some areas, industrial production stopped. Rather than working and studying, workers and students were required to participate in the class struggle of the Cultural Revolution. The Cultural Revolution's legacy was a ramshackle economy, and an entire generation of young people had their confidence in any code of belief destroyed. Young people also lost their only chance at a meaningful education. In large part, the Revolution resulted in a missing generation of Chinese professionals and specialists.

liberal path that included an increased western diplomatic and commercial presence in the P.R.C.. The new leadership elevated the need for socialist construction based on four modernizations- those of agriculture, industry, national defense and science and technology. These four modernizations were eventually enshrined in the preamble to the 1982 constitution. The new leadership realized that the ambitious program of four modernizations needed the support of foreign investment and advanced technology. Attracting foreign investment to help the Chinese economy became a long- term and decided state policy.

Since that decision, foreign investment in the PRC expanded rapidly and played an important role in the modernization of the Chinese economy. It provided and continues to provide the needed capital for economic development. FDI brings with it advanced technology for industrialization; training for Chinese personnel in the area of management and technology; and an increase in state revenues. In return, foreign investors receive valuable benefits from their investment in China. These benefits include: access to China's potential market, domestic sales allowances, low labour costs, and special tax incentives.¹⁰

There has been a misunderstanding among some Western writers about the Chinese Constitution. Some commentators believe that the promotion and protection of foreign investment conflicts with the constitutional principles of socialist public

¹⁰ Philip D. Grub and Jian Hai Lin, "Open Door or Squeezing Through the Keyhole: U.S. Joint Ventures Experience in China" (Dec. 1988/Jan.1989) Vol. 25 Iss:2,3 Mid-Atlantic J. of Business at 21.

ownership and a state planned economy¹¹. They fail to understand that although the Constitution insists on socialist public ownership as the foundation of the Chinese economic system, other types of economic activity are not prohibited. In fact, the Constitution specifically recognizes and protects both the collective and private economy.¹²

Official Chinese policy appears to want to pursue the quickest route to modernization, while still remaining a socialist country. For this purpose, the Constitution insists on public ownership as the basis of a socialist economy while at the same time encouraging other economic activity which will benefit the national economy.¹³

The current Constitution of the P.R.C., adopted in late 1982, grants recognition and protection to FDI for the first time. Art. 18 stipulates:

The people's Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic co-operation with Chinese enterprises and other economic organizations in accordance with the law of the People's Republic of China. All foreign

¹¹ Timothy Haason Wan, "A Comparative Study of Foreign Investment Laws in Taiwan and China" Spr. (1981) 11 Cal. Wes. Int'l L. J. p. 112.

¹² The Report on Amendments to the Constitution given by Peng Zhen, Chairman of the Standing Committee of the Fifth National People's Congress. Nov. 26, 1982. According to art. 12 of the constitution, the state protects socialist public property. Appropriation or damage of state or collective property by any organization or individual is prohibited. Art. 13 says that the state protects the right of citizens to own lawful earned income, savings houses and other lawful property.

¹³ See the Report on Amendments to the Constitution given by Peng Zhen, Chairman of the Standing Committee of the Fifth National People's Congress Nov. 26, 1982.

enterprises and other foreign economic organizations in China, as well as joint ventures with Chinese and foreign investment located in China, shall abide by the law of the People's Republic of China. Their lawful rights and interests are protected by the law of the People's Republic of China¹⁴.

Six different kinds of arrangements can be identified that, taken together, comprise what is often referred to as FDI in China. These are as follows¹⁵:

(1) Equity joint ventures: This arrangement is a limited liability corporation in which the Chinese and foreign partners jointly invest. Profit and risk are shared according to the percentage of equity held by each partner. Investment contributions may be in cash or in kind.

(2) Contractual joint ventures (sometimes known as cooperative joint ventures): These are joint undertakings between one or more foreign entities and one or more Chinese entities. The form allows the contracting parties more flexibility in defining their particular venture. Contracting joint ventures can take two forms: (a) a limited liability entity with the status of a legal person (this form closely resembles an equity joint venture) and, (b) a business partnership in which the parties co-operate as separate legal entities and carry out their respective obligations without establishing a joint management entity. In either case, contractual joint ventures differ from equity joint ventures in two important respects: The form of investment contributed by each party need not be in cash or in kind (e.g. labour

¹⁴ Supra, note 2 Constitution of the People's Republic of China art. 18

¹⁵ Jerme Alan Cohen & Stuart J. Valentine "Foreign Direct Investment in P.R.C.: Progress, Problems and Proposals" (1987) 1:16 *Journal of Chinese Law* p.181.

and utilities have in some cases been allowed as contributions) and profits are shared based on a ratio specified in the contract, not necessarily according to investment contributions.

(3) Wholly foreign-owned ventures: This arrangement is best described as a limited liability entity solely owned and operated by a foreign investor. The foreign investor receives all profits and bears all risks.

(4) Joint development (also known as cooperative development): This form is used for foreign -Chinese cooperation in the exploration and development of mineral resources such as offshore oil. Joint development enterprises are regulated by a separate set of laws and regulations¹⁶.

(5) Compensation trade: Compensation trade has proved to be another valuable instrument of cooperation that the P.R.C. regards as functionally similar to an investment. In this form the purchase of machinery from abroad by local enterprises is paid in whole or in part by the remittance of goods produced after the purchase. In direct compensation trade, the goods are produced by the enterprise. In indirect compensation trade, the goods are produced by a different Chinese enterprise and purchased by the one which imported the machinery.

(6) Processing and assembling: In this arrangement, the foreign parties

¹⁶Regulation of the People's Republic of China on the Exploitation of the Offshore Petroleum was adopted by the State Council on January 12 1982. The English translation can be found in Collection of Laws and Regulations of the PRC Concerning Foreign Economic Affairs (Beijing: the Department of Treaties and Law of the Ministry of Foreign Economic Relations and Trade of the PRC, 1985) Vol. 2 p.93.

provide some or all of the inputs to a product, and sometimes machinery and other know how. The Chinese enterprise uses the inputs to make the product, which is then returned to the foreign party, who pays a fee for the service.

Each of these six activities share many of the important characteristics of FDI. Each of the six usually involves at least some technology transfer, including some management skills.

Deng's decision to open China's doors to FDI was an initial success but the effect of the Tianenmen massacre combined with a government austerity program brought a recession to China in 1989.¹⁷ Foreign investment showed only a modest 4 percent increase that year. While FDI in the coastal provinces recovered in the first half of 1990, the national totals showed a decline. A recovery did begin in the second half of 1990, as government statistics showed a 25.6 percent increase in the number of foreign firms signing direct investment contracts. Contract value also jumped 17.9 percent to US\$ 6.6 billion. This trend appears to be accelerating: during the first four months of 1991 contracted investment was up 164 percent over the same period in 1990 to US\$ 3.26 billion.¹⁸

Joint ventures are still the preferred mode of investment in 1990. But a growing number of firms are choosing the form of wholly foreign-owned enterprise [hereinafter WFO enterprise]. The number of contracts signed for WFO enterprises

¹⁷ Anonymous "Two Years Of Troubles" Nov/Dec. (1990) Vol. 17, Issue:6 China Business Review p. 32.

¹⁸ Business China, "Investor's update" May 27, 1991 Business China p. 76

in 1990 was 99.8 percent higher than in 1986. The 1990 Implementing Regulation on the Law for Wholly Foreign -Owned Enterprises which reduced income tax on WFO enterprises to a level equal to that applied to equity joint ventures should encourage this trend.

By 1991, therefore, FDI in China had recovered from the setbacks of 1989. By the end of April 1991, the total amount of FDI approved in China had reached US\$ 42.18 billion¹⁹. More than 10,000 foreign funded enterprises had actually begun operation with a total of US\$ 17 billion spent²⁰. Most of this foreign investment in China was located along the coast. Hong Kong is currently the largest investor in China, followed by the United States and Japan.²¹

C. China's Special Economic Zones and Open Coast Cities

Shenzhen, located at the Hong Kong border, was the first SEZ, created between the years 1970 and 1980. It is also the largest SEZ (327.5 sqkm). Three other zones followed in 1980: Zhuhai, Xiamen, and Shantou. Special economic policies and flexible trade measures are applied in these regions.

The incentives offered to foreign investors in the SEZs include tax

¹⁹ By the end of 1990, over 25,600 joint ventures and 3,385 wholly foreign owned enterprises had been approved in China. This includes all kinds of FDI, equity and contractual joint ventures, wholly foreign owned ventures, joint offshore oil exploration, leasing, compensation deals, and processing and assembly. Ibid.

²⁰ Ibid.

²¹ From 1979 to 1990, the total amount of foreign investment in China was US\$ 43,781.31 million. Among which, US\$ 26,919.87 million was from Hong Kong, US\$ 4,475.84 million was from the United States, US\$ 3,662.18 million was invested by Japan. Ibid. p.77.

concessions, exemptions from customs duties, and the provision of necessary infrastructure.

The purpose of establishing SEZs and open coast cities was to develop a technologically advanced export-oriented industrial base which would:

1. Attract FDI in export-oriented industries;
2. Introduce advanced technology;
3. Train Chinese workers and managers in the use and better management of new technology;
4. Serve as a testing ground for economic and social reforms,²² and show how to graft selected features of capitalism onto a socialist economy.²³

The SEZs ran into serious trouble in the mid - 1980s. One of the original goals of the SEZ was to attract foreign investment, but in 1984, about two-thirds of the investment in Shenzhen had come from within China itself. In other words, the success of the SEZs depended largely upon the amount of support they could obtain from the central government²⁴.

In the beginning, it was also hoped that the SEZs would attract advanced technology. In fact, the SEZs brought relatively little advanced technology to

²² Suzanne Pepper, "China's Economic Zones The Current Rescous Bid for a Faltering Experiment" (July-Sept.1988) 20(3) Bull. of Concerned Asian Scholars p.4.

²³ Ibid.

²⁴ Ibid. p.10.

China.²⁵ Rather than building mainframe computers, Shenzheng found itself attracting labour-intensive light manufacturing, assembly business and service industries.

In addition, the SEZs sold most of the goods they produced with imported equipment in the Chinese market rather than in the foreign market which was the original intention. This resulted in a growing foreign trade deficit for China.²⁶

Thus, the original goal of transforming the Shenzhen economy into one based on foreign investment, industry and exports was simply not being met by the mid- 1980s.²⁷

As a result of this experience, the Chinese government decided to shift its emphasis from the SEZs to already established industrial centres of the Chinese economy. Perhaps it was wiser, the government thought, to use foreign investment to upgrade the existing industrial base.²⁸

In 1984, the National People's Congress of China approved the formation of new special economic zones in the more developed coastal areas of the country. These new zones, although similar to the SEZs, operated under slightly different rules and regulations. The new zones included fourteen coastal cities: Dalian, Qinhuangdao, Tianjin, Yantai, Qindao, Nantong, Liayungang, Shanghai, Ningbo,

²⁵ See, Tom Grimmer, "China's Slow Boat to Capitalism " (Aug. 1990) Vol. 63 Iss: 8 Canadian Business p.25.

²⁶ Pepper, Supra, note 22 at 10.

²⁷ Ibid. p.10.

²⁸ Ibid. p. 17.

Wenzhou, Fuzhou, Zhanjiang, Guangzhou and Hainan province; and three delta areas: Changjiang River delta, Zhujiang River delta and the triangular area of Xiamen, Zhangzhou, Quanzhou in southern Fujian province; and the peninsulas of Liaodong and Shandong. With a population of only 160 million, these areas turned out one-third of the national industrial output. This coastal region has more autonomous power and enjoys greater flexibility in granting favourable treatment in the areas of foreign investment, transfer of technology and foreign trade. Enterprises in the SEZs and open coast cities may engage in foreign trade more independently than enterprises in other areas of China.

In SEZs and coast cities foreign investors are granted more favourable treatment in a variety of ways. For example, equipment, instruments and workshop building materials, imported by foreign investors as part of their investment are exempt from customs duties and the consolidated industrial and commercial tax. This also applies to imported raw materials, spare parts and packing materials designed for export production.

A 15 percent preferential enterprise income tax is levied on the income of joint ventures, cooperative enterprises or enterprises with sole foreign investment operating in the SEZs and economic and technological development zones of coastal cities. Legally acquired profits of foreign investors remitted abroad are also exempt from income tax.²⁹

²⁹ Henry R. Zheng, China's Civil and Commerce Law (Singapore-USA-Canada: Butterworths, 1988) p.279.

SEZ enterprises may also apply for a tax waiver; the specific terms of which depend upon the type of business product and industrial sector. For example, a joint venture formed for a period of ten years or more is entitled to full exemption from joint venture income tax in the first two profitable years, and a 50 percent reduction in that tax for the next three profitable years.

Joint ventures engaged in relatively low-profit operations such as farming and forestry, or those established in remote underdeveloped regions, are allowed a 15-30 percent tax reduction for the ten years after the period of the first five profitable years³⁰.

A 15 percent preferential income tax is applied, upon approval by the Ministry of Finance, to foreign funded enterprises operating in coastal cities whose investment is involved in technology-intensive projects, or projects having overseas investment exceeding us\$ 30 million and with a long lead time.³¹ The tax is also applied to joint ventures, cooperative enterprises and entirely foreign funded enterprises operating in the coastal cities, in the fields of energy, communication and port construction.³²

Investors in the SEZ areas also benefit from: inexpensive land and services, low labour costs, greater freedom in labour management relations, no customs duty

³⁰ "The China Business Guide" (1988) Journal of the Citizen Ambassador's Program p. 204.

³¹ Zheng, Supra, note 29 p.277.

³² Ibid. p.280.

on reexported inputs, and increased access to the Chinese market.³³

The newest SEZ, Hainan province, applies the same policies as the other SEZs with greater liberalization in the following respects:

(1) The scope of foreign investment is expanded, allowing foreign investors to engage in real estate transactions within designated areas and to develop mineral and other natural resources.

(2) More flexibility is given in respect of the mode of foreign investment. Foreign investors may not only establish enterprises, but may also invest through the purchase of stocks or bonds. They may also lease state-owned or collectively-owned enterprises or conclude management contracts with them.

(3) With the approval of the Hainan Government, certain goods subject to import restrictions may be imported for use within the province.

(4) More flexibility is provided in the flow of goods, personnel and capital.

(5) Greater power of economic management is granted to the province.³⁴

Since April 1988, the Chinese Government has further liberalized certain policies for the coastal areas by according them more autonomy as follows:

(1) Foreign investment projects under US\$ 30 million may be approved by the provinces and municipalities themselves.

(2) The technological transformation of old enterprises through the

³³ Martin Lockett, "China's Special Economic Zones: the Cultural and Managerial Challenges" Spring (1987) Vol. 12 Iss:3 Journal of General Mgmt (UK) p. 21.

³⁴ Jamie P. Horsley, "Foreign Investment Incentives In Hainan" January-February (1989) China Business Review p. 31.

formation of Chinese-foreign joint ventures or co-operative ventures is encouraged.

(3) The importation of raw materials for processing for export has been facilitated.

(4) The entry and exit procedures for businessmen have been simplified.

By establishing SEZs and coast cities, coastal China, with a population of 160 million, is evolving into a single "development belt"; a belt which the central government eventually wants to extend inland north and west³⁵.

The special economic zones of China appear, in the main, to be working satisfactorily. Investors benefit financially while China gains industrial and commercial experience³⁶.

Shenzhen, bordering on Hong Kong, has been by far the most successful of the zones. The main reason for Shenzhen's success is that Hong Kong is one of China's most important sources of foreign exchange earnings. It is also a focal point for its international communications and technology transfer. In the space of ten years Shenzhen has been transformed from a little town into a sprawling city with industrial estates, skyscrapers and new hotels.³⁷

The existence of Shenzhen as a SEZ beside Hong Kong, and the SEZ of Zhuhai bordering on the Portuguese colony of Macau, may also help the integration

³⁵ L. Crawford Brickley, "Equity Joint Ventures in the P.R.C.: the Promised Land is Not Yet In Sight For Foreign Investors" spring (1988) 10 (2) University of Pennsylvania Journal of International Business Law p.167.

³⁶ Katherine Forestier, "Re-Assessing the Shenzhen Experiment" Jan.(1988) Vol. 24, Iss:1 Asian Business (Hong Kong) p.44

³⁷ Ibid. p.44

of these two capitalist colonies into China when they are returned. These two SEZs also operate as China's window to the outside world in terms of foreign policy, new technology and management skills³⁸.

Though many problems still exist, the SEZs remain attractive to foreign investors. Due to the Tiananmen massacre and a government austerity program, foreign investment showed only a modest 4 percent increase in 1989. However, FDI in the SEZs had begun to recover by the first half of 1990.³⁹

In order to attract even more investment in the SEZs and coastal cities, new policies were enacted in these regions in April, 1990. Notably, the lease of land to foreigners is now allowed in the open cities and SEZs⁴⁰. In addition to land leasing, China is now taking a more liberal attitude toward property trading. Some of the SEZs have announced a reduction in land prices by as much as 30 to 40 percent, in order to attract foreign developers.⁴¹

³⁸ Ibid. P.44.

³⁹ Business China, "Investor's update" May 27, 1991 Business China p. 77.

⁴⁰ Ping Zheng, "Foreign Land Leases Will Help Develop Coast SEZs" 13 April (1990) China Daily p.1.

⁴¹ Elizabeth Cheng, "China's Changing Tide: Coastal Cities Rush to Offer Land After Peking Policy Shift" Jan. (1990) Vol. 148, Issu: 26, Far Eastern Economic Review (Hong Kong) p. 68.

Chapter II Institutional Framework for Foreign Investment

A. China's Economic Reforms

In order to describe the institutional framework for foreign investors, one must first outline China's economic reforms.

In the late 1970s China suffered from the following four major problems: a chronic shortage of both consumer and producer goods; massive waste; stagnation of research, development, innovation, and diffusion of modern technology with deleterious effects on the quality of growth; and deficient incentives to labour, management, and entrepreneurship.⁴²

These four problems led to a poor economic performance. The four problems themselves had basically three main causes. Firstly, we must recognize the difficulties arising from the country's huge size and rapid population growth. Secondly, China has suffered from policy errors committed by leaders pursuing either radical or conservative approaches. Thirdly, some commentators have blamed the system itself, arguing for a completely different political and economic structure.⁴³

The economic reforms initiated by the Chinese leadership in 1978 to overcome these problems were not intended to transform China into a true market

⁴² Jans. Prybyla, " Why China's Economic Reforms Fail" (1989) Asia Survey p.1017.

⁴³ Ibid. p.1018.

economy. The sole purpose of the reforms was to make the socialist system work better by adopting certain aspects of a market economy.⁴⁴

The economic reforms can be divided into three distinct phases⁴⁵. The period from 1979 to 1984 was marked by agricultural reforms through various structural reforms. From 1985 to September 1988, reforms were introduced in the industrial field. Finally, from September 1988 to the present, the reform process was frozen as the government conducted an austerity program.

China's economic Reform succeeded greatly in the 1980s was partly because it was enlightened by the experience of past reforms since 1950s⁴⁶, and it took the historical and realistic experience of the reforms of other socialist countries. For example, reform was first implemented in agriculture, then spread gradually to entire area, from specific sectors to the national economy⁴⁷. The Agriculture reform is to dismantle of the collectivist form of agriculture production in favour of the smaller and more autonomous individuals. In response to the reforms, per capita gross agricultural output grew by two-thirds, during the 1978- 1985 period. The rapid

⁴⁴ Wolfgang Klenner, "Administrative Regimentation and Economic Reform in China" (1990) 25 *Intereconomics* p.150.

⁴⁵ Prybyla, Supra, note 42 p.1025.

⁴⁶ Discussion of economic reform by Chinese economists began, like that in east Europe and the former USSR, in the late 1950s. The cultural Revolution, beginning in 1966 obscured the reform debate. But after the death of Mao Zedong in 1976, reform rapidly returned. See, Carol Lee Hamrin China and the Challenge of the Future Boulder, San Francisco, London: Westview Press (1990) p. 19.

⁴⁷ China's Economic Reform: How Far, How Fast? edited by Bruce L. Reynolds. Schenectady, New York: Academic Press, (1989) p. 121.

rise of agricultural out put was achieved.⁴⁸

In the industrial field, the principles of enterprise management have also substantially changed. The principle of separation of ownership and managerial authority of enterprises has been adopted. Most production enterprises are now operating under a system under which the manager has full responsibility and considerable decision-making power in such matters as planning, purchasing and marketing, as well as labour relation. Enterprises are moving towards full responsibility for their own profits and losses. The growth in industrial production was high throughout the 1980s⁴⁹.

The ongoing economic reforms have contributed to economic growth and to a improvement in living standards, but the transition to a more decentralized economy has not been easy. In 1988, the reformers faced a variety of economic difficulties including an inflation rate of 30 percent.⁵⁰ As a response, the government adopted an austerity program to deal with these problems.

The main features of the austerity program are in brief: deficit reduction through higher taxes and lower subsidies; cuts in state investment; higher interest rates; and once again, recentralization of trade⁵¹.

⁴⁸ IBID. p. 122

⁴⁹ This was 12.4 percent annually from 1980 to 1988. World Bank, World Development Report 1990 Oxford: Oxford University Press (1990) p. 180.

⁵⁰ Ibid.

⁵¹ Patricia Alexander, "The Chinese Economy, One Year Later"(1990) Vol. 2, NO.2 Global Business Issues p.1.

Today, China's economy remains stalled in the midst of reforms. The Chinese leadership, while apparently determined not to return to the tight state control of the 1950s, appears uncertain as to how far to push reforms in the future.⁵²

Nevertheless, the reform process remains alive. In December 1990, the proposed outline for the People's Republic of China's Eighth Five-Year Plan was approved by the National People's Congress. The outline provided details on development targets for only a few key sectors. This means that large areas of the economy are gradually coming under the influence of the market and no longer under the direct control of planners. The Plan, therefore, shows that the move away from strict hard-line policies toward reform is continuing. While providing no concrete reform strategies, the Plan reaffirms that China's reform experience has been positive⁵³.

B. Institutional Framework For Foreign Investment- Government Institutions

The reforms have brought about fundamental changes to the Chinese economic system. The foreign trade regime itself has also undergone drastic changes. The reform of the trade regime began with a decentralization of authority which resulted in the break up of the monopoly held by thirteen national foreign trade corporations. There are now about 700 enterprises engaged in import and export transactions. When service corporations are included, the total number of enterprises

⁵² Barry Naughton, "Economic Directions For the 90s" May/Jun.(1991) Vol.18 China Business review p.28.

⁵³ Ibid.

engaged in external economic activities exceeds 1100. The Ministry of Foreign Economic Relations and Trade [hereinafter MOFERT] has been moving away from direct control through the Plan towards indirect control through microeconomic measures such as the exchange rate and customs tariffs. The general objective of this reform is to separate the function of government planning from enterprise management. The aim is to allow foreign trade enterprises to operate on commercial considerations relatively free from administrative interference.⁵⁴ The process of decentralization has also meant that state departments, enterprises and local governments of various levels have been granted considerable power over decisions on foreign trade activities.

1. Ministry of Foreign Economic Relations and Trade

MOFERT was set up in 1982 through the merger of several former national institutions engaged in foreign trade. Since that time MOFERT has lost some of its direct responsibilities to the industrial ministries. However, it is still the principal institution in charge of foreign trade. Drawing up the national trade plan is one of MOFERT's main responsibilities⁵⁵. It has direct responsibility for imports and exports of specific goods and equipment within its power. It is also responsible for the coordination of the trade plans of the industrial ministries and the regional administrations. Finally, it has the power to set the prices of goods exported on its

⁵⁴ Working Party on China's Status as a Contracting Party. China's Foreign Trade Regime General Agreement on Tariffs and Trade, Spec. (88) 13/Add. p.12.

⁵⁵ Ibid. p. 10

own account and to give price formation guidelines or price ranges for the industrial ministries, regional administrations or enterprises. It is MOFERT that approves contractual joint ventures which are above a certain figure, as well as all equity joint ventures.⁵⁶

2. Industry Ministries.

Before 1979, the industrial ministries intervened generally only on the technical side of negotiations between foreign enterprises and the national foreign trade corporations. The ministries are now able to establish their own foreign trade corporations. They can enter contracts with foreign firms and negotiate imports and exports. They also have the power to sign contracts, provided they remain within the import and export quotas laid out in the plan. They can also engage in compensation trade and become partners of foreign firms in joint ventures.

3. Regional Foreign Trade Bodies.

Decentralization also involved granting wider powers to the provinces, municipalities and some districts and cities concerning the import of goods, services and capital. These areas have their own foreign trade bodies generally named import-export commissions. Greater power has also been granted to the coastal regions. They are also empowered to set up their own foreign trade bodies with structures fixed by themselves.⁵⁷

The regional bodies possess considerable powers over their foreign trade

⁵⁶ Ibid.

⁵⁷ Ibid. p.13.

activities. They can, to a great extent, decide the quantities of goods they export and can freely use their own foreign exchanges. The regional investment corporations can raise foreign loans and risk capital for joint ventures or set up compensation trade. In addition, they have the power to approve contracts up to a certain amount. However, only the central authorities can approve equity joint ventures.

Although the regional bodies appear to have considerable powers over trade activities, they are still subject to supervision and control by the central authorities.⁵⁸

4. The State Administration of Exchange Control (SAEC)

Under the leadership of the People's Bank of China, SAEC manages the administrative part of foreign exchange control, by setting exchange rates, drafting exchange control regulations and taking other foreign exchange measures. It controls foreign exchange in accordance with the Interim Regulation of Foreign Exchange Control of the P.R.C. ⁵⁹.

5. The Bank of China.

Due to decentralization of the foreign trade apparatus, the Bank of China is playing an increasingly important role in foreign currency transactions. As authorized by the state and the People's Bank of China, it signs agreements with foreign governments and central banks. It also participates in international financial activities, conducts foreign exchange business for the state and guarantees loan

⁵⁸ Ibid. p.10

⁵⁹ Ibid. p. 12

agreements by foreign banks to Chinese enterprises. The Bank of China also provides guarantees and certifications to foreign banks on the business and financial standing of Chinese enterprises requesting foreign loans⁶⁰.

6. The China International Trust and Investment Corporation (CITIC).

CITIC was founded in 1979 to promote foreign investment and to attract advanced technology for China's modernization. The CITIC helped establish joint ventures by assisting Chinese and foreign enterprises find appropriate business partners. If necessary, the CITIC can take an equity holding; negotiate with wholly foreign owned enterprises; help Chinese and foreign enterprises negotiate compensation trade agreements; and serve as China's principal channel for investment funds from Chinese living overseas and foreigners.

⁶⁰ Ibid.

Chapter III Foreign Investment Laws

A. Legislation Concerning Equity Joint Ventures

The Chinese foreign equity joint venture has been the major form for absorbing foreign investment in China because of its legal security and similarity to the limited liability company popular in most investing countries.⁶¹

By the end of 1990, over 25,600 joint ventures and 3,385 wholly foreign owned enterprises had been approved for operation in China. These include all kinds of FDI: equity and contractual joint ventures, wholly foreign owned ventures, joint offshore oil exploration, leasing arrangements, compensation deals, and processing and assembly.⁶²

The Law of the People's Republic of China on Joint Venture Using Chinese and Foreign Investment [hereinafter JVL] was adopted on July 1, 1979 at the Second Session of the Fifth National People's Congress, and promulgated on July 8, 1979. It contains 15 articles which provide a set of principles governing the establishment and operation of equity joint ventures in China.

In September 1983, the Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment [hereinafter JVL Implementing Regulations] was promulgated by the

⁶¹ Yuanxiang Hu, "Too Little, Too Late?" August (1990) *International Financial Law Review* p.31.

⁶² *Business China*, "Investor's Update" May 27, 1991 *Business China* p.77.

State Council. This Regulation provides detailed rules regarding the registration, capitalization, management, taxation, labour relations and liquidation of equity joint ventures in China.

Due to a sharp decline in new FDI in 1986, the Regulation Concerning Encouragement of Foreign Investment was issued. It was hoped that it would remedy some of the problems encountered by joint ventures.

On April 4, 1990, the Amended Joint Venture Law [hereinafter Amended JVL] was adopted by the Chinese government. This amendment dealt with the appointment of the Chairman of the Board of Directors. This new, more liberal law, was widely seen as a step taken by the Chinese government to restore credibility after the Tiananmen square massacre.

1. Legal Status

According to the JVL and the JVL Implementing Regulation, a joint venture shall take the form of a limited liability company⁶³. Joint ventures established in China are considered legal persons and subject to the jurisdiction and protection of Chinese law.⁶⁴

⁶³ The JVL art. 4. English translation can be found in the Collection of Laws and Regulations of the People's Republic of China Concerning Economic Affairs Vol. I (Beijing: the Department of Treaties and Law of the Ministry of Foreign Economic Relations and Trade of the P.R.C., 1985) p.42.

⁶⁴ Regulation For the Implementation of the Law of the People's Republic Of China On Joint Venture Using Chinese and Foreign Investment art. 2, the English translation can be found in Collection of Laws and Regulations of the P.R.C. Concerning Foreign Economic Affairs Vol. II p.62.

The responsibility which the limited liability company assumes for the debts of the joint enterprise is limited to its registered capital. The other capital of the Chinese and foreign joint ventures is not exposed to the risks of the joint venture enterprise.⁶⁵ Problems can arise, however, if joint ventures borrow money in excess of the capital subscribed by each party. Therefore, the Bank of China requires that all loans to joint ventures be guaranteed by the parent companies or secured by some collateral interest. The limited liability of the joint venture parent company may, therefore, be illusory.⁶⁶

2. Establishment and Registration

A joint venture must apply to the Ministry of Foreign Economic Relations and Trade of the People's Republic of China [hereinafter MOFERT] for authorization of the agreements and contracts concluded between the parties to the venture. The articles of association of the venture must also be submitted for approval. The MOFERT must either reject or authorize the joint venture plan within three months of the application date.⁶⁷ Once approved, the joint venture must register with the General Administration For Industry and Commerce for an operation license⁶⁸.

Two problems frequently arise during the negotiation period of equity joint

⁶⁵ The JVL Implementing Regulations art. 19.

⁶⁶ Brickley, Supra, note 35 p.101.

⁶⁷ JVL Implementing Regulation arts. 8 and 10.

⁶⁸ Ibid.

ventures. Firstly, the whole process itself is quite time consuming due to bureaucratic delays⁶⁹. The 1986 Encourage Foreign Investment Regulations tried to reduce such delays through greater interdepartmental cooperation.⁷⁰

Another problem encountered during the negotiation period is the vague criteria for approval of joint ventures. The Chinese government has never explained its basis for approval of joint ventures except for the minimum conditions expressed in articles 8(1) and 8(2) of the JVL Implementing Regulations. Because of this uncertainty, foreign investors may spend a lot of time and money negotiating a joint venture contract which is eventually rejected by the MOFERT for some previously undisclosed reason.⁷¹

Another concern for foreign investors is the rapid pace of change in Chinese law and the resulting impact of change on current contractual rights and duties⁷². MOFERT has sought to calm nerves by promising that some provisions in contracts may continue even though they run counter to newly promulgated laws or regulations.⁷³ It is still uncertain, however, as to which provisions would be deemed valid or invalid. Brickley has recommended the inclusion of a "renegotiation clause" in any joint venture contract, in order to reduce the risk of subsequent

⁶⁹ Brickley, Supra, note 35 p. 105.

⁷⁰ Ibid.

⁷¹ Ibid. p.105.

⁷² Timothy Gelatt, "Legal and Extra-Legal Issues in Joint Venture Negotiations" (1987) 1 Journal of Chinese Law p. 227

⁷³ "Questions and Answers Concerning Foreign Investment in China" May 12, 1983 China Econ. News p. 5.

adverse legislation⁷⁴.

3. Investment Contributions

The proportion of the investment contributed by the foreign participants cannot be less than 25 percent of the total capital⁷⁵. The profits, risks, and losses are apportioned according to each party's contributions to the registered capital⁷⁶. Registered capital cannot be reduced during the term of the joint venture⁷⁷.

The Chinese JVL and JVL Implementing Regulations impose a number of restrictions applying to contributions⁷⁸. The industrial property right or know-how contributed by the foreign participant as investment must be capable of manufacturing products that China urgently needs. The contribution can also be a product suitable for export or capable of improving either the quality of existing products or manufacturing productivity. The contribution may also be judged satisfactory if it allows for a notable saving in raw materials.⁷⁹

Under JVL Implementing Regulations articles 25 and 48, the Chinese participant is permitted to contribute land-use rights. The valuation of land-use

⁷⁴ Brickley, Supra, note 35 p.101.

⁷⁵ Supra, note 63, the JVL art. 4.

⁷⁶ Ibid.

⁷⁷ Supra, note 64 JVL Implementing Regulation art. 22.

⁷⁸ Stanley J. Marcuss & R. Watson Arthur, "Technology Transfer in the People's Republic of China: An Assessment" (1989) Vol. 15:141 Syr J. Int'l. L. & com. p.149.

⁷⁹ Supra, note 64 at 71 JVL Implementing Regulation art. 28

rights is reserved for the Chinese government⁸⁰. There is no free market mechanism by which the fair market value of real property can be measured. The unilateral determination of land use values by the Chinese government is arbitrary.⁸¹

Foreign investors must be cautious about the timing of any transfer of technology. If the foreign party transfers its technology to the Chinese party before the contract is approved, they may suffer a loss if the contract fails. To avoid this problem, the foreign investors should transfer any technology to the Chinese party only after the approval of the contract.⁸²

Another problem in the area of technology transfer is that the JVL Implementing Regulation limits the term of any technology licensing to ten years. Following this period, the Chinese party is free to continue using the technology. Because of this, some potential investors with very advanced technology may be reluctant to transfer their technology to China.⁸³

4. Control and Management

A joint venture is required to have a Board of Directors. The composition of the Board must be stipulated in the contracts and the articles of association.⁸⁴

Article 6 of the 1979 JVL required that the Chairman of the Board be appointed

⁸⁰ Ibid. JVL Implementing Regulation art. 49.

⁸¹ Brickley, Supra, note 35 p.106.

⁸² Ibid.

⁸³ Marcuss, Supra, note 78 p.149.

⁸⁴ JVL art. 6.

by the Chinese party and the Vice Chairman by the foreign party. The Board of Directors reaches its decisions through consultation on the principle of equality and mutual benefit. Art. 6 of the 1979 JVL came in for considerable criticism from both the Chinese and foreign parties. In certain cases the foreign party's share in the registered capital exceeded 50 percent, sometimes going over 80 percent. In such situations, it was reasonable for the foreign shareholder to want the position of Chairman⁸⁵. This problem was addressed in the Amended JVL Art. 6, where it was stated that either party can appoint the Chairman of the Board.⁸⁶ The Board of Directors is empowered to discuss and take action on all fundamental issues of management.⁸⁷

A major problem for foreign investors concerns the very slow pace of Chinese decision making at the Board level. Chinese law requires unanimity of the board in only four situations⁸⁸. However, most decisions, in practice, tend to be made through unanimity. Government interference is another obstacle to effective decision making at the Board level.⁸⁹

5. Termination

On October 22, 1990, MOFERT issued the Amended JVL which provided

⁸⁵ Yuan Xiang, Hu, "Too Little? Too Late?" August 1990 Int'l. Financial L. Rev. p.31.

⁸⁶ Amended Joint Venture Law art. 6. English translation can be found in Business China (April 4, 1990) p.62

⁸⁷ JVL art. 6.

⁸⁸ Art. 36 of JVL Implementing Regulation

⁸⁹ Brickley, Supra, note 35 p. 108.

rules on the joint venture period for Chinese -foreign equity joint ventures. The provisions permitted unlimited terms for joint ventures⁹⁰. The provisions extended the unlimited option to existing joint ventures. Such pre-existing joint ventures could change over to unlimited operation, providing they did not belong to one of the restricted industries. Any change, however, had to be approved by the authority that gave the original approval.

Joint ventures involved in the following areas may not benefit from unlimited terms: the service trade; real estate development; exploration and development of natural resources; and those projects restricted by the state or where the state requires a time limit.

The amendment provided confidence for foreign investors as firms no longer faced an expiration date. It also brought China into line with international norms, which do not usually impose a limit on the duration of an enterprise⁹¹.

The JVL provides the procedure for termination of a joint venture. The duration of a joint venture is determined by contractual agreement⁹². On termination of a joint venture a liquidation committee is established.⁹³ The main task of the liquidation committee is to conduct a thorough check of the property of the joint venture concerned. That task includes: the calculation of the ventures debts

⁹⁰ 1990 Amended JVL Supra, note 86 p. 62.

⁹¹ "Joint Venture Open-Ended Lifetimes: Who is Eligible" January 28, 1991 Business China p. 14.

⁹² JVL art. 12.

⁹³ JVL Implementing Regulation arts. 103, 104.

and credits; the drawing-up of a balance sheet; the itemizing of property; the determination of an evaluation method; and the formulation of a liquidation plan.

A new paragraph has been added in Art. 2 of the 1979 JVL which says the state shall not nationalise or expropriate joint ventures. Under special circumstances, or when it is in the public interest to do so, the state may still expropriate a joint venture. However, any expropriation must be done in accordance with legal procedures and must include compensation.

It remains unclear in Chinese law, however, as to just what kind of legal procedure is to be followed and what is appropriate compensation⁹⁴. However, China has concluded investment protection Bilateral Investment Treaties [hereinafter BITs] with many countries which contain provisions governing compensation. Foreign investors may rely on the protection of BITs' if they are faced with expropriation.

B. Contractual Joint Venture Law

In April 1988, the Law on Chinese-Foreign Contractual Joint Ventures [hereinafter CJL] was enacted.⁹⁵ The law, reflecting nine years of operating experience, provides a basic framework for contractual joint ventures.

1. Legal Status

Under the law, contractual joint ventures may take two different forms. A contractual joint venture may, if it meets the conditions, operate with the status of

⁹⁴ "Too Little? Too Late? " Supra, note 85 p.31.

⁹⁵ Law on Chinese-Foreign Contractual Joint Ventures was adopted by the National People's Congress in April 1988. An English translation can be found in Law In The People's Republic of China (Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1989) p.771.

a Chinese legal person. On the other hand, a contractual joint venture may operate as a non-legal entity such as a partnership.⁹⁶ The state protects the lawful rights and interests of contractual joint ventures. A contractual joint venture is subject to Chinese law and to the supervision of the state authority⁹⁷.

2. Establishment and Registration

A contractual joint venture must apply for approval of the agreement, contract and articles of association signed by the parties.⁹⁸ The relevant authority shall decide whether or not to grant approval within 45 days. Once the application is approved, the venture must register with the administrative authorities for industry and commerce to obtain a business license and register with tax authorities⁹⁹.

3. Capital

CJL provides the investors a greater degree of flexibility regarding the forms in which the parties may contribute to the capital of the enterprise than that under the JVL¹⁰⁰

Under the CJL, investment provided by the parties may be in cash or in kind. It may also include rights to the use of land, industrial property rights, non-

⁹⁶ Ibid. art. 2.

⁹⁷ Ibid. art.3.

⁹⁸ Ibid. art. 5.

⁹⁹ Ibid. art. 6.

¹⁰⁰ A.J. Easson, "Contractual, Cooperative and Equity Joint Ventures In the P.R.C." Review of the International Business Law p. 162

patent technology or other property rights¹⁰¹. A contractual joint venture is not required to have a registered capital. As a result, the Chinese and foreign parties can distribute earnings or products and undertake risks and losses in accordance with the signed contract.¹⁰²

4. Management

A contractual joint venture possessing the status of a legal person must establish a Board of Directors. If the contractual joint venture does not possess legal person status it must establish a joint management body to decide on the major issues concerning the venture.

5. Operations

The CJL contains provisions governing employment¹⁰³, foreign exchange,¹⁰⁴ borrowing,¹⁰⁵ insurance,¹⁰⁶ and the import and export of materials.¹⁰⁷

6. Termination

The period of operation of a contractual joint venture must be stated

¹⁰¹ Supra, note 95 p. 771. CJL art. 8.

¹⁰² Ibid. p.775. art. 22.

¹⁰³ Ibid. CJL art. 13.

¹⁰⁴ Ibid. articles. 16 and 20.

¹⁰⁵ Ibid. art. 17.

¹⁰⁶ Ibid. art. 18.

¹⁰⁷ Ibid. art. 19.

clearly in the contract.¹⁰⁸ Generally, contractual joint ventures have shorter terms than those of equity joint ventures.

The CJL indicates that ventures are expected to have a fixed term of operation, but it does not itself set a precise limit. Upon termination, the assets are liquidated and distributed in accordance with the contract, which must specify the ownership of the venture's property.¹⁰⁹ Like the equity joint venture legislation, the CJL neither specifically mentions, nor expressly precludes, the possibility that rather than choosing to "liquidate" the enterprise, the Chinese party may buy out the foreign party's interest.

C. The Law on Wholly Foreign Owned Enterprises

The legal framework in the P.R.C. for wholly foreign-owned enterprises has traditionally been even more vague than that for joint ventures. Wholly foreign owned enterprises did not appear in China until 1986.

On April 12, 1986, the Law on Wholly Foreign -Owned Enterprises [hereinafter WFOL] was adopted by the National People's Congress. China became the first socialist country to pass a law governing the establishment of domestic enterprises wholly owned by foreigners¹¹⁰. The law provides that the P.R.C. will protect the lawful rights and interests' of foreign ventures in China, including their right to remit profit abroad. The new law says that the state cannot nationalize

¹⁰⁸ Ibid. art. 25.

¹⁰⁹ Ibid. The CJV Law articles 2 and 24.

¹¹⁰ Preston M. Torbert "Wholly Foreign Owned Enterprises Come of Age" July, August 1986 the China Business Review p. 50.

wholly foreign owned enterprises. In special circumstances, for the purpose of social or public interests, the state may expropriate wholly foreign owned enterprises, but with commensurate compensation.¹¹¹

The Wholly Foreign Owned Ventures Law Implementing Regulations [hereinafter WFOI Implementing Regulation] issued on December 12, 1990 provides the basic guidelines for new investment.

1. Legal Status

According to the law, a wholly foreign owned enterprise which meets certain requirements shall have the status of a Chinese legal person.¹¹² The Civil Code of P.R.C. provides China's statutory definition of a legal person:

- (1) It must be lawfully established.
- (2) It must possess the necessary property or funds.
- (3) It must possess it's own name, organizational structure and residence.
- (4) It must be able to assume civil liability independently.¹¹³

After registration with the industry and commerce administrative authorities, the wholly foreign owned enterprise is recognized as a Chinese legal person.

2. Establishment and Registration

¹¹¹ The Law on Wholly Foreign Owned Enterprises art. 5. was adopted by the National People's Congress on April 12, 1986. English translation can be found in Law In the People's Republic Of China (Dordrecht/ Boston/ London: Martinus Nijhoff publishers, 1988) p 761.

¹¹² Ibid. art. 8.

¹¹³ Civil Code of P.R.C. art.37.

Art. 3 of the WFOL sets forth the criteria for the establishment of a wholly foreign owned venture. The foreign owned enterprise must use advanced technology or export all or most of their products. This requirement is stricter than the provisions of the JVL.¹¹⁴ The WFOL Implementing Regulations add to these basic requirements by listing specific industries in which wholly foreign owned investments are either prohibited or restricted.

Prohibited areas are: newspapers, film, or broadcasting; domestic commerce, foreign trade, or insurance; post and telecommunications; and other industries that China has prohibited from wholly foreign ownership.

Restricted areas requiring MOFERT approval are: public utilities, transportation, real estate, trust and investment, and leasing.

In addition, the WFOL Implementing Regulations impose requirements on the balancing of foreign exchange when establishing a venture. Applicants must show how they can meet their foreign exchange needs. If the investor promises to balance the exchange and subsequently fails to do so, the government will not assume responsibility.¹¹⁵

The foreign investors must apply to the examination and approval authorities for approval of applications for the establishment of the wholly foreign owned enterprise. The relevant authorities decide whether or not to grant approval within 90 days. Once the application is approved, the foreign investors shall apply

¹¹⁴ Marcuss, Supra, note 78 p.162.

¹¹⁵ Business China, "PRC State Council Lays Ground Rules For New Sole Investments" Jan. 1991 Business China p.14.

for registration with the administrative authorities for industry and commerce and obtain a business license ¹¹⁶.

3. Investment Contributions

The regulations regarding the type of capital that foreign investors may contribute to wholly foreign owned ventures are similar to those of joint ventures. Capital can include foreign currency, equipment, industrial property, and proprietary technology. Renminbi (non-convertible Chinese currency) profit from an investor's other ventures may also be reinvested in wholly foreign owned projects.

A wholly foreign owned enterprise must make the investment within the period approved by the examination and approval authorities. If no investment has been made by the end of the period, the relevant authority has the right to revoke the business license of the enterprise¹¹⁷.

These rules differ from the JVL where partners may determine the capital contribution schedule by contract.

4. Management

Enterprise autonomy is a critical issue for wholly foreign owned ventures in China. The administrative authorities still play an important role in the operation and management of China's enterprises. The activities of WFO enterprises are

¹¹⁶ Supra, note 111 p.761. WFOL art. 7.

¹¹⁷ Under the WFOL Implementing Regulations the first instalment of capital constituting at least 15 percent of the total must be paid within 90 days of when a wholly foreign owned company is granted its business license. The final instalment of the investment must be made within three years of that same date.

reviewed by three Chinese government authorities: the approval authorities who pass judgment on the project;¹¹⁸ the industrial and commercial administrative authorities who examine and supervise the investments of wholly foreign-owned enterprises;¹¹⁹ and a government department in charge of WFO enterprises. The law stipulates that the production and operating plan of a wholly foreign owned enterprise must be submitted to its department in charge for record keeping.¹²⁰ The law does, however, limit the government role by prohibiting interference in the operation and management activities of a wholly foreign owned enterprise conducted according to its approved articles of association.¹²¹

5. Operations

The WFOL states that a wholly foreign -owned enterprise employing Chinese staff must enter into a contract with its workers. The contract shall contain provisions relating to matters of employment, dismissal, remuneration, benefits, labour protection and labour insurance¹²². In order to protect the lawful rights and interests of the staff and workers, a trade union must be established. The enterprise itself must provide the necessary facilities for the activities of its trade

¹¹⁸ WFOL art. 6. Supra, note 111 p.761.

¹¹⁹ Ibid. articles 7 and 9.

¹²⁰ Ibid. art. 11.

¹²¹ Ibid. art. 11.

¹²² Ibid. art. 12.

union.¹²³ The law also contains provisions governing accounting,¹²⁴ supply of raw materials¹²⁵ and insurance¹²⁶.

The WFOL Implementing Regulation does not provide detailed rules on labour management, financial matters or dissolution. These areas are governed by "relevant laws". But what exactly these relevant laws are remains unclear. Perhaps joint venture legislation in these areas will be applied to wholly foreign owned ventures. The government should clarify exactly which regulations are to apply in the future.¹²⁷

6. Termination

The WFOL Implementing Regulation remains silent as to whether or not the wholly foreign owned ventures, like joint ventures, can run without time limits. Currently, all wholly foreign owned ventures have fixed terms of operation. The term of operation of a wholly foreign owned enterprise must be submitted by the foreign investors for approval by the relevant authorities.¹²⁸ When a wholly foreign owned enterprise terminates its operation it must cancel its registration with the

¹²³ Ibid. art. 13.

¹²⁴ Ibid. art. 14.

¹²⁵ Ibid. art. 15.

¹²⁶ Ibid. art. 16.

¹²⁷ "PRC State Council Lays Ground Rules For New Sole Investments" Jan. 1991 Business China p.14.

¹²⁸ The WFOL art. 20. Supra, note 111 p.761.

administrative authorities for industry and commerce and return its business license
129. Meanwhile, a prompt public announcement must be made and liquidation
conducted¹³⁰. The assets of the enterprise shall not be disposed before the
completion of the liquidation.

¹²⁹ Ibid. art. 22.

¹³⁰ Ibid. art. 21.

Chapter IV China's Civil Law

The basic principles of Chinese civil law are reflected in the General Principle of Civil Law Of P.R.C. [hereinafter Civil Code] which was adopted by the Fourth Session of the Sixth National People's Congress on 12 April 1986¹³¹. The law makers never stated whether they had drawn from the experience of the 1929 Nationalist Civil Code or from the German and Japanese codes. Nevertheless, a brief examination of the document shows that the law makers did take some inspiration from other codes, particularly the German Civil Code¹³².

China's Civil Code has gone through several drafts over a period of more than thirty years. In 1949, the new Communist government repealed all of the laws of the previous regime, including the Nationalist Civil Code. Ever since then, the government has been trying to draft a replacement. The progress towards this objective has been slow. Political instability has often interrupted the process.

By 1982, the fourth draft of the Civil Code had been completed. However, while the Civil Code was being drafted, economic reform was also under way in the whole country. These economic reforms brought about substantial changes in the basic economic relations which the Civil Law had attempted to regulate. The

¹³¹ General Principle of Civil Law of the P.R.C. adopted by the Fourth Session of the Sixth National People's Congress on 12, April 1986. Reprinted in People's Daily, 18 April 1986 at 2-3. It came into effect on 1 January 1987.

¹³² Edward J. Epstein, "The Theoretical System of Property Rights in China's General Principles of Civil Law: Theoretical Controversy in the Drafting Process and Beyond" Spring (1989) Vol. 52: No.2 Law and Contemporary Problems p.193.

enactment of the law was therefore delayed.

While the codification of the Civil Law proceeded, many single civil statutes were enacted. Since 1980, the Marriage Law was revised and the Economic Contract Law, Inheritance Law, Patent Law and Trademark Law were enacted. Because many single civil statutes had already been enacted, the Civil Code was designed to provide basic principles and, to a lesser extent, rules that were not already covered. Hence, the code is constructed in the form of general principles rather than the "catch-all-provisions" format found in the German or Japanese civil codes.¹³³

The Civil Code contains eight chapters and 156 articles. The rules embodied in the Civil Code are classified into six broad categories. These include the laws concerning subjects of civil law, contract, the law of agency, property, civil liability and remedies, and rules governing foreign economic relations.

A. Legal Person

The term "legal person" has been frequently used in Chinese judicial practice and legislation without a definition. The Civil Code clarifies the concept of "legal person"¹³⁴ and therefore provides some assistance to foreign businessmen in identifying which P.R.C. organizations are authorized to sign contracts and whether or not they are acting within the scope of their authority.¹³⁵ Under the

¹³³ Henry R. Zheng, "China's New Civil Law" (1986) Vol. 34 the American Journal Of Comparative Law p.671.

¹³⁴ Civil Code art. 41. Supra, note 131 p.2

¹³⁵ See Jerome Alan Cohen, "China Adopts Civil Law Principles" Sept. 1986 China Business Review p.48.

Code, legal persons are defined as "organizations that have civil capacity, and are competent to perform civil acts, and according to law independently enjoy civil rights and bear civil liabilities¹³⁶". Accordingly, a legal person must: be lawfully established; possesses the necessary property, name, organizational structure and residence; and be able to assume civil liability independently¹³⁷. The person who exercises authority on behalf of a legal person according to the charter of association or according to the law is the legal representative of the legal person.¹³⁸

The Civil Code distinguishes enterprise legal persons from other legal persons such as government agencies, social groups and non-business entities. Enterprises may acquire the status of a legal person upon approval and registration¹³⁹. The legal status of joint ventures and wholly foreign owned enterprises as legal persons is reaffirmed in the Civil Code. However, contractual joint ventures remain in somewhat of a legal limbo. The Civil Code states that to be considered a legal person in China, contractual joint ventures must meet the conditions of a legal person as set forth in the Civil Code itself. But, the code does not make clear in what circumstances a contractual joint venture will satisfy the condition that it "must be capable of assuming civil liability independently."

Government agencies, public institutions and social organizations that meet

¹³⁶ Supra, note 131 art. 36.

¹³⁷ Ibid.

¹³⁸ Ibid. art. 38.

¹³⁹ Ibid. The Civil Code articles 37 and 41.

the requirements of a legal person may also register as a legal person upon approval.¹⁴⁰

The civil liability of an enterprise legal person is limited to the extent of the property it owns and operates.¹⁴¹ When the enterprise dissolves or goes bankrupt¹⁴², a liquidation organization will be established by the court or competent authority to deal with the liquidation proceedings¹⁴³.

B. Contract

The P.R.C. has never issued a uniformly codified contract law. China has, in fact, issued two contract laws: the Economic Contract Law [hereinafter ECL] and the Foreign Economic Contract Law [hereinafter FECL]¹⁴⁴. The ECL is designed mainly to implement the state Plan. In contrast, the FECL is largely based on the freedom of contract principle. As described by one scholar, the FECL is "like a codification of the Anglo-American common Law of contracts"¹⁴⁵. The law is intended to apply to all economic contracts with foreign bodies. The ECL, on the

¹⁴⁰ Ibid. the Civil Code art. 50.

¹⁴¹ Ibid. art. 48.

¹⁴² The Enterprise Bankruptcy Law of the P.R.C. was adopted on December 2, 1986. For an English translation of the law, see 19 Vand. J. Int'l. L. (1986) p.733.

¹⁴³ The Civil Code art. 47.

¹⁴⁴ The Economic Contract Law was adopted in December 1981. An English translation can be found in C.B.T.L.(1982). The Foreign Economic Contract Law was adopted in May 1985. For an English translation, see Vol.1 C.B.T.1 (1985)

¹⁴⁵ Philip J. Wilson, "The legal Structure Governing Technology Transfer and Joint Ventures With the P.R.C." (1985) 3 Int'l. Tax & Bus. Law p.15.

other hand, is designed to govern all contracts between Chinese domestic enterprises.

These two laws do not cover all the legal issues arising in contract. Some rules, such as capacity of the contracting parties and rules governing mistakes, are not dealt with in the ECL or FECL. The contract law of the Civil Code furnishes rules in those areas not covered by the ECL and FECL and provides guiding principles for coordinating the application of these statutes¹⁴⁶.

1. Concept of Civil Legal Act

The Civil Code Chapter 4, section 1, provides the rules governing civil legal acts. Art. 54 of the code defines the concept as: "civil legal acts are lawful acts by which citizens or legal persons establish, modify or terminate civil rights and duties." The law provides that a valid civil legal act must satisfy the following conditions: the person performing the act must have the appropriate competence; the real intent must be expressed; and there must be no violation of the law or public interest.¹⁴⁷ Civil legal acts can be in oral, written, or any other form. When the law requires a specific form, the provisions of the law must be followed.

Under the Civil Code, legal acts come into legal force from the time they occur, unless stated otherwise in law, or following agreement between the parties. The person who must perform the act may not himself modify or revoke it.¹⁴⁸

¹⁴⁶ Zheng, Supra, note 29 p.51.

¹⁴⁷ The Civil Code art.55.

¹⁴⁸ The Civil Code art. 57.

Art. 58 lists seven civil acts that are void:

(1) Acts performed by a person who is incompetent.

(2) Acts performed by a person with limited competence, who according to law may not independently perform such an act.

(3) Acts performed under circumstances where one party, by using deceit or duress, or by taking advantage of the other party's distress, causes the other party to act contrary to his real intent.

(4) Acts which involve maliciously conspiring to injure the interests of the state, of a collective, or a third party.

(5) Acts which violate the law or the public interest.

(6) Economic contracts which violate the state mandatory plan.

(7) Acts which use a lawful form to conceal an illegal purpose.

From the time it occurs, a void civil act has no effect¹⁴⁹.

Other civil acts that are voidable include those that are obviously unfair, and those where there has been a significant misconception as to the contents of the contract¹⁵⁰. A party has the right to request from the People's Court or an arbitral organ the modification or rescinding of a voidable civil act.

The Civil Code provides that invalidity of part of a civil act does not affect the validity of the other parts.

Art. 62 says, a civil legal act may be made subject to a condition. A civil

¹⁴⁹ The Civil Code art. 58.

¹⁵⁰ The Civil Code art. 59.

legal act subject to a condition takes effect when the condition is satisfied.

2. Definition of Contract

Under the Civil Code, a contract is defined as "an agreement whereby parties establish, modify, or terminate a civil relationship." Contracts formed in accordance with the law are protected by law. Parties to a contract must fully perform their duties in accordance with the contract. If the terms of a contract relating to quality, duration, place, or price are not clear and definite, and these cannot be determined from the content of related provisions of the contract, or through mutual agreement, the Civil Code provides the applicable rules.

When one party to a contract makes a partial or complete transfer to a third party of his contractual rights or obligations, he must obtain agreement from the other party. Some contracts also require approval from the government¹⁵¹.

3. Secured Transactions

The Civil Code provides several methods to assure the performance of obligations. First, a guarantor may guarantee to the obligee that the obligor will perform the obligation. If the obligor does not perform according to the agreement, the guarantor may choose to perform or be held jointly liable. After a guarantor performs the obligation, he is entitled to seek compensation from the obligor. Second, an obligor or third party may offer certain property as a pledge. Where the obligor does not perform the obligation the obligee is entitled, in accordance with the provisions of the law, to value the pledged property in cash or sell the pledged

¹⁵¹ The Civil Code art. 91.

property and obtain compensation by priority right. Third, a party may within the limits provided by law, give the other party a deposit. After the obligor performs the obligation, the deposit must be deducted from the price or returned. If the party which gives the deposit does not perform the obligation, he does not have a right to ask for the return of the deposit. If the party who receives the deposit does not perform the obligation, he must return the deposit plus an equal amount. Fourth, when one party is in possession of the property of the other pursuant to a provision of a contract, the possessor may, if the other party fails to pay within the agreed time, retain the property. The property holder can then value the retained property in cash or sell it and obtain compensation by priority right.¹⁵²

4. Civil Liability for Breach of a Contract

Chapter 6 section 2 of the Civil Code provides the rules on liability for breach of contract. When one party fails to perform his contractual duty, or his performance of his contractual duty is not in accordance with the agreed terms, the other party has a right to demand performance. The aggrieved party may instead demand the taking of corrective measures and has the right to demand compensation for any loss.¹⁵³ The liability for compensation of a party who breaches a contract must be equal to the loss the other party incurred as a result of the breach.¹⁵⁴ When both parties have breached a contract, it is necessary to

¹⁵² The Civil Code art. 89.

¹⁵³ The Civil Code art. 111.

¹⁵⁴ The Civil Code art. 112.

determine separately the amount of civil liability each should bear.

A party that sustains a loss due to a breach of contract by another party must take appropriate measures to prevent an increase in the extent of the loss. The injured party does not have a right to demand compensation for losses due to a failure to mitigate on his part.¹⁵⁵

If a party is unable to perform his contractual duty due to a supervisory organization, the party must, in accordance with the contract, pay compensation to the other party or take measures to correct the problem. The supervisory organization is then responsible for dealing with the loss that the party sustained as a result.

C. The Law of Agency

An entire section ¹⁵⁶ of the Civil Code regulates the creation and termination of the principal-agent relationship and rights, duties and liabilities arising from it.

Under the Civil Code, both citizens and legal persons may perform civil legal acts through agents. Agents perform civil legal acts in the name of the principal within the limits of their authority. Principals bear civil liability for acts performed by agents on their behalf. Civil legal acts cannot be performed by an agent where,

¹⁵⁵ The Civil Code art. 14.

¹⁵⁶ The Civil Code Chapter 4, section 2.

by law or agreement, specific performance by one of the parties is demanded.¹⁵⁷

There are three kinds of agencies: agency by agreement, agency by operation of law, and designated agency. An agency by agreement involves the exercise of authority by an agent in accordance with his appointment by a principal. An agency by operation of law grants authority to an agent in accordance with a provision of the law. A designated agent exercises his authority as an agent in accordance with a designation by the people's court or designating unit.

Any act performed by an agent outside his authority results in civil liability for the principal only if the act has been ratified by him after the fact. As for an unratified act, the person who performed the act bears civil liability. If a person knows that another person is performing a civil act in his name and does not object, he is deemed to have consented.

When an agent's failure to perform his duty causes loss to his principal, he must bear civil liability. When an agent conspires with a third party to the detriment of the principal's interests, the agent and the third party are jointly liable. When a third person, knowing that an agent is acting either without authority, beyond the scope of his authority, or after its termination, continues to perform the civil act with that person, thereby causing loss to another, the third person and the agent are jointly liable.

An appointed agency can be terminated in the following ways: (1) The term of the agency ends, or the task of the agency is accomplished. (2) The principal

¹⁵⁷ The Civil Code art. 63.

revokes the appointment or the agent withdraws from the agency relationship. (3) The agent dies. (4) The agent becomes incompetent. or (5) The status of a legal person acting as principal or agent is terminated.

Legal representative and designated agency relationships are terminated when: (1) The principal acquires or regains competence. (2) The principal or agent dies. (3) The agent becomes incompetent. (4) The people's court or unit which designated the agent revokes the designation. or (5) The guardianship relationship between agent and principal terminates for another reason.

D. Property Right

Chinese property law is one of the most underdeveloped areas in Chinese law.¹⁵⁸

In accordance with the 1982 Constitution, the Civil Code divides the system of ownership into three categories: state owned property, collective property, and citizen's personal property. State property belongs to all of the people. Unlike the former Soviet Codes, China's Civil Code expressly permits private ownership.¹⁵⁹ The two socialist codes differ in other regards as well. Under the Soviet Codes, the state enjoys property rights and is subject to civil law. But in China's Civil Code state property is owned not by the state but by the whole people. Because state property belongs to the whole people, the state itself is removed from the sphere of civil

¹⁵⁸ Zheng, Supra, note 29 p. 33.

¹⁵⁹ Epstein, Supra, note 132 p.186.

activities and thus can no longer be viewed as subject to the civil law.¹⁶⁰

State ownership refers to the holding of property by state enterprises, government agencies and certain non-profit institutions. Under the centrally planned Chinese economy of the 1950s, enterprises acted as little more than branches of the state. The state made all the important economic decisions for the enterprises. Assets held by state enterprises have always been said to be "owned" by the state and not by the enterprise itself. The enterprise merely had the right to use and manage the state's property. The Chinese have now recognized that enterprises in a pure centrally planned economy lack initiative and are often wasteful and unprofitable. Under the economic reforms, the separation of ownership from management has been proposed as the means to stimulate productivity. The increasing independence of enterprises under the reforms has been reflected in their new status as legal persons bearing limited liability. Now, state enterprises are allowed to dispose of, rent or transfer their surplus fixed assets and to use after-tax profit.¹⁶¹

Despite increased control over their assets, state enterprises still do not own them. The property still belongs to the state. Ideally, enterprise autonomy means that an enterprise is able to engage in production and commercial activities free from state interference and is also allowed to use state property as its own.

¹⁶⁰ Ibid.

¹⁶¹ Before economic reforms, state owned enterprises had to pay all of their profit to the state. See, Howard Chao & Xiaoping Yang, "The Reform of the Chinese System of Enterprise Ownership" (1987) 23 (1) Stanford Journal of International Law p.373.

China has chosen the Civil Code to define this relationship between the state and state enterprises. Under Chapter 5 of the Civil Code, the concept of ownership is described as "an owner's right in accordance with law to possess, use, benefit from and dispose of his own property."

These four constituent powers and functions of ownership can be separated from ownership individually or in combination, but they cannot become independent property rights¹⁶².

Chinese theorists break ownership into four parts so they can create new rights for the state enterprises to operate state owned property. Chapter 5 section I includes five property rights related to ownership: (1) The right of a state owned or collective unit to use and benefit from land owned by the state.¹⁶³ (2) The right acquired by contract, of citizens or collectives to operate publicly owned land.¹⁶⁴ (3) The right of state or collective units or citizens to exploit natural resources. (4) The rights of an enterprise owned by the whole people to operate property given to it by the state. (5) Rights in the property of others necessary for the conduct of a neighbourhood relationship. These rights authorize the productive entities to utilize the means of production owned by the state or collectives.

¹⁶² For example, in Chinese Civil Law, the right of possession is not sufficient to support an action asserting a better right to a third party's. Such an action must be brought by its owner. See Wang, Liming, "Problems concerning possession, the right of possession and ownership " (1986) 1 Faxue Pinlun (Law Review) p. 15. (Bimonthly Journal of Wuhan University Law Department)

¹⁶³ The Civil Code art. 81(1).

¹⁶⁴ The Civil Code art. 81(3).

According to the law, even though the enterprises do not own the property, they have a right to operate it. But the nature of the property right enjoyed by the state enterprises is still the subject of theoretical controversy¹⁶⁵. Is the "right to operate" a property right, or is it merely an authority to use public property as directed by the state? The lack of a clear theoretical basis for state enterprise property rights is an obstacle to reforming China's state owned industrial sector.¹⁶⁶ For enterprise autonomy to mean anything, the state enterprises must be able to exclude the state from interfering in their activities.

In April 1988, the National People's Congress took two important steps to give legal expression to urban economic reforms. The first step was to amend the 1982 Constitution to expressly permit and protect the private economy¹⁶⁷ and the lawful transfer of the right to use land. Secondly, the state enterprise law was issued providing the structure necessary to give the state enterprises their economic autonomy. Although not in great detail, the property rights in the state enterprises were at least defined. Enterprise property rights are set out in the same terms as art. 82 of the Civil Code. But the law adds a limitation to their autonomy in that disposition of property must be according to the law. That limitation clearly preserves powers of administrative intervention in the hands of the state. The law remains unclear with regards to enterprise autonomy.

¹⁶⁵ Ibid. p. 212.

¹⁶⁶ Ibid.

¹⁶⁷ The Constitution art. 11

E. Foreign Civil Relationship

Chapter 8 of the Civil Code explains the rules that apply in foreign civil relationships. The concept of "foreign civil relationship" is defined as: Where one or both parties to a civil relationship are foreigners, stateless persons, or foreign legal persons; or the subject matter of the civil relationship is located abroad; or the legal facts that create, change, or destroy a relationship of civil rights or obligations occur abroad.¹⁶⁸

When an international treaty signed by China contains a provision which differs from the Civil Code, the provision in the international treaty applies, except for those articles to which the P.R.C. has declared a reservation. Where neither the law of the P.R.C. nor the treaty itself contains a relevant provision, international custom applies.¹⁶⁹

The Civil Code sets forth a series of rules to deal with disputes involving a conflict of laws. In determining ownership of immovable property, the law of the place where the property is located applies. The parties to a foreign contract may choose the law applicable to settlement of dispute arising from the contract, unless the law provides otherwise. Where the parties to a foreign contract have not made a choice, the law of the country which has the closest connection to the contract

¹⁶⁸ Opinion (for trial use) of Supreme People's Court on Question Concerning the Implementation of the General Principles of Civil Law of the P.R.C.. The English translation is in Spr. (1989) 52 Law and Contemporary Problems p. 59.

¹⁶⁹ The Civil Code art. 142.

applies. In regards to support, the law of the country which has the closest connection with the supported person applies. In regard to succession determined by inheritance law, the law of the deceased's domicile at the time of death applies to movable property. For immovable property, the law of the place where the immovable property is located applies. Where foreign law or international custom is applied in accordance with this law, there must not be a violation of the public interests of the P.R.C.¹⁷⁰

¹⁷⁰ The Civil Code articles 142 to 150.

Chapter V Technology Transfer

FDI often involves technology transfer. This chapter outlines the legal framework for technology transfer to the P.R.C., including a discussion of areas of particular concern to foreign investors.

A. Ascertaining Authority of the Chinese Party

Investors have to confirm the legal status of their Chinese partners¹⁷¹ before signing a technology transfer contract. The scope, authority and legal status of Chinese enterprises are murky areas facing foreign investors in China. China's evolving economic policies and alternating tilts to and from centralized economic decision-making have made it difficult for foreign investors to identify which enterprises are authorized to negotiate and sign the contract or to determine whether the project itself has been authorized.¹⁷²

China operates a socialist, centrally-planned economy. Thus, all

¹⁷¹ In the past several years, an increasing number of enthusiastic Chinese businessmen and officials have misrepresented their authority to enter into binding sales or investment contracts with foreigners. Misrepresentations by briefcase companies, so-called because the full extent of their authority and activities is in a briefcase, are fraudulent. Other misrepresentations stem from employees of legitimate Chinese organizations misunderstanding the scope of their personal or enterprise's authority. See, Denny F. Wong & Christopher G. Oechshi "Getting A Binding Contract: Legal Status and Authority of Chinese Enterprises and Their Representatives." January (1989) East Asian Executive Reports p.11.

¹⁷² A. Wolff. " Technology Transfer to People's Republic of China" (1989) Vol. 4 International Journal of Technology Management p.451.

economic activity must fit within the state economic Plan.¹⁷³ The foreign party must, therefore, ensure that the P.R.C. planning authorities have authorized the proposed project before transferring technology.¹⁷⁴

As in any centrally planned economy, the state defines long-term economic goals and identifies intermediate development targets. It lists sectoral priorities in five- year and annual plans, which spell out what types of products or technology are to be imported and which major projects are to be initiated. These plans offer solid clues as to what projects will take top priority. The Eighth Five Year Plan (1991-1995), for example, emphasizes the areas of agriculture and services¹⁷⁵. The Chinese government has also in the past looked with favour on foreign investment in the fields of oil exploration, electricity production, and assembly type industries.¹⁷⁶

In order to confirm the identity and legal status of the Chinese party, foreign investors can review the Chinese party's business licence and its articles of association. However, this may not be enough, as attempts to decentralize foreign trade early in the reform process have been reversed in recent years. The government discovered that smaller operations were importing useless technology. As a result, few end users of technology have the right to sign technology import

¹⁷³ The Constitution art. 15

¹⁷⁴ Wolff, Supra, note 172 p.452 and 453.

¹⁷⁵ Barry Naughton "Economic Directions for the 90'" May-June (1991) the China Business Review p.10.

¹⁷⁶ The World Bank, China: Between Plan and Market (1990) P.54.

contracts today. Under the 1988 Technology Detailed Rules, enterprises lacking the authority to sign technology import contracts may use an agent, such as a state import-export corporation. In this situation, the foreign investor has to deal with two entities on the other side of the contract; namely, the state import-export corporation and the end user.¹⁷⁷

B. Legal Framework for Technology Transfer

China recognized the importance of protecting intangible property rights in its modernization program. Since 1979, the Chinese government has promulgated a number of laws and regulations intended to encourage foreign investment and to provide a stable legal climate. The Joint Venture Law (1979), and the Law on Wholly Foreign- Owned Enterprises (1986) contain some provisions concerning technology transfer. Under these two laws, the technology transferred by the foreign parties as investment must be truly advanced and appropriate to China's needs¹⁷⁸. Other laws and regulations concerning technology transfer are: the Foreign Economic Contract Law(1985), the Contractual Joint Venture Law(1988), the Trademark Law(1982),¹⁷⁹ and 1988 Revised Implementing Regulation on the

¹⁷⁷ Mitchell, A. Silk, " Recent Efforts in China's Drive to Promote Investment through the Protection of Intellectual Property Rights: the 1988 Trademark Rules and the 1988 Technology Import Contract Rules" (1989) Vol. 15:203 *Syr.J. Int'l. L. Com.* p.227

¹⁷⁸ JVL art. 5, WFOL art. 3.

¹⁷⁹ The Trademark Law was adopted on August 23, 1982, at the 24th Session of the Standing Committee of the Fifth National People's Congress. The English Translation can be found in CCH Australia, *China Laws for Foreign Business*, n. 11-500. The Detailed Implementing Rules for the Trademark Law were promulgated and effective on March 10, 1983. An English translation can be found in

Trademark Law, the Patent Law (1984) and its set of Detailed Implementing Rules of 1985,¹⁸⁰ and the Regulations on the Administration of Technology Import Contract (1985) and related regulations.¹⁸¹

1. The Regulation of the P.R.C. on the Administration of Technology Import Contracts

Technology transfer to the P.R.C. is mainly governed by the Regulation of the P.R.C. on the Administration of Technology Import Contracts [hereinafter TICR] promulgated by the State Council on May 24, 1985. MOFERT promulgated a set of rules, the Detailed Rules on Regulation of the P.R.C. on The Administration of Technology Import Contracts of the P.R.C. [hereinafter the 1988 Technology Detailed Rules]¹⁸² on January 20, 1988. The Chinese government, for

II China's Foreign Economic Legislation (foreign languages Press 1986) p. 184.

¹⁸⁰ The Patent Law was adopted on March 12, 1984 at the Fourth Session of the Standing Committee of the Sixth National People's Congress. The English translation can be found in CCH Australia, China Law for Business at n.11-600. The Detailed Implementing Rules of the Patent Law were approved by the State Council and promulgated by the Patent office of the P.R.C. on January 19, 1985. The English translation can be found in CCH Australia, China Law For Business, at n. 11-603.

¹⁸¹ The Regulations on the Administration of Technology Import Contracts was promulgated by the state Council on May 24, 1985. The English translation can be found in CCH Australia, China Law for Business, at n 5-570, The Law on Technology Contracts was adopted on June 23, 1987 by the 21th Session of the Standing Committee of the Sixth National People's Congress. The English translation can be found in CCH Australia, China Law for Business, at n. 5-577.

¹⁸² The Detailed Rules and Regulations For the Implementation of the Regulation on Administration of Technology Import Contract of the P.R.C. was approved by the State Council December 30, 1987 and promulgated by MOFERT on January 20, 1988, Translation in China Economic News Supplement No.1, Feb. 8, 1988.

the first time, issued new legislation to replace current legislation less than three years old,¹⁸³ in an effort to clarify the treatment given to foreign corporations doing business in China.

(a) Scope of Technology Import Legislation

The TICR defines technology imports as technological items obtained, through trade or economic and technical cooperation, by companies, enterprises, organizations or individuals within the P.R.C. from companies, enterprises, organizations or individuals outside the P.R.C.¹⁸⁴ Thus, the TICR does not cover the transfer of technology in general, but only technology imported into China.

The TICR governs technology transfer contracts of all enterprises that operate with foreign investment, ie. equity joint ventures, contractual joint ventures and wholly foreign-owned ventures¹⁸⁵. The regulations do not apply when the technology forms part of the foreign party's capital contribution to a joint venture. In that situation, the JVL and JVL Implementing Regulation applies.

"Technology Import" refers to the transfer or licensing of industrial property rights derived from a patent or trademark. The licensing of technical know-how and contracts for technical service are also included within the definition.¹⁸⁶

In the past decade, the transfer of technology to China has grown rapidly. It has

¹⁸³ The 1988 Technology Detailed Rules replaced the Procedures For Examination and Approval of Technology Import Contracts which was promulgated by MOFERT on 18 Sept. 1985.

¹⁸⁴ The TICR art. 2.

¹⁸⁵ The 1988 Technology Detailed Rules art. 4.

¹⁸⁶ The 1988 Technology Detailed Rules art.2.

been argued that much of this technology has been outdated and unsuited to the economic conditions of China. Chinese legislation, therefore, has attempted to address this problem. Under the TICR, imported technology must be "advanced" and "appropriate". The regulation provides no definition of these words, but rather sets forth the necessary criteria for imported technology to be accepted: (1) It must be capable of developing and producing new products. (2) It must be capable of improving the quality and performance of products, reduce production costs and lower consumption of energy or raw materials. (3) It must be favourable to maximum utilization of local resources. (4) It must be capable of expanding export products. (5) It must be favourable to environmental protection. (6) It must be favourable to production safety. (7) It must improve management skills. (8) It must contribute to the advancement of scientific and technological levels.

(b) Approval

All contracts for the transfer of technology must be approved by MOFERT or its delegates¹⁸⁷. This procedure allows the government agency to examine the level of the technology transferred and to control technology transfer according to the state plan. Some commentators consider the approval procedure an additional layer on the negotiation process which can be costly and frustrating, leading to unnecessary delays in the implementation of the contract.¹⁸⁸

(c) Eight Requirements as to the Content of the Contract

¹⁸⁷ The 1988 Technology Detailed Rules art. 2.

¹⁸⁸ Silk, Supra, note 177 p. 227.

In an effort to guard against vague and incomplete contracts intended to evade the requirements of technology transfer regulations, the 1988 Technology Detailed Rules specify the required contents of technology transfer contracts. The essential terms that must be included in the contract are as follows: name of the contract; contents, scope and requirements of the technology; criteria, time limits and measures for verifying the technology once transferred; confidentiality obligations and requirements relating to improvements and modifications in the technology; the itemized contract price and terms of payment; compensation guidelines in the event of breach; dispute resolution provision; and measures for interpreting key terms and phrases¹⁸⁹.

Over the years, the P.R.C. has negotiated many technology transfer contracts and is, therefore, very familiar with the usual contents of such contracts. The 1988 Technology Detailed Rules does not deviate in this respect from international practice.¹⁹⁰

According to Art. 12 of the Foreign Economic Contract Law, the contract must also set forth: (1) The content, scope and description of the technology to be acquired and a list, if any, of patents and trademarks. (2) The objective to be achieved using the technology and the time required for its achievement. (3) Terms on price, amount and way of payment, and various incidental expenses.

(d) Prohibition of Certain Restrictions

¹⁸⁹ The 1988 Technology Detailed Rules art.7.

¹⁹⁰ Wolff, Supra, note 172 p.458.

Like other developing countries, the P.R.C. has set up rules on restrictive clauses in its technology transfer legislation. The Joint Venture Law Implementing Regulations provides that, unless otherwise agreed, there should be no restrictions on the quality, price or region of sale of exported products.

Art. 9 of the 1988 Technology Detailed Rules provides that the supplier may not require the recipient to accept unfair restrictive conditions. It then lists restrictive provisions which may not be included in the contract without special permission from the approval authority. Those provisions requiring special approval are as follows:

(1) Requiring the recipient to accept additional conditions unrelated to the technology acquired, such as forcing the recipient to purchase unnecessary technology, technical services, raw materials, equipments or products.¹⁹¹

(2) Restrictions on the recipient's freedom to purchase raw materials, parts and components or equipment from sources other than the supplier.¹⁹²

(3) Restricting the recipient from developing and improving the technology acquired¹⁹³. Provisions restricting the acquiring party's research into imported technologies hinders the recipient's chance to compete effectively with the supplier and, as indicated by A. Wolff, has been the object of prohibitions under transfer of technology laws in many developing countries and under most anti-trust

¹⁹¹ TICR art. 9.

¹⁹² Ibid.

¹⁹³ Ibid. art.9(3).

systems.¹⁹⁴

(4) Restricting the recipient from acquiring similar or competing technology from other sources.¹⁹⁵ Limitations on the use of competing technology prevents the recipient from making a selection of the technology appropriate to its particular needs. Normally the foreign supplier prefers an exclusive relationship with their Chinese partner. If the Chinese partner imports technology from different sources, it would be difficult for the supplier to maintain trade secrets. In this situation the contract should offer the supplier some protection.¹⁹⁶

(5) Non-reciprocal terms of exchange of improvements of the acquired technology.¹⁹⁷ The 1988 Technology Detailed Rules further provide that: (a) the improved technology, including the right to apply for a patent right, shall belong to the improving party; and (b) the conditions and terms for the recipient providing improvements to the supplier should be the same as when the supplier provides improvements to the recipient. This provision operates as a restriction on the ability of the transferor of the technology to negotiate a "grant back" clause.

(6) Restricting the quantity, type and sales price of products manufactured with the acquired technology.¹⁹⁸ The Joint Venture Law Implementing Regulation also contains a similar provision: " unless otherwise agreed upon by both parties, the

¹⁹⁴ A. Wolff. Supra, note 172 p.461.

¹⁹⁵ The TICR art.9(4).

¹⁹⁶ A. Wolff, Supra, note 172 p.463.

¹⁹⁷ The TICR art. 9 (5).

¹⁹⁸ The TICR art. 9(6).

technology exporting party shall not put any restrictions on the quality, price or region of sale of products for export."

(7) Unreasonably restricting the recipients distribution channels and export markets¹⁹⁹. Art. 14 of the 1988 Technology Detailed Rules provides exceptions where the supplier has already concluded licensing contracts and where the supplier has concluded sale agency contracts. These exceptions are in line with similar prohibitions on export restrictions in other developing countries.²⁰⁰

(8) Restricting the use of the acquired technology by the recipient after the expiration of the contract.²⁰¹ Chinese law allows the recipient to use the technology after the contract expires²⁰². Thus, in many practical respects, the foreign supplier is engaged in a sales transaction rather than a licensing arrangement. The Government may find it necessary to grant exemptions from this provision in order to attract advanced technology from developed countries.²⁰³ The 1988 Technology Detailed Rules attempted to address this problem. Art. 5 states that, if at the time a contract expires, a patent involved in the imported technology has not expired, the matter shall be handled in accordance with the relevant provisions of the Patent Law of the P.R.C.

(e) Guarantees

¹⁹⁹ The TICR art. 9(7).

²⁰⁰ Wolff, Supra, note 172 p.463.

²⁰¹ The TICR art. 9(8).

²⁰² The JVL Implementing Regulation art. 46 (3)(4).

²⁰³ A. Wolff, Supra, note 172 p.463.

The issue of guarantees appears in many Chinese technology transfer regulations. China's opening to FDI was intended to supplement domestic sources of capital for modernization and to obtain advanced technology. For this purpose, Chinese laws repeatedly indicate that the technology transferred by the foreign parties as investment should be truly advanced and appropriate to China's needs.²⁰⁴ A similar provision can also be found in Art. 6 of the TICR. The supplier must guarantee that it is the lawful owner of the technology transferred and that it is correct, complete, effective and capable of achieving the objectives as specified in the contract. In the past, China had some unsatisfactory experiences in technology transfer dealings with some western companies.²⁰⁵ As a result, Chinese negotiators often demand that the foreign supplier guarantee the success of the technology transfer. Art. 7 of the 1988 Technology Detailed Rules provides that the contract shall contain standards, terms and a method for the assessment and examination of whether the import technology has reached its objectives. The article also puts responsibility for failure on the shoulder of the supplier.

²⁰⁴ JVL art.5.

²⁰⁵ Wolff, Supra, note 172 p.465. In 1979, due to the foreign trade reforms, the decision making process became more decentralized. But local enterprises and provincial import export corporations proved inexperienced and ill-equipped to make technology import decisions. Many enterprises entered negotiations with little idea of what they wanted. In some cases, Chinese authorities complain that foreign firms took advantage of their inexperience to unload obsolete goods. By early 1985, imported equipment lay idle throughout China, large amounts of foreign exchange were being wasted on unnecessary equipment and technology. See also, Alice Davenport "Local Technology Import Decisions" (May/ June 1987) China Business Review p. 40

(f) Confidentiality

Technology transfer is a risky business as the confidentiality of intangible rights once exported, is difficult to protect. Under Art. 7 of the TICR, the parties are expressly permitted to negotiate agreements as to the scope and length of time the recipient will be bound by the confidentiality period over the ten year term of the contract. The 1988 Technology Detailed Rules restricts the confidentiality period to the duration of the contract unless special approval is secured.

For some investors with very advanced technology, a ten year confidentiality period is insufficient. Thus, foreign investors generally sell their technology to the recipient rather than simply permitting the use of it.²⁰⁶ However, for foreigners who transfer their latest, previously unpatented techniques to China, the Chinese Patent Law may provide some reassurance. A foreign company enjoys 15 years protection against unauthorized use of its technology in China if it has a patent registered in the country.

2. The Patent Law of the PRC

The Patent Law came into force on April 1, 1985. On Jan. 19, 1985, the Patent Office of the P.R.C. promulgated the Regulations for Implementing the Patent Law²⁰⁷ [hereinafter Patent Law Regulations]. Both the law and regulations

²⁰⁶ Marcuss, Supra note, 78 p.145.

²⁰⁷ The Patent Law of the P.R.C. was adopted on March 12, 1984, at the Sixth National People's Congress, and came into effect on April 1, 1985. The Regulation for Implementing the Patent Law, was promulgated by the Patent Office of the P.R.C. (The Patent Office was established in 1980) on Jan. 19, 1985.

are rooted in the open door policy and economic reform period of the 1970s. As private enterprise developed in China it soon became obvious that the existing intellectual property protection system was inadequate. This problem led to higher costs, especially with regards to the importation of foreign technology. The government therefore, began to move China closer to international norms in this area throughout the 1980s²⁰⁸.

In addition to the new Patent Law and Patent Law Regulations, China also proclaimed its intention to adhere the Paris Convention for the Protection of Industrial Property [hereinafter Paris Convention] on March 19, 1985, and formally acceded to it in November of 1986.²⁰⁹

The Patent Law does not replace other intellectual property protection laws already existing in the P.R.C. The Regulation on Awards for Inventions remains in effect. It applies to new scientific or technological achievements already proven through actual application. The Patent Law on the other hand, focuses on conceptual methods for resolving technical problems which have not yet been put into practice.²¹⁰

The Chinese Patent Law has several interesting features. Firstly, the definition of novelty under the Patent Law is very different from that of the American law. The relevant American statute provides that any invention does not

²⁰⁸ Zheng, Supra, note 29 p.410 and 411.

²⁰⁹ 21 UST 1630-1677.

²¹⁰ Zheng, Supra, note 29 p. 413.

lose its novelty because it has been patented abroad.²¹¹ But, under the Patent Law, an application must not have entered the public domain in any form which includes having received a foreign patent.²¹²

An exception to this requirement was created when China acceded to the Paris Convention. Signatories to the convention agree to grant a one-year priority right to inventions patented in other signatory countries. The grace period allows inventions for which patents are sought in China to be considered novel notwithstanding the filing of patent applications not more than one year earlier(six months for design patents) in other signatory nations.

Secondly, the Patent Law imposes a general obligation upon the patentee to make the potential product or to use the patented process in China. If the patentee fails to do so within a three year period following granting of the patent, another person or entity may be licensed to do so.²¹³ Compulsory licensing is a common feature among patent regimes of western countries but is non-existent in U.S. patent law which grants the patentee absolute authority to withhold the benefits of his invention.²¹⁴

Thirdly, Chinese Patent Law does not offer protection for computer programs and software. Under certain circumstances, computer software may be

²¹¹ Ibid. p.425.

²¹² The Patent Law art. 22.

²¹³ Ibid. art.52.

²¹⁴ Marcass, Supra, note 78 p.181.

patentable providing it has a direct impact on computer hardware technology.²¹⁵ China's Patent Law also fails to protect pharmaceutical products and products resulting from chemical processes. This exclusion has created considerable discontent among U.S. pharmaceutical and fertilizer companies.²¹⁶

The treatment of foreign applications under China's Patent Law is consistent with the Paris Convention.²¹⁷ In accordance with the Paris Convention, Chinese law forbids foreigners from applying for patents unless they have a habitual residence or business establishment in China.²¹⁸ Therefore, joint ventures, wholly foreign owned ventures and other business entities that have offices in China are able to make patent applications directly with the Chinese Patent Office. Other foreign applicants have to submit their applications through a Chinese patent agency.

Under Art. 19 and 20 of the Patent Law, only agencies specifically designated by the State Council have the authority to process foreign patent applications. The following four institutions have been appointed by the State Council to assist foreign applicants in processing Chinese patent applications and other related matters: the China Council for the Promotion of International Trade (CCPIT), the Shanghai Patent Agency, the China Patent Agency Ltd. of Hong Kong

²¹⁵ Zheng Supra, note 29 p. 416.

²¹⁶ Marcass, Supra, note 78 p.181.

²¹⁷ Ibid. p. 179.

²¹⁸ The Patent Law arts. 18, and 19.

and Yongxin Patent Agency Ltd.²¹⁹

3. The Trademark Law of the PRC

On August 23, 1982, the Standing Committee of the Fifth National People's Congress adopted the Trademark Law of the P.R.C [hereinafter the Trademark Law]. This law replaced the 1963 Trademark Regulations.²²⁰ The Trademark Law came into effect on March 1, 1983, and on March 10, 1983, the State Council promulgated the Trademark Law Implementing Regulations²²¹ [hereinafter 1983 Implementing Regulation].

In an attempt to further enhance the investment environment in general, and the protection of intellectual property rights specifically, in January 1988 China promulgated the Revised Trademark Law Implementing Regulation²²².

In the past, due to an overburdened bureaucracy, trademark applicants in China had to wait between 12 and 18 months for an application to be

²¹⁹ Zheng Supra, note 29 p.439.

²²⁰ The Trademark law of the P.R.C. was adopted at the 24th Session of the Standing Committee of the Fifth National People's Congress on Aug. 23, 1982. English translation can be found in CCH Australia, China law for Foreign Business n. 11-500 [hereinafter China Law for Business].

²²¹ The Trademark Law Implementing Regulation was promulgated, and effective as of March 10, 1983. The Chinese text and English translation is in II China's Foreign Economic Legislation (Beijing: Foreign Language Press, 1986) p.184.

²²² Revised Trademark Law Implementing Regulation which was promulgated in . 1988, English translation is in China L. for Business at n. 11-520.

approved.²²³

The 1988 Revised Trademark Implementing Regulation tried to speed up the application process by expanding the number of official trademark agencies. Under the 1983 Trademark Implementing Regulation, foreign companies had to handle all trademark matters through a Chinese trademark agency such as the CCPIT. The 1988 Trademark Implementing Regulations permits the State Administration of Industry and Commerce (SAIC) to appoint other organizations to act as foreign trademark agents²²⁴.

The 1988 Trademark Implementing Regulations provides clearer guidance in a number of areas that were previously vague under the 1983 legislation.²²⁵

Under the Trademark Law, a trademark application must clearly specify the product for which the trademark is to be used. The 1988 Trademark Implementing Regulation further stipulates, that the goods may not exceed the applicant's registered scope of business. However, this rule is difficult to enforce, as applicants are not required to submit a business license or certificate to show the scope of their business.²²⁶

China also uses the Trademark Law as a means of ensuring consumer

²²³ David B, " Trademark Update" July-August 1988 the China Business Review p. 49.

²²⁴ Ibid.

²²⁵ Ibid, p.49.

²²⁶ Ibid.

protection in the absence of more developed consumer protection legislation.²²⁷ Previously, only pharmaceutical and tobacco products were required to bear registered trademarks. Under the 1988 Trademark Implementing Regulations, CIPIT has the right to add other products to the list in order to more easily regulate items that pose a potential hazard to consumers²²⁸.

The 1988 Trademark Implementing Regulations lifted various obstacles to effective trademark protection. Those obstacles included denying rightful owners of trademarks living outside China the right to challenge trademark registrations. China's trademark system also had, under the 1983 Regulations, a relatively strict first-to-file rule which did not require an applicant to file in good faith. The government accepted the applicant as the trademark's true owner or authorized licensor. Some registrants took advantage of the first-to-file system by registering the trademark in China before the rightful owner. This resulted in the rightful owner having to buy back the exclusive rights to use the trademark in China.²²⁹

The 1988 Trademark Implementing Regulations has relaxed the standing requirement giving rise to this problem. The regulations allow anyone, not just the prior registrant, to apply to cancel an improperly registered trademark.²³⁰ The objector may make a cancellation request after more than one year.

²²⁷ Silk, Supra, note 177 p.220.

²²⁸ Ibid.

²²⁹ Ibid. p.221.

²³⁰ 1988 Trademark Law Implementing Regulation art. 25.

The 1988 Trademark Implementing Regulations also contains provisions against infringement. Art. 38 expands the definition of infringement to include the unauthorized use of an identical or similar trademark on like good, and the unauthorized manufacturing or marketing of a registered trademark or otherwise injuring the exclusive trademark rights of another person. The rules also specify acts that are to be considered an infringement. These acts include the distribution of goods bearing an infringing trademark; the use of any name or design on the packaging of goods if the word or the design are the same as or similar to another person's registered trademark; or such use is sufficient to cause confusion.²³¹

Under the Trademark Law, CCPIT and its affiliates have a monopoly on the representation of foreigners. Problems arise when CCPIT must represent foreign applicants seeking to show an infringement by another foreigner also represented by the organization. In such a situation, it is difficult for CCPIT to conduct its obligations to both parties.²³²

Under the 1988 Trademark Implementing Regulation, fines imposed on violators have been changed from a maximum of 5,000 yuan to up to twice the profit earned through the infringement ²³³. Some commentators believe this penalty will fail to act as a deterrent. Compared to other countries, the fine is very low. For the counterfeiter, the fine may be nothing more than an added cost of doing business,

²³¹ Ibid. art. 41.

²³² Silk, Supra, note 177 p.225

²³³ The 1988 Trademark Implementing Regulation art. 42.

rather than an deterrent.²³⁴

²³⁴ Silk, Supra, note 177 p.225.

Chapter VI Chinese Tax Law and Chinese Bilateral Tax Treaties

At present there are six different types of tax regimes applicable to foreign investors in China: individual income tax, consolidated tax, foreign funded enterprise income tax, custom duties, real estate tax, and the vehicle and ship license tax.

A. Individual Income Tax

In 1980, China adopted the Individual Income Tax Law²³⁵. China's individual income tax is levied on individuals regardless of citizenship, according to their residence and source of income. Art. 1 of the law provides for the taxation of incomes gained inside and outside China by an individual residing in China for one year or more. However in practice, because of a series of concessions made by the Chinese tax authorities, no foreigner pays income tax on income other than Chinese source income²³⁶.

An individual residing in China is taxed only on income earned in China. According to Art. 2 of the law, the following income is to be taxed: wages and salaries; compensation for personal services; royalties; interest; dividends; bonuses; income from the leasing of property; and other kinds of income specified as taxable by the Ministry of Finance.

Art. 3 provides that income from wages and salaries should be taxed at

²³⁵ The Individual Income Tax Law was adopted by the National People's Congress in 1980. An English Translation can be found in Vol. 1, C.B.T.L. (1985)

²³⁶ Zheng, Supra, note 29 p. 277.

rates of 5 to 45 percent, and all other types of income listed in Art. 2 are to be taxed at a flat rate of 20 percent. According to the interpretation of the Ministry of Finance, Chinese citizens are not subject to the 1980 Income Tax Law after they pay the individual income regulatory tax²³⁷. Therefore, the 1980 Individual Income Tax Law applies only to foreigners.

B. Consolidated Industrial and Commercial Tax

Under the 1958 Consolidated Industrial and Commercial Tax Act [hereinafter CICTA]²³⁸, a tax is levied on all commodities and services in China. The tax applies to all enterprises and individuals engaged in the production of industrial products, or the purchase of agriculture products. It also applies to anyone importing foreign goods or engaged in the commercial retailing, communications, transport, or service sectors.²³⁹

Since 1984, the CICTA is no longer applicable to domestic enterprises.²⁴⁰ However, foreign enterprises with establishments in the P.R.C. continue to be subject to the tax.

Taxable items under the CICTA are classified according to the type of

²³⁷ "Interview with the tax official of Ministry of Finance" December 12, 1986 The People's Daily P.2. In September 1986, the State Council adopted the Provisional Regulations of Individual Income Regulatory Tax which only applies to Chinese citizens.

²³⁸ The 1958 Consolidated Industrial and Commercial Tax Act and its Detailed Regulations were both published in 1958 and continue to apply to foreign enterprises operating in China.

²³⁹ Ibid. art. 12.

²⁴⁰ Zheng Supra, note 29 p. 274.

business or product. There are 104 industrial products listed, with 42 different rates of taxation, ranging from 1.5 percent for grey cotton to 69 percent for cigarettes. Most tax rates under the CICTA do not exceed 20 percent. There are four distinct tax rates applied under CICTA: commerce (3 percent), communications and transport (2.5 percent), services (between 5 and 7 percent) and those industrial commodities not specifically listed in the CICTA tables (5 percent). Agricultural goods not specifically listed are not subject to the tax.

Over the past several years, the Chinese Government has offered a number of exemptions to foreigners, in order to encourage investment. Machinery, parts, components, and other materials that are necessary for building factories and installing or renovating equipment imported into China by an equity joint venture as part of its investment, or for the development of China's offshore oil reserves, are exempt from the CICTA.²⁴¹ This also applies to imported raw materials, spare parts and packing materials designed for export production. Art. 11 of the Encourage Foreign Investment Regulation provides that all export commodities produced by enterprises with foreign investment are also exempt from CICTA.

C. Income Tax of Foreign Funded Enterprises

On April 9, 1991, the National People's Congress passed the Law Concerning the Income Tax of Foreign-Funded Enterprises [hereinafter TFFE]²⁴² The law came into force on July 1, 1991 and replaced two earlier pieces

²⁴¹ JVL Implementing Regulations art. 71.

²⁴² "China, North Korea Country Report" (1991) No.2, The Economist Intelligence Unit 1991, p.27.

of legislation: the Law Concerning the Income Tax of Sino-Foreign Equity Joint Venture and the Law Concerning the Income Tax of Foreign Enterprise. The purpose of the legislation was to simplify the complex and overlapping tax structures²⁴³.

1. Removal of the Differential In Favour of Joint Ventures

In the previous law, equity joint ventures and foreign funded enterprises (including some contractual joint ventures) were subject to different tax rates. For Sino-foreign joint ventures, income tax was limited to 33 percent. Whereas, wholly foreign owned ventures and some contractual joint ventures paid tax at a progressive rate of 30 to 50 percent. The TFFE removed the differential in favour of joint ventures. Under the new law, joint ventures, contractual joint ventures and wholly foreign owned ventures, pay a 33 percent tax on income. Of that total, 30 percent goes to the central authorities, and 3 percent goes to local authorities. The law imposes a 20 percent withholding tax on passive income. In addition, the law states that when enterprises find themselves worse off under the new system, provisions can be made for the former tax rates to apply²⁴⁴.

2. Tax Holidays for More Enterprises

TFFE also extended the tax exemptions which previously applied only to equity joint ventures and enterprises using advanced technologies with foreign investment to all productive industries with foreign investment. The law offers two

²⁴³ Ibid.

²⁴⁴ "P.R.C. Unified Tax Law: What It Means For Foreign Firms" June 10 1991 The Business China p.86.

year tax exemptions and 3 year 50 percent tax cuts to firms that meet qualifying criteria. However, those foreign funded enterprises engaged in tourism, commerce or service industries are excluded from this preferential system²⁴⁵.

3. Transfer Pricing

The old tax law contained no specific provisions to deal with the problem of transferring pricing. Art. 13 of TFFE provides for the prevention of tax evasion through transfer pricing. Transfer pricing is one of the easiest ways for investors to reduce their tax exposure: a joint venture buys raw materials at a high price from the foreign partners or an affiliate or sells its products at a low price back to the foreign partner. The joint venture then shows decreased profits or even a loss when China's tax authorities calculate its taxable income; the money it "lost" stays with the affiliate. The new regulations attack transfer pricing by requiring enterprises with foreign investment to deal with their affiliated companies at third- party prices. If prices are artificially low or high, the tax authorities may use market prices or cost-plus method to adjust the price for tax purposes.²⁴⁶

The TFFE includes a number of changes that affect how foreign investors are treated for tax purposes. According to art. 3 of the TFFE, the location of a company's head office determines whether an enterprise is a resident of China.

Under the law, the world-wide income of a resident company is subject to tax, while non-resident companies only pay tax for income made in China.

²⁴⁵ Ibid.

²⁴⁶ Ibid. p.87.

Therefore, equity joint ventures, wholly foreign owned enterprises and limited liability contractual joint ventures as Chinese legal persons, are subject to treatment as Chinese resident companies. Unlimited liability contractual joint ventures are not considered residents of China, only their Chinese sourced income is taxable.

4. No Withholding Tax on Profit Remittance

The old JVL required that the foreign partner of equity joint ventures pay a remittance tax of 10 percent on profits taken outside China. Art. 19 of the TFEE has removed this requirement.

All enterprises with foreign investment can now get tax refunds for reinvestment. Under the old tax law only some enterprises, mainly equity joint ventures and technologically -advanced or export enterprises, could apply for reinvestment tax refunds. The TFEE enables all enterprises with foreign investment to receive a 40 percent tax refund for profits reinvested in China.

Another development in the new law is the permittance of a dual pricing system. The price of products for sale domestically and abroad can now be different. Lower prices are allowed for export products to enable the enterprise to be more competitive in the international market.²⁴⁷

D. Custom Duties

In 1983, China joined the International Customs Cooperation Council. In March 1985, the Regulation on Import and Export Duties was enacted, in 1987, the

²⁴⁷ Joyce Peck " China's New Unified Tax Law Code Will Benefit Most Foreign Companies" Sept.-Oct. (1991) China Business Review p. 14.

Law of the People's Republic of China on Customs took effect. These regulations replaced the 1951 Regulations²⁴⁸. In general, the new rates are significantly lower than under the previous tariff. These developments have brought China's customs regime closer to the norms of international practice.²⁴⁹

Customs duties are levied on imports which are in short supply in China and certain exports. The rates levied vary according to whether the government is trying to encourage or discourage the import or export of the particular goods. The customs tariff is mainly aimed at regulating imports and exports, rather than raising revenue. Lower rates and exemptions are used to encourage the import of technologically advanced equipment that China needs badly but cannot manufacture domestically. Relatively high duty rates are applied to certain imported industrial and agricultural producers in order to protect domestic products. Because of limited reserves of foreign currencies, high duty rates are applied to non-necessities and high-grade consumer goods in order to restrict their importation.²⁵⁰ The majority of export commodities are free of duty. Only a few items, such as raw materials and

²⁴⁸ The 1951 Interim Customs Law and the 1951 Tariff Schedule. See, Yvonne Chan "The New Customs Law", "Understanding the Tariff System" (November/ December 1987) The China Business Review p. 44 and 46.

²⁴⁹ Ralph H. Folsom & John H. Minan eds, Law in the People's Republic of China (Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1988) p.827

²⁵⁰ GATT Documents L Series, L/6270, p.86.

semi-manufactured products, are subject to export duties.²⁵¹

There are two kinds of import duty rates: a minimum rate and a general rate. The former is for goods originating in countries with which China has concluded trade treaties or agreements containing most favoured nation clauses. The later rate, applies to goods originating in countries with which China has not concluded such trade treaties or agreements. There is only one uniform export tariff which is applied to all countries.²⁵²

Since June 16, 1985, an import regulatory tax- a surtax in addition to the import tariff- has been levied on certain goods.²⁵³ At present, seventeen commodities are subject to the import regulatory tax, including passenger vehicles, motor-cycles, colour television sets, mini-electronic computers, electronic calculators, and woven fabrics of chemical fibres.²⁵⁴ The import regulatory tax was aimed at protecting domestic production of a number of commodities from foreign competition.²⁵⁵

The import regulatory tax is applied to products from countries all over the world. The tax is also applied to products imported into the special economic zones. The levels of the import regulatory tax rates are dependent upon the particular

²⁵¹ Working party on China's Status As a Contracting Party, China's Foreign Trade Regime. General Agreement on Tariffs and Trade Restricted Spec (88) 13/Add.4 p.32.

²⁵² Ibid. p. 33.

²⁵³ Ibid. p.34.

²⁵⁴ Ibid. p.34.

²⁵⁵ GATT Document L Series, L/6215, p. 15.

needs of the protected industry. It is viewed as a temporary measure and is not intended to be incorporated into the tariff. The product coverage, tax rates and duration of implementation are decided by the tariff commission under the State Council.²⁵⁶

The import regulatory tax will be no longer in effect after April 1992.²⁵⁷

China intends to reduce custom tariffs when it fully resumes membership in the General Agreement on Tariffs and Trade.²⁵⁸

E. Urban Real Estate Tax (URET)

The Provisional Urban Real Estate Tax Regulations [hereinafter URET] was proclaimed in August of 1951. This tax is paid by the owners of property²⁵⁹. If the right to the use of the property is transferred to an individual or entity in a non rental transaction, the transferee is the taxpayer.²⁶⁰

In 1973, the URET was incorporated into the industrial and commercial

²⁵⁶ GATT Document L Series, L/ 6270, p. 102-103.

²⁵⁷ March 5, 1992, People's Daily. p.3.

²⁵⁸ Supra, note 249 p.827. China was one of the 23 original signatories to the GATT. When the GATT was signed on October 30, 1947, China was ruled by the nationalist government. The PRC was founded two years later, on October 1949. The nationalist government (Taiwan) purported to withdraw all of People's Republic of China from the General Agreement. China began to express interest in resuming its GATT membership in 1970s and it received observer status to the GATT in 1984. In July 1986, it formally notified the contracting parties of its desire to rejoin the GATT.

²⁵⁹ Provisional Urban Real Estate Tax Regulations art. 3. An English translation can be found in Vol. 1 C.B.T.L. (1985)

²⁶⁰ Ibid. art. 3

tax when applied to Chinese enterprises. As a result, the tax was imposed as a separate levy only on individual Chinese property owners, joint ventures and wholly foreign owned enterprises.

On September 15, 1986 the State Council issued the Provisional Regulation of the P.R.C. on Real Estate Tax.²⁶¹ [hereinafter the 1986 Real Estate Regulations]. The new law no longer divides the tax into a building and land tax. There is now only one levy at 1.2 percent per annum for a property's "residual value" or 12 percent of its rental income.²⁶²

When a Chinese party contributes its right to the use of a building as part of its equity contribution to a joint venture, the joint venture becomes responsible for the urban real estate tax. If however, the building is leased to the joint venture, then the lessor pays the required tax.

F. Vehicle and Ship License Tax

The Vehicle and Ship License Tax [hereinafter PVSLT] is a local tax which applies to all vehicle owners in China. The tax, however, is not used in rural areas. Revenue raised by the VSLT, which is paid on an annual basis in the form of a license fee, is used by the government for road construction. This tax is levied

²⁶¹ The Provisional Regulation on Real Estate Tax was issued by the State Council on September 15, 1986, An English translation can be found in China Laws For Foreign Business (Sydney: CCH, Australia) (loose leaf), Paragraph 39-505.

²⁶² Ibid. art.4.

according to the 1951 Provisional Vehicle and Ship License Tax Regulations.²⁶³

G. Chinese Bilateral Tax Treaty Program

1. Double Taxation and General Rules of International Law

International law permits the taxation of foreign economic transactions when a sufficient connection exists between the taxpayer and the taxing state. The "sufficient connection" is determined through an examination of the taxpayer's residence, habitual abode, citizenship, or situs of assets. No territoriality principle of international law prohibits the application of domestic law to situations arising in foreign countries, including the taxation of foreign income for domestic purposes. Double taxation results from the interaction of the domestic laws of two (or more) states. International law does not contain rules to settle the problem of a corporation or individual being taxed by two states for the same income, only bilateral double tax treaties can fulfil this role.²⁶⁴

2. Chinese Bilateral Tax Treaty Program

In the past decade, China's economy grew rapidly and many countries developed commercial interests in the country. In order to overcome the problem of double taxation, the government negotiated income tax treaties with both developed and developing countries.

²⁶³ Provisional Vehicle and Ship License Tax Regulation was adopted in 1951, English translation is in Vol. 1, C.B.I.L. (1958)

²⁶⁴ Samuel B. Sebree, "The Economic Reality of the United States' Tax Treaty With China: Sacrificing Gains Today With An Eye Toward The Future" Spring (1990) Vol. 43.No. 3. Tax Lawyer p.795 and 797.

The treaties which borrow elements from model treaties drafted by the Organization for Economic Cooperation and Development (OECD), and the United Nations,²⁶⁵ seek to reduce double taxation of income and tax evasion. The treaties incorporate and coordinate tax measures such as tax credits, nondiscrimination provisions, mutual agreement arrangements and exchange of information provisions²⁶⁶. As provisions covered by the various bilateral tax treaties are mostly identical, the following discussion will focus on the United States-China Income Tax Treaty²⁶⁷ and the Canada-China Income Tax Agreement²⁶⁸.

(a) The Treaty's Jurisdiction

(1) Tax Covered

The Canada -China Income Tax Agreement covers Chinese individual income tax, income tax concerning joint ventures with foreign investment, income tax concerning foreign enterprises, and income tax imposed by the Government of

²⁶⁵ Organization for Economic Cooperation and Development (OECD), Model Double Taxation Convention on Income and Capital (1977) reprint in 1 Tax Treaties (CCH) n 151 (1980) [hereinafter OECD Model Double Taxation Convention], United Nations Model Double Taxation Convention Between Developed and Developing Countries U.N. Doc. ST/ESA/102, 3(1982) [hereinafter U.N. Double Taxation Convention].

²⁶⁶ William A. Turner & Elizabeth M. Orazem, "United States-China Income Tax Treaties: Opening the Door to Increased Economic Cooperation" (1988) Vol. 13 N.C.J.Int'l. & Com. Reg. p.529.

²⁶⁷ The United State-China Income Tax Treaty text can be found in (1984) Vol. 23 Int'l. Leg. Mats. p.667.

²⁶⁸ Canada-China Income Tax Agreement (1986) Text can be found in Canada's Tax Treaties Toronto/Vancouver: Butterworths (1991) Vol. 3, p. 20,365.

Canada.²⁶⁹

(2) Residence and Permanent Establishment

The two key jurisdictional concepts in the U.S.-China Income Tax Treaty are "residence" and "permanent establishment".²⁷⁰

The concept of "permanent establishment" defines the contracting states jurisdiction to impose taxes under the treaty. Permanent establishment is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."²⁷¹ This definition provides the degree of business activity necessary to subject the enterprise to taxation on profits earned inside the taxing country. The presence or absence of a permanent establishment determines whether the business profits of a corporation entity residing in one contracting country are taxable in the other country under the treaty. For business profits to be taxable in the country in which the taxpayer is not a resident, they must be attributable to a permanent establishment in that country.

Taxpayers who qualify as residents of the United States, P.R.C. or the both are eligible for the treaty's benefits²⁷². A resident is defined in article 4 of the treaty, as any person or entity that is liable for tax in a contracting state because of domicile, residence, place of head office, place of incorporation or any other

²⁶⁹ The Canada-China Income Tax Agreement art. 2.

²⁷⁰ Turner, Supra, note 266 p.550.

²⁷¹ The United States- People's Republic of China Income Tax Treaty art. 5, the Canada- China Income Tax Agreement art. 5.

²⁷² United States-China Income Tax Treaty, art. 1.

criterion of a similar nature²⁷³.

If an individual is found to be a resident of both contracting states, his residence for tax purposes is determined by such factors as nationality, location of permanent home, and area of economic activities. If none of these factors are determinative, the competent authorities must resolve the question of residence by mutual agreement.²⁷⁴

If a company is found to be a resident of both contracting states, its residence is determined by mutual agreement between the competent authorities in the two states.

(b) Substantive Rules of Taxation

(1) Business profit

The business profits of an enterprise residing in one contracting state are taxable in the other state only to the extent that the profits are attributable to a permanent establishment in the other state through which the enterprise conducts its business.²⁷⁵

(2) Personal services

In determining which contracting state has the right to tax income from independent personal service, the treaties provide that, in general, the state in which the person rendering the independent personal service is a resident has the taxation

²⁷³ United States-China Income Tax Treaty, art. 4.

²⁷⁴ Ibid.

²⁷⁵ The Canada-China Income Tax agreement art. 7, the United States-china Income tax Treaty art.7.

right.²⁷⁶ The other contracting state may impose a tax only when that person is present for a period exceeding 183 days or has a fixed base regularly available to him in the nonresident country for the purposes of performing his services.²⁷⁷

(3) Passive Income

Chinese bilateral tax treaties covers the treatment of passive income from investment assets like dividends, interest, and royalties. Under China's tax law, passive income from investment assets is subject to a 20 percent tax.²⁷⁸ The normal 20 percent withholding tax for dividends is reduced to 10 percent in the Canada-China Income Tax Agreement and the United States-China Income Tax Treaty. Under the treaties, the withholding rates allowed in the source state on dividends, interests and royalties are set at ten percent of the gross amount. The resident country of the income recipient also imposes a tax on income received, if the recipient is a resident of the other contracting state and is the beneficial owner of the payments. The treaty limits the amount that may be withheld by the other contracting state to ten percent of gross dividends.²⁷⁹

Under the United States-China Income Tax Treaty art. 9, interest and

²⁷⁶ United States-China Income Tax treaty arts. 13 and 14, Canada-China Income Tax Agreement art. 14.

²⁷⁷ Ibid.

²⁷⁸ The Law Concerning the Income Tax of Foreign Funded Enterprises and the Individual Income Tax Law provide for a 20 percent rate.

²⁷⁹ The Canada-China Income Tax Agreement art. 10. Under art. 22 of the treaty, the withholding tax is credited against the tax imposed by the recipient.

royalties are subject to a withholding tax regardless of the taxpayer's residence when the individual operates a permanent establishment in the other country.

The Chinese bilateral treaties rules with respect to the taxation of dividends, interest and royalties are similar to those in the U.N. model treaty²⁸⁰.

(c) Elimination of Double Taxation

Double taxation occurs when two different states assert jurisdiction to tax the same item of income. To avoid double taxation, Chinese bilateral treaties provide coordinated measures such as tax credits, nondiscrimination, mutual agreement, and exchange of information.

(1) Tax Credits

Chinese bilateral treaties provide that a state shall grant a tax credit for tax payable in the other state on profits, income, or gains arising there.²⁸¹ This credit will not exceed the amount of domestic tax payable on an equivalent amount of income, since it is calculated on the basis of the domestic tax law and regulations.²⁸² Where a Canadian (or American) company pays tax to China for dividends it has received, Canada (or the United States) must give an additional

²⁸⁰ U.N. Model Double Taxation Convention Between Developed and Developing Countries. U.N.Doc. St/ESA/102,3(1980), reprint in 1, Tax Treaties(A) 171 (1982) at Arts 10,11, 12. Under the U.N. Model Treaty, both the source jurisdiction and the country of residence may tax this income. The rate of withholding is left open to negotiation between contracting states.

²⁸¹ The Canada-China Income Taxation Agreement, art. 21, the United States-China Income Tax Treaty art. 22

²⁸² Canada-China Income Tax Agreement art. 21 (1)

credit to the extent of income tax paid to the P.R.C.²⁸³.

(2) Nondiscrimination

The treaties have a nondiscrimination clause that prohibits discrimination on the ground of nationality, or situs of an enterprise.

(3) Exchange of Information

The treaties provide for the exchange of information that is necessary to prevent tax evasion and fraud, and to carry out the provisions of the treaties or of the contracting countries' domestic laws.

(4) Application of the Mutual Agreement Procedure

The Chinese bilateral treaties contain administrative procedures that authorize the competent authorities in contracting countries to attempt to resolve any difficulties over an interpretation or application of the treaty.²⁸⁴

²⁸³ The United States-China Income Tax Treaty art. 22, The Canada-China Income Tax Agreement art. 21

²⁸⁴ The United States-China Income Tax Treaty art. 24, the Canada-China Income Tax Agreement art.23.

Chapter VII Foreign Exchange Control

A. Non-Convertibility of the Renminbi

Because Chinese currency, the renminbi (RMB), is not freely convertible, demand for foreign exchange exceeds supply, thereby causing a shortage of foreign exchange and tight government controls over its allocation.

The JVL Regulations require joint ventures to maintain foreign exchange accounts from which all payment must be made.²⁸⁵ The biggest problem facing most foreign companies that have invested in the P.R.C., or those considering doing so, is how to recover their investment and repatriate their earnings.

Ideally, foreign companies would be sufficiently successful at exporting their product to earn enough foreign exchange to supply their own needs. But a large proportion of the ventures established with FDI in China are unable to do so. Chinese policy has displayed a preference for joint ventures capable of exporting their products. However, the Chinese government adopts a flexible attitude, and so long as the foreign investor has supplied advanced technology, or the products of the enterprise are what China needs to import, China will open part of its domestic market. In such situations some companies may face difficulties in achieving a balance of their foreign exchange.

²⁸⁵ The JVL Implementing Regulation art. 74.

Chinese legislation has attempted to address this problem.

B. The Laws and Regulations Concerning Foreign Exchange Control

The fundamental principles governing foreign exchange are contained in the Regulation on Foreign Exchange Control²⁸⁶. Under the regulation, all organizations and individuals in China are subject to the supervision of the State Administration for Exchange Control and the Bank of China, with regards to their foreign exchange transactions.²⁸⁷

All foreign income and expenditure by governmental and non-governmental organizations alike are subject to the state Plan²⁸⁸. The People's Bank of China [hereinafter PBC] acts as a central bank controlling foreign exchange. The State Administration for Exchange Control [hereinafter SAEC], as a government institution under the PBC, is responsible for implementing exchange regulations to control all foreign exchange transactions in accordance with state policy. The Bank of China [hereinafter BOC] is the special foreign exchange bank of the P.R.C.. Other banking and financial institutions, including affiliates of nonresident banks, may handle designated transactions with the approval of SAEC.

China has enacted many other regulations governing foreign exchange management. In 1983, the State Council issued the JVL Implementing Regulation.

²⁸⁶ The Regulation on Foreign Exchange Control was adopted in December, 1980 effective in March, 1981. English translation is in Vol. 1, C.B.T.L. (1985).

²⁸⁷ Ibid. art. 4.

²⁸⁸ Ibid. art. 5.

In the same year, the SAEC issued Rules For the Implementation of Exchange Control Regulations Relating to Enterprises With Overseas Chinese Capital, Enterprises with Foreign Capital, and Chinese -Foreign Joint Ventures²⁸⁹ [hereinafter Foreign Funded Enterprises Exchange Control Implementing Regulation]. This law permits ventures with foreign investment in China to sell products to Chinese entities for foreign exchange, provided the products meet certain criteria relating to import substitution and the ventures first go through a special approval procedure.

In January 1986, the State Council issued the Provisions on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Sino-Foreign Joint Ventures [hereinafter Provision on Foreign Exchange Balance] In October 1986, the State Council issued the State Council Regulations Concerning the Encouragement of Foreign Investment [hereinafter the 22 articles]. These regulations offer some relief from the foreign exchange requirements of all enterprises established with foreign investment. The WFOL Implementing Regulations imposes requirements on the balancing of foreign exchange when establishing the venture. These regulations provide some procedures, listed below, to balance the foreign exchange earnings and expenditures of a venture:

1. The government agency responsible for the venture may remedy the shortfall. Joint ventures are encouraged to buy raw materials domestically and sell products abroad. With approval, joint ventures can sell their products on the

²⁸⁹ The Regulation was promulgated in August of 1983.

domestic market for RMB. In this circumstance, when a joint venture has a shortfall in foreign exchange, the relevant government may step in with aid to make up the deficit.²⁹⁰

2. Ventures with foreign investment can sell products to Chinese entities for foreign exchange, providing the products meet certain criteria relating to import substitution and the ventures first go through a special approval procedure. This "import substitution" shall be incorporated into the long-term or annual plans for the use of foreign exchange for imports.²⁹¹

3. If a joint venture sells to enterprises outside the SEZs and the economic and technological development zones of the coast open cities, it can compute the price and settle accounts in foreign currencies with approval from the state foreign exchange control agencies.²⁹²

4. Art.6 of the JV Foreign Exchange Balancing Regulations allows a joint venture operating with a foreign exchange imbalance, to market domestic products for export in order to earn foreign exchange with government approval. However, in the case of products that are centrally managed by the state, subject to export quotas, or require export licences, the matter must be reported to MOFERT for special approval.

5. With approval of MOFERT and the foreign exchange control

²⁹⁰ JVL Implementing Regulation art. 57, and 60.

²⁹¹ The Provision on Foreign Exchange Balance art. 4. The regulation issued by the State Council, January 1986.

²⁹² Ibid. art. 8

department, the foreign partner of a joint venture with a foreign exchange deficit may, in accordance with Art. 7 of the JVL, reinvest its RMB profits in a Chinese enterprise with the capacity to earn foreign exchange.

6. A foreign investor can balance a foreign exchange shortfall in one of its enterprises with a foreign exchange surplus in another of its enterprises.²⁹³ However this idea is limited, as few foreign investors have set up more than one joint venture in China and it would be extremely difficult to obtain the consent of the Chinese party. The Chinese partner in a joint venture with a foreign exchange surplus would be reluctant to sell to another joint venture at a lower rate than available at a foreign exchange adjustment centre, even though the latter is linked to its foreign partner.

7. The WFOL Implementing Regulation attempted to address the exchange balance problem in the creation of a joint venture. Under the regulation, when establishing the venture, applicants must show how they can meet their foreign exchange needs. If the investor promises to balance its exchange and later fails to do so, the government is free of any responsibility.²⁹⁴

The second and fifth methods have proven of little assistance in practice. The fourth method is problematic because if a product can be exported, the enterprise would naturally want to do it by itself and make foreign currency rather

²⁹³ The Provisions on Foreign Exchange Balance art. 9 and 22 Articles art. 14, which issued in October 1986.

²⁹⁴ "Joint Venture Open-Ended Lifetimes: Who is Eligible" . (1991) *the Business China* p. 14

than sell to another enterprise for RMB. The first procedure, successful exporting, is the most reliable source of exchange. The foreign currency issue should be addressed as early as possible by those intending to create a foreign funded enterprise.

The most recent innovation adopted by the Chinese Government to alleviate the concerns of foreign investors with regards to the shortage of foreign currency has been the evolution of a system allowing the swapping of currencies among enterprises.

Foreign Exchange Adjustment Centres (FEAC) are now found in regional centres across the country where enterprises with a surplus of foreign exchange are permitted to sell to enterprises with a shortage. This system, however, does not create a true market for foreign exchange. Both supply and demand are restricted in the FEAC system. The price set tends to be lower than the rate required to clear market demand for foreign exchange. One successful joint venture with strong export sales found that it could earn more RMB by curtailing exports and selling products domestically than through the FEAC system.²⁹⁵ The FEAC system does not offer a solution to the foreign currency shortage problem.²⁹⁶

There exists a variety of strategies for dealing with the foreign exchange problem. Paul McKenzie has suggested addressing the problem as early as possible

²⁹⁵ Paul McKenzie "Foreign Exchange and Joint Ventures With China: Short-term Strategies and Long-Term Prospects" (1990) Vol. 17 Canadian Business Journal p. 130.

²⁹⁶ Ibid.

in the process of creating a joint venture.²⁹⁷ Ideally, the problem can be overcome through successful exporting of the product. If the joint venture cannot export successfully, McKenzie says, it should secure import substitution status or an assurance by an influential member of the Chinese bureaucracy that assistance will be provided by the government if necessary. To increase the likelihood of assistance, investors should focus on high priority or highly visible sectors of the economy²⁹⁸.

The foregoing laws and regulations represent a genuine attempt to mitigate the difficulties faced by foreign investors in recovering their investment and remitting their profits from the P.R.C.. However, they do not solve the problem completely.

²⁹⁷ Ibid. p.139.

²⁹⁸ Ibid.

Chapter VIII China's Bilateral Investment Protection Treaty Program

A. Friendship Commerce and Navigation (FCN) Treaties, Bilateral Investment Insurance Agreements and Bilateral Investment Protection Treaties

1. FCN Treaties

Traditionally, FCN treaties focused on the problems of commerce and navigation, but with the increased volume of foreign investment following World War II, they evolved into quasi-investment treaties.²⁹⁹ The FCN treaty was the primary bilateral mechanism utilized by the U.S. government to protect U.S. international trade and investment.³⁰⁰ However, FCNs aim to provide a comprehensive framework for all affairs of commerce and navigation rather than dealing solely with international investment relations.³⁰¹ FCN treaties have been criticized for failing to address the problem of creeping expropriation and poorly drafted arbitration clauses.³⁰² Moreover, FCNs have been associated with U.S. economic expansionism and alleged imperialism, thereby making them historically unappealing

²⁹⁹ For a detailed discussion of FCN treaties see Herman Jr. Walker, "Modern Treaties of Friendship, Commerce and Navigation." (1958) 42 Minn. L. Rev. p. 805.

³⁰⁰ Gerald Aksen, "The Case For Bilateral Treaties." (1982) 24 Private Investors Abroad p.357 to 359,

³⁰¹ Prior to World War II, only one of 30 articles in the FCNs concerned investment. By 1958, over half of the articles in the FCNs concerned investment. See, Walker, Supra, note 299 p. 816.

³⁰² M.S. Bergman, "Bilateral Investment and Protection Treaties: An Examination of the Evolution and Significance of the US. Prototype Treaty" (1983) 1, 8n 16 N. Y. U. J. Int'l. L. and Pol. p.37

to developing countries where investments faced high risks. Consequently, FCN treaties are now considered out of date as a means for protecting foreign investment.

2. Bilateral Investment Treaties

(a) Bilateral Investment Insurance Agreements

Another form of treaty for foreign investment is known as the bilateral investment insurance agreement concluded between a capital-importing country and a capital-exporting country. This kind of agreement is designed to protect private investors' interests by offering investment insurance against losses from political risk. These risks include expropriation, non-convertibility of currency, war, insurrection and riots.³⁰³

(b) Bilateral Investment Protection Treaties [hereinafter BITs]

BITs are the modern day successor to the post World War II FCN treaties. The BIT is a reciprocal agreement which encourages investment and guarantees protection for investment activities in a foreign country³⁰⁴. BITs were initiated by European countries in the 1960s and early 1970s, focusing exclusively on investments by nationals or companies of one state in the territory of another.³⁰⁵

Although most BITs are concluded between developed countries and developing countries, there have been instances of such treaties between developing

³⁰³ See, China-United States Investment Insurance Agreement and letters of understanding art. 1, Vol. 19 (1980) Int'l Leg. Mats p. 1482.

³⁰⁴ Z. A. Kronfol, Protection of Foreign Investment (Netherland: A.W. Sijthoff Int'l Publishing Company N.V., 1972) p. 157

³⁰⁵ Bergman, Supra, note 302 p.8-9.

countries themselves. BITs are concluded with three primary objectives in mind: the promotion and protection of private investors; the minimization of risk and loss in the event of expropriation; and the submission of investment disputes to arbitration. For these purposes, a BIT generally includes the following substantive provisions: treatment of investment, expropriation, free transfer of capital, and settlement of investment disputes.

B. Chinese Bilateral Investment Treaty Program

The development of the Chinese BIT program paralleled reforms to the domestic legal system. In 1980, China signed its first investment insurance agreement with the United State signalling a step on the road to providing treaty guarantees for foreign investment.³⁰⁶ The P.R.C. signed its first BIT with Sweden in 1982. Since then, some 20 more treaties have been concluded with other countries. To date, China has concluded BITs with Romania(1983), the Federal Republic of Germany (1983), France (1984), Belgium-Luxembourg (1984), Finland, Australia (1988), Austria, Denmark, Italy, Kuwait, Malaysia, the Netherlands, New Zealand, Norway, Pakistan, Singapore, Sri Lanka, Switzerland, Great Britain, Thailand and Japan (1988)³⁰⁷.

1. Investment Protected

³⁰⁶ China -United States Investment Incentive Agreement and Letters of Understanding art. 1, 19. Int'l. Leg. Mats. (1980) p. 1482.

³⁰⁷ Shishi Li, "Bilateral Investment Promotion and Protection Agreements: Practice of the People's Republic of China" International Law and Development (Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1988) p.177.

The extent to which an investment will be recognized and protected in a BIT is largely determined by the definition of the terms "investor" and "investment". The parties to a BIT always try to define these terms as concretely as possible, during negotiations, so as to avoid any future controversy.

Under Chinese BITs, the term "investment" is given a liberal interpretation. It includes rights derived from various forms of direct investment, intellectual property rights, rights of know-how, technical processes, trade names, good will, and concession rights related to natural resources.³⁰⁸

Protection under the BIT is usually afforded to approved investments by the host government. The distinction between approved and unapproved investment comes about as a result of the host country seeking to control the entry of foreign investment. Many host countries set certain requirements such as limited acquisition of new business, and export of products as part of the criteria for approval of foreign investment. Such regulatory mechanisms now exist not only in developing countries, but in developed countries as well.³⁰⁹ The approval requirement is adopted by Chinese BITs. Under Chinese BITs, an "investment" is subject to an important qualification: It must be permitted by the laws and regulations of the state in which it is situated and it must be approved by the host country. The China-France BIT explicitly provides for approval requirements. It stipulates each

³⁰⁸ See, People's Republic of China-Sweden Agreement on the Mutual Protection of Investments, reprint in 21 Int'l. Leg. Mats. (1982) p. 477.

³⁰⁹ J.L. Ross and D.A. Rubin, "Investment Canada Act: A New Regime for Foreign Investment" Comm. L.J. (1986) p. 141.

contracting party may guarantee, on a case by case basis and the extent permitted by its laws, the investments of its own investors in the territory or maritime zones of the other party, it being understood that such investments shall first have been approved by the other party.³¹⁰ This requirement is also recognised by the UN Resolution 1803 on Permanent Sovereignty Over Natural Resources,³¹¹ and is clearly stated in the OECD Draft Convention on the Protection of Foreign Property. According to art.1 (b), the Convention shall not affect the right of any party to allow or prohibit the acquisition of property or the investment of capital within its territory by nationals of another party.³¹²

There are different definitions of the term "investors" in China's BITs. Some Chinese BITs concluded prior to the urban economic reforms, define "investors" in a rather restrictive manner: The word "investors" is taken to include companies, firms or other economic organizations which are recognized by the Chinese government, as registered and entitled to cooperate with foreign countries on economic matters.³¹³

Another definition adopted by Chinese BITs, applying to either of the

³¹⁰ China-France BIT art. 6.

³¹¹ UN Resolution 1803 On Permanent Sovereignty Over Natural Resources, declares the investment should be in conformity with rules and conditions which the people and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities.

³¹² The OECD Draft Convention art. 1(b) (1968) Vol. 7 Int'l. Leg. Mats. p. 117

³¹³ China-Federal Republic of Germany (FRG) Agreement.

contracting parties, is "a partnership without juridical personality or a legal person constituted in accordance with the laws and regulations of that contracting party and domiciled in the territory of that contracting party"³¹⁴. Under this definition, an "investor" is determined by both the place of registration and by the domicile.

In addition, in some Chinese BITs other types of companies conditionally fall under the coverage. Companies registered in a third country but owned or controlled by nationals of one of the contracting parties to the BIT fall under its coverage.³¹⁵

2. Treatment of Investment

"Treatment" refers to the various standards such as national, most favoured nation or other specified standards imposed by a host-state on foreign investment. There is no universal consensus that states have an obligation to accord national treatment to foreign investments. This kind of treatment results from the recognition of the treaty in domestic law.

There has been a growing recognition among developed countries of the importance of granting national treatment to foreign investors. The BIT clauses that grant national treatment represent an ambitious attempt to attain a higher level of bilateral economic relations with foreign partners. However, China does not offer national treatment in its BITs. The main reason for China's refusal to offer national

³¹⁴ China-Netherlands Agreement art. 1(b).

³¹⁵ Li, Supra, not 307 p.169. The first type is mentioned in the BITs with Belgium-Luxembourg, Finland, Norway, Netherlands and Austria. The second type is listed in BITs with Belgium-Luxembourg, Denmark, Austria and UK.

treatment is the peculiar concept of Chinese property ownership. There are three forms of ownership existing in China. Ownership by the whole people, collective ownership, and individual ownership, all of which possess different rights and duties. National treatment in such a context would be meaningless.

Fair and equitable treatment of foreign investment has been advocated as a requirement of international law.³¹⁶ This requirement has been accepted by China. Art. 2 of both the China-Great Britain BIT and China-FRG BIT, for example, provides for "equitable and reasonable treatment" at all times. In both of these BITs, investors are accorded general most favoured nation treatment, regardless of the existence of other treaties.³¹⁷

3. Financial Transfer

Profits are the main aim of foreign investment, therefore the availability of financial transfer from the host country is of particular importance. All the BITs entered into by China have recognized the right of investors to financial transfer.³¹⁸

According to China's BITs, unrestricted transfer of investor's assets applies in the following areas: funds in repayment of loans related to investments; additional

³¹⁶ The OECD Draft Convention, art. 4, text in 7 ILM 117 (1986)

³¹⁷ China-Great Britain Agreement Concerning the Promotion and Reciprocal Protection of Investment, art. 2. Journal of Chinese Law May 15, 1986

³¹⁸ For example, see art. 5 China-Belgium Luxembourg BIT which can be found in (1985) Vol.14 Int'l. Leg. Mats. p.538. art. 5 China-France BIT which can be found in (1985) Vol. 24 Int'l. Leg. Mats. p.550. China-Sweden BIT, art. 4.

funds necessary for investment; the earnings of employees who are nationals of the other contracting party; the proceeds of total or partial liquidation of the investment; royalties, and the amount of compensation for expropriation.³¹⁹

Because RMB is unconvertible, China's BITs require that the money in question must be transferred abroad from the foreign exchange account of the investors in a convertible currency. Problems arise, when the account of the foreign investor does not have sufficient foreign exchange for the transfer from China. In BITs with France, Federal Republic Germany, Belgium-Luxembourg, Austria and the UK, China offers special guarantees for the conversion of local currency into a freely usable currency for the transfer of certain items including: proceeds from total or partial liquidation; royalties from industrial property rights; know-how, good-will copyrights, payments to a loan guaranteed by the Bank of China; and other profits permitted by the relevant authority of China. The treaties further provide that each party shall ensure that the transfer is made without undue delay.³²⁰

4. Expropriation and Nationalization

Expropriation or nationalization as a sovereign right of state has been recognized in international law, as well as in state practice.³²¹ A sharp divergence of opinion remains, however, over the proper criteria to be used in determining the legality of such acts and over the standard for compensation.

³¹⁹ Li, Supra, note 307 p.171.

³²⁰ China-Belgium Luxembourg Treaty art. 5, China-France BIT art. 5.

³²¹ Kronfol, Supra, note 304 p. 22,23.

Developing countries maintain that the right to nationalise foreign property is an inherent attribute of state sovereignty and that the essential legitimacy of the exercise of this right does not admit of any conditions that constitute unacceptable limitations on sovereignty. The traditional formula of "prompt, adequate and effective compensation" has been rejected as unduly onerous on the ability of developing countries to take appropriate measures to restructure their economies. In practice, compensation for expropriation has always been partial, as when Mexico expropriated American petroleum companies in the 1930s and Egypt nationalized the Suez company in 1956.³²²

A new legal formula calling for "appropriate" or "reasonable" compensation has been adopted by a series of UN resolutions, such as the UN General Assembly Resolution On the New International Economic Order,³²³ and the Charter of Economic Rights And Duties of States.³²⁴

The OECD Draft Convention has also abandoned the triple standard for compensation. It provides that "compensation shall represent the genuine value of the property affected, shall be paid without undue delay, and shall be transferable

³²² Li, Supra, note 307 p.173.

³²³ UN General Assembly Resolution 3201, S-VI, UN doc. a/9559, (1974).

³²⁴ Art. 2 (c) of the Charter reads: each state has the right to nationalize, expropriate, or transfer ownership of foreign property, in which case appropriate compensation should be paid by the state adopting such measures, taking into account its relevant laws and regulations and all circumstances that the state consider pertinent. (1975) 14 Int'l. Leg. Mats p.251

to the extent necessary to make it effective for the national entitled thereto".³²⁵

With regards to compensation, Chinese BITs have adopted a similar approach to that set out in the OECD Draft Convention.³²⁶ The China-France BIT provides for "appropriate compensation", while the China- UK BIT requires "reasonable compensation". As for the compensation amount, according to BITs with Finland, Norway, the Netherlands, the UK, and Denmark, it must equal to the value of the investment expropriated immediately before the expropriation became public knowledge. The compensation must also be convertible, freely transferable and paid without undue delay.

Chinese domestic legislation provides a solid basis for the creation of BITs. According to the Amended JVL (1990) and WFOL, nationalization or expropriation of foreign invested enterprises is not allowed. However, in special cases, where expropriation is necessary for the public interest, it should be done in accordance with legal procedures and include appropriate compensation.

5. Dispute Settlement

From the point of view of foreign investors, the lack of a fair dispute settlement mechanism would render the discussion of compensation for expropriation almost meaningless.

An efficient and comprehensive mechanism for dispute settlement

³²⁵ The OECD Draft Convention art. 3, reprint in (1968) Vol.7 Int'l. Leg. Mats p. 117 .

³²⁶ Li, Supra, note 307 p.174.

constitutes one of the most important factors in building an atmosphere of mutual confidence. One of the prime objectives of a BIT, therefore, is to provide a viable mechanism for the settlement of investment disputes.

The BITs often devote specific clauses applicable to either the settlement of disputes between investors and the host state, or disputes between the contracting parties.

(a) **Dispute Resolution Between Investors and the Host Government**

(1) **Disputes in connection with investment (including expropriation)**

Under Chinese BITs, disputes (including the legality of expropriation) between private investors and the state can only be settled through amicable means or local remedies. The parties to the dispute must first attempt to settle their differences through amicable means.³²⁷ If this approach does not succeed within a certain period of time, administrative or judicial means may be resorted to. When resort to amicable means or local remedies have been exhausted, the investor can always turn to his home government for support.³²⁸

(2) **Disputes Involving the Amount of Compensation**

China's BITs provide only for international arbitration of investor-state disputes on the issue of the compensation amount³²⁹. The reason for this is that expropriation is seen as a sovereign act of state, and, therefore, incapable of being

³²⁷ China-Netherlands Agreement.

³²⁸ Li, Supra, note 307 p.175.

³²⁹ See, e.g. China-Great Britain BIT, art. 7. China-Singapore BIT, art.13, -Japan BIT, art. 11. See also, Li, Ibid. p. 175.

reviewed through international arbitration. Only disputes concerning the amount of compensation may be submitted to international arbitration, perhaps because they are more technical in nature.

A majority of the agreements provide that if negotiation and consultation fail to arrive at an agreed sum, investors may either submit the case to a competent local court or to an ad hoc international arbitration tribunal.³³⁰

(b) Disputes Between Parties To the Treaty

Disputes between parties to the treaty concerning its interpretation and application, must be settled through negotiation. If this is impossible within a certain period of time, the dispute may be submitted to international arbitration at the request of either party.

Normally, the nature, composition and procedure of the arbitral tribunal are stipulated in the BIT. Arbitral awards are considered final and must be enforced according to domestic law.

As to procedural rules, China's BITs with France and the UK refer to the rules of United Nations Commission on International Trade Law [hereinafter UN CITRAL].

Since China currently is not a signatory to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States [hereinafter ICSID Convention], it refuses to submit investment disputes to it for

³³⁰ China-FRG Agreement.

arbitration. However, China tends to be flexible on procedural rules. Some BITs³³¹ refer to ICSID rules explicitly. In an exchange of notes to the China-France Treaty, the Chinese suggested that when it became a party to the ICSID Convention, China would negotiate with France to include an additional arrangement for dispute settlement under the rules and procedures of the convention.³³²

As regards the law applicable to any dispute, BITs with France and the Netherlands provide three sources: the provisions of the agreement, relevant domestic laws and principles of international law accepted by both parties. The BITs with Belgium and Luxembourg refer to the domestic law of the host country, including its rules on conflict of laws, and the provisions of the contract. From the Chinese government's point of view, the latter approach is superior because it is consistent with the principle of territorial jurisdiction of international law, and it focuses on the will of the contracting parties. Conversely, rules regarding conflict of laws are unacceptable as they weaken the application of the domestic law of the host country.³³³

³³¹ Those with FRG, Belgium-Luxembourg, Finland, Norway, Denmark, Netherlands and Austria.

³³² China-France Treaty Exchange of Letters.

³³³ Li, Supra, note 307, p.175.

Chapter IX Dispute Settlement Mechanisms

In order to meet the needs of China's foreign trade and investment, the government has made strenuous efforts to create enforceable dispute settlement mechanisms for Chinese and foreign parties.

At the present time, investment disputes in China are settled by three mechanisms: mediation, arbitration, and litigation.

A. Mediation

The use of mediation to settle disputes has been a traditional approach throughout Chinese history for thousands of years.³³⁴ The use of mediation reflects the fact that the Chinese people have been deeply influenced by Confucianism, particularly its emphasis on compromise, yielding, and harmony in human relationships. In recent years, this tradition has been extended to the procedures developed for arbitration of international business disputes. For instance, the Provisional Rules of Procedure of the Maritime Arbitration Commission stipulates that the Commission may endeavour to settle by conciliation any dispute of which it has taken cognizance.

In China's arbitration institutions, conciliation is the preferred method for settling disputes, but it is neither a necessary nor compulsory step in the process. If no compromise agreement can be reached after a reasonable period of time, or if one party is not willing to go on with the conciliation proceedings, arbitration

³³⁴ See J. Alan Cohen, "Chinese Mediation on the Eve of Modernization." 54 Cal.L. Rev 1966 p.1201.

proceedings should be carried out in accordance with the rules of procedure and an arbitral award should be rendered as soon as possible.

Joint conciliation is a new method developed by the China International Economic Trade Arbitration Commission [hereinafter CIETAC] together with arbitration institutions of other countries.³³⁵ Under this procedure, the Chinese party to a dispute applies to CIETAC, and the foreign party applies to the corresponding arbitration institution in its own country for joint conciliation. Upon such applications, CIETAC and the foreign arbitration institution each appoint one conciliator to jointly conciliate the case. If the conciliation succeeds, the dispute is solved. If it fails, the dispute is referred to arbitration in accordance with the arbitration clause of the contract.

In China, mediation has a place not only in the process of arbitration but also in that of litigation. The Civil Procedure Law stipulates that in trying civil cases, the People's Courts should stress mediation.³³⁶

B. Arbitration

The importance of international commercial arbitration lies mainly in the fact that through it international trade has become increasingly independent of national judicial systems.

³³⁵ Weisan Shi, "Arbitration and Conciliation: Resolving Commercial Disputes In China" (1989) Vol. 12:1 Loy. L. A. Int'l. & Comp. L. J. p.97.

³³⁶ Civil Procedure Law of P.R.C. art. 6. Ralph H. Folsom & John H. Minan eds Law In the People's Republic of China (Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1988) p.1023.

Arbitration avoids any conflict of law through the use of a "choice of law" clause in the arbitral agreement. Arbitrators are also considered more qualified than ordinary judges to deal with the technicalities of trade as they are experts chosen from the particular branch of commerce involved in the case. The low cost of arbitration compared to legal proceedings is another important factor to recognize, especially for people or businesses with a modest income. Arbitrators also possess considerable freedom in resolving a dispute.³³⁷

However, there are limits and disadvantages to the process of international commercial arbitration. The main difficulty facing arbitration remains the impossibility of operating independently of domestic judicial systems. A foreign arbitral award can only be enforced by the judicial bodies of the country where enforcement is sought.

In order to meet the needs of China's developing foreign trade and business, the CCPIT set up the Foreign Trade Arbitration Commission [hereinafter FTAC] in 1956 and the Maritime Arbitration Commission [hereinafter MAC] in 1959. After China adopted its open door policy in 1979, both Chinese and foreign arbitration experts recognized that the 1956 FTAC rules were outdated, inadequately serving China's needs as a centre for international arbitration. In February 1980, the State Council renamed the Commission as the Foreign Economic and Trade Arbitration Commission [hereinafter FETAC]. Along with the name change,

³³⁷ William B. Grenner "The Evolution of Foreign Trade Arbitration In the People's Republic Of China" (1989) Vol. 21 Int'l. Law. & Politics p.295.

FETAC's jurisdiction was enlarged and its staff increased. FETAC handles disputes arising from foreign trade and economic transactions with foreign countries. It also resolves any disputes arising from foreign trade with agencies created to purchase or sell merchandise. Among the disputes under FETAC's jurisdiction are those regarding material processing, parts assembly, and compensation trade. Although FETAC was allowed to handle a wide scope of disputes, it only heard those cases in which an arbitration agreement had been concluded between the disputing parties.³³⁸

On June 21, 1988, the State Council of the P.R.C. approved the renaming of FETAC to the CIETAC. CIETAC's jurisdiction covers all disputes arising from international economic and trade transactions³³⁹.

CIETAC now ranks as the second-busiest international arbitration body in the world, just behind the International Chamber of Commerce (ICC) in Paris. In 1990, CIETAC's pending cases increased to more than 400 compared to a mere 30 cases in 1985. In the pending cases, mainland China accounts for 60 percent and foreign land 40 percent of the plaintiffs with the litigants belonging to 24 different countries.³⁴⁰

1. Arbitration Situs

The selection of the arbitration situs has a great impact on the outcome of

³³⁸ Civil Procedure Law art. 192.

³³⁹ Shi, Supra, note 335 p.101 and 102.

³⁴⁰ Michael J. Moser " Arbitration in China" The China Business Review (September- October 1990) p. 42.

the dispute settlement process. The choice of forum will directly affect the following matters: enforcement of the arbitration award abroad; the availability of interim remedies during the course of the arbitration; selection of arbitrators; the right to appeal the arbitral award; and the expense of the arbitration process³⁴¹. Both the JVL Implementing Regulation and FECL provide that parties to a dispute may either submit the case to CIETAC or to an arbitration tribunal in a third country or to the country where the sued party is located³⁴². Normally Chinese negotiators propose to have the arbitration conducted by CIETAC. However, foreign parties are often unwilling to subject themselves to its jurisdiction³⁴³. As a result, the most frequent arbitration situs selected by Chinese and foreign parties is a third-party country.

In general, Chinese negotiators press for arbitration to be held in Stockholm, Sweden, a place well-renowned for its arbitration of east-west trade disputes.³⁴⁴

Other arbitration situs selected by the Chinese in the past, have included

³⁴¹ Daniel M. Kolkey, "Fora For the Resolution of International Business Disputes When Doing Business with the P.R.C." (1989) Loy. L.A. Int'l. and Comp. L. J. p.102.

³⁴² The JVL Implementing Regulation art. 110, FECL art. 37.

³⁴³ According to some western writers, although CIETAC is referred to as being independent, its underlying goals are potentially indistinguishable from those of the Chinese Government which normally is a party to the dispute due to the public ownership of the economy.

³⁴⁴ Baotai Chu, Legal Problems Concerning Foreign Investment In China (hi: Industrial Press, 1988) P.430. The author is the director of the Department of treaties and Law of the Ministry of Foreign Economic relations and trade of the P.R.C.

the American Arbitration Association, the London Court of International Arbitration, and the Zurich Chamber of Commerce.³⁴⁵ International Chamber of Commerce (ICC) arbitration has been unacceptable to Chinese parties until very recently due to Taiwan's participation in the body.³⁴⁶

2. Procedural Rules

If Chinese and foreign parties agree to submit their case to CIETAC arbitration, they must use CIETAC rules. Chinese law is silent on whether the parties may choose the procedural rules of a foreign arbitration organization. However, According to a Chinese official, the UN CITRAL rules are the only other procedures that may be adopted by CIETAC.³⁴⁷

The UN CITRAL rules have been adopted by the London Court of International Arbitration and the Inter-American Commercial Arbitration Commission.³⁴⁸ The rules were developed to bridge the gaps between socialist and capitalist systems, and between developing and developed countries.³⁴⁹

In future, China may accept other procedural rules of some permanent

³⁴⁵ Thomas Peel and Marsha A. Cohan "Dispute Resolution in China" September/ October 1988 the China Business Review p.46.

³⁴⁶ Ibid.

³⁴⁷ Houzhi Tang, "Arbitration-A Method Used By China to Settle Foreign Trade and Economic Disputes," (1984) 4 Pace. L. Rew. p. 527.

³⁴⁸ William B. Devoe, "Commercial Dispute Resolution Between the United States and the P.R.C.: Problems and Prospects." (1983) 7 Suffolk Tansnat'l L. J. p. 229.

³⁴⁹ Chu, Supra, note 344 p.432.

arbitration organizations, such as the rules of the International Centre for the Settlement of Investment Disputes [hereinafter ICSID].³⁵⁰

ICSID was created by the World Bank through the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States [hereinafter ICSID Convention]. ICSID was framed to facilitate the establishment of arbitral tribunals to resolve investment disputes between contracting states and private investors. Like the UN CITRAL arbitration rules, the ICSID Convention has received widespread international acceptance. China now lists ICSID as a potential forum for arbitration³⁵¹.

3. Applicable Law

Specification of the substantive law used to govern disputes is the most difficult drafting task facing contract negotiators. There is no clear answer in Chinese law concerning which law should be applied by the two permanent arbitration commissions. However, there are "choice of law" provisions found in both the FECL and the Civil Code. The 1987 Responses of the People's Supreme Court to Questions Arising out of the Application of the Foreign Economic Contract Law³⁵² also contains provisions concerning the choice of law. According to these

³⁵⁰ Ibid.

³⁵¹ James A.R. Nafziger & Ruan Jiafang " Chinese Methods of Resolving International Trade Investment and Maritime Disputes" Law In the People's Republic of China Supra, note 336 p.148.

³⁵² According to the 1979 People's Court Organic Law art. 32 and 33, the Supreme People's Court can give interpretations on question concerning specific application of laws and in judicial proceedings. Since 1987, the Supreme Court has been issuing interpretative notices concerning P.R.C. law.

documents, we can roughly conclude that the application of law in a Chinese arbitration organization is as follows:

(1) International bodies have recognised the principle of party autonomy regarding international commercial arbitration. This principle has also been adopted in Chinese law.³⁵³

The contracting parties may choose the law applicable to the contract and for the arbitration of their contractual disputes, when the contract is concluded or after a contractual dispute has arisen³⁵⁴.

(2) Where no governing law is chosen by the parties, the arbitration tribunal shall decide which law to apply. The arbitration tribunal should apply the law which has the closest connection to the contract.³⁵⁵

(3) The FECL stipulates that Chinese law must apply in Chinese foreign equity joint venture contracts, contractual joint venture contracts, or any contract involving Sino-foreign exploration and the development of Chinese natural resources³⁵⁶.

³⁵³ The Foreign Economic Contract Law art. 5, The Civil Code art. 145.

³⁵⁴ The People's Supreme Court Responses Para. 4, art. 2.

³⁵⁵ Foreign Economic Contract Law art. 5 provides that the parties to a contract may seek settlement to disputes, in accordance with laws of their choosing applicable to such disputes. If the parties make no such choice, the law of the country most closely related to the contract shall apply.

³⁵⁶ JVL Implementing Regulation also stipulates that the formation of a joint venture contract, its validity, interpretation, execution and the settlement of disputes under it, shall be governed by the Chinese law.

Article 18 of the 1982 Constitution stipulates that the rights of joint ventures are protected by the law of the People's Republic of China. This provision means that foreign enterprises will be subject to the laws of China, if their contracts and agreements are silent as to the governing law.

4. Enforceability of Arbitral Awards

(a) The conditions for enforcement of foreign arbitral awards

In 1986, the Standing Committee of the National People's Congress approved China's accession to the United Nation's Convention on the Recognition and Enforcement of Foreign Arbitral Awards [hereinafter, FAA Convention]³⁵⁷. China joined the FAA Convention to help build a favourable climate for international trade. The FAA Convention applies to both the recognition and enforcement of Chinese arbitral awards in other contracting countries and recognition and enforcement of foreign arbitral awards from other contracting countries in China. However foreign arbitration organizations when applying this FAA Convention in China should consider the promulgated implementing regulations for the Convention contained in the Supreme People's Court's Notice on the Implementation of China's Accession to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards to Higher and Intermediate Level Courts and Certain Special Courts [hereinafter Notice]³⁵⁸.

³⁵⁷ Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958. 21 U.S.T. 2517, T.I.A.S. No. 6997.

³⁵⁸ The Notice on the Implementation of China's Accession to The Convention on the Recognition and Enforcement of Foreign Arbitral Awards issued by the Supreme People's Court, (1987)

These regulations explain certain reservations to China's acceptance of the FAA Convention. China will apply the FAA Convention only on the basis of reciprocity and only to commercial disputes as so defined by Chinese law.³⁵⁹

The Civil Procedure Law also stipulates that before recognizing and enforcing a foreign award the court must ensure that it does not violate the basic principle of the law of the PRC or the national or social interests of the country.

According to the FAA Convention, the Civil Procedure Law and the Notice, the conditions applying to the enforcement of foreign arbitral awards are the following:

(1) According to the Notice, where provisions of the FAA Convention differ from those of the Civil Procedure Law, provisions of the FAA Convention shall apply.

(2) China shall only apply the FAA Convention to arbitral awards made in the territory of other signatory states³⁶⁰. The reciprocity reservation therefore, refers to reciprocity in terms of the situs of the arbitration, not to the national origin of the parties themselves.

(3) When signing the FAA Convention, China also included a reservation that it would only apply to disputes arising out of commercial legal relationships of

³⁵⁹ Decision of the Standing Committee of the National People's Congress with Respect to China's Accession to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Adopted Dec. 2, 1986.

³⁶⁰ Supra, note 358

a contractual or non-contractual nature.³⁶¹ Such relationships refer to economic rights and duties created by contracts, torts or statutory law, such as: the purchase and sale of goods; property leasing; engineering contracts; processing contracts; technology transfer; equity joint ventures; cooperative joint ventures; the exploration and exploitation of natural resources; insurance credit; labour matters; agency; consulting services; the transport of passengers and goods by sea; product liability; environmental pollution; accidents at sea; and disputes over ownership rights.³⁶²

(4) The FAA Convention also contains standards for recognition and enforcement of foreign arbitral awards. Under art. 5, section 1, technical and procedural grounds for refusal to enforce an award are enumerated. Grounds for refusal include: invalidity of the arbitration agreement; an award beyond the scope of the submission for arbitration;³⁶³ the composition of the arbitral tribunal or the arbitral procedure is not in accordance with the agreement of the parties or is not in accordance with the law of the country where the arbitration took place; and where the award has either not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which the award was made. Section 2 of article 5 stipulates that recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where

³⁶¹ Ibid.

³⁶² Ibid.

³⁶³ In that case, the portion which is beyond the submission to arbitration is invalid. The other portion may be recognized and enforced. FAA Convention art. 5.

recognition and enforcement is sought finds that: (a) The subject matter of the dispute is not capable of settlement by arbitration under the law of that country. (b) The recognition or enforcement of the award would be contrary to the public policy of that country.

The Notice contains a further exception which excludes from FAA Convention coverage disputes between foreign investors and the governments of host countries.

The Chinese approach to sovereign immunity, as explained by Houli Wang, is: "That the restrictive theory of sovereign immunity characterized by classification of state acts into those which are "sovereign" and "non-sovereign" is theoretically unfounded" ³⁶⁴. China stands by the traditional principle of the jurisdictional immunity of states. The government holds that compulsory jurisdiction over a foreign state is inconsistent with the principle of sovereign equality among states enshrined in the United Nations Charter.³⁶⁵

Even though insisting on the theory of absolute immunity, China may give a restrictive interpretation to the host country exception. The Chinese government's willingness to submit to international arbitration may be analogous to its willingness to submit itself to domestic PRC courts. The Civil Procedure Law allows parties to lawsuits to include state "enterprises, offices, and organizations"³⁶⁶. The CIETAC

³⁶⁴ Wang Houli "Sovereign Immunity: Chinese Views and Practice" (1987) 1:23 Journal of Chinese Law p.29.

³⁶⁵ U.N. Charter art. 1 Para.2, art. 2, Para. 1.

³⁶⁶ Civil Procedure Law art. 144.

Procedure Rules grant it jurisdiction to hear cases concerning Chinese firms, companies, or other economic organizations. These laws and regulations provide some basis for believing that the government will adopt a restrictive reading of the host country exception³⁶⁷.

It must be emphasized that the principle of state jurisdictional immunity applies to states, but not to enterprises and corporations possessing a separate legal capacity. The latter do not enjoy immunity from the exercise of jurisdiction by foreign courts over disputes arising out of their transnational activities. Since 1978, following foreign trade reform, a great number of state owned enterprises have become legal persons. Their commercial transactions, therefore, are carried out by a legal entity other than the government. In this circumstance, application of the traditional principle of sovereign immunity would not pose a legal impediment to the conduct of economic and trade activities with China.

(b) The Enforcement Procedure

(1) The Enforcement of the Arbitral Awards of CIETAC

Generally, the arbitral awards rendered by CIETAC will be automatically carried out by the Chinese parties. The Civil Procedure Law provides that an arbitration award rendered by a Chinese foreign arbitration agency is final and legally binding on both parties³⁶⁸. Art. 195 of the Civil Procedure Law provides that when one party does not carry out the verdict of a foreign affairs arbitration

³⁶⁷ Procedure Rules of the CIETAC art. 2.

³⁶⁸ The Civil Procedure Law art. 193.

organization of the P.R.C., the other party may apply for its execution according to the relevant provisions of the Civil Procedure Law. The appropriate body to hear the case is the intermediate people's court located in the city of the arbitration organization or where the property itself located. Under Article 203 of the Civil Procedure Law, when an award is rendered by a Chinese arbitration organization against a party whose property is outside the P.R.C., the People's Court may turn to a foreign court for assistance according to the FAA Convention or in accordance with the principle of mutual reciprocity.

(2) Enforcement of Foreign Arbitral Awards

According to art. 4 of the FAA Convention, a party to an arbitration award must apply to a Chinese court for recognition and enforcement of the decision if it was made in another contracting country. The intermediate People's Court shall receive the application submitted by the party³⁶⁹. In cases of enforcement sought against a natural person, the proper court is the intermediate people's court located where he registered his house or where he has his domicile. In the case of enforcement sought against a legal person, the appropriate court for the application is the intermediate People's Court of the place where the legal person has its principal place of business. Finally, in the case of an enforcement sought against a party without a residence, household registration, or place of business in China but who owns property in the country, the proper court shall be the intermediate

³⁶⁹ Civil Procedure Law art.204.

People's Court of the place where his property is located.³⁷⁰

According to the Civil Procedure Law, a foreign arbitral award that is to be enforced in China should satisfy two requirements. First, the award must be effective according to the foreign law. Second, the award must be entrusted by a foreign court to the Chinese court.³⁷¹ When entrusted by a foreign court to assist in the execution of an already affirmed award, a People's Court shall review the award in accordance with the Civil Procedure Law and the FAA Convention. The standards for recognition and enforcement of foreign arbitral awards are as follows: (1) The award must not violate China's public policy or basic legal principles. (2) The subject matter of the arbitration must be capable of settlement by arbitration under Chinese law. (3) There must be no technical violation in the procedure of the arbitration. (4) The enforcement must also meet China's reservation regarding reciprocity and involve a commercial dispute as defined by Chinese law.

If no grounds for refusal exist, the court shall rule that the judgment or award be recognized as legally valid and shall execute it in accordance with the provisions of the Civil Procedure Law. Otherwise, the People's Court shall return the request to the foreign court.³⁷²

The FAA Convention shall apply to awards rendered after April 22, 1987, the date at which the FAA Convention came into force in China. The application

³⁷⁰ Civil Procedure Law art. 195.

³⁷¹ The Civil Procedure Law art. 204.

³⁷² Art. 204 of the Civil Procedure Law.

for enforcement must be made within the limitation period provided by the Art. 169, Civil Procedure Law. The relevant period is one year where one or both of the parties is a natural person. If neither party is a natural person, the limitation period is six months.

C. Litigation

Litigation is another method used to settle civil economic disputes in China. Many laws provide the legal basis for settlement of foreign related disputes by litigation including the Civil Code, Civil Procedure Law, and the FECL. The Civil Procedure Law has special provisions for foreigners involved in the litigation process:

Foreign nationals and people without nationality who file or respond to a lawsuit in the People's Courts have the same litigation rights and obligations as citizens of the People's Republic of China. Foreign enterprises and organizations which file or respond to lawsuits in the People's Courts shall enjoy litigation rights and bear litigation obligations in accordance with the provisions of this law. In the event that the court of a foreign country imposes restrictions on the litigation rights of citizens, enterprises and organizations of the P.R.C., the people's court shall follow the principle of reciprocity with respect to the litigation rights of citizens, enterprises and organizations of that foreign country.³⁷³

In China, jurisdiction over civil and economic cases involving foreigners at the first instance is exercised by the intermediate People's Courts.³⁷⁴

In the past, the People's Courts often submitted their decisions for review to the local Communist Party Committee. Art. 126 of 1982 Constitution was intended to insulate the courts from the influence of the Chinese Communist Party. The courts shall now, in accordance with the law, exercise judicial power

³⁷³ The Civil Procedure Law art. 186.

³⁷⁴ The Civil Procedure Law art. 17

independently without interference from state agencies or individuals.³⁷⁵ The court has responsibility for its own work in insuring the accurate and effective application of law in China.³⁷⁶

Trials before People's Courts are open to the public except when they involve state secrets, juveniles or confidential matters (intimate relations).

The Civil Procedure Law provides that if foreign litigants want to retain legal counsel to represent them, they must choose a Chinese lawyer³⁷⁷. In China, individuals are not allowed to practice law, Chinese lawyers must joint legal advisory office, which are part of the state controlled organization. Foreign litigants can find suitable Chinese lawyers through the recommendation of the legal advisory offices.

Mandarin, with some local exceptions, is the language used in Chinese courts. A translator will be provided if a litigant so requests, although he must pay a service fee.³⁷⁸

The People's Courts at various levels have handled an increasing number of foreign -related cases, most of which are concerned with inheritance, property and contract disputes. Resort to Chinese courts for resolution of foreign investment

³⁷⁵ Supra note 336 p.967. The Constitution of the P.R.C. art. 126 stipulates that the people's courts must in accordance with the law, exercise judicial power independently and not subject to interference by administrative organs, public organizations or individuals.

³⁷⁶ Ibid. art. 135.

³⁷⁷ The Civil Procedure Law art. 191.

³⁷⁸ Ibid. art. 190.

dispute is still rare.³⁷⁹ Most investment contracts between foreign and Chinese parties provide for arbitration rather than litigation in the event of a dispute. The Civil Procedure Law provides that disputes arising from external economic relations shall not be brought to the People's Court if the parties have agreed to refer the dispute to arbitration. Any decision made by the arbitration organization is final and cannot be appealed to a People's Court.³⁸⁰

Generally, the Chinese people are reluctant to submit a dispute to a court. Litigation is often a slow and costly process. In addition, the Chinese people believe that bringing a lawsuit may destroy a business relationship and foster uncertainty in business transactions³⁸¹. For foreign investors the thought of launching a lawsuit in China can be quite daunting considering the differences in language and legal systems. They may prefer to settle any disputes through arbitration. However, when arbitration is not provided for in a contract, litigation provides an alternative.

Hence, there are three methods for resolving international business disputes in China: mediation, arbitration and litigation. Amendments in the area of arbitration, combined with acceptance of the FFA Convention, shows that China's leaders want to participate in an increasingly interdependent commercial world.

³⁷⁹ (November/ December 1985) The China Business Review p. 27.

³⁸⁰ Ibid. arts. 192, 193.

³⁸¹ William B Grenner" The Evolution of Foreign Trade Arbitration In the People's Republic of China" Winter (1989) Vol. 21 J. of Int'l. L. & Politics p.294.

Chapter X Conclusion

To improve the investment environment and to increase long term confidence on the part of foreign investors, China's leaders have promised that they will never abandon the open door policy and efforts to provide a sound legal system for foreign investment. Paralleling domestic legislative reform in this field, China has also constructed a bilateral investment treaty program within a short period of time. Thus China has built up a comprehensive though not perfect legal framework for foreign investment.

The previous chapters of this thesis have reviewed the development of foreign investment law in the P.R.C. showing its distinctive features. Most distinctive of all, foreign investment law in China has been largely enacted at two levels: national and regional. The regional rules are applicable only in specifically defined geographical areas, mostly in the special economic zones and coast cities. China has made FDI easier through the offering of strong incentives to investors in four SEZs and fourteen coast cities. These incentives have attracted a substantial portion of foreign investment. Therefore, localized legislation regarding foreign investment plays an important role in the overall scheme. An investor must study both the national and regional laws in order to form a complete picture of the foreign investment environment for a given project.

Chinese investment law remains in its formative stages. There exists many

rules which often overlap³⁸². This situation is further complicated by a growing number of local rules operating alongside national regulations which are applicable in specific geographical areas, and which govern similar issues in different ways and with different scopes of application. This overlap may result in confusion among Chinese and foreign investors. However, the Chinese government has tried to address this problem. In April 1991, the National People's Congress passed the Law Concerning the Income Tax of Foreign Funded Enterprises which simplifies China's complex and overlapping tax structure.

The thesis also shows how in order to provide a stable and predictable environment for economic development and to encourage foreign trade and investment, China has renewed its interest in international law.

During the Cultural Revolution, China refused to recognize or adhere to almost all international treaties except the Charter of the United Nations and the four Geneva Red Cross Conventions³⁸³. But, with surprising speed, the post Cultural Revolution PRC has adhered to many international treaties. China has accepted the Paris Convention and the FAA Convention, while also receiving observer status with GATT in 1984. Adherence to international law has brought change to China's domestic laws. For instance, after joining the International

³⁸² For instance, Chinese contract law is codified in three statutes: the FECL, the ECL and the Civil Code. Although each of the three statutes have different implications, they could be easily incorporated into one single statute with some modification.

³⁸³ Hungdah Chiu, "Chinese Views on the Sources of International Law" Spring (1987) Vol. 28 Number 2 Harvard Int'l Law Journal p. 306.

Customs Cooperation Council in 1983, China was forced to reduce significantly its tariff rates. China's Patent Law and Trademark Law have also been adapted to bring them within the minimal requirements of the Paris Convention³⁸⁴. Moreover, the Civil Code now provides that when an international treaty signed by China contains a provision differing from the Civil Code, the international treaty prevails.

Most of China's 20 BITs have been concluded with developed countries. These BITs reflect the practice and experience of those individual states. However, a common characteristic of all BITs is the high priority given to the protection of foreign property. Those characteristics drawn from Chinese concepts include the national treatment standard of compensation in expropriation cases and the settlement of disputes. The BITs weave a mixture of common interests and compromise in a carefully designed legal framework³⁸⁵

Finally, this thesis has shown that problems remain with regards to FDI in China. Major concerns still exist over the non-convertibility of RMB and the lack of enterprise autonomy. However, these problems are not insurmountable. The movement towards reform continues to the present day. It can be anticipated that as long as China continues to pursue its reform process, the Chinese legal system will move in a direction that is amenable to the promotion and protection of foreign investment and closer to international legal norms.

³⁸⁴ Stanley J. Marcass, Supra, note 78 p.179.

³⁸⁵ Li, Supra, note 307 p.177.

Selected Bibliography

I Books

Brown, D. G., Partnership With China: Sino-Foreign Joint Ventures in Historical Perspective (London: Westview Press, 1986)

Byrd, W. A., The Market Mechanisms and Economic Reforms In Chinese Industry (Ann Arbor: UMI. 1987)

Chan, Peter P.F., People's Republic of China, Modernization and Legal Development (Oyez Longman Publishing ltd, 1983)

Folsom, Ralph H. and Minan, John H. eds, Law In the People's Republic of China, Commentary, Readings and Materials (Dordrecht/Boston/London: Martinus Nijhoff Publishers, 1988)

Huenemam, R. W. & Zhang. P. eds, China's Foreign Trade (Halifax: Institute for Research on Public Policy, 1987)

Jackson, J.H., The World Trade System (London: MIT Press, 1989)

Moser, M. J. ed., Foreign Trade, Investment, and the Law in the People's Republic of China 2nd ed. (Oxford: Oxford University Press, 1987)

Reynolds, B. L. ed., Chinese Economic Reforms: How Far How Fast? (New York: Academic Press, 1988)

Simon, Denis Fred & Goldman, Merle eds, Science and Technology in Post-Mao China (Combridge/ London: Harvard University Press, 1989)

✿
✿
Zhang, Qinfan, The History of the Chinese Legal System (Beijing: The Chinese
People's University Press, 1981)

II Articles

Aksen, Gerald, "The Case for Bilateral Investment Treaties" (1981) Symposium: Private Investors Abroad. P.359

Alexander, P., "The Chinese Economy: One Year Later" (1990) 2:2 Global Business Issues 1.

Brahm, Laurence J., "Joint-Venture Law Update." (1990) 28 China Trade Report 8.

Brahm, Laurence J., "Copyright Law Adopted" (1990) 28 China Trade Report 4.

Chao, H. & X. Yang, "The Reform of the Chinese System of Enterprise Ownership" (1988) 23:1 Stanford Journal of International Law 365

Cheng, Elizabeth, "More Trade Disputes." (1990) 28 China Trade Report 12.

China Trade Report, "Joint Venture/Investment/Contracts" (1991) 29 China Trade Report 11.

China Trade Report, "Foreign Investment Agreements (Contracts) Approved-1st Half 1990." (March 1991) 29 China Trade Report 15.

Chiu, Hungdah, "Chinese views on The Sources Of International Law" (1987) Vol. 28 Harvard International Law Journal 289.

Cohen, Jerome Alan & Valentine, Stuart J., "Foreign Direct Investment in the People's Republic of China: Progress, Problems and Proposals" (1987) Journal of Chinese Law 161.

Deckers, W., "World Bank Plans For China" (1990) 20: 3 Bulletin of Concerned Asian Scholar 70.

Easson, A. J. & J. Li, "The Evolution Of the Tax System In the People's Republic Of China." (1988) 23:1 Stanford Journal of International Law 399.

Easson, A.J., "Contractual, Co-operative and Equity Joint Ventures In the People's Republic of China." (1989) 3 Review of the International Business Law 145.

The Economist, "Joint Venture in China: Inscrutable." (17 March 1990) The Economist 66.

Ellis, S.L., "Decentralization of China's Foreign Trade Structures" (1981) 11 Georgia Journal of International and Comparative Law 283.

Epstein, E.J., "The Theoretical System of Property Rights in China's General Principles of Civil Law: Controversy In the Drafting Process and Beyond" (1989) 52:2 Law and Contemporary Problems 177.

Gelatt, Timothy A., "China's New Cooperative Joint Venture Law." (1989) 15 Syracuse Journal of International Law and Commerce 187.

Grenner, William B., "The Evolution of Foreign Trade Arbitration in the People's Republic of China" (Winter 1989) Vol. 21 International Law and Politics 293.

Gescher, Jeanne-Marie C., "A Legal Opinion." (May 1990) 28 China Trade Report 6.

Goossen, Richard J., "Canadian Business Negotiations in Post-Mao China: A Progress Report on the New Foreign Economic Legislation." (1985) 31 McGill Law

Journal 1.

Gudgeon, K. S., "United States Bilateral Investment Treaties; Comments on Their Origin, Purposes and General Treatment Standards" (1986) 4 International Tax & Business Lawyer 109

Hu, Zhixin, "Tax Legislation Will Induce Foreign Investment."
(1986) 12 China Foreign Trade

Huan, G., "China's Open Door Policy: Development Problems, and Prospects" in C.A. Cerami, ed., A Marshall Plan For The 1990's: An International Roundtable On World Economic Development (New York Preager, 1989) 153.

Jiang, Ping, "The Scope and effectiveness of the General Principles Of Civil Law." 3 (1986) FaXue Yanjiu 1.

Klenner, W., "Administrative Regimentation and Economic Reform in China" (1990) 25 Intereconomics 149.

Marcuss, Stanley J., and Arthur R. Watson "Technology Transfer in the People's Republic of China: An Assessment." (1989) 15 Syracuse Journal of International Law And Commerce 141.

McKenzie, Paul D., "Foreign Exchange And Joint Ventures With China: Short-Term Strategies And Long-term Prospects." (1990) 17 Canadian Business Law Journal 115.

Moser, Michael J., "International Commercial Arbitration in the People's Republic of China: A primer" (June 1990) International Business Lawyer 254.

Schulberg, Bruce R., "China's Accession to the New York Convention: An

Analysis of the New Regime of Recognition and Enforcement of Foreign Arbitral Awards" (1989) Journal of Chinese Law 117.

Sornarajah, M., "State Responsibility And Bilateral Investment Treaties " (1986) 20 Journal of World Trade Law 79

Pepper, S., "China's Special Economic Zones: The Current Rescue Bid For A Faltering Experiment" (1990) 20:3 Bulletin of Concerned Asia Scholars 2.

Prybyla, J. S., "Why China's Economic Reforms Fail." (1989) 11 Asian Survey 1017

Pye, L.W., "China: Erratic State, Frustrated Society" (1990) 69: 4 Foreign Affairs 56

Ren, Jianxin, "Mediation, Conciliation, Arbitration and Litigation in the People's Republic of China." (1987) 15 International Business Lawyer 395

Ross, J.L., "Investment Canada Act: A New Regime for Foreign Investment In Canada." (1986) 91 Comm.L. J. 141

Silk, Mitchell A., "Recent Efforts in China's Drive to Promote Investment Through the Protection of Intellectual Property Rights: The 1988 Trademark Rule and the 1988 Technology Import Contract Rules." (1989) 15 Syracuse Journal Of International Law and Commerce 215.

Tang, An & Chen, Xing-Yuan, "Arbitration Under Chinese Law " (1989) Vol. 6 Journal of International Arbitration 57.

Thibeault, R., "Rural Enterprises In China: Too Many Too Soon?" (1989) 1380 China News Analysis 1.

Townsend, D.E., "The Foreign Economic Contract Law of the People's Republic of China: A New Approach to Remedies" (1989) 24:2 Stanford Journal of International Law 479.

Triebel, Volker & Xu, Guojian, "International Economic Trade and Maritime Arbitration In the People's Republic of China: New Development." (1989) Journal of International Arbitration 13.

Vogel, K., "Double Tax Treaties and Their Interpretation." (1986) 4 International Tax and Business Lawyer 5.

Wolff, A., "Technology Transfer to People's Republic of China" (1989) Vol. 4 International Journal of Technology Management 463

Wang, Hanbin, (Chairman of the Civil Law Drafting Committee), Explanation on the General Principles of Civil Law. April 17, 1986. People's Daily P.2

Wang, Jiafu, "A Civil Law With Chinese Characteristics" (1986) 3 Faxue Yanjiu (Studies In Law) 7

Wang, Zen, "Continuance and Development of People's Mediation in China" (1985) 6 Fa Xue Yan Jiu (Studies In Law) 30

Zheng, Henry R., "An Comparative Analysis of the Foreign Contract Law of the People's Republic of China" (1985) 4 U.C.L.A.L.J. 30

Zheng, H.R., "China's New Civil Law" (1986) 34 Am.J. Comp. L. 669

Zheng, H. R., "Foreign Investment Law in the People's Republic of China: A 1986 Update" (1987) 19 N.Y.U.J.Int'l L.& Pol. 269