

**FOREIGNERS AT THE GATE: SWEEPING  
REVOLUTIONARY CHANGES ON THE CENTRAL  
KINGDOM'S LANDSCAPE—FOREIGN DIRECT  
INVESTMENT REGULATIONS & DISPUTE RESOLUTION  
MECHANISMS IN THE PEOPLE'S REPUBLIC OF CHINA**

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“The elevation of law over politics is very new in China and the extent to which it is to be taken seriously is not always clear to the Chinese involved. The Chinese official and the Chinese citizen are part of a political structure in which the Party’s will and policies have been the most effective law . . . . Laws and regulations have to be understood in this wider context of a society in which the formal legal position is only one consideration and still often not the most important.”<sup>1</sup> “China is the most

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This article is dedicated the author’s wife, Arceli Casas White, for her love and devout support in our journeys together ranging from the beautiful and exotic rice terraces of Banaue, the Philippines, and ancient Magyar castles of Budapest, Hungary, to the Great Wall of China—what a wonderful journey it has been. The author would like to thank Tibor Varady, Professor of International Commercial Law at Emory University and Central European University, for his invaluable advice, guidance, and critique of the final manuscript. The views expressed in this article are the author’s alone.

<sup>1</sup> ALICE E-S TAY & CONITA S C LEUNG, *Introduction: The Relation Between Culture, Commerce and Ethics*, in GREATER CHINA: LAW, SOCIETY AND TRADE 1, 7 (A. Tay & C. Leung eds. 1995).

active market in the world. It's like a big magnetic field and will draw in more and more international investment."<sup>2</sup>

## I. INTRODUCTION

A new economic world order took effect with the advent of the People's Republic of China (China or P.R.C.)<sup>3</sup> being admitted into the World Trade Organization (WTO)<sup>4</sup> on November 10, 2001.<sup>5</sup> For a country with a population of over 1,300,000,000,<sup>6</sup> this proved a

<sup>2</sup> *Investment in China Increased Most*, ASIAINFO DAILY CHINA NEWS, Sept. 14, 2001, at 1 (quoting the president of Ericsson Co., Ltd.). The President went on to say "China is likely to become the most important market of Ericsson in the world." *Id.*

<sup>3</sup> See Overview of Modern-Day China at <http://www.freep.com/news/nw/deng/deng5.htm> (last visited March 21, 2002) (indicating that as of 1995 China's population stood at 1.2 billion people—one-fifth of the world's population—and its landmass is slightly larger than that of the U.S.).  
<sup>4</sup> See, e.g., Susan Tiefenbrun, *Free Trade and Protectionism: The Semiotics of Seattle*, 17 ARIZ. J. INT'L & COMP. L. 257, 267 (2000).

The WTO was proposed in 1990 by the Minister of Trade of Canada and was finally established in April 15, 1994 in Marrakesh, Morocco as a result of the Uruguay Round of multilateral trade negotiations . . . the WTO was [thus] born on January 1, 1995. For fifty years and until 1995, international trade functioned without a firmly established organization, under the aegis of the GATT, where rules of the game developed and were generally respected despite the fact that the GATT did not have the same international and political standing as the IMF or the World Bank . . . [Now,] [t]he WTO is the principle international agency overseeing and administering the rules of international trade . . . Membership of the WTO has mushroomed to one hundred thirty-six countries [now 137 countries with the People's Republic of China as a contracting member] (one hundred developing nations and about thirty developed nations) with [twenty-nine] nations . . . waiting to join . . .

*Id.*

<sup>5</sup> See generally *China's great step forward*, FORTUNE, Sept. 17, 2001, at 128. China also won the rights to host the Summer Olympic Games in 2008, for which it is expected to spend US \$22 billion on domestic investment—four times that of the Sydney games. See Martin Walsh, *Olympics opportunity, but be cautious*, ASIA TODAY INT'L, Oct./Nov. 2002, at 17.

<sup>6</sup> See Econ. Intelligence Unit, *Country Homepages: China* at [http://www.viewswire.com/index.asp?layout=country\\_home\\_page&country\\_id=cn](http://www.viewswire.com/index.asp?layout=country_home_page&country_id=cn) (last visited Feb. 20, 2002).

momentous occasion, and would forever change the investment climate in Asia. China's international stature is very difficult to label. It could be called a developing country, because severe poverty, illiteracy, labor, population, and environmental concerns, which are all elements associated with developing countries, exist throughout the country.<sup>7</sup> Yet, China is a land of vast opportunity. With the suggested third largest economy in the world, its domestic markets are expansive and potential purchasing power is measureless.<sup>8</sup> Most economists predicted China to be the most powerful economy by the middle of the 21<sup>st</sup> century.<sup>9</sup> At one time China was "... an island among nations, isolated and greatly misunderstood ..."<sup>10</sup>; but now, as the greatest investment destination in the world, it is appreciated by virtually every major multinational enterprise.<sup>11</sup> Even prior to being accepted into the WTO and winning the bid to host the 2008 Summer Olympic Games,<sup>12</sup> other than the United States, China had attracted more foreign direct investment (FDI),<sup>13</sup> than any other country in the

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<sup>7</sup> See Ralph H. Folsom & W. Davis Folsom, *An Introduction To International Business Agreements In The PRC*, in INTERNATIONAL BUSINESS AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 3 (Ralph H. Folsom & W. Davis Folsom eds. 1996).

<sup>8</sup> See John S. Mo, *International Foreign Investment Law*, in INTRODUCTION TO CHINESE LAW 275 (Wang Chenguang & Zhang Xianchu eds. 1997) (stating that in 1996 China had a foreign currency reserve totaling U.S.\$800 billion).

<sup>9</sup> See *id.*; see also Daniel J. Brink & Xiao Lin Li, *China on the Horizon: Exploring Current Legal Issues: A Legal and Practical Overview of Direct Investment and Joint Ventures in the "New" China*, 28 J. MARSHALL L. REV. 567, 570-71 (1995) (stating that "China consists of 9.65 million square kilometers of territory and 1.2 billion people, including fifty-six minorities . . . [thus] by using a 'step-by-step' approach, the Chinese government has managed to open nearly all of China's territories to foreign investment.").

<sup>10</sup> Gary J. Demelle, *Direct Foreign Investment and Contractual Relations in the People's Republic of China*, 6 DEPAUL BUS. L.J. 331, 331 (1994).

<sup>11</sup> See, e.g., Steve Stackhouse, *Outward Bound?*, AREA DEV., Nov. 2001, at 42 (explaining that "Companies are interested in locating in China because of the size of the market and the fact that consumer wealth has nowhere to go but up. 'The only major economy in the world still showing significant growth is China.'"). "When it comes to overall annual foreign direct investment . . . China is still tracking near the \$40 billion mark, where it's been for about three years." *Id.*

<sup>12</sup> See generally Stefano Hatfield, *China's the New Gold Rush, But Nothing is as it Appears*, ADVERTISING AGE, Jan. 21, 2002, at 20.

<sup>13</sup> See Adjunct Professor Robert Bejesky, Class Lecture in International Trade at Thomas M. Cooley Law School (Jan. 14, 2000) (notes on file with the author)

world.<sup>14</sup> It is estimated that China "will absorb \$57.6 billion worth of direct foreign investment in five years [time], which will control 6.5% of the global economy."<sup>15</sup> This estimate is an increase from the intake of FDI in 2001 equaling an astonishing record \$46.8 billion.<sup>16</sup> Foreign investors are eager to invest in projects and ventures (and are confident as to their interest and profit potential) in China, but they may not be so sure as to what laws apply or understand the legal system. In fact, the FDI regulatory (legal) structure is, to many investors, unclear, "uncertain, risky, and mired in red tape."<sup>17</sup> "[T]here have been cases where foreign corporations have invested in joint ventures following what they thought to be all the requisite guidelines, only to find out after the money had exchanged hands that something was terribly wrong with the entire agreement."<sup>18</sup> Such unfavorable occurrences have caused many to question the ability of the Chinese government—including its mammoth legal and administrative branches—to reform a rather unfriendly FDI environment plagued by inconsistent rulings, opaque operations, inefficiency, confusion, and a lack of predictability.<sup>19</sup>

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(explaining that foreign direct investment is when a non-national entity/legal person invests in a foreign country).

<sup>14</sup> See Wei Gu, *China Enters The WTO*, GLOBAL FINANCE, Nov. 1991, at 59; see also Hatfield, *supra* note, at 12 (estimating that FDI for 2001 reached a new high of around \$47 billion). Companies presently investing or building projects in China is a who's who among fortune 500 companies, including Motorola, General Motors, GE, Kodak, Coca Cola, Exxon Mobile, Dupont, United Technologies, Intel, IBM, Pepsi, Ford, Hewlett Packard, and British Petroleum, to name a few. See International Trade Administration, U.S. Department of Commerce, *Foreign Investment Laws: Changes, May 2001*, at <http://infoserv2.ita.doc.gov/ticwebsite/apweb.nsf> (last visited Mar. 1, 2002).

<sup>15</sup> *Investment in China Increased Most*, ASIAINFO DAILY CHINA NEWS, Sept. 14, 2001, at 1 (quoting the president of Ericsson Co., Ltd.). The President went on to state "China is likely to become the most important market of Ericsson in the world." *Id.*

<sup>16</sup> James Kynge et al., *China's Bank Chief Criticizes Low Value of Yen*, FIN. TIMES, Jan. 16, 2002, at 10. "The promised FDI was \$69.1bn—a figure that expresses the enthusiasm permeating the foreign business community following China's entry into the WTO last year." *Id.*

<sup>17</sup> Leontine D. Chuang, *Investing in China's Telecommunications Market: Reflections on the Rule of Law and Foreign Investment in China*, 20 J. INT'L L. BUS. 509, 510 (2000).

<sup>18</sup> *Id.*

<sup>19</sup> But see, Michael Santoro, *Should LDCs Love MNCs?*, 32 J. OF INT'L BUS. STUD. 3 (2001), at [http://www.foreignpolicy.com/issue\\_janfeb\\_2002.gns.html](http://www.foreignpolicy.com/issue_janfeb_2002.gns.html) (stating that



However, unlike many other countries in the region, China has boundless potential to grow.<sup>20</sup> If foreigners see the benefits outweighing the costs and risks involved with investing and doing business in China, as seen by most today,<sup>21</sup> then they must be cautious of the hurdles and pitfalls faced when dealing with a weak and developing legal system. Chinese authorities are keenly aware of the fact that potential foreign investors, throughout the world, are keeping a close eye on when and by what means they create greater clarity in the legal investment framework, by way of strengthening the rule of law in China.<sup>22</sup> "Though the Chinese leadership has signaled . . . that it is willing to make [much needed] changes in exchange for the ability to reinvigorate its economy and secure its position as a world leader, these changes will not come easily, nor will they come quickly."<sup>23</sup>

## II. A BRIEF HISTORY

China is considered to be one of the oldest living civilizations on earth.<sup>24</sup> Up until the twentieth century, and for essentially five

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"China welcomes foreign investment with open arms and a pro-business regulatory environment."); Michael Santoro, *Should LDCs Love MNCs?*, 32 J. OF INT'L BUS. STUD. 3 (2001). China is the second largest market for every good and service worldwide, but for foreign venture capital firms and other equity investors, its morass of regulations make it a mystery. Although the country is the second largest recipient of direct foreign investment in the world—about \$40 billion annually—private equity investment in China either has failed miserably or produced spotty returns. Vincent Ryan, *Golden Opportunities, Hidden Difficulties*, TELEPHONY, Dec. 3, 2001, at 45. See generally Peter Howard Come, *Lateral Movements: Legal Flexibility and Foreign Investment Regulation in China*, 27 CASE W. RES. J. INT'L L. 247, 247-48 (1995).

<sup>20</sup> See Chuang, *supra* note 17, at 511.

<sup>21</sup> See generally Jeffrey E. Garten, *The Wrong Time for Companies to Beat a Global Retreat*, BUS. WEEK, Dec. 17, 2001, at 22 (stating that "AOL Time Warner[] just concluded [a] joint venture with China's largest computer company, the Legend Group, and Wal-Mart Stores[] [announced] that it would build five new stores in Beijing alone."). "Guangdong recently attracted one of the big wheels of American retailing, Wal-Mart Stores, Inc. The giant chain will open discount stores and Sam's Club membership warehouses in Shenzhen and Shanghai . . ." Henry J. Graham, *Foreign Investment Laws Of China And The United States: A Comparative Study*, 5 J. TRANSNAT'L L. & POL'Y 253, 269 (1996).

<sup>22</sup> See generally Chuang, *supra* note 17, at 511.

<sup>23</sup> *Id.*

<sup>24</sup> See Ralph H. Folsom & John H. Minan, *Chinese Legal Tradition*, in LAW IN THE PEOPLE'S REPUBLIC OF CHINA 3 (Ralph H. Folsom & John H. Minan eds. 1989).

thousand years, China was ruled by a series of feudal lords and hermit kings.<sup>25</sup> In fact, not until thirty years after Chairman Mao Zedong<sup>26</sup> and the Communist Party's declaration of the People's Republic of China (on October 1, 1949), would any form of economic openness take root.<sup>27</sup>

Before the ascendance of the People's Republic of China, the Chinese central authority could not effectively control the influences and methods for which foreign businesses operated in China "which . . . operated as 'states within a state.'"<sup>28</sup> Because of this historical problem, the Communist party had a deep "distrust for capitalist endeavors and, correspondingly, of western traders and investors."<sup>29</sup> "In an effort to prevent any further exploitation, the Chinese Government sought to eliminate the autonomy of foreign owned enterprises, if not eradicate them."<sup>30</sup> For example:

[o]ne of the key impediments to the growth of the Chinese economy during the Mao regime was the over-emphasis on the concept of self-reliance. During this era, regions were expected to operate in full autonomy without outside assistance. This created a weakening of

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See generally DUN J. LI, *THE AGELESS CHINESE* 31-54 (Charles Scribner's Sons 3rd. ed. 1978) (1965).

<sup>25</sup> See generally LI, *supra* note 24, at 31-37.

<sup>26</sup> Chairman Mao's name can also be spelled "Tse-Tung." See *MAO TSE-TUNG: A Biography*, at <http://www.marxists.org/glossary/people/m/a.htm#mao-tse-tung> (last visited Mar. 22, 2001) (indicating that Chairman Mao was born into a poor peasant family on Dec. 26 1893, and died as the leader of Communist China on Dec. 9, 1976).

<sup>27</sup> See Chuang, *supra* note 17, at 509. In the days of Mao Zedong, China defended its economic security by burrowing factories deep in the mountainous regions, stockpiling grain and stationing soldiers at bridges and dams. It has come a long way since then, opening its economy to foreign goods, capital and management shifting from a defensive, war-like economic footing to one based on closer ties to the outside world.

Bruce Gilley, *Building a Wall Or a Bridge?*, FAR EASTERN ECON. REV., Feb. 2, 2002, at 30.

<sup>28</sup> Dernelle, *supra* note 10, at 331. One can look to the Treaty of Nanking in 1842, concluding the Opium War, which was fought between the British and Chinese, essentially "forced open" the Chinese doors to commercial trade and investment with the West. See LI, *supra* note 24, at 340. As an example, the island of Hong Kong was ceded to the British and became part of the British Empire by the Treaty of Nanking. See *id.*

<sup>29</sup> Dernelle, *supra* note 10, at 331-32.

<sup>30</sup> See *Country Homepages: China*, *supra* note 6.

economic and trade relations between regions and generated inter-regional rivalries which resulted in shortages of essential materials and products.<sup>31</sup>

At its very essence, the communist government was anxiety-ridden over the idea that anything other than a "closed door policy" would bring a return to "difficult times" suffered prior to Communist control, "when foreign economic domination, interference, and exploitation were believed to have led to national humiliation and poverty."<sup>32</sup>

However, Deng Xiaoping,<sup>33</sup> predecessor to Mao Zedong, eschewed the Communist concerns and recognized the inescapable "death of the communist world"<sup>34</sup> thereby establishing a liberal plan to "suit [China's] unique characteristics and ensure its survival"<sup>35</sup> by allowing a greater western commercial presence in China.<sup>36</sup> Thus "... in 1979, the sleeping giant awoke when it voluntarily opened its doors to foreign investment . . . by adopting an open door policy"<sup>37</sup> thereby intending to "implement China's 'Four Modernizations' program."<sup>38</sup> This program was an attempt to "accelerate China's socialist regime,"<sup>39</sup> by way of attracting foreign investment in an effort to modernize China's lagging domestic industries, primarily agriculture, science and technology, and national defense.<sup>40</sup>

<sup>31</sup> See Chang Hung Tai, *Investment Factors, in CHINA'S INTERNATIONAL TRANSACTIONS: TRADE AND INVESTMENT* §2, at 21 (K C D M Wilde ed. 2000).

<sup>32</sup> *Id.* at 332. Again, see the example in note 27 demonstrating concerns faced by the Chinese and Communist government. Also consider these concerns within the whole Chinese concept of "saving face." See *infra* Part IV.1.A.

<sup>33</sup> See *Biography: Deng Xiaoping*, at

<http://www.freep.com/news/nw/deng/deng3.htm> (last visited Mar. 22, 2002)

(explaining that Deng Xiaoping was born in Sichuan province, China, in 1905, and died from Parkinson's disease on Feb. 19, 1997, at the age of 93).

<sup>34</sup> Anna M. Han, *China's Company Law: Practicing Capitalism In A Transitional Economy*, 5 PAC. RIM L. & POL'Y J. 457, 458 (1996).

<sup>35</sup> *Id.*

<sup>36</sup> See Folsom *supra* note 24, at 13 (describing Deng Xiaoping's promulgation of new laws and regulations as part of a post-Mao, post Cultural Revolution renaissance era).

<sup>37</sup> *Id.* This was done by way of the December 1978 meeting of the Third Plenary Session of the Eleventh Central Committee of the Chinese Communist Party. See Han, *supra* note 34, at 458.

<sup>38</sup> Dernelle, *supra* note 10, at 332, & n.8. Dernelle went on to state that "Until 1978, [FDI] in China was virtually prohibited." *Id.* at 331.

<sup>39</sup> *Id.*

<sup>40</sup> See Tai, *supra* note 31, at 19.

Furthermore, since 1979, the Chinese economy and legal structure has been, shaky at best.<sup>41</sup> Nonetheless, while the road has been "bumpy," Deng Xiaoping's "open door policy" has produced results. For example, it is estimated that since 1979 China's economy has grown, on average, anywhere from 7% to 13%,<sup>42</sup> and FDI, last year, rose by 15% over the previous year.<sup>43</sup> In fact, there were "[22,915] new foreign capital investment enterprises in China in the first 11 months of 2001 . . . . increase[d] 16.32% [from] last year."<sup>44</sup> Over \$348 billion<sup>45</sup> was invested in China by foreign enterprises from 1979 to 1997.<sup>46</sup> It is estimated that "foreign funded" companies employ up to as many as 18 million people, equaling roughly 10% of China's non-farming population.<sup>47</sup> "Currently, more than 200 of the world's top 500 firms have invested in China [and] a majority of these are involved in the [much needed] machinery, electronics and infrastructural sectors."<sup>48</sup>

### III. FOREIGN DIRECT INVESTMENT REGULATIONS: A LOOK AT THE MOST POPULAR & EFFECTIVE INVESTMENT VEHICLES CURRENTLY BEING USED

As previously mentioned, when the Chinese Government instituted the "open door policy," there was virtually no legal structure to act as a regulatory mechanism.<sup>49</sup> There was also virtually no codified law or regulations pertaining to foreign commercial enterprise ventures/investments.<sup>50</sup> Because of these endemic problems, the

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<sup>41</sup> See Chuang, *supra* note 17, at 509.

<sup>42</sup> *Id.* (stating that "[f]rom 1978 to 1993, its economy grew between US \$2,000 and \$4,000 per capita and in the early 90's its economic growth was unprecedented at 13% a year); see also *Is it at risk? - Globalisation*, 362 THE ECON., Feb. 2, 2002, at 73 (stating that the Chinese economy grew at a rate of 7% throughout the 1990's and by 12% in 2000).

<sup>43</sup> See *Economic Monitor: China*, FAR EASTERN ECON. REV., Feb. 7, 2002, at 52.

<sup>44</sup> *Investment Realm of China Develops Rapidly in 2001*, ASIAINFO DAILY CHINA NEWS, Dec. 21, 2001, at 1.

<sup>45</sup> U.S. dollars (\$).

<sup>46</sup> See KUI HUA WANG, CHINESE COMMERCIAL LAW § 3.1.1, at 84 & n.5 (2000).

<sup>47</sup> See *id.* at 84.

<sup>48</sup> *Id.*

<sup>49</sup> See *id.* at 83.

<sup>50</sup> See *id.* The terms foreign enterprise, venture, & investor are all synonymous in this article.

Chinese government set-out to create a conducive investment environment by way of enacting laws and regulations providing foreign investors "certain rights and interests."<sup>51</sup> Since the passage of the Law on Chinese-Foreign Equity Joint Ventures of 1979<sup>52</sup>—which is the fundamental piece of legislation dealing with foreign investment in China—the Chinese government has passed over 200 laws and regulations relating to, e.g., foreign joint ventures, offshore oil exploration, foreign economic contracts, mediation and arbitration proceedings, and Special Economic Zones.<sup>53</sup> For example:

[i]t has been claimed . . . that over the past 20 years (1979-99): (1) the NPC [National People's Congress] and its Standing Committee have examined and adopted a total of 327 laws and decisions[;] (2) the State Council has enacted more than 750 administrative laws and regulations and[;] (3) the local People's Congresses at various levels have formulated more than 53[, ]000 local decrees.<sup>54</sup>

It must also be mentioned that many countries have entered into bilateral treaties with China for the purpose of protecting FDI projects and ventures for their national enterprises.<sup>55</sup>

Besides enacting new foreign investment laws to protect foreign investors, the Chinese government also amended its Constitution,<sup>56</sup> which was adopted on December 1982.<sup>57</sup> This revision stated "foreign enterprises, economic organisations and individual entrepreneurs are permitted to invest in China and to take part in various forms of economic co-operation with Chinese enterprises and other economic organisations."<sup>58</sup>

<sup>51</sup> Tai, *supra* note 31, at 24.

<sup>52</sup> See MOFTEC at <http://www.moftec.gov.cn> (last visited Mar. 20, 2002).

<sup>53</sup> See *id.*

<sup>54</sup> See WANG, *supra* note 46, § 3.1.1, at 83 & n.1.

<sup>55</sup> See *id.* at 83-84 & n.3 (stating that 41 bilateral treaties have been entered between China and various other countries and 24 of the bilateral treaties are presently in force). Some of the countries that have enacted such treaties are Germany, Great Britain, France, Italy, Austria, Denmark, Sweden, Finland, Norway, Australia, New Zealand, Japan, South Korea, Singapore, Thailand, Indonesia, Vietnam, and Turkey.

*Id.*

<sup>56</sup> See Chuang, *supra* note 17, at 512.

<sup>57</sup> See Tai, *supra* note 31, at 24.

<sup>58</sup> *Id.*



The Chinese government also took a revolutionary step by establishing the Ministry of Foreign Trade and Economic Cooperation (MOFTEC).<sup>59</sup> MOFTEC was formed for the purpose of administering China's foreign trade and economic cooperation arrangements.<sup>60</sup> MOFTEC has a number of responsibilities, these include: (1) to formulate laws, regulations, and policies; (2) co-ordinate foreign trade, investment, and economic development; (3) form nationally strategic plans; and (4) administering all foreign investment contracts, laws, and regulations.<sup>61</sup> It is estimated that since China's opening-up, MOFTEC has approved over 314,000 investment projects, "but less than half of them have begun operating . . . [t]hese projects have a combined contractual foreign investment of US\$545.366 billion, of which US\$242.321 billion have already been invested."<sup>62</sup>

Among all of the important activities and functions that MOFTEC has executed, the most important was the Catalogue For The Guidance Of Foreign Investment Industries.<sup>63</sup> This system is vitally important because it serves as a guide for all foreign investors "because it lists the industries in which foreign investment is encouraged, restricted, or prohibited."<sup>64</sup> However, unless the catalogue is quickly modified to meet WTO specifications, it will become defunct and eventually be replaced by WTO guidelines and agreements.<sup>65</sup>

The two most popular forms of FDI, which are encouraged by the Chinese government, are equity joint ventures and wholly foreign-owned enterprises (100% foreign owned enterprises).<sup>66</sup> These are the primary mechanisms (which comprise an overwhelming majority of

<sup>59</sup> See Chuang, *supra* note 17, at 512. See generally MOFTEC, *supra* note 52.

<sup>60</sup> See Chuang, *supra* note 17, at 512. This foreign ministry was originally named the Ministry of Foreign Economic Relations and Trade (MOFERT). See Michael J. Moser, *Foreign Investment in China: The Legal Framework*, in FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 91 (Michael J. Moser ed. 2<sup>nd</sup> ed. 1987).]

<sup>61</sup> See Chuang, *supra* note 17, at 512.

<sup>62</sup> WANG, *supra* note 46, § 3.1.2, at 85.

<sup>63</sup> See *id.*

<sup>64</sup> *Id.*

<sup>65</sup> See *id.*; see also Gu, *supra* note 14, at 60 (stating that China's membership in the WTO will force it to open its "severely restricted distribution channels" and that this "will be the most profound change for foreign investors").

<sup>66</sup> See also WANG, *supra* note 46, at 84 & n.4. See generally Folsom, *supra* note 24, at 747.

FDI vehicles) for which foreign-owned enterprises structure their investments and operate. It must be noted that these investment vehicles have been revised and amended on numerous occasions.<sup>67</sup> The most recent revisions were authorized in April of 2001.<sup>68</sup>

#### A. Wholly Foreign-Owned Enterprises

Wholly foreign-owned enterprises (WFOEs) are formed by foreign investors with their own "capital" under Chinese law without Chinese partner involvement in the investment.<sup>69</sup> WFOEs are generally formed as limited liability companies.<sup>70</sup> As limited liability companies, WFOEs become "legal persons" under the 1986 Chinese Civil Law.<sup>71</sup> Therefore, a WFOE may possess "the corporate characteristics of continuity of life, centralization of management and free transferability of interests."<sup>72</sup> But, "mergers and other important changes in WFOEs must be approved by the relevant Chinese authorities."<sup>73</sup>

These investment vehicles came about by way of legislation adopted on April 12, 1986 at the fourth session of the Sixth National People's Congress (NPC).<sup>74</sup> At this session it was stated that:

<sup>67</sup> See generally *supra* note 54.

<sup>68</sup> See *Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

<sup>69</sup> See Dernelle, *supra* note 10, at 338. Art. 8 of the *Wholly Foreign-Owned Enterprise Law of the People's Republic of China*. *Id.*

<sup>70</sup> See Stephen C. Curley & Darren R. Fortunato, *Tax Considerations for Investors in China: A Preliminary Look*, 20 N.C. J. INT'L L. & COM. REG. 531, 545 (1995).

<sup>71</sup> See Folsom, *supra* note 24, at 750.

<sup>72</sup> *Id.* Just as under United States corporate regulations. See *id.*

<sup>73</sup> *Id.*

<sup>74</sup> See Tai, *supra* note 31, at 30.

Under Article 57 of the *Constitution of the PRC*, the NPC is the highest State legislative body. It is entitled to amend the *Constitution* and also to enact and amend basic laws concerning criminal offences, civil affairs, State organs, [etc.]. The standing committee is the permanent body of the NPC . . . . There are approximately 3000 members comprising the NPC. Members hold office for a term of five years . . . . The full NPC meets once a year for a period of 1 or 2 weeks. In theory, the NPC plays the role of parliament in the PRC. It is the highest organ of State power. Apart from its legislative power, the NPC also has the power to: (a) appoint and remove leaders and members of the highest State organs, (b) make decisions on national development plans and the State budget and (c) supervise the implementation of the *Constitution*.

WANG, *supra* note 46, § 1.2.4, at 20-21.

with a view to expanding economic cooperation and technological exchange with other countries and promoting the development of its national economy, the People's Republic of China permits foreign firms, other economic entities or individuals . . . to set up enterprises exclusively with foreign capital in China and protects the lawful rights and interests of the enterprises so established.<sup>75</sup>

Before the WFOE law came into existence, very few companies were permitted to do any form of business in China via a wholly owned subsidiary model.<sup>76</sup> Virtually all of FDI was required to be within the confines of Special Economic Zones (SEZs).<sup>77</sup> WFOEs are now the wave of the future for FDI in China. Today (with the new and improved FDI regulations in place) WFOEs are by far the most popular investment vehicle for foreign investors in terms of contracts which have been signed, and projects developed.<sup>78</sup> "Over 40 percent more WFOE contracts than joint venture contracts were signed, and the value of contracted investment in WFOEs was 70 percent more than that in joint ventures in 2000."<sup>79</sup>

The reasons for WFOE popularity are simple and quite obvious. While the other two major investment vehicles<sup>80</sup> allow for certain advantages, they also have a significant number of disadvantages. For instance, Equity Joint Venture Law (EJVL) requires that foreign investors use certain equipment in investment that

<sup>75</sup> Tai, *supra* note 31, at 30 (quoting Zhonghua Renmin Gongheguo Waizi Qiye Fa—The Law of the People's Republic of China Concerning Wholly Foreign-Owned Enterprises—established April 18, 1986); see also CHINA BUS. REV. 52-53 (Jul.-Aug. 1986).

<sup>76</sup> See Tai, *supra* note 31, at 30.

<sup>77</sup> See *id.* at 30-31; see *infra* Part III.C.

<sup>78</sup> See *Foreign Investment Laws: Changes, May 2001*, *supra* note 14; see also James Kynge & Edward Young, *Wal-Mart wins go-ahead for Beijing opening*, FIN. TIMES, Nov. 8, 2001, at 19 (describing the fact that Wal-Mart, a U.S. retail company, has already opened its first supermarket in Beijing, and has secured permission from the Chinese government to open five more supermarkets in Beijing within the next few years). Wal-Mart has already opened several stores in the cities of Shenzhen, Kunming, Fuzhou, Dalian, Shenyang, Shantou, and Dongguan (15 stores altogether). These stores are WFOEs. See Kynge & Young, *supra* note 78, at 19.

<sup>79</sup> *Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

<sup>80</sup> See, e.g., *infra* Part III.B.

is "appropriate" to the needs of the Chinese government.<sup>81</sup> Also, something that has become extremely controversial and quite problematic for many foreign investors is the fact that the EJVL also requires that foreign investors allow their Chinese partners access to all pertinent documentation regarding such things as industrial property and know-how (i.e., research and development).<sup>82</sup>

### 1. Recent WFOE Law Revisions Positively Affecting FDI

The National People's Congress (NPC) agreed to various revisions of the WFOE law in October of 2000, "and subsequently approved implementing regulations in April 2001."<sup>83</sup> These revisions were predominantly very positive and pragmatic.<sup>84</sup> Some of the most important positive revisions are as follows: (1) the export performance requirements "(i.e., rules that required companies to export certain percentages of [their] product[s])"<sup>85</sup> were eliminated—now exports are generally encouraged but not obligatory;<sup>86</sup> (2) advanced technology and import substitution requirements were deleted<sup>87</sup> (previously, the law had stated that a WFOE must use advanced technology and equipment "to develop new products, promote conservation, and upgrade products for import substitution[.]"<sup>88</sup>—now these activities are generally encouraged but not obligatory;<sup>89</sup> (3) foreign exchange balance requirements were deleted (previously, the law had required "that WFOEs balance their foreign exchange receipts and expenditures");<sup>90</sup> (4) prohibitions opposing WFOE direct domestic

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<sup>81</sup> WANG, *supra* note 46, § 3.4.3, at 106.

<sup>82</sup> *See id.* at 98.

<sup>83</sup> *See Foreign Investment Laws: Changes, May 2001, supra* note 14. Please note that Chinese laws are generally drafted very ubiquitously, therefore implementing regulations are, on top of the Chinese laws, approved to provide more thorough detailed guidance. *See generally id.*

<sup>84</sup> *See* State Council Order # 301.

<sup>85</sup> *Foreign Investment Laws: Changes, May 2001, supra* note 14.

<sup>86</sup> *See id.* "(It is unclear whether export performance requirements contained in existing contracts [will] remain valid.)" *Id.*

<sup>87</sup> *See id.*

<sup>88</sup> *Id.*

<sup>89</sup> *See id.*

<sup>90</sup> *Id.* "The State Administration of Foreign Exchange (SAFE) had not seriously enforced the balancing requirement in recent years, reflecting China's relative strong foreign exchange reserves. Nevertheless, the law had remained on the books." *Id.*

sales of products without prior government approval were deleted;<sup>91</sup> (5) the prerequisite "that raw materials and fuel for WFOEs be obtained solely within China unless unavailable from the domestic market,"<sup>92</sup> and the requirement that "imports of capital equipment and technology" for which could be obtained from the domestic economy"<sup>93</sup> has been revoked;<sup>94</sup> (6) the requirement that "WFOEs submit production and operation plans to local authorities"<sup>95</sup> was deleted; (7) the requirement that "WFOEs sell products in accordance with China's price control regulations or record the prices with price control and tax authorities"<sup>96</sup> was deleted; and (8) the law regarding particular "limitations or prohibitions to WFOE investment in certain business lines, including media, real estate, communications and transportation, and public utilities"<sup>97</sup> were deleted from the regulations. Now, most of the provisions relating to "limitations or prohibitions" will be published in the Catalogue For The Guidance Of Foreign Investment Industries (which is published annually) guiding foreign investment in the particular industries listed.<sup>98</sup> The changes recently made in the WFOE laws were colossal steps by the Chinese government in showing the world that they are now extremely serious about restructuring their FDI laws for the purpose of opening-up to the rest of the world and fostering positive investor sentiment.<sup>99</sup>

Essentially, the basic underlying theme spelled out by the WFOE laws is that these enterprises will be developed while taking China's national economy into consideration.<sup>100</sup> Although these requirements are changing at a very rapid pace, WFOEs can be in

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*see also supra* note 8 and accompanying text (explaining that in 1996 China had a foreign currency reserve totaling U.S. \$800 billion).

<sup>91</sup> *See Foreign Investment Laws: Changes, May 2001, supra* note 14. This is one of the most monumental steps the Chinese government has taken, to date, with regard to the open door policy and restructuring of its FDI laws in an effort to crystallize foreign investor confidence and harmonize its laws with those of many western countries. *See generally supra* Part II.

<sup>92</sup> *Foreign Investment Laws: Changes, May 2001, supra* note 14.

<sup>93</sup> *Id.*

<sup>94</sup> This was, again, an incredible leap-forward for the Chinese government to make. *See generally id.*

<sup>95</sup> *See generally id.*; *supra* note 93 and accompanying text.

<sup>96</sup> *Foreign Investment Laws: Changes, May 2001, supra* note 14.

<sup>97</sup> *Id.*

<sup>98</sup> *See id.*; *supra* note 63.

<sup>99</sup> *See generally supra* notes 85-100 and accompanying text.

<sup>100</sup> *See Tai, supra* note 31, at 31-32.



areas such as advanced technology and equipment "[and/]or [be willing to] market all or most of their products outside China."<sup>101</sup> Furthermore, as of date, the progressive WFOE model for FDI in China allows for complete protection of the investment, profits derived from the investment, and rights and interests of the foreign investor under Chinese law.<sup>102</sup>

## 2. The WFOE Screening Process

Wholly Foreign Owned Enterprises are not a favorite foreign investment vehicle by the Chinese regulators. This is due to the fact that there is not much of a mechanism for regulatory supervision by governmental authorities once the WFOE has been approved.<sup>103</sup> Thus, as a result, the foreign investor interested in this form of investment vehicle must go through a stricter form of approval process, compared to, e.g., Equity Joint Ventures.<sup>104</sup>

There is a 90-day approval process for WFOEs for which application to at least two approving authorities is required, "for the record."<sup>105</sup> The first step is for the foreign investor to apply to the local government authority (above the county level).<sup>106</sup> This application should contain details regarding such items as: (1) "the purpose . . . scope and scale of operations;"<sup>107</sup> (2) what is to be produced and/or manufactured and what types of technology and equipment are to be used;<sup>108</sup> (3) expected percentage of output to overseas vs. domestic markets;<sup>109</sup> (4) "area of land and land requirements;"<sup>110</sup> and (5) infrastructure prerequisites required for the enterprise to stay viable (i.e., water, fuel, public utility, electricity, coal, gas, etc., requirements).<sup>111</sup> The local government agency is

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<sup>101</sup> *Id.*; see also *supra* note 48 and accompanying text. But see *supra* notes 87-88 and accompanying text.

<sup>102</sup> See Tai, *supra* note 31, at 31-32.

<sup>103</sup> See generally WANG, *supra* note 46, § 4.9.1, at 131.

<sup>104</sup> See *id.* at 133.

<sup>105</sup> See *id.*; see also Folsom, *supra* note 24, at 750.

<sup>106</sup> See WANG, *supra* note 46, § 4.9.2, at 132.

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

<sup>108</sup> See *id.*

<sup>109</sup> See *id.*

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

<sup>111</sup> See *id.*

normally given 30 days, upon receipt of the report, to make a final determination regarding the feasibility of the proposed WFOE.<sup>112</sup>

If, and when, the local authority approves of the proposed project—better known as preliminary approval—then the foreign investor is required to apply (depending on the situation, locality, and type of enterprise) for final approval.<sup>113</sup> There are several documents which are required for this final approval process, they include: (1) the actual application;<sup>114</sup> (2) “the written response of the local people’s government [above the county level] in the locality of the proposed enterprise;”<sup>115</sup> (3) a feasibility study;<sup>116</sup> (4) articles of association of the enterprise;<sup>117</sup> (5) a list of legal representatives and/or candidates for the board of directors;<sup>118</sup> (6) a detailed list of goods and materials desired to be imported;<sup>119</sup> and (7) any other necessary documents required by government authorities.<sup>120</sup> All of these documents must either be written in Mandarin Chinese or be translated into Mandarin Chinese.<sup>121</sup>

The safest and most conducive way to be granted approval by MOFTEC is to specify in the formal application that the investment and/or project involves certain manifest aims. These aims could include, e.g., aiding with the development of the Chinese economy, helping to create an ecologically sustainable development, the usage of high technology and equipment, and/or the exportation of the majority of all the products produced in China to other countries.<sup>122</sup> Once the application has been approved and an approval certificate has been issued by MOFTEC, the applicant should file, within 30 days, a

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<sup>112</sup> See *id.*

<sup>113</sup> See John Zhengdong Huang, *China On The Horizon: Exploring Current Legal Issues: An Introduction To Foreign Investment Laws In The People’s Republic Of China*, 28 J. MARSHALL L. REV. 471, 478-79 (1995).

<sup>114</sup> See *id.* at 479.

<sup>115</sup> WANG, *supra* note 46, § 4.9.3, at 132.

<sup>116</sup> See Huang, *supra* note 113, at 479.

<sup>117</sup> See *id.*; see also WANG, *supra* note 46, §4 at 132.

<sup>118</sup> See Huang, *supra* note 113, at 479; see also WANG, *supra* note 46, §4 at 132.

<sup>119</sup> See Huang, *supra* note 113, at 479; see also WANG, *supra* note 46, §4 at 132.

<sup>120</sup> See Huang, *supra* note 113, at 479; see also WANG, *supra* note 46, §4 at 132.

<sup>121</sup> See Mo, *supra* note 8, at 283.

<sup>122</sup> WANG, *supra* note 46, § 4.9.5, at 133. The most interesting of these concepts is the precept of positive approval based on the guarantee that a majority of the products produced will be exported to other countries outside of China. See *supra* Part III.

written request to register the enterprise and receive a business license with the State Administration for Industry and Commerce (SAIC).<sup>123</sup> When a business license has been issued by SAIC (thereby legitimizing the enterprise) the WFOE must register with the local tax authority prior to thirty days of receipt of the license.<sup>124</sup> The foreign investor should propose the general terms which the enterprise will operate in the application to SAIC.<sup>125</sup> Generally speaking, the terms of operation set out by the enterprise will also be subject to approval by the government.<sup>126</sup> Finally, "[n]o minimum capital requirements [will be] imposed" and the sum of registered capital which the enterprise will use to start its operations shall coincide with the scale and scope of operations.<sup>127</sup> It must be noted that there are certain sectors of industry which WFOEs are either heavily discouraged or altogether barred from operating in.<sup>128</sup> WFOEs are heavily discouraged from operating in the sectors of transport facilities, public utilities, real estate, leasing and trust investment.<sup>129</sup> If a potential WFOE decides to apply to enter one of these sectors, MOFTEC will strictly scrutinize the application prior to its approval/disapproval.<sup>130</sup> On the other hand, potential WFOEs are altogether prohibited from applying for investment approval in the sectors of "newspapers, publishing, broadcasting, television or films;<sup>131</sup> domestic

<sup>123</sup> See Huang, *supra* note 113, at 479.

<sup>124</sup> WANG, *supra* note 46, § 4.9.6, at 134.

<sup>125</sup> See Huang, *supra* note 113, at 479.

<sup>126</sup> See *id.*

<sup>127</sup> See *id.*

<sup>128</sup> See WANG, *supra* note 46, § 4.9.5, at 134 (detailing that FDI in various industrial sectors is generally divided-up into four main sectors: encouraged, permitted, restricted, and prohibited).

<sup>129</sup> See *id.* at 135.

<sup>130</sup> See *id.*

<sup>131</sup> But see, e.g., *Around the world: Chairman Murdoch Strikes a Deal*, 17 EARTH ISLAND J. 1, 15 (2002).

News Corp. media mogul Rupert Murdoch has finally attained his long-sought goal of extending his communications empire to China. Murdoch's Star TV has been granted permission to transmit to cable viewers in 'a restricted area in Guangdong province.' China asked only one thing in return: that Murdoch ensure that a China Central Television channel be widely available in the U.S. To accommodate China's rulers, Murdoch removed the BBC broadcast documentaries critical of the Chinese government. Star TV's pitch was doubtless enhanced when Murdoch's son . . .

commerce,<sup>132</sup> foreign trade or insurance; postal services and telecommunications;<sup>133</sup> and other industries that the Chinese [g]overnment prohibits a sole investment enterprise from establishing.”<sup>134</sup>

### B. Equity Joint Ventures

Equity joint ventures (EJVs) have traditionally received the most attention, before the wholly owned foreign enterprise became the new “hot” investment vehicle for both foreign investors and their Chinese counterparts.<sup>135</sup> The first series of joint venture laws—*Law of the People's Republic of China on Sino-Foreign Joint Equity Enterprises*—was adopted on July 1, 1979 “at the 2<sup>nd</sup> Session of the 5<sup>th</sup>

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openly criticized the Falun Gong, an outlawed religious movement that has been brutally suppressed by Beijing.

*Id.*

<sup>132</sup> But see, e.g., *supra* note 78 and accompanying text (discussing Wal-Mart's decisive entry into the Chinese commercial market). Also, other foreign international commercial supermarket chains, such as Carrefour, a French conglomerate, have been acting within the Chinese domestic “scene” for some time now. See Kynge & Young, *supra* note 78, at 19. So, there are exceptions to the rule. See *id.*; See also Mike Troy, *Wal-Mart to open five in Beijing*, DSN RETAILING TODAY, Nov. 19, 2001, at 2 (detailing that since China's admittance into the WTO, there will be fewer restrictions on foreign business ownership). And, in the near future there will be “reduced import taxes, upgraded distribution infrastructure and more foreign investment . . .” *Id.* (quoting Linda Kristiansen, of UBS Warburg).

<sup>133</sup> But see, e.g., Shu-Ching Jean Chen, *CT Ruling Upends Local Telecom Investment*, THE DAILY DEAL, Dec. 27, 2001.

In February 2001, two foreign investors (along with two politically well-connected Chinese commercial banks . . .) made the first direct equity investment in China's still protected telecom sector. The two foreign investors splashed out \$325 million for a combined 12% stake in China Netcom Corp. Ltd., a telecom upstart set to challenge State-owned monolith China Telecom. *Id.* While this is basically a joint venture, and not a WFOE, it still represents the fact that while the telecommunications sector is considered off limits to FDI, there are exceptions.

See *id.*; see also *infra* Part III.B. (describing equity joint ventures in detail).

<sup>134</sup> Chen, *supra* note 133.

<sup>135</sup> See also *Foreign Investment Laws: Changes, May 2001*, *supra* note 14 (stating that Joint Ventures are now considered the second most popular foreign investment vehicle in China, behind the Wholly Foreign Owned Enterprise). See generally Moser, *supra* note 60, at 100.

National People's Congress,"<sup>136</sup> and were later amended on April 4, 1990 "at the 3<sup>rd</sup> Session of the 7<sup>th</sup> National People's Congress."<sup>137</sup> This came about by the advent of normalized trade relations between the United States and China in 1979.<sup>138</sup> These laws were designed to attract foreign investment, capital, and expertise (i.e., know-how). EJV's have since been a major form of foreign investment. By 1987, over 3,210 EJV's were established in China.<sup>139</sup> (Editor's Note: this source does not say this where did the 3,210 number come from?) Because of their popularity, the EJV laws are by far the most developed of all Chinese foreign investment laws. Therefore, EJV's quickly became the main FDI tool for ventures between Chinese and foreign enterprises, and are now only second in popularity to WFOEs.<sup>140</sup>

While there is no true definition of what an EJV should actually be, there are some fundamental criteria establishing certain basic characteristics. These include such characteristics as: (1) both the foreign and Chinese parties (EJV partners) should share in the profits of the enterprise, along with bearing the risks of loss, in proportion to their contribution of registered capital;<sup>141</sup> (2) the EJV should be "established within China's territory in accordance with relevant Chinese law and is subject to the jurisdiction and protection of Chinese law;"<sup>142</sup> (3) the EJV should be registered as a Chinese legal person thereby taking the form of a limited liability enterprise;<sup>143</sup> and (4) "the foreign investor must not contribute less than 25 percent of the venture's registered capital."<sup>144</sup> An EJV cannot reduce its registered capital, once it has registered with the Chinese

<sup>136</sup> WANG, *supra* note 46, § 3.2.1, at 94.

<sup>137</sup> *Id.* at 94-95. A conclusive Chinese text of these Sessions, with an English translation, can be found in CHINA'S FOREIGN ECONOMIC LEGISLATION 1-7 (Foreign Languages Press 1982).

<sup>138</sup> See generally Folsom, *supra* note 24, at 747.

<sup>139</sup> See, e.g., *id.*

<sup>140</sup> See Moser, *supra* note 60, at 101.

<sup>141</sup> See WANG, *supra* note 46, § 3.2.2, at 95.

<sup>142</sup> *Id.*

<sup>143</sup> See *id.*

<sup>144</sup> See Curley & Fortunato, *supra* note 70, at 534. "Registered capital means the total amount of contributed capital that is registered at the registration and administration Office for the establishment of the Equity Joint Venture and is the total amount of capital subscribed by the parties." *Id.*; see also WANG, *supra* note 46, § 3.2.2, at 95.



authorities.<sup>145</sup> Also, if there is a subsequent increase in registered capital, the EJV's board of directors must approve the increased capital, as well as the authority for which originally examined and approved of the venture (i.e., the Registration and Administration Office for the Establishment of the EJV).<sup>146</sup> Nonetheless, being economically feasible, an EJV is also expected to assist with the development of China's economy and carryout at least one of a number of possible positive tasks. These tasks include: (1) "adopt advanced technical equipment and scientific management;"<sup>147</sup> (2) promote commercial and technological renovation;<sup>148</sup> (3) "produce export oriented products;"<sup>149</sup> and/or (4) provide the means for organizing and training managerial and technical personnel.<sup>150</sup> These tasks must not only be "advanced" in nature, but also must be in line with China's economic needs.<sup>151</sup>

### 1. *Recent Equity Joint Venture Law Revisions Positively Affecting FDI*

Up until recently, foreign investors had favored using the EJV vehicle.<sup>152</sup> EJVs were seen by the Chinese government as a way to prop-up under performing and ailing domestic enterprises.<sup>153</sup> In a nutshell, EJVs were a sort of rescue package handed to the enterprise by the government at the bequest of the foreign investor. In March 2001, the NPC made some minor revisions to the *Law of the People's Republic of China on Sino-Foreign Joint Equity Enterprises*.<sup>154</sup> While the changes were relatively minor in nature, the "Chinese media heralded the revised law as 'a milestone in the country's quest to

<sup>145</sup> See Curley & Fortunato, *supra* note 70, at 534.

<sup>146</sup> See *id.*

<sup>147</sup> Huang, *supra* note 113, at 474-75; see also, e.g., WANG, *supra* note 46, § 3.2.3, at 96.

<sup>148</sup> See Huang, *supra* note 113, at 474-75; see also, e.g., WANG, *supra* note 46, § 3.2.3, at 96.

<sup>149</sup> Huang, *supra* note 113, at 474-75; see also, e.g., WANG, *supra* note 46, § 3.2.3, at 96.

<sup>150</sup> See Huang, *supra* note 113, at 474-75; see also, e.g., WANG, *supra* note 46, § 3.2.3, at 96.

<sup>151</sup> See WANG, *supra* note 46, § 3.2.3, at 96.

<sup>152</sup> See *supra* Part III.A.

<sup>153</sup> See generally *Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

<sup>154</sup> See *id.*; see also *supra* notes 136-37.

provide a legal framework that will better serve the development of joint ventures in China.”<sup>155</sup> But, the EJV law has yet to be finalized and implemented.<sup>156</sup> Due to China’s admittance into the WTO, it is soon expected that more precise and sweeping amendments will be approved to provide healthier incentives to potential foreign investors.<sup>157</sup>

Several positive and pragmatic revisions of the amended EJV law have been made to date, including: (1) the requirement that EJVs “either procure raw materials, fuel and some capital goods from the domestic market or source from the international market using on-hand foreign currency”<sup>158</sup> has been deleted—the amended law allows sourcing from the international market, but adds the provision that the procurement process must be done in a manner that effectuates probity and impartiality;<sup>159</sup> (2) no longer request that EJVs “file production [and/or] business plans with government offices and implement plans through business contracts;”<sup>160</sup> (3) now all insurance plans of an EJV will be provided by a local Chinese insurance company in the territory where the enterprise is operating—the old EJV law more loosely decreed that insurance must simply be provided by a Chinese insurance company.<sup>161</sup>

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<sup>155</sup> *Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

<sup>156</sup> *See id.*

<sup>157</sup> *See State to Revise Related Laws for New FDI Model*, ASIAINFO DAILY CHINA NEWS, Sept. 26, 2001, at 1. “China examined over 1,500 laws, regulations and documents . . . and found that over 500 of them should be eliminated around 200 should be revised according to . . . (WTO) rules, and over 20 new regulations should be laid down.” *Id.* “China will strive to complete the revision and drafting . . . [of the] laws concerning foreign-funded enterprises that did not adhere to WTO rules . . .” *Id.*

<sup>158</sup> *Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

<sup>159</sup> *See id.*

<sup>160</sup> *Id.* This is a remarkable and rather progressive amendment showing the governments willingness to allow some form of foreign investment autonomy. *See id.* It is also more of a counter-strike against what the WTO will soon be demanding. *See supra* note 157 and accompanying text.

<sup>161</sup> *See Foreign Investment Laws: Changes, May 2001*, *supra* note 14.

## 2. *The EJV Screening Process*

The first and most basic step of an interested potential foreign investor is to locate an appropriate partner.<sup>162</sup> Obviously, this first step is essential and absolutely crucial in developing a viable EJV. Locating an appropriate partner is relatively simple, especially since China is in great need of foreign capital infusions and western technologies.<sup>163</sup> The immense demand for these resources by way of FDI is far greater than the present supply.<sup>164</sup> Thus, as the government hastily opens China's gates, most of the domestic Chinese companies lie in wait for opportunities to establish EJVs with foreign enterprises so they too can enjoy the potential profits and derivative benefits of such an undertaking.<sup>165</sup> For example:

China is likely to have a domestic television industry strong enough to be a big export [sic] of cheap sets. Japanese firms will have a stake in that []: they are providing the technology now. Toshiba, Japan Victor Company Matsushita, Sanyo and Sony are all starting joint ventures with Chinese partners. Of the 2.8m sets sold last year, 1.5m were supplied by domestic joint ventures, the biggest of which is Hitachi's at Fujian.<sup>166</sup>

An EJV must be approved by MOFTEC before it can be established.<sup>167</sup> In the preliminary approval phase, the Chinese partner must follow certain procedures and must provide certain materials: (1) an application for the establishment of the EJV; (2) a EJV agreement

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<sup>162</sup> See generally, e.g., Keqiang Guo & Kaiyuan Tao, *The Chinese-Foreign Joint Venture: Law And Practice*, 3 D.C.L. J. INT'L L. & PRAC. 309, 317-19 (1994).

<sup>163</sup> But see *supra* notes 11-14 and accompanying text (explaining how FDI is steadily increasing and describing the vastness of the Chinese FDI market). See generally Gao & Tao, *supra* note 162, at 310-21.

<sup>164</sup> See Mo, *supra* note 8 (discussing the relatively large currency reserve China has established).

<sup>165</sup> See WANG, *supra* note 46, § 3.3.1.1, at 98.

<sup>166</sup> Tai, *supra* note 31, at 29 (citing a relatively old, yet very relevant quote from THE ECONOMIST, Apr. 6, 1985); see also Karby Leggett, *J.P. Morgan Chase Seeks Growth in China*, WALL ST. J., Nov. 2-3, 2001, at 20 (highlighting the fact that even major investment banks, such as J.P. Morgan Chase, are partnering-up with local Chinese banks and financial firms in creating joint ventures).

<sup>167</sup> See Tai, *supra* note 31, at 29. Authorized local authorities can mean provincial, county, township, etc. See Huang, *supra* note 113, at 475.

and articles of association signed by agents (authorized representatives) of the proposed venture must be submitted; (3) the parties (Chinese and foreign) must submit a joint feasibility study report; (4) a project proposal; (5) a letter of intent or memorandum of understanding stating that, at the present time, this is not a binding agreement but a mere statement of the parties intentions; (6) a list of candidates for board of directors and highest executive positions; and (7) various written opinions by local government agencies for the jurisdiction where the proposed EJV is to be established.<sup>168</sup> All documents must be written in Mandarin Chinese.<sup>169</sup> After the application has been reviewed and approved by authorized local authorities, it must then be submitted to MOFTEC for final approval.<sup>170</sup> MOFTEC will have three months to make a final determination.<sup>171</sup> However, the time for approval could be extended, if the Chinese authorities find something they would want investigate further.<sup>172</sup> Finally, if approved, the parties to the EJV must conduct work relevant to the feasibility study, negotiate and sign an EJV agreement and other related contracts, and posit the articles of incorporation.<sup>173</sup>

Generally, projects are denied on a certain number of principal reasons. The main reasons for denial of an EJV are: (1) that the proposed EJV would be "detrimental to China's sovereignty;"<sup>174</sup> (2) there's some a violation of Chinese law;<sup>175</sup> (3) "non-conformity with the requirements for the development of China's national economy;"<sup>176</sup> (4) the proposed enterprise would possibly propagate

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<sup>168</sup> See Huang, *supra* note 113, at 475.

<sup>169</sup> See *id.*

<sup>170</sup> See WANG, *supra* note 46, § 3.3.1, at 99.

<sup>171</sup> See *id.* at 100.

<sup>172</sup> See Guo & Tao, *supra* note 162, at 319-20. Due to the slow beaurocratic machinery at work, this could take some time. See *id.*

<sup>173</sup> See *id.*

<sup>174</sup> WANG, *supra* note 46, § 3.5.2, at 108-09.

<sup>175</sup> See *id.* at 109.

<sup>176</sup> *Id.*

environmental pollution;<sup>177</sup> and/or (5) when the agreement between the Chinese and foreign enterprise is unconscionable.<sup>178</sup>

Once a certificate of approval to establish an EJV has been received, an EJV is required to register with the local bureau of the State Administration for Industry and Commerce (SAIC).<sup>179</sup> This must be done within one month of receipt of the certificate of approval.<sup>180</sup> When applying for registration, the parties to the EJV should provide, e.g.: (1) "the document of approval;"<sup>181</sup> (2) "copies of the Chinese and foreign-language [EJV] texts of the joint venture agreement, the joint venture contract, and the company charter;"<sup>182</sup> (3) "a copy of the foreign party's business license or other similar documents;"<sup>183</sup> and (4) "a complete registration form, in triplicate."<sup>184</sup> The day when the business license for operation has been issued is the day that the investment becomes a legal entity with protection under the auspices of the PRC laws.<sup>185</sup> Generally speaking, it could take anywhere from six to twelve months, from beginning to end, for this process to transpire.<sup>186</sup>

Without going into detail regarding percentages of capital contributions as to the value of the investment or standards of registration fees, it is important to note a few important fine points on EJV capital contribution regulations. It is essential that the parties applying for the EJV pledge their own capital for the venture.<sup>187</sup> This means that the capital pledged should not be mortgaged, have a lien placed against it, be secured by a creditor, and be free of all encumbrances.<sup>188</sup> Capital contributions can be in the form of cash,

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<sup>177</sup> See *id.* This is an especially "hot" item on the list due to the fact that Beijing is trying extremely hard to clean-up the environment and strengthen environmental regulations before the 2008 Olympics in China. See Angela Leary, *Ready, Set, Go*, ASIAN BUS., Oct. 2001, at 61.

<sup>178</sup> See WANG, *supra* note 46, § 3.5.2, at 109.

<sup>179</sup> See Huang, *supra* note 113, at 475.

<sup>180</sup> See *id.*

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

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

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

<sup>184</sup> *Id.*

<sup>185</sup> See Guo & Tao, *supra* note 162, at 320.

<sup>186</sup> See generally Huang, *supra* note 113, at 475 (describing procedures for establishing an equity joint venture).

<sup>187</sup> See Guo & Tao, *supra* note 162, at 320.

<sup>188</sup> See *id.*



equipment, buildings, and/or intangible property such as expertise and know-how, intellectual property, land use rights, etc.<sup>189</sup> If there is a determined form of investment other than cash, then both the parties must agree to this, and it would also have to be approved by the authorized examination and approval authority.<sup>190</sup>

There are many advantages and disadvantages of choosing an EJV over a WFOE. The most obvious advantage is that the Chinese party will be very helpful in assisting with obtaining the necessary government approvals to necessitate the project/investment. This will come about due to the Chinese partner's *guanxi*<sup>191</sup> and familiarity with the complex procedures inherent in dealing with the multi-layered Chinese bureaucracy.<sup>192</sup> On the other hand, there are also some major disadvantages of developing an EJV (compared to a WFOE). The most obvious disadvantage is that the foreign investor will have to "transfer" technology and know-how over to the Chinese party, which means that there is a sharing of asset's (including, e.g., research and development activities) at the behest of the foreign investor.<sup>193</sup> Foreign investors would also have to consult with the Chinese partner when dealing with management, facility, and production issues.<sup>194</sup> And the Chinese government would have significantly more oversight and control over an EJV versus and WFOE.<sup>195</sup>

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<sup>189</sup> See WANG, *supra* note 46, § 3.4.3, at 106-107.

<sup>190</sup> See *id.* at 107.

<sup>191</sup> Telephone Interview with Dr. Ronald R. Robel, Director, Critical Languages Center, International Honors Program, Asian Studies Program, University of Alabama, Tuscaloosa, Al. (Feb. 27, 2002) (stating that *guanxi* are Connections fostered via friendships—in China these take considerable time and skill in developing, especially at high levels); see also Bee Chen Goh, *Trade And Investment Negotiation With The Chinese*, in CHINA'S INTERNATIONAL TRANSACTIONS: TRADE AND INVESTMENT 39 (K C D M Wilde ed., 2000) (explaining that many businesses start off business relations by way of relying on *guanxi*).

<sup>192</sup> See WANG, *supra* note 46, at 97-98.

<sup>193</sup> See *supra* Part III.B.

<sup>194</sup> See WANG, *supra* note 46, at 98.

<sup>195</sup> See *id.*

C. *A Short Note On "Special Areas"—Special Economic Zones & Coastal Economic Open Areas*

A major by-product of the China's "open door policy" is the highly publicized development of "Special Areas" including "Special Economic Zones" (SEZs) and "Coastal Economic Open Areas."<sup>196</sup> SEZs are clever tools used by the Chinese government for which the main purpose is to act "as 'windows' to the outside world."<sup>197</sup> These are, for the most part, to necessitate domestic employment opportunities and to draw-in much needed know-how and technology by way of FDI.<sup>198</sup> They are essentially defined areas existing throughout China, which offer numerous and rather large forms of special incentives and preferential treatment to foreign investors located within in specified area. There are two broad principles for which the SEZs operate: (1) "foreign investors and enterprises located in the special areas are to enjoy preferential treatment in the form of lower tax rates and easier entry and exit procedures;"<sup>199</sup> and (2) "the local government authorities are to have greater decision-making power than as previously available to them in China."<sup>200</sup>

There are several "Special Areas" that have been administered to date. All of these areas benefit from particular types of special regulations and policies for which highlight each particular areas

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<sup>196</sup> See, e.g., Elson Pow & Michael J. Moser, *Law and Investment in China's Special Investment Areas*, in FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 199 (Michael J. Moser ed., Oxford University Press 2<sup>nd</sup> ed. 1987).

<sup>197</sup> Raymond W.K. Lau, Book Review, HEAD & HAND: ASIAN ECONOMIES, 128 (reviewing WEIPENG WU, PIONEERING ECONOMIC REFORM IN CHINA'S SPECIAL ECONOMIC ZONES (1999)); see Mark B. Baker, *Forgotten Legal China*, 17 Hous. J. INT'L L. 363, 389 (1995) (noting that the basic policy for SEZs was to experiment with the market economy and to attract foreign investments).

<sup>198</sup> See Lau, *supra* note 197.

<sup>199</sup> *Id.* See also Stephen C. Curley & Darren R. Fortunato, *Tax Considerations for Investors in China: A Preliminary Look*, 20 N.C. J. INT'L L. & COM. REG. 531, 551 (1995).

The income tax rate on a Foreign Investment Enterprise and a Foreign Enterprise with an establishment or site in China engaged in production or business operations . . . may be entitled to various tax rate reductions and/or holidays depending on the requirements of the region in which they are established. *Id.*

<sup>200</sup> *Id.*

comparative advantage.<sup>201</sup> They include the five SEZs (Shenzhen—the first, largest, and most successful of the SEZs; also, Shantou, Zhuhai, Xiamen, and Hainan Island),<sup>202</sup> and fourteen “Coastal Economic Open Areas” (CEOAs),<sup>203</sup> which were opened (as part of the “open door policy”) for fostering trade and investment in 1984.<sup>204</sup> There are a few important differences between SEZs and CEOAs. SEZs were primarily formed for the purpose of “general development.”<sup>205</sup> With this in mind, foreign capital can be invested in many ways, such as in “industry, agriculture, animal husbandry, aquaculture, tourism, housing, the building industry, high-grade technology development”<sup>206</sup> and numerous other activities. Almost all imported capital and consumer goods are exempt from customs duties.<sup>207</sup> Presently, in SEZs, investors pay a modest 15% income tax

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<sup>201</sup> See Bin Xue Sang, *Another Special Economic Zone in China? – An Analysis of the Special Regulations and Policy for Shanghai’s Pudong New Area*, 14 J. INTL. L. BUS. 130, n.3 (1993) (remarking that there is no clear definition of what an SEZ actually is). A comparative advantage is:

[when] a particular country, while maybe not as efficient as other countries, focuses on what it does best—and invests in what it does best—even though it may still produce a product less efficiently than another country. What then happens is other countries will then shift production to other areas where their expertise and skills will be of better use maximizing efficiencies in a less competitive environment.

George O. White III, *From Snowplows To Siopao—Trying To Compete In A Global Marketplace: The ASEAN Free Trade Area*, 8 TULSA J. COMP. & INT’L. L. 177, 195-96 & n.146 (2001).

<sup>202</sup> See Tai, *supra* note 31, at 20 (explaining that Shenzhen was the first of the SEZs, established in 1980; and the rest were established and then all elevated to provincial status in 1988).

<sup>203</sup> These are also known as “Coastal Cities.” See *id.* CEOAs have spread to twenty-seven provinces and cities throughout the PRC. See Guo & Tao, *supra* note 162, at 320.

<sup>204</sup> See Tai, *supra* note 31, at 20. The fourteen coastal cities are Dalian, Beihai, Qinhuangdao, Tianjin, Zhanjiang, Yantai, Qindao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, and Guangzhou. See *id.*

<sup>205</sup> See Tai, *supra* note 31, at 20.

<sup>206</sup> Tai, *supra* note 31, at 20. For example, China’s Silicon Valley or Shanghai which are considered “the” places for future high-tech development in China, and most of Asia. See *China’s Silicon Road*, ELECTRICAL ENGINEERING TIMES, Oct. 15, 2001, at 1.

<sup>207</sup> Except for such things as alcohol and cigarettes, and other “luxury” goods. See generally Tai, *supra* note 31, at 20.

rate.<sup>208</sup> Also, the Unified Foreign Tax Law<sup>209</sup> implies that local taxes on foreign investors can be waived or reduced by the local governments of the provinces and municipalities where the SEZ exist.<sup>210</sup> But, government ministry officials are contemplating phasing out the preferential tax rate in order to harmonize domestic tax rates, thereby complying with WTO policies.<sup>211</sup> Ultimately, this will work to the disadvantage of foreign companies already invested in SEZs and create a less attractive opportunity for potential future foreign investors.<sup>212</sup> Nevertheless, it is clear that the tax policies will soon be revised to reflect China's determination to be a major player within the WTO. The impact, to SEZ local economies, may be immense by not having added tax perks to draw-in foreign investment.<sup>213</sup>

On the other hand, in CEOAs investment must be "directed towards production and research and therefore [is] most specifically aimed at the development of new technology and new products and

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<sup>208</sup> See Curley & Fortunato, *supra* note 199, at 551-55; HENRY R. ZHENG, CHINA'S CIVIL AND COMMERCIAL LAW 277-80 (1988).

<sup>209</sup> See *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises*, China Laws for Foreign Bus. 31-745 (Dec. 13, 1993); Curley & Fortunato, *supra* note 199, at 546 & 112.

<sup>210</sup> See *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises*, *supra* note 209 (stating that for practical purposes—to continue to compete against other SEZs & encourage local investment—the local authorities usually always waive or reduce taxes on FDI in these areas).

<sup>211</sup> See James Kynge, *China Ready to Scrap Tax Breaks for Foreign Companies' Special Economic Zones*, FIN. TIMES, Nov. 13, 2001, at 15 (stating that "the five SEZs – the booming southern cities of Shenzhen, Zhuhai, Xiamen, Shantou and the island of Hainan – may find it more difficult to attract foreign investment after they are stripped of their power to award tax perks."). The vote by the National People's Congress to ratify the agreement to phase out preferential tax treatment in the SEZs could take place any day now. See *id.*

<sup>212</sup> See *id.* The harmonization of local (Chinese) rules with national laws to conform to WTO standards is a perplexing and extremely time consuming task being carried out by relevant government authorities. See *id.* But, one unidentified Chinese official stated that "[w]hy should we continue to subject Chinese companies to disadvantages even after we have opened our big gate to foreign competition and joined the WTO? . . . It would not be fair." *Id.*

<sup>213</sup> See generally *id.* One very interesting twist here is that the inevitable tax revisions could also sack the prevalent abuse of what is called "round-tripping." "[R]ound-tripping" [is when] Chinese groups set up shelf companies in Hong Kong, which they then use as mainland investment vehicles in order to qualify for 'foreign' rates of tax." *Id.*

industries.”<sup>214</sup> Correspondingly, only imported capital goods are considered to be exempt from customs duties in CEOAs. Also, only approved enterprises in CEOAs, strictly in the areas of economic and technological development, can take advantage of the preferential tax treatment granted SEZs<sup>215</sup>—all other enterprises not approved for the lower tax rate must pay a higher rate of 24%.<sup>216</sup> Nonetheless, CEOAs will also be hit by the same tax law revisions as the SEZs.<sup>217</sup> Furthermore, the pending ratification of new tax revisions fostering harmonization of domestic tax laws, thereby complying with WTO policies and creating a level playing field, could mildly chill foreign investor interest in CEOAs.<sup>218</sup>

All of these areas deal with the governments theme of “spacial placement” and planning activities centered on the unique qualities of each specific “Special Area.”<sup>219</sup> “Spatial placement . . . refers to active state initiatives in site selection . . . .”<sup>220</sup> The whole idea of “spacial placement” is to look at proximity pertaining to economic, geographical, political, and cultural proximity.<sup>221</sup> A good example of how this idea works, in fostering FDI growth, can be seen by the example of Shenzhen.<sup>222</sup> An SEZ was established in Shenzhen by the Chinese government and put under the newly created Administrative Committee of the Special Economic Zones of Guangdong Province.<sup>223</sup> Because Shenzhen was within close proximity to Hong Kong, many foreign enterprises in Hong Kong slowly relocated their “low-tech, labour-intensive industries across the border . . . stock and barrel . . .

<sup>214</sup> Tai, *supra* note 31, at 21.

<sup>215</sup> See *id.*; ZHENG, *supra* note 208, at 280-81.

<sup>216</sup> See Huang, *supra* note 113, at 483.

<sup>217</sup> See Kynge, *supra* note 211, at 15.

<sup>218</sup> See *id.* It must be noted that the new WTO sanctioned FDI tax policies would most severally hurt the Chinese government’s foreign investment push to the west, in new development zones such as Lhasa & Lanzhou. See *id.*

<sup>219</sup> See Lau, *supra* note 197, at 128; *supra* notes 203-08 and accompanying text. See generally China wooing FDI for neglected region, BUSINESSLINE, Oct. 6., 2001, at 1 (describing that the ambitious Great Western Development or “Go West” project started by the Chinese government to steer foreign investment may be in jeopardy once domestic laws are harmonized to comply with WTO regulations).

<sup>220</sup> Lau, *supra* note 197, at 128.

<sup>221</sup> See *id.*

<sup>222</sup> See generally note 202 and accompanying text (briefly discussing Shenzhen).

<sup>223</sup> See Pow & Moser, *supra* note 196, at 200. Prior to being named an SEZ, Shenzhen was considered a “trade and investment zone.” *Id.*



[so that by the early 1990's] 96% of Shenzhen's textiles and dyeing, [and] 95% of garment joint-ventures were financed by Hong Kong investors."<sup>224</sup> The reason for Shenzhen's incredible success is because of its geographical and economic proximity to Hong Kong.<sup>225</sup> Because of these factors, Shenzhen has facilitated ties to a highly leveraged and developed foreign investment pool (Hong Kong), thereby maximizing its comparative advantages (i.e., much lower wages, relatively modest tax rates, a vast supply of raw materials and manpower, etc.) combined with a positively regulated investment area (the Shenzhen SEZ).<sup>226</sup> This is exactly why the "SEZs" and "CEOs" were contrived and developed by the Chinese government—regulatory efficiency creating an investment friendly environment.

#### IV. UNDERSTANDING CHINESE CULTURE'S PLACE IN FDI DISPUTE SETTLEMENT MECHANISMS

We do not live in a perfect world. While the overwhelming majority of FDI ventures/projects in China turn-out to be successful (without any problems hindering them), there will always be that one venture/project that will go bad, for which must be resolved in the best interests of the parties involved. Such problems as government expropriation,<sup>227</sup> obscurity of the law and problems with the government's reliance on a non-public operational code, rather than

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<sup>224</sup> See Lau, *supra* note 197, at 129.

<sup>225</sup> See *id.*

<sup>226</sup> See *id.*

<sup>227</sup> Expropriation is "to take possession of, especially for public use by the right of eminent domain, thus divesting the title of the private owner . . . to dispossess of ownership." WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 683 (3d ed. 1996). It must be noted that Chinese law forbids nationalization of FDI ventures, including joint ventures, equity joint ventures, and wholly foreign owned enterprises. See *Foreign Investment Laws: Changes, May 2001*, *supra* note 14. However, there are special circumstances when this would be allowed, including "national security considerations and obstacles to large civil engineering projects." *Id.* "There have been no cases of outright expropriation of [FDI] since China opened to the outside in 1979." *Id.* But, if there was, and it could be proved, Chinese law allows for compensation of expropriated foreign investments, but has, so far, failed to define what the actual terms of compensation would be. See *id.*; Folsom, *supra* note 24, at 761-64 (detailing anti-expropriation laws in *The Law on Wholly Foreign-Owned Enterprises* (1986)).

publicly accessible regulations (i.e., lack of transparency);<sup>228</sup> uncoordinated laws and policies at different levels of the Chinese bureaucracy (i.e., administrative and political control);<sup>229</sup> inconsistent interpretations of the law;<sup>230</sup> a lack of fiduciary duty rules with respect to joint venture partners;<sup>231</sup> and profit restrictions on investments,<sup>232</sup> to name just a few,<sup>233</sup> are still major concerns that foreign investors should be keenly aware of when investing in China. A good example is what happened to McDonald's in Beijing:

Beijing recently ordered McDonald's to vacate its prize location in a shopping district near Tiananmen Square. The American fast-food chain not only has its largest restaurant on the site, as a commitment to the Chinese market, but also signed a twenty-year lease . . . They [McDonald's] have been ordered off the property to make way for a development project. . . As a result, McDonald's, one of China's earliest investors, is reviewing its China investment strategy. [Meanwhile]

<sup>228</sup> See Pat K. Chew, *Political Risk and U.S. Investments in China: Chimera of Protection and Predictability?*, 34 VA. J. INT'L L. 622 (1994). "Conflict between the Chinese and Western approaches to the law is not helped by the Chinese practice of citing unpublished laws." "Under the Western notion of law, this practice clashes head on with due process . . ." *Id.*

<sup>229</sup> See Anna M. Han, *China's Company Law: Practicing Capitalism In A Transitional Economy*, 5 PAC. RIM. L. & POL'Y J. 488-90 (1996) (stating that "[d]espite provisions in the Chinese Constitution to the contrary, the confusing and often overlapping lines of authority remains a problematic issue facing China's enterprises."); Daniel C.K. Chow, *The Limited Partnership Joint Venture Model In The People's Republic Of China*, 30 LAW & POL'Y INT'L BUS. 39 (1998).

<sup>230</sup> See Han, *supra* note 229, at 491-92.

<sup>231</sup> See Daniel C.K. Chow, *The Limited Partnership Joint Venture Model In The People's Republic Of China*, 30 LAW & POL'Y INT'L BUS. 1, 38 (1998) ("Current Chinese law does not appear to have an equivalent concept to fiduciary duty. While this means that all non-control groups are exposed to the risks associated with the lack of such duty, the local partner in the type of foreign-controlled joint venture. . . is particularly vulnerable because of the amount of control vested in the foreign investor. This lack of general protections most clearly exposes the non-control group to risks where the control group seeks to intentionally exploit the non-control group.")

<sup>232</sup> See Henry J. Graham, *Foreign Investment Laws Of China And The United States: A Comparative Study*, 5 J. TRANSNAT'L L. & POL'Y 253, 277 (1996).

<sup>233</sup> Another problem is the concept of requiring "foreign operators . . . [to] generate at least half their sales volume from Chinese-made goods." See *id.*

[o]ther possible investors, like Ford Motor Company, remain on the sidelines.<sup>234</sup> There is no doubt that this creates an environment of "business disenchantment" regarding the Chinese investment market.<sup>235</sup> Thus, before a foreign investor decides to enter the Chinese market and begin operations, there are many cultural and legal concepts for which it should be acutely aware of. So, over a long period of time, the foreign firm will begin to better understand the relational conditions and environment they are in.<sup>236</sup> Therefore, the longer the foreign enterprise functions in China, the more competent and efficient it will become in navigating the Chinese bureaucratic malaise and avoiding problematic situations.<sup>237</sup> This ranges from understanding basic concepts of Chinese culture, to understanding how to handle arbitration, or, if necessary, litigation issues.

#### *A. Chinese Culture and Business Relationships: How These Factors Affect FDI Negotiations*

Understanding Chinese culture is vital in understanding how to effectively negotiate in and out of business deals in China. The way Chinese attorneys and businessmen cultivate long lasting relationships and negotiate business transactions will often baffle an

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<sup>234</sup> *Id.* But see, e.g., *id.* at 268-69.

One bright shining example for the world and the rest of China to behold is Guangdong province, the mainland[s] alter ego of its vibrant neighbor, Hong Kong. Guangdong is blazing the path for the rest of China, providing regulations governing . . . joint ventures, the transfer of land-use rights [etc.] . . . Western legal concepts have taken hold in Shenzhen [as well], courtesy of Hong Kong . . . Whether China can emulate Guangdong's success and adaptability remains to be seen,

See also *supra* note 21 and accompanying text (talking about Wal-Mart's entry into China).

<sup>235</sup> See *id.* at 277. While such uncertainty may not forebode well for the near term investment, the Chinese government is hastily trying to create a much improved investor environment. See *supra* Part III.

<sup>236</sup> See Rajib N. Sanyal & Turgut Guvenli, *American Firms In China: Issues In Managing Operations*, MULTINATIONAL BUS. REV., Fall 2001, at 40, 41.

<sup>237</sup> See *id.*

unknowledgeable foreigner. Thus, there are a few concepts that must be understood by a potential foreign investor (and its attorneys structuring the deal) before negotiating a project/venture in China.

### 1. Face

It is no overstatement to declare that saving face is by far the most important concept in Chinese society. Face is a Confucian<sup>238</sup> concept basically meaning "prestige" and "personal character."<sup>239</sup> A loss of face by a person can be extremely detrimental to one's ability to adequately negotiate a deal. Direct and confrontational behavior is inherently part of most foreign legal and business systems.<sup>240</sup> But "[c]hinese negotiators consider direct and confrontational behavior as rude, offensive and losing face."<sup>241</sup> Because of the whole concept of saving face, many Chinese are particularly sensitive and will quickly take offense to any sort, even if unintentional, of remarks which could cause them to lose face. Thus, when negotiating with Chinese counterparts, it would behoove the foreign investor and their attorney(s) to take heed in understanding the behavior surrounding the concept of face during negotiations, or else cultural "confusions" could lead to greater "frustrations" ultimately undermining the investment/venture opportunity.

### 2. Guanxi

*Guanxi* is another very important part of Chinese culture that will inevitably play a major role in both business and legal negotiations, and in fostering business relationships in China. At its essence, *Guanxi* is a derivative of a friendly relationship to be used as an apparatus allowing for requests for favors to be carried out.<sup>242</sup> *Guanxi* is "a special relationship individuals have with each other in

<sup>238</sup> See generally Li, *supra* note 24, at 340 (explaining that Confucius was born in 551 B.C. and Died in 479 B.C. . . . and taught the virtue of Li, which are the concepts of "propriety, ceremony, ritual, rite, mannerism, etiquette, etc.").

<sup>239</sup> Goh, *supra* note 191, at 39.

<sup>240</sup> Such as the United States legal system.

<sup>241</sup> Goh, *supra* note 191, at 39 - 40.

<sup>242</sup> See *id.*; see also Santyal & Gavenli, *supra* note 236, at 42.

which each can make unlimited demands on the other.”<sup>243</sup> Most business and professional relationships generally tend to begin and develop by way of *Guanxi* connections.<sup>244</sup> “What is uniquely Chinese is the fact the moral sense of obligation is so overwhelming that one normally has to comply with requests, unless the request itself is impossible, or outside one’s means to perform it.”<sup>245</sup> If, for some particular reason, a refusal of a *guanxi*-based request occurs, then the requesting party will lose face.<sup>246</sup> Furthermore, the quality of “good” *guanxi* cannot be overemphasized; it will go a long way in Chinese society.<sup>247</sup>

### 3. *Patience, Flexibility, and Compromise*

The Chinese are a people based in a society where the idea of reasonableness is considered a constant of everyday life.<sup>248</sup> Yet, the idea of reasonable contract terms (in Chinese society) is not the same as in most western Common Law systems.<sup>249</sup> Generally speaking, contract negotiations in China are broadly based, where the Chinese “seek general principles,” rather than detailed rules explicitly built into to contract.<sup>250</sup> For example:

[t]he Chinese step back from an actual agreement and begin negotiations by presenting a letter of understanding that outlines general principles. US managers are often put off because they want to get to details. They’re not averse to the rhetoric of the preambles, but they want to build a relationship on facts. For their part, the Chinese stress friendly introductions as a way of establishing their relationship.<sup>251</sup>

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<sup>243</sup> Goh, *supra* note 191, at 39-40.

<sup>244</sup> *See id.*

<sup>245</sup> *Id.*

<sup>246</sup> *See supra* Part IV.1.A.

<sup>247</sup> *See* Sanyal & Guvenli, *supra* note 236, at 43.

<sup>248</sup> This is called “*chian tao li*,” meaning the reasonable way. *See* Goh, *supra* note 191, at 40. This is a concept that started back during the time of Confucius—it is a Confucian precept. *See supra* note 238 and accompanying text.

<sup>249</sup> *See generally* Goh, *supra* note 191, at 40.

<sup>250</sup> *See id.*

<sup>251</sup> *Id.*



Therefore, the Chinese do not place priority on contractual specificities, but on "other social precepts such as mutual benefit, social harmony and long-term objectives as their guiding principles in observing the spirit of the transaction."<sup>252</sup> This is a concept deeply imbedded in Chinese societal history and culture by way of the teachings of great philosophers and writings such as Confucius (including Neo-Confucian philosophies)<sup>253</sup> in the *Analects*,<sup>254</sup> Sun Tzu's *Art of War*,<sup>255</sup> *The Book of Changes* (the *I Ching*),<sup>256</sup> the *Tao-te Ching* (*Book of Taoist Virtue*),<sup>257</sup> and the *Book of Mencius*.<sup>258</sup> Therefore, the Chinese place a premium on an agreement that enables "both parties to act flexibly and reasonably and to make compromises as the situation so requires while at the same time abiding by the actual objectives of the dealings themselves."<sup>259</sup> In essence, the

<sup>252</sup> *Id.*; see, e.g., ERIC LEE, COMMERCIAL DISPUTES SETTLEMENT IN CHINA 1-4 (1995) (explaining the "Confucian virtue of compromise").

<sup>253</sup> See LI, *supra* note 24, 229-34 (explaining that the emergence of Neo-Confucianism came about by the increasing popularity of Buddhism and Taoism during the T'ang Dynasty). One of the primary figures promoting Neo-Confucianism was Chu Hsi (1130-1200), regarded by many to be one of the greatest Chinese philosophers of all time. *Id.* at 228. Neo-Confucianism is the Chinese philosophy, which developed the concept of Yin and Yang. *Id.* at 232. See *infra* note 254 and accompanying text. E.g., see generally PETER HOWARD CORNE, FOREIGN INVESTMENT IN CHINA: THE ADMINISTRATIVE LEGAL SYSTEM 17-42 (1997) (providing informative insight into the Confucian value system and its affect on social order in China).

<sup>254</sup> The *Analects* (circa 479) was a book of Confucius' sayings compiled by his disciples shortly after his death. See *id.* at 71. The basic premise behind this extremely important Chinese philosophy (Chinese society is built around these ideals) is man's relationship to man, to relatives, to their gods, ancestors, and the state (government). See generally *id.* at 76-77.

<sup>255</sup> See generally, e.g., SUN TZU, THE ART OF WAR 27-30 (Thomas Cleary trans., 1988) (establishing that the book was based on sayings by a great military leader, Sun Tzu, during the Warring States period (403-221 B.C.) of the Chou dynasty).

<sup>256</sup> See LI, *supra* note 24, at 81. The *I Ching* deals predominantly with the supernatural, and was claimed by both Confucians and Taoists as part of their tradition.

<sup>257</sup> See *id.* at 327. The *Book of Taoist Virtue* was the primary book of the Taoist belief system and philosophy, which was founded by Lao-tzu in the sixth century B.C. See *id.* at 84-85. This was a philosophy based on the ideas of fate and the idea of "nothingness"—that nothing is what it really seems to be. See *id.* at 85-86.

<sup>258</sup> See *id.* at 77-78. This book was written by the great Confucian philosopher Mencius (372-289 B.C.), and it stresses man's inherent good nature.

<sup>259</sup> Goh, *supra* note 191, at 41.

Chinese way to handle contracts is for a very general contract to be established, which can then be amended at various times to suit the parties wishes—this allows the parties greater maneuverability for which contractual terms can be changed according to the situation.<sup>260</sup> While this may seem rather frightening to the foreigner, it is business as usual to the Chinese.

The foreign investor (i.e., foreigner)<sup>261</sup> must also learn to be patient. Patience is truly a virtue in China, not to mention in almost every other country in Asia. “[T]o do successful business in China you need large reservoirs . . . [of] patience . . . patience . . . [and] patience.”<sup>262</sup> The Chinese consider patience a valued asset, thus Chinese negotiators take a very leisurely approach when negotiating investment contracts and ventures.<sup>263</sup> Furthermore, the Chinese place strong emphasis on “poise, reason, and self-control”<sup>264</sup>—impatient and negative behavior will be heavily frowned on.<sup>265</sup>

#### *B. The Consultation Process—The Culturally Preferred Method Of Dispute Resolution*

Most foreign investors generally consult with lawyers before and during the process of FDI negotiations. However, it is normal for the Chinese to not consult with lawyers because this would infer that they did not trust the parties involved in the negotiations.<sup>266</sup> In fact, lawyers would normally only be brought in after the FDI contract has already been negotiated.<sup>267</sup> Thus, when a problem with the preceding agreement is found or when a problem arises during the life of the investment/venture, the Chinese will always prefer to settle the dispute by amiable consultation.<sup>268</sup> Consultation is the preferred way to solve

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<sup>260</sup> See *id.*

<sup>261</sup> “Wei-gorin” in Mandarin Chinese. See generally JOHN DEFRANCIS, BEGINNING CHINESE (Yale University Press 2nd ed. 1976) (1964).

<sup>262</sup> Goh, *supra* note 191, at 42.

<sup>263</sup> See *id.*

<sup>264</sup> *Id.*

<sup>265</sup> See generally *id.*

<sup>266</sup> See Graham, *supra* note 232, at 254.

<sup>267</sup> See *id.*

<sup>268</sup> See Zhang Yuqing, *Like Bamboo Shoots After a Rain: Exploiting the Chinese Law and New Regulations on Sino-Foreign Joint Ventures*, 8 J. INT’L BUS. 59, 97 (1987).

disputes, "and has been the main method for settling disputes for thousands of years."<sup>269</sup> Most Chinese FDI regulatory devices stipulate that if a dispute arises, the parties should try to settle the dispute by way of consultation.<sup>270</sup> Although China is a member of the International Center For The Settlement Of Investment Disputes (ICSID) and has ratified the United Nations Convention On The Recognition And Enforcement Of Foreign Arbitral Awards (The New York Convention), it places strong emphasis on resolving disputes through informal consultation. Furthermore, consultation is the most natural form of dispute resolution for Chinese enterprises primarily because of "Chinese culture and attitudes . . . [which] favours harmony and good relationships between people [and enterprises] and . . . [due to the fact that] most Chinese . . . would prefer a compromise reached by themselves to a decision imposed by another."<sup>271</sup> At its core, this exemplifies the true spirit of the Chinese—control.

Consultation<sup>272</sup> is simply a discussion between the parties to the dispute, trying to achieve a settlement.<sup>273</sup> This is a method of informal voluntary (and friendly) discussion between the parties.<sup>274</sup> While Chinese regulations (and laws) do not directly explain how to go about the consultation process,<sup>275</sup> generally speaking, both parties must first agree to "consult each other to determine the rights and liabilities and to obtain the truth from facts."<sup>276</sup> Because it is an

<sup>269</sup> Dernelle, *supra* note 10, at 357; Sanyal & Guvenli, *supra* note 236, at 43 (inferring that starting with this process will help build good relations with the local governments and businesses involved). See generally *supra* Part IV.1.C and accompanying text. It must also be noted that studies have suggested that the better the foreign enterprise communicates with the Chinese government, the easier it is to maneuver within the Chinese system. See, e.g., Sanyal & Guvenli, *supra* note 236, at 42.

<sup>270</sup> See Dernelle, *supra* note 10, at 358; see also Sanyal & Guvenli, *supra* note 236, at 43 (asserting that "the firm in solving various operational problems . . . reaffirms that positive government cooperation can help foreign firms address specific operational problems that they may face."). Obviously, the longer the foreign enterprise has operated in China, the smoother things will operate. See generally, e.g., Sanyal & Guvenli, *supra* note 236, at 43.

<sup>271</sup> WANG, *supra* note 46, §9.2.2, at 280.

<sup>272</sup> "Xieshang" in Chinese; see DEFRANCIS, *supra* note 261.

<sup>273</sup> See ERIC LEE, COMMERCIAL DISPUTES SETTLEMENT IN CHINA 9-10 (1995).

<sup>274</sup> See Mo, *Alternative Dispute Resolution*, in INTRODUCTION TO CHINESE LAW 368 (Wang Chenguang & Zhang Xianchu eds., 1997).

<sup>275</sup> See *id.*

<sup>276</sup> LEE, *supra* note 273, at 10.

informal process, the process can be started at anytime agreed to and can end once the parties believe that they have either achieved their aims or that the consultation process is defunct.<sup>277</sup> It must be noted that this is not a method of "compromise through concession and apportionment of liabilities."<sup>278</sup> While consultation is premised on the idea of fairness and "fully-informed voluntariness," parties can take advantage of each other and/or make certain unfair concessions.<sup>279</sup> Once an agreement is reached, in order for it to be binding—since this is an informal process—both parties to the consultation must be happy with the final result.<sup>280</sup> "A dissatisfied party may renege on the agreement and resort to other means of settlement such as arbitration or litigation."<sup>281</sup> Furthermore, while it's a rather *ad hoc* process and can be abused by the more powerful (and influential) of the parties, consultation serves a very good starting point to resolve disputes between parties (foreign and Chinese) in FDI disputes.

### C. The Mediation Process—The Favored Back-up To Consultation

While consultation is the preferred method, mediation<sup>282</sup> is by far the second most favored way for resolving FDI disputes in China,<sup>283</sup> and is generally considered by many to be part of the same process as consultation.<sup>284</sup> The reason for this is the historical fact that, as with consultation, the origins of mediation are "deeply rooted"

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<sup>277</sup> See *id.* at 10-11.

<sup>278</sup> *Id.* at 10.

<sup>279</sup> See Mo, *supra* note 274, at 368-69.

<sup>280</sup> See *id.* at 369.

<sup>281</sup> *Id.*

<sup>282</sup> In China, mediation and conciliation are synonymous with one another. Here, to avoid confusion, mediation will be used for ease of understanding and reading.

[Mediation/conciliation is] a consensus based dispute resolution process in which the parties to a dispute meet with a third party [the mediator] to discuss mutually acceptable options for resolution of the dispute. The [mediator] has some input into the resolution of the dispute in the sense that the [mediator] encourages the parties to consider options for resolution, which are fair in all circumstances.

WANG, *supra* note 46, § 9.3.1, at 282.

<sup>283</sup> See *Foreign Investment Laws: Changes, May 2001*, *supra* note 14; see also Yuqing, *supra* note 268, at 97.

<sup>284</sup> See generally *id.*

in Confucian philosophy which strongly discourages social conflict due to its possible obstruction with the natural order of life and other intrinsic disharmonious principles.<sup>285</sup> Even under the rule of Mao Zedong's long lasting communist regime, mediation was used as a powerful tool for applying social, political, and economic pressures on problematic (at least in Mao's eyes) enterprises and individuals.<sup>286</sup> In fact, the Communist party, under Chairman Mao, used mediation to consolidate the Communist party's power-base, thereby instituting its policies as way of social control.<sup>287</sup> Today mediation is a favored option for dispute resolution by the Chinese government because it embodies certain communist tenets such as "communal obligations and rejects formal judicial mechanisms which [have] traditionally been characterized as pre-revolutionary institutions for class manipulation."<sup>288</sup> Hence, the link between mediation (along with consultation), Confucian philosophy, and the Communist ideology is deeply embedded in China's modern business practices and FDI negotiation structure.<sup>289</sup>

Mediation is considered by most Chinese officials to be the "first line of defense" against the deterioration of 'disputes between friends'"<sup>290</sup> which could end-up being, in the end, a dispute between enemies, as often occurs in other forms of dispute resolution, i.e. litigation. It is viewed as a "pre-arbitration or pre-litigation"<sup>291</sup> process. Therefore, when the consultation process has proven unsuccessful or inappropriate for the particular FDI dispute at hand, either party involved may request for mediation.<sup>292</sup> Considering the alternatives, especially the potentially hazardous and opaque process

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<sup>285</sup> See Parts IV.A-C; see also LEE, *supra* note 273, at 11.

<sup>286</sup> See Ralph H. Folsom & John H. Minan, *Mediation and Conciliation, in* INTERNATIONAL BUSINESS AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 86 (Ralph H. Folsom & W. Davis Folsom eds., 1996); see also *supra* Part II.

<sup>287</sup> See LEE, *supra* note 273, at 11 (stating that "[i]n February 1954, with the promulgation of the Provisional General Rules Concerning the Organization of the People's [Mediation] Committees, hundreds of People's Committees were set up throughout the country."). These rules "consolidated the work of the people with regard to conciliation and placed the conciliation machinery on a proper footing." *Id.* at 11-12.

<sup>288</sup> *Id.*

<sup>289</sup> See *id.*

<sup>290</sup> *Id.* See generally, e.g., Folsom & Minan, *supra* note 286, at 86-113.

<sup>291</sup> See LEE, *supra* note 273, at 12.

<sup>292</sup> See Dernelle, *supra* note 10, at 358.



of litigation,<sup>293</sup> mediation is the safest method for a foreign investor to protect their interest in expensive and rather valuable FDI projects/ventures. Furthermore, mediation is the safest and most cost effective way to manage a dispute in a country where "lawyers are scarce . . . discovery procedures are limited . . . courts do not possess injunctive or contempt powers . . . there is little [] liability insurance . . . judges are undertrained . . . [and] there is a tradition of [Communist] party review of judicial decisions."<sup>294</sup>

The actual mediation process is quite informal—procedural issues will not arise within the context of the mediation process.<sup>295</sup> Essentially each process is molded to fit the particular dispute at hand.<sup>296</sup> Numerous commercial dispute laws have been passed in China.<sup>297</sup> However, the most important legal mechanisms for commercial (FDI) mediation in China are the Arbitration Law of the People's Republic of China (China Arbitration Law),<sup>298</sup> the China International Economic and Trade Arbitration Commission (CIETAC) rules,<sup>299</sup> and the Rules of the Beijing Conciliation Centre.<sup>300</sup> "[Mediation] has [also] been accepted as a means of dispute settlement

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<sup>293</sup> See Folsom & Minan, *supra* note 286, at 86-87; *infra* Part IV.5.

<sup>294</sup> Folsom & Minan, *supra* note 286 at 86.

<sup>295</sup> See LEE, *supra* note 273, at 12.

<sup>296</sup> See WANG, *supra* note 46, § 9.3.1, at 282

<sup>297</sup> See generally, e.g., Mo, *supra* note 274, at 370-81 (detailing all of the various forms of mediation/conciliation in China).

<sup>298</sup> See WANG, *supra* note 46, at 284 n.18 (describing that the China Arbitration Law "was passed by the Standing Committee of the NPC on 31 August 1994 and became effective on 1 September 1995. Articles 51 and 52 [] deal with [mediation].").

<sup>299</sup> See Professor Tibor Varady, Class Lecture in International Commercial Arbitration at Emory University School of Law (Jan. 24, 2002). CIETAC is a very popular Chinese arbitration tribunal working under a formalized set of international arbitration rules, however, the tribunal does regularly assist "disputing parties" in mediation proceedings. See *id.*

<sup>300</sup> See generally WANG *supra* note 46, at 286-89.

The Beijing Mediation Centre was setup in 1987 under the China Chamber of Commerce. It deals with international commercial mediation and maritime mediation. The Centre's headquarters are situated in Beijing. It presently has about 25 local branches throughout the country and about 250 listed mediators. The centre was set up in response to demands for international commercial mediation . . . from the China Chamber of Commerce.

Mo, *supra* note 274, at 380.

in Article 128 of the Contract Law [and]. . . Article 14 of the Equity Joint Ventures Law.”<sup>301</sup>

There are a few basic tenets that should be followed in order for mediation to actually take place. For example, under CIETAC, certain guidelines exist, such as: 1) there must be rules that both parties are willing to accept;<sup>302</sup> the mediation must be “conducted by CIETAC to ascertain the facts and distinguish right from wrong on questions under dispute,”<sup>303</sup> thereby leading both parties to a form of compromise;<sup>304</sup> the parties may decide on the choice of law provisions, which will be completely recognized and enforceable;<sup>305</sup> international practices can be used and are generally honored;<sup>306</sup> and if an agreement cannot be reached or mediation cannot be continued, mediation will be terminated and “an examination and oral hearings” can take place in accordance to arbitration rules and standards.<sup>307</sup>

Under CIETAC rules, there are several ways mediation can be carried-out prior to moving towards arbitration, including face-to-face discussions, discussions over the telephone, discussions by mail (including e-mail).<sup>308</sup> Also, the parties can request that two members of an informal CIETAC mediation panel talk with each side separately, thus being a conduit for compromise;<sup>309</sup> or having a sole mediator “passing compromise schemes or conveying opinions to the other party.”<sup>310</sup> Furthermore, while CIETAC is by far the most popular forum for mediation, there are other options, such as administrative mediation by local/city governments,<sup>311</sup> or court conducted mediation.<sup>312</sup>

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<sup>301</sup> See WANG, *supra* note 46, at 284.

<sup>302</sup> See *id.* at 285 (stating that the basic mediation tenets were established by CIETAC arbitrator Yanming Huang).

<sup>303</sup> *Id.*

<sup>304</sup> See *id.*

<sup>305</sup> See *id.*

<sup>306</sup> See *id.*

<sup>307</sup> *Id.*

<sup>308</sup> See *id.* at 286.

<sup>309</sup> See *id.*

<sup>310</sup> *Id.*

<sup>311</sup> See Mo, *supra* note 274, at 374-75 (stating that these “organizations have a general power and obligation to resolve ‘small’ disputes falling within their jurisdiction in order to strengthen social stability.”).

<sup>312</sup> See *id.* at 377-79 (explaining that Chinese courts may initiate a mediation session in most economic/business cases at any point of the litigation process, if they so

### D. Arbitration

Arbitration is naturally the next step in the process, if the parties are unable to settle their dispute(s) by way of negotiation or mediation.<sup>313</sup> Over the last decade or two, even though the Chinese prefer negotiation or mediation, arbitration has become a mainstream form of dispute resolution in China, and the primary way to resolve international commercial disputes.<sup>314</sup> In fact, "[b]etween 1992 and 1997, the CIETAC accepted 3292 international economic and trade cases and resolved 2793 of them."<sup>315</sup> This is primarily due to the fact that foreign multinationals establishing investment projects in China find this process most attractive because of the "control" and autonomy over the process.<sup>316</sup> Many international investors view this

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desire). See generally LEE, *supra* note 273, at 13-14 (explaining that this form of mediation dates back to "the Chinese Resistance against the Japanese Invasion before the People's Republic of China was established. A judge, Ma Xi-wu, first combined court proceedings with [mediation] in . . . [l]iberated [a]reas.").

<sup>313</sup> See LEE, *supra* note 273, at 15. See generally Frederick Brown & Catherine A. Rogers, *The Role of Arbitration in Resolving Transnational Disputes: A Survey of Trends in the People's Republic of China*, 15 BERKELEY J. INT'L L. 329, 330 (1997) (providing a very thorough discussion on the arbitration process in China).

<sup>314</sup> See generally Graham, *supra* note 232, at 254-55.

Arbitration eventuated, in part, from the Confucian ideal of social harmony and conciliation. Historically, such self-regulation kept most 'private law' disputes out of the state courts, depending instead on local conciliation [or arbitration] and the threat of local censure. [Today,] [a]rbitration and other forms of dispute resolution represent the mainstream in China . . . Furthermore, arbitration can serve the dual purposes of providing a 'face-saving' approach to dispute resolution while preserving the underlying business relationship benefiting both sides. [Thus,] the increasing prevalence of long-term contractual relationships in international business [and investment] underscores the importance of conciliatory dispute resolution mechanisms.

*Id.*

<sup>315</sup> WANG, *supra* note 46, § 9.4.2, at 293.

<sup>316</sup> See Brown & Rogers, *supra* note 313, at 330 (stating that "[t]he key paradox is that, while arbitration in China is imperfect, it remains the best alternative for international investors."). See generally Professor Tibor Varady, Class Lecture in International Commercial Arbitration at Emory University School of Law (Jan. 8, 2002) (discussing that, while the fate of the case does lie with a third party, the proceedings must follow what is provided in the arbitration clause, in the FDI contract).

as a way to get around China's very problematic court system.<sup>317</sup> Nonetheless, technically speaking, arbitration is a contractually stipulated—with an arbitration clause as part of the FDI contract—agreement to submit any dispute to an impartial tribunal chosen by the parties.<sup>318</sup> Inherent in , international commercial arbitration, with regard to Chinese FDI disputes, are very appealing qualities such as procedural fairness, party autonomy in being able to choose the rules to be followed by the arbitration tribunal, neutrality, efficiency and cost effectiveness, arbitrator competence, and binding awards for the parties to enforce.<sup>319</sup>

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<sup>317</sup> See generally *infra* Part V.

<sup>318</sup> See Brown & Rogers, *supra* note 313, at 330; see also Zhang Yuqing, *Like Bamboo Shoots After a Rain: Exploiting the Chinese Law and New Regulations on Sino-foreign Joint Ventures*, 8 J. INTL. L. BUS. 59, 97 (1987). See generally INTERNATIONAL COMMERCIAL ARBITRATION §II.1. (Tibor Varady, et al eds., 1999) (noting that an arbitration tribunal from practically any country—due to party autonomy—can be chosen by mutual agreement of the parties).

<sup>319</sup> See INTERNATIONAL COMMERCIAL ARBITRATION, *supra* note 318, at §§ II-V; John A. Spanogle, Jr. & Tibor M. Baranski, Jr., *Chinese Commercial Dispute Resolution Methods: The State Commercial and Industrial Administration Bureau*, in INTERNATIONAL BUSINESS AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 129 (Ralph H. Folsom & W. Davis Folsom eds., Kluwer Law International Ltd 1996); John A. Spanogle, Jr. & Tibor M. Baranski, Jr., *Chinese Commercial Dispute Resolution Methods: The State Commercial and Industrial Administration Bureau*, in INTERNATIONAL BUSINESS AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 129 (Ralph H. Folsom & W. Davis Folsom eds., Kluwer Law International Ltd 1996); see also Professor Tibor Varady, Class Lecture in International Commercial Arbitration at Emory University School of Law (Jan. 8, 2002; Jan. 18, 2002; Feb. 19, 2002). But:

Investment contracts often stipulate arbitration in Stockholm because the forum there is considered neutral. Most Chinese contracts stipulate arbitration by [CIETAC]. During the past year, several western participants and panel members in CIETAC proceedings raised concerns about the organizations procedures and effectiveness. In one instance, a highly respected American member of an arbitration panel threatened to resign from CIETAC over alleged procedural irregularities during consideration [of] a case . . . . enforcement of arbitral awards is sporadic. Sometimes, even when a foreign company wins in arbitration, the People's Intermediate Court in the locality where the foreign venture is situated may fail to enforce the decision. Even when the courts do attempt to enforce a decision, local officials often ignore court decisions with impunity.

*Foreign Investment Laws: Changes, May 2001, supra* note 14.

The main international commercial arbitration commission in China is CIETAC.<sup>320</sup> In fact, CIETAC is the "sole organization in the PRC authorized to hear non-maritime commercial arbitration cases between Chinese and foreign parties."<sup>321</sup> It must be noted that the China Chamber of Commerce originally developed CIETAC's arbitration rules.<sup>322</sup> CIETAC is an official Chinese administrative body able to exercise its "delegated legislative power under the Chinese Constitution and the relevant regulations of the State Council."<sup>323</sup> While not going into the complexities of how the arbitration process works (this is virtually a universal and uniform practice),<sup>324</sup> CIETAC does have jurisdiction to cover international or foreign trade related disputes, including those related to the Hong Kong SAR, Macao or Taiwan regions;<sup>325</sup> disputes arising "between enterprises with foreign investment and disputes between an enterprise with foreign investment and another Chinese legal person . . . or economic organisation,"<sup>326</sup> disputes arising, for example, from project

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<sup>320</sup> See WANG, *supra* note 46, §9.4.4, at 297.

The CIETAC was established in Beijing . . . . It also has two regional offices, one established in Shenzhen . . . and the other in Shanghai . . . the CIETAC has 418 arbitrators on its name list for international economic and trade arbitration. Among these arbitrators, 25 are citizens of Hong Kong SAR and 112 are foreigners, of whom eight are Australians.

*Id.* For a good and very short expose on CIETAC, see Paul R. Weber, *China International Economic and Trade Arbitration Commission*, in CHINA AND HONG KONG IN LEGAL TRANSITION: COMMERCIAL AND HUMANITARIAN ISSUES 73-75 (Joseph W. Dellapenna & Patrick M. Norton eds., American Bar Association 2000).

<sup>321</sup> Ge Liu & Alexander Lourie, *International Commercial Arbitration in China: History, New Developments, and Current Practice*, in INTERNATIONAL BUSINESS AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 389 (Ralph H. Folsom & W. Davis Folsom eds., Kluwer Law International 1996).

<sup>322</sup> See Mo, *supra* note 274, at 384.

<sup>323</sup> *Id.*

<sup>324</sup> E.g., INTERNATIONAL COMMERCIAL ARBITRATION §1 (Tibor Varady et al. eds., West Group 1999); Guo & Tao, *supra* note 162, at 327. See generally Jerome Alan Cohen, *The Role of Arbitration in Economic Co-operation with China*, in FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 508-531 (Michael J. Moser ed., Oxford University Press 2<sup>nd</sup> ed. 1987) (1984); See Guo & Tao, *supra* note 162, at 327.

<sup>325</sup> See Mo, *supra* note 274, at 383.

<sup>326</sup> See *Id.*



financing,<sup>327</sup> or certain special cases stipulated in the administrative regulations of the PRC.<sup>328</sup>

"China ratified the New York Convention in 1986."<sup>329</sup> It did make a few reservations to the Convention, which included that China would only enforce the Convention on the basis of mutual recognition (thereby refusing to enforce an award in a non-New York Convention country), and that the Convention would only apply to disputes recognized under Chinese law.<sup>330</sup> Also, an interesting CIETAC arbitration feature is that an award must be rendered within nine months from the date when the arbitration tribunal is formed.<sup>331</sup> However, if the parties to the dispute want a quicker and more efficient process to take place, they would simply need to agree in writing and apply for the case to be conducted under the Summary Procedure of CIETAC.<sup>332</sup> This means that an award would be rendered within 30 days if heard orally, or within 90 days of the formation of the arbitration tribunal if the case is examined "on the basis of documents only."<sup>333</sup> Finally, and most importantly, there is only institutional arbitration—no *ad hoc* arbitration—pertaining to commercial (investment) matters in China.<sup>334</sup>

#### *E. Litigation—Venturing Into The Undesired World Of Last Resort*

As previously mentioned, the Chinese have a very bad impression of the court process and prefer more amicable ways of settling disputes, primarily due to being non-confrontational in nature and not wanting to risk losing face.<sup>335</sup> However, over the past few

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<sup>327</sup> See *id.*

<sup>328</sup> See *id.*

<sup>329</sup> *Id.* at 392. The New York Convention of 1958 was named after the place where the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards was held. See, e.g., DOCUMENTS SUPPLEMENT TO INTERNATIONAL COMMERCIAL ARBITRATION 1 (Tibor Varady et al. eds., West Group 1999).

<sup>330</sup> Mo, *supra* note 274, at 392; see *supra* Part IV.3.

<sup>331</sup> See WANG, *supra* note 46, § 9.4.4.4, at 299.

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

<sup>333</sup> *Id.*

<sup>334</sup> However, "CIETAC does not object to *ad hoc* arbitration." *Id.* at § 9.4.4.5, at 300. In fact, "[i]n cooperation agreements signed between CIETAC and arbitral institutions of other countries, there are provisions allowing parties to select UNCITRAL Arbitration Rules and form an *ad hoc* arbitration tribunal." *Id.*

<sup>335</sup> See LEE, *supra* note 273, at 9.

decades the Chinese government has established economic court divisions within the legal framework to handle civil litigation regarding economic and commercial disputes for the purposes of curtailing "speculation, profiteering, and all kinds of criminal activities."<sup>336</sup> But,

[l]itigation of a dispute is possible, but is usually a last resort. To litigate a dispute involving a foreign economic contract in the Chinese court system, the foreign economic contract must not include an arbitration clause and a written agreement to arbitrate must not later be reached. In practice, few foreigners or foreign countries have litigated their contractual disputes.<sup>337</sup>

Hence, the rule of law is still developing in China.<sup>338</sup> In realizing this, the court system is still predominantly state controlled and opaque in character, many Chinese court justices and attorney's have relatively inadequate legal training—compared to western standards,<sup>339</sup> and biases against foreigners in the Chinese court system is commonplace.<sup>340</sup> Plus, other problematic factors include rapidly changing and volatile laws, Mandarin Chinese (the official Chinese language) is required in all court proceedings, and the fact that foreign parties can only be represented by Chinese counsel could cause

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<sup>336</sup> *Id.* at 18.

<sup>337</sup> Dernelle, *supra* note 10, at 358-59; see also Zhang Yuqing, *Like Bamboo Shoots After a Rain: Exploiting the Chinese Law and New Regulations on Sino-foreign Joint Ventures*, 8 J. INTL. L. BUS. 59, 97 (1987). See generally Guo & Tao, *supra* note 162, at 328-29.

<sup>338</sup> Brown & Rogers, *supra* note 313, at 333; see also Stanley B. Lubman, *Sino-American Relations and China's Struggle for the Rule of Law*, in CHINA AND HONG KONG IN LEGAL TRANSITION: COMMERCIAL AND HUMANITARIAN ISSUES 9-60 (Joseph W. Dellapenna & Patrick M. Norton eds., American Bar Association 2000) (detailing the significant legal reforms presently underway in the Chinese legal system).

<sup>339</sup> See generally Ralph H. Folsom & John H. Minan, LAW IN THE PEOPLE'S REPUBLIC OF CHINA 169-241 (Ralph H. Folsom & John H. Minan eds., Martinus Nijhoff Publishers 1989).

<sup>340</sup> See Brown & Rogers, *supra* note 318, at 333. See generally, Zheng Zhaohuang, *On the Adjudicatory Jurisdiction of Chinese Courts over Foreign Investment Disputes*, in FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 532-531 (Michael J. Moser ed., Oxford University Press 2<sup>nd</sup> ed. 1984) (1987).

considerable hardship and uncertainty in the litigation process for a foreign enterprise.<sup>341</sup> Furthermore, it would behoove a foreign enterprise doing business in China to most definitely have a good arbitration clause built into their investment or joint-venture contract, or otherwise find an alternative means for resolving a dispute in a neutral international forum, rather than contending with a Chinese court.<sup>342</sup>

## V. CONCLUSION

China's investment climate has changed dramatically over the past few decades.<sup>343</sup> With the advent of the "open door policy," and most recent accession into the WTO, China has changed its image from one of a hermit kingdom to the last great commercial frontier.<sup>344</sup> During this same period the Chinese government has established a number of laws and regulations concerning foreign direct investment and international commercial activities.<sup>345</sup> It has also agreed to and ratified several international agreements.<sup>346</sup> While still perceived as having a relatively opaque, inefficient and weak legal system, it is in a period of rapid development and change.<sup>347</sup> This present transition period may seem quite precarious to the foreign investor, but it is necessary and inescapable. However, most importantly, China is pressing on with much needed economic and legal reforms establishing a more positive investment climate for foreign investment enterprises operating within its borders.<sup>348</sup> China's recent entry into the WTO has only accelerated this process of dramatic transformation.

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<sup>341</sup> See WANG, *supra* note 46, § 1.2.9.12, at 35-36; § 1.2.13.2, at 45; § 9.5, at 306-08.

<sup>342</sup> See Brown & Rogers, *supra* note 313, at 333-34, *see also* Graham, *supra* note 232, at 254-55. *See generally supra* Part I.

<sup>343</sup> *See supra* Parts I, II.

<sup>344</sup> *See id.*

<sup>345</sup> *See supra* Parts III, IV.

<sup>346</sup> *See supra* Parts I, III, IV.

<sup>347</sup> *See supra* Part II.

<sup>348</sup> *See supra* Parts III, IV.