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Looking For Law in China III: How Foreign Investors and Business Have Faced Legal Uncertainty in China

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LOOKING FOR LAW IN CHINA: III

HOW FOREIGN INVESTORS AND BUSINESSES HAVE FACED LEGAL UNCERTAINTY IN CHINA

This last of the three talks I will have given here at Oxford looks at yet another aspect of what I have called "looking for law in China." Today I will look at Chinese law from the perspective of foreign investors that have had to cope with the uncertainty of a business environment in which legal institutions have been vague, incomplete and weak. I speak to you today from under two hats, that of a scholar and that of practicing lawyer, since for over thirty years I have combined those two careers. My observations here, then, are not just those from the academic ivory tower but from what is laughingly known as real life.

Foreign businesses in China face considerable legal uncertainty, which necessarily has shaped business practices. I will first summarize some characteristics of Chinese law that nourish uncertainty. Against that background I will note some of the various types of conduct or transactions that are intended in some manner to reduce uncertainty—but which often involve violations of Chinese law.

Prologue: The China trade under Chinese rules

Before addressing current concerns, I want to remind you how far China has come since the days it was following the Maoist policy of "self-reliance"—in order to suggest how deep must be the changes in legal culture that must replace previous and long-lived habits of thought. Before 1979, China's foreign trade was conducted in a legal vacuum. From 1949 to 1979, the small number of centralized state trading corporations that monopolized China's foreign trade used only simple standard form contracts that made no reference to Chinese law, because there was none governing trade with foreigners. The contracts did provide for dispute settlement—by stating that disputes would be resolved through friendly negotiations. When disputes did arise, they were almost always settled through negotiations conducted against a background of past dealings and in anticipation of continuation of business relations; a Chinese arbitration commission was established to deal with Sino-foreign commercial disputes, but it was invoked only rarely.

When foreign investors began coming to China after the reform policies were announced, foreign trade with non-Communist countries since 1949 was purely bureaucratic. The adoption of legal rules, to set practice both for foreigners and the

bureaucrats who would regulate them, was an innovation for which the mentality of most bureaucrats—and indeed, most Chinese—were necessarily unprepared. It is against this background -- of a legal vacuum in a highly politicized society-- that laws on foreign investment were developed.

I am not going to describe the very large body of laws and regulations that has been developed in order to create a framework for the conduct and regulation of foreign direct investment ("FDI") and trade. My concern is not what Chinese law says, but what it does not say.

A. UNCERTAINTY IN CHINESE LAW

Before discussing how foreigners have coped with uncertainty, we should be mindful of some of the sources of that uncertainty:

insufficiency of formal law
Laws and regulations: incomplete, absent or unclear
tentativeness

When the new welcome to foreign direct investment ("FDI") was extended, neither a legal system nor the very concept of a legal system existed. The legal vacuum has been filled slowly, incompletely and tentatively. Newly promulgated laws, when they appear, have often been explicitly provisional or tentative, and have had to be supplemented by additional legislation afterwards. This of course reflects the difficulty of filling what had been a legal vacuum. Typically, initial legislation addressed to a particular subject has been loosely drafted and then followed (often years later) by incomplete implementing regulations.

One example: The initial skeletal law on foreign investment that appeared in 1979 loosely defined only the limited liability company that became known as the equity joint venture (EJV). But for almost ten years after that, another form of joint venture, the contractual joint venture (CJV) – a kind of partnership -- developed by analogy. Creation of such vehicles for investment was approved—in the absence of any legislation defining that vehicle. It was not until 1988 that a law on CJVs was promulgated that described the basic characteristics of that business entity.

That new law was itself vague on many aspects. Even after it appeared foreign investors and government officials alike had to continue to refer to the rules on EJVs as they had been doing in the past. Regulations implementing the CJV law did not appear

until 1995, fifteen years after CJVs had themselves appeared, to clarify many details about their establishment, structure and management.

Another example: Wholly foreign-owned enterprises ("WFOEs") were not even authorized in 1979, but nonetheless a few were authorized in the Special Economic Zones ("SEZs") in the early 1980s. It was not until 1986 that a law on this investment vehicle was promulgated, followed by implementing regulations in 1990.

Loose drafting and use of law as a tool

A basic difficulty is created by Chinese legislative techniques. Chinese national-level legislation is intentionally drafted in "broad, indeterminate language" that permits administrators to vary the specific meaning of legislative language extensively.

Lack of transparency

The lack of transparency in Chinese governance is well-known, and the Chinese bureaucracy has frequently and aptly been dubbed "impenetrable." In the early years of FDI, Chinese negotiators and officials did not understand, or affected an inability to understand, the need for governmental transparency. In practice, throughout the 1980s, certainly, many regulations and rules were for internal (*neibu*) use only. In recent years progress toward increased transparency has grown, especially as China approached accession to the WTO and since then, as well.

Formalistic Law-Making, Weak Implementation.

After rules are promulgated little attention may be paid to enforcing them or ensuring uniformity in implementation. Perhaps the best-known example among many throughout the last decade and today as well has been the failure of Chinese officials to enforce Chinese legislation on violation of intellectual property rights.

Difficulties arise, in part, from the formalism of policy-makers' approach to law, which often treats the texts of laws, once promulgated, as equivalent to practice. The real meaning of any rule, however, turns on policies and the discretion given to the implementing agencies, which often fail to enforce the law.

Discretion and its discontents

Chinese governance is pervaded by great discretion given to all agencies to interpret laws flexibly. Excessively broad administrative discretion—only incompletely controlled by external agencies, including higher-level superiors—raises complex and disorderly obstacles to legality.

The arbitrariness of China's bureaucracy is legendary, among Chinese as well as foreign investors and traders. Peasants are ordered by local officials to pay taxes exceeding amounts stipulated by law; the houses of urban residents are often demolished with little notice, opportunity to protest, or adequate compensation: These are just a few examples of common complaints by Chinese. An evolving administrative law has begun to address these problems, but the law has only limited reach , however, and comprehensive administrative procedure legislation is scheduled to strengthen it.

Structural causes of legal weakness

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

Basic problems encountered by foreign businesses stem, too, from confusion among the sources of law and the allocation of powers to make and interpret rules among the basic organs of the Chinese state. Under the Constitution adopted in 1982, different types of laws or regulations are enacted by three bodies: the NPC, its Standing Committee and the State Council. The generality with which their respective jurisdictions are defined is astonishing to the western lawyer's eye. The categories of rules are nowhere defined, and the respective jurisdictions and relationships of the three bodies are worked out through informal negotiations on each law that is adopted, in a system that one scholar has aptly described as "chaotic."

Also, after legislation is enacted by the NPC, the State Council exercises its power to draft implementing legislation—which may distort or pervert the legislation on which it is purportedly based.

Moreover, the departments supervised by the State Council can, when they implement laws and regulations, issue rules that depart from or ignore the intent of the drafters. Their authority may derive either from specific grants of such power by a legislative body such as the NPC Standing Committee, or from a technically distinct, broad category of inherent rule-making power. The breadth of the rule-making power of the Chinese bureaucracy is a major structural problem in the organization of the Chinese state, with serious implications not only for foreign businesses that wish to ascertain the state of the law on a particular subject, but for the future of Chinese legal development.

Inconsistencies Between National and Local Legislation.

Provincial and lower-level governments also issue rules, and their capacity to frustrate national policies and laws has been greatly expanded by the delegation of considerable power to them. Local legislation has often been inconsistent with national legislation and policy. The central government in Beijing has had great difficulty in restraining local disregard of restrictive approval requirements, and the prospects for greater uniformity in practice are not encouraging

Continuing incoherence in law-making.

The striking disorderliness of Chinese law-making and interpretation reinforces the potential for arbitrariness that presently infects the system. Efforts have been under way for some years to inject greater coherence into the system, with only limited success.

The inadequacy of institutions for dispute resolution

Ample reasons exist for avoiding the Chinese courts. They are expected to follow Party policies and their changing emphases. The low educational level of China's judges creates significant difficulties. Although professional standards are being raised, many judges still have not had a full legal education. The most serious problem in the courts is extra-judicial influence by local officials on the outcomes of non-criminal disputes.

Judges are appointed and paid by the local governments in the jurisdictions in which they serve. The increasing stakes of local governments in economic enterprises have stimulated "local protectionism," which creates pressures on the courts to protect enterprises whose revenue is important to the locality. Relationships between judges and local officials or others promote "back- door" influences on outcomes that shade into downright corruption and bribery, which are potent causes of perversions of justice. Courts may persuade complaining parties to withdraw suits, issue judgments not in accord with law and facts, and punish judges who try to be impartial with transfers. "Local protectionism" consistently makes it difficult to enforce judgments of the courts when the successful litigants must attempt to obtain payment in a place where defendants live or do business.

As an alternative to litigating disputes before the courts, arbitration is desirable, but arbitration in China presents difficulties that Anthony Dicks will discuss, and local protectionism makes difficult or impossible the enforcement of arbitration awards whether they are Chinese or foreign.

Conclusion to Part A: causes of uncertainty

Legislative incoherence + structural problems combine with localism and weak legal culture to buttress uncertainty

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To show the extent of the problem in more than conclusory terms, I will illustrate effects of uncertainty on business practice.

B. UNCERTAINTY: STRATEGIES

The level of ambiguities in law and policy has varied, of course, with time and also according to the particular line of business that interested investors. The attitudes of foreign investors have varied, also, according to nationality.

I venture to generalize, though, that faced with legal ambiguity, foreigners, with the active cooperation of Chinese officials, have employed or consented to use a variety of methods to navigate through uncertain waters. These methods often involve outright violation of applicable Chinese laws or, at least, dubious evasion of their requirements Here are some examples:

1 Evading the law with the approval of senior Chinese officials

Rupert Murdoch

In some cases where the law was not even "murky" but clearly forbade particular types of investment, foreigners have been able to proceed as they wished after they were given the go-ahead by high- ranking officials. Not every prospective foreign investor has access to the highest possible levels of the Chinese leadership, but some of those who do have curried favor in order to gain commercial success.

One well-known journalist wrote about what he called "shoe-polishing" some time ago, although he used a much ruder term. An article in the Financial Times stated that "Few foreigners have polished more Chinese shoes more energetically than Rupert Murdoch, " Murdoch is perhaps the most visible foreigner to engage in public shoe-polishing in Beijing.. Early in the 1990s the News Corporation that he owned was broadcasting the BBC into China from Hong Kong. In 1993 he stated publicly that satellite TV represents "an unambiguous threat to totalitarian regimes."

Not long after that, Murdoch decided that he wished to do business in China. He ended the BBC broadcasts and, as reported in the Financial Times, set about demonstrating his dependability to Beijing by spending, eight years in "repairing a reputation" that he had damaged. He made a series of statements that could only find favor in Beijing, such as denouncing the Dalai Lama by quoting favorably "cynics who

say that he's a very old political monk shuffling around in Gucci shoes," and suggesting that China has done much for Tibet since it occupied that region. Thereafter a publishing company that he controlled broke its contract with former Hong Kong Governor Chris Patten to publish Patten's book on Sino-Western relations. At the time, Murdoch stated "I told them not to publish Patten's book...we are trying to get set up in China. Why should we upset them? Let somebody else upset them."

Murdoch has since been rewarded for his ingratiating gestures. While foreigners are not allowed to participate directly in Chinese telecom enterprises, that rule was evaded when Murdoch was allowed to invest in China Netcom Corporation's Hong Kong subsidiary, in which former Chinese President Jiang Zemin's son sits on the board. By 2001, Murdoch's News Corporation was given permission to broadcast TV programs into Guangdong Province. It is no wonder that the Financial Times observed that "the kowtow still works."

CCF

Less visibly than Murdoch, other foreigners have sought promises from high-ranking officials of favorable treatment of a proposed investment, even when the project would violate Chinese law. A notable example: For many years, Chinese law prohibited foreign investment in the telecommunications industry. A technique for avoiding the prohibition appeared in the early 1990s: A Sino-foreign joint venture would invest in a Chinese entity, which would then in turn form a joint venture for telecommunications services with a second Chinese entity. These joint ventures were Chinese legal persons, but the foreign investor had no direct stake in the actual Chinese provider of the services, hence the arrangement was dubbed "CCF" (Chinese-Chinese-Foreign). In these CCF enterprises, in lieu of a share of profits the foreign investor was paid a variety of fees A number of foreign companies were encouraged by high-ranking officials including the former premier, Li Peng, and Wu Jichuan, Minister of Information Industry, to believe that this device could serve as a substitute for equity ownership.

CCF came under criticism, however, and was declared illegal late in October 1998. The illegal joint ventures were closed down on the grounds that they were deriving revenues from installation fees, which Chinese law prohibited. In late 1999, foreigners who had used this device in 45 projects were warned that they had to divest themselves of

their interests in these joint ventures. The Ministry ordered "revision" of the contracts, which led to the foreign investors having to accept much smaller shares and returns.

2. Reliance on locally encouraged violation of central law and policies

In general

The preceding examples of high-level willingness to overlook the requirements of Chinese law are unusual both because they occurred at such high levels and because they were so visible. This central characteristic of Chinese legal culture, however, is evident when we leave the center and venture out beyond Beijing, into the China that most investors experience. In practice, there is not one China, but many. Officially China is a unitary state, but in fact power is greatly decentralized, and often controlled and coordinated from above with surprising weakness. One veteran China lawyer has commented as follows:

> "The fact is that, contrary to American images of the PRC as a ruthlessly-effective authoritarian regime whose writ runs from the Standing Committee of the Party Politburo in Beijing to the most remote hamlet, in many respects contemporary Chinese government resembles a series of feudal baronies more than a totalitarian dictatorship."

An Australian business consultant has stated the effects very clearly: "Officials use their discretionary local power to advantage their income-gathering, even though their actions may be at odds with central government policies and laws."

violation of law by local officials : some examples

The arbitrary exercise of discretion by local officials has been a major source of investor anxiety and resentment since foreign investors were invited back to China in 1979. The late Michel Oksenberg, a political scientist who specialized on China throughout his long career, conducted research over a period of years on the governance of a single county in North China. After repeated visits over a period of years during which he came to be known to county officials, he called on the head of the county Financial Bureau, and asked to see the county's budget. The reply: "I can't show that to you, I don't even show that to Beijing."

This review of local strategies for evading requirements of Chinese law in FDI transactions begins with actions that constitute outright violations and proceeds to – relatively—more subtle stratagems.

Local disregard of central policies
retail joint ventures

A vivid illustration of the nation-wide extent to which local governments can carry their flouting of law and policy and a striking example of central-local disarray caused by wholesale local violations of central laws and policies is the opening of the retail trade to foreigners, in the early 1990s. Until 1992, retail sales were entirely off-limits to foreigners unless the products were manufactured in China, and even then only limited percentages of the products could be sold locally.

The interest of foreign retailers in selling to China's many millions was of course intense. In June, 1992, the State Council, together with the Central Committee of the CCP, issued a directive that authorized a limited number of *only on or two* foreign-invested joint ventures in each of 11 locations, a maximum of 22 altogether. The directive further provided that *each* such FIE had to be approved by local authorities, the Ministry of Domestic Trade and in Beijing, by the State Council itself, **regardless of the size of the investment.**

By 1994, in response to an inquiry by a client, research suggested that evasions of national law and policy practiced by local governments had already led to the establishment of hundreds of Sino-foreign retail activities in numbers far exceeding the 22 permitted by law. A variety of devices were employed, all locally- approved.

As the years passed, other foreign companies continued to rush in, and eventually, between 1998 and 2001, the State Council issued not one but four directives that were intended to rectify the wholesale violations of law that had occurred all over China. These measures were applied with limited success. In 1998 and 1999, some 35 outlets were closed, and some foreign investors had to sell their shares to their Chinese partners. Nonetheless, some foreigners persisted. Notably, the success of Carrefour, the French chain, in defying the legal rules has been breath-taking.

In February 2001, it was reported that Carrefour, was the most successful foreign retailer in China. It had 27 stores, and had gained its position by failing to obtain government approval for **any** of them, "relying instead on the good will of local authorities." In November of the 2001 negotiations with the central government ended, and Carrefour was authorized to resume opening its supermarkets. It is notable that while

the negotiations were going on, Carrefour became a major purchaser of Chinese products. By late 2001, it had purchased over $10 billion in Chinese goods, and was permitted to own up to 65% equity in some of its Joint Venture Distribution Enterprises. By the end of 2002, as one observer noted, "the final reprimand was fairly light. " Carrefour was the largest foreign retailer in China, with 31 stores, and it was planning to increase its purchases in China in 2002 to $12 billion. By 2004 it had 40 stores.

These developments were hardly lost on Chinese retailers, and in May 2004 , at their annual meeting, participants angrily expressed their "widespread anger at the speed foreign companies have gained market share, through legal and illegal means. " Now, under the terms of China's accession to the WTO, restrictions on the number of foreign-invested retail have disappeared.

This little history illustrates not only the frequent weakness of the central government in permitting the spread of establishments lacking the required approvals, but also the muddiness of law and practice with regard to the consequences of violations of apparently clear rules.

investment incentives

Another example of local violation of central laws and policies has been the excessive granting of incentives to foreign investors. It has long been the central government policy to give certain tax incentives to foreign investors such as reduced income tax rates for stated periods of time, especially if they establish their projects in certain specially designated zones along the China coast. Local governments have been given discretion to offer certain additional incentives.. A survey published in 2000 notes that in many areas the discretion has been used to offer the incentive in question indefinitely rather than for limited periods of time. In addition, however, some of the zones offer incentives that are entirely unauthorized, including substantial tax refunds.

Research has suggested that despite directives from the State Council, some provinces are continuing previous illegal practices.

Arbitrary imposition of fees

FIEs frequently encounter attempts by local officials to extract benefits that are unauthorized by any law or policy. A trade publication commented in 1997 "[F]or cash-starved Chinese authorities, foreign investors appear to represent a golden goose that is

increasingly hard to resist," Examples included fees that supposedly have to be paid by all enterprises, but in practice are assessed only against FIEs, as well as arbitrary fees imposed for permits. In one instance, an FIE that sought a construction permit was presented with a lengthy list of fees for such items as "white ants," a contribution to a local education fund, a "civil air defense fee," a "special garbage fee," and a "greening fee," which were reduced or waived after negotiations. These fees are often unpredictable, imposed without any semblance of transparency and random, and have varied widely across China. Central control over the practice has been non-existent or weak, and the usual remedy for the foreigner is to negotiate the amount that will satisfy the local agency.

3. The approval process

Perhaps the most widespread problems arise out of local discretion that manipulates the process of granting the many approvals that investors require in the course of establishing and operating their enterprises. The strong inclination to regulate foreign investment converges with localism to complicate the approval process that is required for every FIE.

Throughout the 1980s, foreign investors commonly complained that after Chinese and foreign counterparts had agreed on all the details of their joint venture, the approval authorities insisted that certain provisions be renegotiated. Problems with the approval process have been receiving less attention in recent years than they did a decade ago, either in professional journals or in the press. With 25 years of experience, the investment approval authorities on the China coast, at least, have an established body of practice, as do experienced foreign lawyers. More important, China's national policy toward FDI has moved from emphasizing tight control over foreign presence in the economy to one of selective encouragement. The Chinese government has classified projects into the categories of "encouraged," "permitted" or "restricted." Investors whose projects fall within the "encouraged" or "permitted" categories ought to find the approval process fairly routine. On the other hand, those who wish to apply for investments in the "restricted" category will encounter greater difficulty .

I will only note in passing that exit from an investment in China may be more difficult than entry because of the need for multiple approvals. Local authorities may not

wish to admit that an FIE has been a failure in their jurisdiction, and consequently may be unwilling to ease the exit of the foreigner.

Imposition of local policies

Another example of use of the approval process to assert local interests is suggested by one study that notes that although formal law has given FIEs considerable discretion in hiring and staffing matters, local authorities can withhold their approvals unless some of their concerns in this areas are addressed to their satisfaction. For example, they may be concerned if the foreign investor wishes to reduce the number of workers at the FIE, because of the undesirability of increasing unemployment.

Evasion of approval limits

Another example of lower-level flouting of central laws and policies has been the eagerness of local governments to evade rules that allowed projects with specified levels of total investment to be approved only locally (although the details of the projects in question had to be reported to Beijing). Thus, during most of the 1980s and 1990s, local authorities could not approve FIEs in which the total invested amount exceeded $30 million. This rule was routinely evaded by officials who pressed investors to divide proposed projects artificially into smaller segments, each nominally involving investment below the threshold limit, in order to avoid the notice of the Beijing authorities who would otherwise have to pass on the project. One commentary noted, "the local approval threshold...of less than $30 million has become the stuff of legends among the e foreign investment community."

In one example, an investor based in Southeast Asia sought out an American partner for a mammoth project that would have required total investment of over $100 million. When advised that the size of the project would necessitate approval in Beijing, it proposed to divide the project into small stages, each under $30 million, and apparently the local authorities were willing to agree.

Central control over the size of investments has recently became even more attenuated. In two circulars issued in 1999, MOFTEC authorized provincial (but not sub-provincial) investment authorities to approve any projects as long as they were in the "encouraged" category in the Foreign Investment Industrial Guidance Catalogue that

became has been mentioned above, and as long as "overall State planning was not required."

4. Corruption and bribery

The spread of official corruption throughout China that has followed economic reform is regarded as a persistent source of difficulty by many foreign investors. A survey in 1998 of 96 European companies in China indicates that 60 percent reported that "corruption was a constraint on their operations." More pungently, the U.S.-China Business Council reported in early 1998:

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

There is every indication that corruption has not decreased since those words were written. An article in the New York Times in August, 2004, said the following:

> China has become something of a **kleptocracy**, with tens of millions of government and party officials using largely unchecked political powers to enrich themselves. Top leaders have called corruption a cancer that is eating away at the party's legitimacy and posing the greatest challenge since the street protests of 1989

C. CONCLUDING NOTE

In some respects, the legal and business environment are improving:

1. As I have already stated, established forms of business in areas in which FIEs are encouraged are permitted today encounter fewer problems than they did 10 years ago;
2. There has been a proliferation of legislation adding rules where there were none before;
3. more generally, at the central level and in some localities, there has been greater concern manifested to raise the level of legality and reduce corruption

BUT

1. In newer areas of activity there is the same tentativeness in rules, as well as continuing vagueness. A prominent example is in merger and acquisition involving state owned enterprises. We can expect continuing uncertainty in these and other new areas.
2. Extensive corruption continues.

3. I have already noted the problems presented by the courts. I regret that I do not foresee any improvement in the courts, either as forums for settling disputes, or for enforcement of Chinese or foreign arbitration awards.

Anthony Dicks will discuss the resolution of Sino-foreign commercial disputes, and I am sure that your questions will provoke interesting discussions.