Legal Uncertainty in Foreign Investment in China: Causes and Management

My talk today will be based on an article -- "Looking for Law in China"-- that was published last year. In it, looked 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 wrote, and today speak to you, 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.

The problems I will discuss reflect not only those of foreign investors but general characteristics of Chinese legal institutions. I am going to compress my summary of essential points so that I can have time to speculate on the prospects for Chinese law reform overall, not just as it affects foreigners, and I am going to interweave some of my speculations with my summary of the essential points in the article.

Foreign businesses in China face considerable legal uncertainty, which necessarily has shaped business practices.

thesis is simple:
uncertainty initially marked the rules and vehicles for foreign investment when they were introduced, but has been reduced as they have matured

However, as new institutions are introduced they, too, will generate new uncertainty. Chinese law relating to foreign investment is likely, for the foreseeable future, to continue to exhibit what I describe as *rolling uncertainty*.

A. LEGALIZATION UNDER ECONOMIC REFORM

Before 1979, neither a legal system nor the very concept of a legal system existed.

It is against this background -- of a legal vacuum in a highly politicized society—that the current configuration of China's laws, including those on foreign investment, were developed.

Economic reform impelled China's leadership to create a new role for law by using promulgated laws of the state as the primary vehicles for declaring and implementing policy

Creation and definition of new legal relationships, economic actors and transactions

Examples: contracts, business organizations

FDI

B. UNCERTAINTY IN CHINESE LAW- FOUR MAJOR CAUSES

1. *The legal vacuum has been filled slowly, incompletely and tentatively.*

Typically, initial legislation addressed to a particular subject has been loosely drafted (it is often explicitly provisional or tentative) and then followed (often years later) by incomplete implementing regulations. This reflects the difficulty of filling a legal vacuum.

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 practice —and 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 in some respects. 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.

As additional investment vehicles created, same pattern followed

Σ WFOE in the 1990s Σ a new area of law, merger and acquisitions, has appeared

In the meantime, the earliest laws have been supplemented and enlarged by additional legislation.

Σ Legislation on joint stock companies that provided a vehicle for enterprises that wish to restructure and list shares on the stock exchange;

Σ A securities law;
Σ laws on PS enterprises;
Σ banking regulations
Σ anti monopoly law

By now --a framework for FDI has been created that is a considerable legislative accomplishment. and now provides some guidance on many important questions for foreign and Chinese parties establishing FIEs. At the same time, however, uncertainty is fostered by other factors.

2. Policy trumps law

Protection of politically sensitive industries

A succession of rules on foreign companies operating in the **media and publishing** industries has limited their abilities to operate

Politically sensitive industries-the internet

Policies intended to protect or control certain industries-New concerns about foreign acquisition of Chinese companies

The critique of movement toward a marketized economy.

Late last year, a respected US economist who has long specialized on China wrote: "In the past few years, public discussion in China has shifted dramatically to the left. There is much more criticism of markets and of the shortcomings and inequities of China's economic reforms." Barry Naughton, China Leadership Monitor, No. 17

critique of neo-liberalism in economic policy. Discussion of need to beware of:

- absolute liberalization
- comprehensive privatization
- complete marketization
- globalization

- **criticism of sale of shares in Chinese state-owned banks to foreign financial institutions**
- **restrictions on purchases of real estate by foreign individuals and institutions, moratorium on acquisitions of brokerages, limited the competitiveness of retail companies**

On September 8, 2006, the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors (the New M&A Provisions), issued by China's Ministry of Commerce

(MOFCOM) and other agencies, became effective, **If a M&A transaction would (a) result in any change in control of any domestic company in a key industry; (b) involve the holder of a well-known Chinese mark or brand; or (c) have potential or actual impact on national or economic security, such transaction must be approved by MOFCOM.** This approval process is independent of the usual approval processes imposed on all foreign investment in China, including M&A transactions. **Note that the New M&A Provisions do not define terms such as "key industry" or "well-known brand" and do not specify the approval procedures or timeline applicable in this context.**

By 2.007, no approvals had been given

December 2006: State Assets Supervision and Administration Commission chair stated that in key sectors the State must have "absolute control". These are armaments, power generation and distribution, oil and petrochemical, telecommunications, coal, aviation and shipping industries.

Chairman of SASAC also said that "central SOEs should also become heavyweights in sectors including machinery, automobiles, IT, construction m iron and steel, non-ferrous metals" (FT 12.19.2006)

A. Σ Xugong

Carlyle Group negotiated in 2005 to take 85% interest in major Chinese manufacturer of construction equipment for $375 million. However, the backlash against foreign investment caused approval to be delayed; after more than a year of renegotiation, Carlyle finally agreed in 2007 to take 50% interest.

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B. Implications

Obvious rise of economic nationalism, with no indication at moment of how far or deep it will go.

One observer has commented, though:

"China, it seems , is wedded to the idea of an industrial policy promoted by the state, that ensures that the commanding height of the economy are still in the hands of the state or at least protected against foreign incursions or acquisitions. Therefore, it appears that China is not ideologically committed to markets as a solution to all of its economic development problems." [1]

3. Structural causes of legal weakness: Mention only two

A. Inconsistencies Between National and Local Legislation and local practice.

Local legislation and practice 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

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Efforts have been under way for some years to inject greater coherence into the system, with only limited success.

A long-established principle is that if a court finds that an inconsistency between laws issued by different legal of government, they can refuse enforcement but they may not invalidate either; Cts lack the power to review the legality of legislation, but can only decide whether a law has been applied correctly. The Legislation Law of 2000 provided that citizens and organizations could file with the NPCSC objections to lower-level norms that were inconsistent with the constitution or laws, this device has been used on less than 40 occasions.

B. The inadequacy of institutions for dispute resolution

Ample reasons exist for avoiding the Chinese courts.

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1 **Mark Williams,"Competition Policy and Law", in Rule of Law in China: Chinese Law and Business (Foundation for Law, Justice and Society, University of Oxford, 2007) www.fljs.org**

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

Recent scholarship

Emphasizes the well-known differences between the quality of rural and urban districts generally and , more specifically, between wealthy and poor districts.

Xin He article on enforcement of judgments in commercial cases by the courts of a wealthy district in the Pearl River Delta area.[2] He found that local protectionism "is not particularly serious," because although local governments rely on revenues from local businesses, they have depended mostly on SOEs, but in the district studied the economy has become more diversified and local government income has come more from taxing the private sector. Financial reform has caused the courts to submit all of their administrative income to the local governments, which then provide the courts with adequate funding. Xin He did say that when large SOEs are involved, there is still influence from local governments. Xin He also found increased professionalism in the court staffs, and strict requirements on the behavior of court staff.

Other developments tend in a different direction:

The rise of judicial mediation. Mediation, a traditional form of dispute resolution, had been politicized under Mao, and then substantially depoliticized as the courts were revived. However, there is a new emphasis on this form of dispute resolution.

Peerenboom and Xin He: "The SPC and Ministry of Justice were worried that more cases wee being appealed, adding to the burdens on the courts." [3] Judges did not want to be reversed on appeal, since reversals would affect their chances for promotion, their salaries and their bonuses. Also, this was a response to popular perceptions that the courts were not competent, plagued by

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2. Xin He, "Enforcing Commercial Judgments in the Pearl River Delta of China" forthcoming in the Journal of Empirical Legal Studies

3 Randall Peerenboom and Xin He, "Dispute Resolution in China: Patterns, Causes, and Prognosis," in Rule of Law in China: Chinese Law and Business, (Foundation for Law, Justice and Society, 2007) www.fljs.org

corruption, had difficulty in enforcing judgments, and had excessively high expectations of the legal system. It was also a response to the rise in social protests.

But a political factor entered: Hu Juntao, intending to address widespread social discontent and the continuing rise in socio-economic inequality, announced a policy of creating a "harmonious society."

Σ conversation with senior provincial judge last May

Σ Chinese law professor reactions the next evening.

Peerenboom and Xin He note that one consequences has been judicial attention to the political requirement of a higher mediation rate. In order to achieve it, he notes that "some judges persuade, please and even force the litigation parties to accept a mediation result." He adds that "consequently, many litigants change their mind after they reluctantly sign the mediation [agreement that technically terminates the judicial proceedings except for enforcement if necessary]…" and further notes that if litigants do change their minds, then this leads to a higher rate of compulsory enforcement."

Another possible and basic trend in dispute-settlement that will perpetuate the weakness of the courts.

Peerenboom and Xin He claim that the government is steering away socio economic disputes away from the courts using mediation, as I have mentioned, but other nonjudicial institutions as well:

Arbitration

labor disputes: litigation has increased, but so has arbitration of labor cases. Peerenboom and Xin He say that about 1/3 of the cases brought to arbitration are mediated, and about ¼ of the labor cases brought to the courts are settled by mediation.

The Petition system

Carl Minzner has written an excellent article on the rise of letters and visits from the people—that is, the raising of protests by direct appeal to government authorities. Petitioners may seek relief from a variety of sources, including Party organs, government agencies, the procuracy and the courts. Peerenboom notes that in many cases petitioners unable to obtain effective relief persist in their efforts, even escalating the disputes by taking their cases to Beijing. This has led both to attempts to increase fairness and to

local government retaliation through use of administrative detention carried out by the police.

Notable trends: Summary

Peerenboom and Xin He claim that there is a shift toward rule-based governance, but one that limits the role or courts in contrast to political and administrative mechanisms. They argue that courts are not the best forum for resolving the types of complex social, economic and political issues that arise in a lower-middle country such as China. Moreover, many of the problems are not amenable to judicial solution – courts simply cannot come up with effective and enforceable remedies.

Many of the disputes are essentially economic in nature. Examples include claims for pensions and other welfare benefits, labor disputes, challenges to the taking of land and the amount of compensation offered, and environmental issues. In sum, they say that "the government has steered socio-economic disputes away from the courts toward other mechanisms such as administrative reconsideration, mediation, arbitration,public hearings and the politicalprocess more generally, when it became apparent that the courts lacked the resources, competence, and staturs to provide effective relief in such cases"

4. CAUSES OF UNCERTAINTY ARISING FROM CHINESE LEGAL CULTURE

A. Loose drafting of laws and regulations

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

B. 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 recent years, progress toward increased transparency has grown, especially as China approached accession to the WTO and since then, as well.

Peerenboom and Xin He: "The primary complaint of foreign investors has not been weak courts unable to enforce contractual rights but lack of transparency in the making of laws and regulations, inconsistent implementation of laws, excessive red tape, and predatory government behavior."

C. Discretion and its discontents

Chinese governance is pervaded by great discretion given to all agencies to interpret laws flexibly

personalized rule at the top

bureaucracy is fragmented, segmented and hierarchical; considerable interagency bargaining may precede approvals of new transactions

Assessment

Reform has moved faster than the processes of law-making

- Bureaucratic discretion is so broad that officials can or must formulate or adapt rules quickly to deal with new developments and encourage experimental reforms.
- ad hoc decision making is too easily detached from principle or accountability, or may well be tainted by the interests of the rule maker.
- Well-established patterns of legal interpretation are lacking.

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The conclusion of one long-time academic observer of Chinese law, Perry Keller, should come as no surprise: "Law in China… does not function as a fundamental source of certainty and predictability in social, commercial or administrative relationships." I will suggest the effects of uncertainty on business practice.

III UNCERTAINTY : STRATEGIES

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

One journalist wrote that "In Hong Kong the polite word for bumsucking is shoe-polishing. Few foreigners have polished more Chinese shoes more energetically than Rupert Murdoch." Murdoch is perhaps the most visible foreigner to engage in public shoe-polishing in China. In the early 1990s, he was broadcasting the BBC into China from the Hong Kong satellite owned by his News Corporation, and in 1993 he stated publicly that satellite TV represents "an unambiguous threat to totalitarian regimes." After he decided that he wished to do business in China, he ended the BBC broadcasts and set about demonstrating his

dependability by spending, as reported in the Financial Times, eight years "repairing a reputation" that he had damaged. He made a series of statements intended to find favor in Beijing, such as denouncing the Dalai Lama by favorably quoting "cynics who say that he's a very old political monk shuffling around in Gucci shoes," and suggesting that China has done much for Tibet since it occupied that region. A publishing company that Murdoch controlled broke its contract with former Hong Kong Governor Chris Patten to publish the latter's book on Sino-Western disputes with China and his views of Sino-Western relations. At the time, 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 was rewarded for his ingratiating gestures. He was allowed to invest in China Netcom Corporation, the board of which includes former Chinese President Jiang Zemin's son. Although foreigners were not then permitted to participate directly in Chinese telecom enterprises, the rule was waived when Murdoch was allowed to invest in Netcom's Hong Kong subsidiary. Murdoch's News Corporation was also given permission to broadcast TV programs into Guangdong province in 2001. It is no wonder that the Financial Times observed that "the kowtow still works." Rupert Murdoch's high-profile kowtow was particularly noteworthy because his reward was an equally high-profile Chinese disregard for the illegality of his investment in China Netcom. The extent to which he was willing to go is also remarkable because it epitomizes and caricatures the search by Western businessmen for close relations, or guanxi, with Chinese officialdom.

2. Local disregard of central policies

In general

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

The paradigmatic example: retail joint ventures

Until the early 1990s the retail sector was closed to foreign investors. After a limited number of FIEs were permitted under conditions of central govt approval, Carrefour became the leading foreign investor in retail enterprises by opening over 20 stores without any central government approval at all. It did this by large-scale local sourcing of products locally in China, to the delight of local govts that ignored national law. Carrefour was only the single most egregious violator of law, but hundreds of illegal JVs were established during a period in which Chinese law only permitted 22.

[MOFTEC lawyer reaction] This little history illustrates something besides the frequent weakness of the central government in permitting the spread of establishments

lacking the required approvals. It suggests the muddiness of law and practice with regard to the **consequences** of violations of apparently clear rules. What is "legal" and what is "illegal" when the central government makes a rule, local governments ignore the rule, and the central government *knowingly* allows that situation persist? How can a prospective investor assess the business risks of choosing to ignore central-level policy and law if a local government proposes an arrangement that seems to violate formal law at one level, but is consistent with locally-approved practice at the lower level?

Common practices:
1. **Evasion of approval limits**
2. Corruption and bribery

Omitting discussion of guanxi, as too complicated for the time I have, except to say that foreign investors frequently rely on personal relationships with local officials, and have to be on their guard against obvious hazards.

Kellee Tsai, a political scientist at Johns Hopkins, has studied the behavior of local officials when they adjust, ignore, or evade various provisions of formal institutions, characterizing this behavior as "adaptive informal institutions," which are "regularized patterns of interaction that emerge as adaptive responses to the constraints and opportunities of formal institutions, that "violate or transcend the scope of formal institutions, and that are widely practiced." [4]

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

1. Established forms of business in areas in which FIEs are favored today encounter fewer problems than they did 10 years ago;
2. as some new or expanded forms of foreign business activity grow and practice accumulates, uncertainty should be restrained and reduced.
3. also, at the central level and in some localities, there has been greater concern manifested to raise the level of legality, curb bureaucratic arbitrariness and reduce corruption

BUT

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4 Kellee S. Tsai. "Adaptive Informal Institutions and Endogenous Institutional Change in China,"
World Politics 59 (Oct. 2006) 116, 125-26.

1. **We can expect continuing tentativeness in newer areas of activity**, as well as continuing vagueness, that has marked earlier years of reform and FDI. **The autonomy of local governments continues to challenge the frequent weakness of the center in holding them to adherence to national laws and policies**

2. defining the goals of economic reform and guiding its course are works in process

3 . extensive corruption continues.

4. Although there may be slow improvement in the courts in some relatively prosperous areas along the Chinese coast, resort to the courts either as forums for settling disputes, or for enforcing arbitration awards still remains questionable.

5. Judicial reform remains restricted because of the contradiction between maintaining CCP power and strengthening courts that could weaken that power.

6. the overriding goal of the CCP continues to be maintaining its dominance- a check on law reform.

CONCLUDING THOUGHTS: THE LIMITS AND POSSIBILITIES OF LEGAL CHANGE

1. **Chinese society in flux: Social change is dramatic and China is experiencing a crisis of values**

Opportunistic conduct in contemporary China

Σ business ethics

"..the practice of printing fake invoices and receipts is widespread in China. Indeed, it is one of the country's boom industries. In 2007 almost 3,000 cases were uncovered, involving more than 10m fake receipts and at least 100 printing facilities." "On the fake take", The Economist, march 1, 2008

Σ **corporate governance**

no time to go into detail, will merely quote from a report by the Chartered Financial Advisors Institute Centre, which concluded that "while the Chinese government has put in place a relatively sound framework for improving corporate governance, observable changes are still not evident in financial disclosures and transparency.'"
Professor Donald Clarke was recently quoted as saying "There is a lot of corporate book-cooking in China; the data is very unreliable."

2**. social instability hampers legal reform- t**he number of public protests and demonstrations is increasing

3. legal culture: only slow changes

A. from above: Mixed. Policy of CCP dominance v. work in progress on legal reform, such as administrative law, experiments with public participation in rule-making, legislative process

Reform aimed at changing the legal culture of officials, e.g., 2004 State Council promulgation of the "Implementation program for comprehensively promoting the exercise of administrative functions in accordance with the law."

There are recent signs that the Chinese leadership is aware of the need to reconsider current institutions and the ideology underlying them. At the opening of the NPC on March 5th, Wen Jiabao, Prime minister, spoke of the need to "liberate thought" and to "break the shackles of outdated ideas".—but without offering any initiatives. As the Economist said, Chinese leaders wish to preserve stability and one-party-rule, but "they appear ready to think about making the party a bit more accountable."
The same article mentioned but did not discuss a book published by the Central Party School in Beijing, called "Storming the Fortress: Report on Research on Reform of China's Political Institutions"

B. **from below**: **Citizens' attitude toward law –increased consciousness of rights**

Σ Shanghai taxi driver and "special rights" of officials

The development of Chinese legal institutions is a work in progress -- slow progress--- and it is unlikely to increase in speed very dramatically in the near future. China has made impressive progress since legal reform began in 1979. Reform, however, still has very far to go in order to make Chinese legality meaningful. **T**he policy considerations, structural causes and an only slowly developing legal culture suggest that the near-term prospects seems to be that the *rolling uncertainty* that has marked the last twenty-five years will continue.

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I believe that authoritarianism has a long future in China, and will long constrain meaningful legal reform.