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# A Comparative Assessment of U.S. Direct Investment in China and India

Kalpana Arjunan

*University of Georgia School of Law*

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A COMPARATIVE ASSESSMENT OF U.S DIRECT INVESTMENT IN CHINA AND  
INDIA

by

KALPANA ARJUNAN

(Under the Direction of Professor GABRIEL M. WILNER)

ABSTRACT

Foreign direct investment (FDI) has made a dynamic surge into the world economy in the last fifteen years by growing strongly at rates well above those of global foreign trade. China and India attract a significant portion of the global FDI, however, the magnitude of China's FDI flows is much larger than that of India's. The special reason for China's super-magnetic attraction of FDI is intriguing. This dissertation is an attempt to answer the question by making a comparative assessment of the legal framework governing FDI in China and India, with special reference to U.S direct investment, thereby identifying lessons for India and other developing nations in order to increase their FDI inflows.

INDEX WORDS: Foreign Direct Investment (FDI), China, India, Investment policies, Positive and Negative Impacts of FDI, Legal framework of FDI, U.S direct investment, Investment guarantees, Bilateral Agreements, Dispute Resolution

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KALPANA ARJUNAN

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KALPANA ARJUNAN

Major Professor: Gabriel M. Wilner

Committee: Charles R. T.  
O'Kelley  
Gabriel M. Wilner

Electronic Version Approved:

Maureen Grasso  
Dean of the Graduate School  
The University of Georgia  
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## CHAPTER I

### INTRODUCTION

#### A. Purpose of study

Foreign direct investment (FDI) has made a dynamic surge into the world economy in the last fifteen years by growing strongly at rates well above those of global foreign trade.<sup>1</sup> After a declivitous fall over three years, the global FDI flows regained its impetus in 2004.<sup>2</sup> The two Asian giants, China and India attracted a significant portion of the global FDI.<sup>3</sup> China reaffirmed its position as the most attractive destination in the world.<sup>4</sup> India zoomed to the third position from Sixth lining up just behind the United States by occupying center stage in global FDI networks.<sup>5</sup> Subsequently, the Chinese government took efforts to slow down the economy by employing macroeconomic measures.<sup>6</sup> Efforts by Chinese authorities to cool off the economy did little to deter investors. China still attracted enormous amounts of FDI and established its position as the world's top two destinations for FDI.<sup>7</sup> The striking shifts in the direction of FDI flows have drawn worldwide attention. More countries are becoming part of the global FDI

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<sup>1</sup> RAVINDRA REDDY, *INVESTING IN INDIA 2* (2003).

<sup>2</sup> A. T. Kearney, *FDI Confidence Index*, vol. 7 GLOBAL BUSINESS POLICY COUNCIL. 2 (2004), available at <http://www.atkearney.com/main.taf?p=5,3,1,89> (Last visited, June 19, 2005).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> U.S DEPARTMENT OF STATE, 2005 Investment Climate Statement, available at <http://hongkong.usconsulate.gov/uscn/trade/sprpt/2005/ics.htm> (Last visited, June 19 2005) (hereinafter China Investment Climate).

<sup>7</sup> *Id.*

network fueled by the increasing internationalization. Today, wooing FDI has become a highly competitive game among the countries.

FDI is taking place principally through mergers and acquisitions (M & A) by major transnational business corporations (TNCs).<sup>8</sup> TNCs can participate in host countries through FDI, portfolio investment, exports and licensing of technology and patents.<sup>9</sup> All these investments generally involve a transfer of tangible and intangible assets from one country into another country in return for a participation in the earnings of that enterprise. FDI, on the other hand specifically refers to an investment by an enterprise in one country in an enterprise in another country involving “a long-term relationship”<sup>10</sup> with “a significant degree of control of the management by the foreign investor”.<sup>11</sup>

The word ‘FDI’ literally sounds like a magical spell to most of the developing nations.<sup>12</sup> In order to improve their status, developing nations need to import more capital, as well as technical, marketing and managerial expertise.<sup>13</sup> Furthermore, international investment projects are the source for easier access to global markets and international sources of finance.<sup>14</sup>

The benefits of FDI for the host countries include long-term economic development, creation of employment opportunities, development of infrastructure, growth in productivity and competition, increased capital investment and increased foreign exchange earnings resulting in the strengthening of host country’s balance of payments.<sup>15</sup> Consumers also benefit from FDI as

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<sup>8</sup> MANOJ PANT, FOREIGN DIRECT INVESTMENT: THE ISSUES INVOLVED 8(1995).

<sup>9</sup> *Id.*

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

<sup>11</sup> *Id.*

<sup>12</sup> VIJAY VARADARAJAN, THE ECONOMICS OF TRADE AND INVESTMENT 3 (1998).

<sup>13</sup> *Id.* at 67

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*, at 14

goods and services are competitively priced and there are a greater variety of goods and services offered with higher standards of quality.<sup>16</sup>

However, attitudes toward FDI are not always positive.<sup>17</sup> TNCs invest in developing nations with the goal of maximizing their profits and to obtain a competitive advantage over other investing firms by using favorable factors such as availability of market, access to natural resources and cheap cost of labor.<sup>18</sup> The pessimism towards FDI is based on the fear that if TNCs gain substantial power in the host country, they could interfere with the host country's social and economic reforms which could pose a risk to the host country's sovereignty or national security.<sup>19</sup>

Therefore, a developing country's FDI policy is generally based on two aspects. One is to create a good investment climate to attract foreign investment and the other is to restrict investment in certain sectors for the purposes of shielding its economy, sovereignty and national security.<sup>20</sup>

From the perspective of TNCs, they wish to rule capital rather than land.<sup>21</sup> International capital is footloose and travels across the globe, looking out for lucrative avenues of investment.<sup>22</sup> Foreign investors also face some risks to their investment in the form of "commercial"<sup>23</sup> and "non-commercial risks".<sup>24</sup> Risks such as supply risk and demand risk fall under the category of commercial risks, whereas, non-commercial risks are political risks and

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<sup>16</sup> *Id.*, at 16

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*, at 26

<sup>19</sup> *Id.*

<sup>20</sup> ASHISH VARMA, TRADE AND INVESTMENT IN INDIA AND CHINA 3 (2003).

<sup>21</sup> DHARMENDRA BHANDARI, INVITING THE INVADERS 1 (1998).

<sup>22</sup> *Id.*

<sup>23</sup> See VARMA, *supra* note 20, at 4

<sup>24</sup> *Id.*

legal risks.<sup>25</sup> Political risks include the actions of the host government such as expropriation of property without adequate compensation and failure to honor contractual obligations.<sup>26</sup> Lack of adequate legal structure in the host country to support the commercial law and clear tax regulations are examples of legal risks.<sup>27</sup> Protection of investments from these risks is indispensable to attract investment.<sup>28</sup> Therefore, a country's FDI policy also encompasses the foregoing issues.

China and India, like many other developing nations, view FDI as the prime driver for economic development.<sup>29</sup> Both nations have significantly liberalized their economies and have been open to western economic, political and cultural influences and imported technology.<sup>30</sup> Both have significantly benefited from the increase in global FDI flows.<sup>31</sup> Although both the nations are success models as largest recipients of FDI, the magnitude of China's FDI flows is much larger than that of India's.<sup>32</sup> In fact, the volume of China's inward FDI look so impressive that some economists have reportedly used the phrase "China fever" to describe the inflow of FDI into the country.

The special reason for China's super-magnetic attraction of FDI is intriguing. This dissertation is an attempt to answer the question by making a comparative assessment of the legal framework governing FDI in China and India, thereby identifying lessons for India and other developing nations in order to increase their FDI inflows.

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<sup>25</sup> *Id.*

<sup>26</sup> *Id.*, at 5.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*, at 19.

<sup>30</sup> *Id.*

<sup>31</sup> See Kearney, *supra* note 2.

<sup>32</sup> *Id.*, at 3.

United States is the leading foreign investor in India<sup>33</sup> and the second major investor in China next only to Japan.<sup>34</sup> In order to make an effective assessment of FDI in China and India, this paper will examine the specific aspects of FDI in both the countries with special reference to U.S direct investment.

The United States outbound investment policy is based on two major factors.<sup>35</sup> One is the investment policy of the host countries and the other is the policy affecting foreign corporations and affiliates of the United States firms.<sup>36</sup>

The fundamental notion of the United States outbound investment is that the policy should be neutral as to national treatment of the firms.<sup>37</sup> Other policy considerations of the United States government include “reciprocal treatment, easy market access, protection of intellectual property, guaranteed investment repatriation, reduced performance requirements and more bilateral investment treaties”.<sup>38</sup> It is thus apparent that several legal aspects and considerations of FDI are dominant in the success or failure of FDI activities. The analysis of FDI in China and India will address all these issues.

Chapter II of this dissertation will discuss FDI in China as a whole. The initial subchapters will lay the groundwork by discussing the history of economic liberalization and progress of the law governing FDI. The current FDI policy is discussed in the following subchapter.

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<sup>33</sup> Financial Times (Jan. 5, 2005), *FDI Fact file*, available at <http://www.fdimagazine.com/news/fullstory.php/aid/1025/India.html>

<sup>34</sup> *Id.*, *India* available at <http://www.fdimagazine.com/news/fullstory.php/aid/1023/China.html>

<sup>35</sup> EDWARD M. GRAHAM, *FOREIGN DIRECT INVESTMENT IN THE UNITED STATES* 129 (1991).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*, at 138.

<sup>38</sup> CYNTHIA D. WALLACE, *FOREIGN DIRECT INVESTMENT IN THE 1990's* 160 (1990).

Chapter III examines FDI in India in the same hierarchy. In the same vein, this dissertation briefly examines the positive and negative impacts of FDI on the respective economies.

Chapter IV makes a comparative assessment of the advantages and disadvantages that are generally encountered by TNCs in China and India. Chapter V is the conclusion.

## CHAPTER II

### FDI IN CHINA

China has undeniably carved a unique niche for itself in the history of FDI by attracting huge, unprecedented amounts of investment from countries around the world. The Chinese government has clearly understood the significant role of FDI in propelling China forward in the international economic scene. China's economic success is startling the rest of the world as it focuses on becoming an economic super power by moving with the times.<sup>39</sup>

#### **A. A Historical Review of Economic Liberalization**

China is considered to be one of the oldest living civilizations on earth.<sup>40</sup> The opening of domestic market did not take root until thirty years after the declaration of the People's Republic of China (on October 1, 1949).<sup>41</sup> Before 1978, China shielded its economy from the outside world because of the Communist party's "deep distrust for capitalist endeavors and, correspondingly, of western traders and investors"<sup>42</sup>. During Mao Zedong's<sup>43</sup> regime, the system

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<sup>39</sup> See VARMA, *supra* note 20 at 5.

<sup>40</sup> RALPH H. FOLSOM & JOHN H. MINAN, *LAW IN THE PEOPLE'S REPUBLIC OF CHINA* 3 (1989).

<sup>41</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>42</sup> VARMA, *supra* note 20 at 6.

<sup>43</sup> The Communist leader Mao's name can also be spelled "Tse-Tung", Id at 7.

was based upon communist ideology – totalitarian, egalitarian and poor.<sup>44</sup> China was impoverished with a feeble economy, increasing population and high illiteracy rate.<sup>45</sup> During this era, the rule of law was virtually non-existent.<sup>46</sup> The weak economic and trade relations between regions and the inter-regional rivalries also resulted in shortages of essential materials and products.<sup>47</sup> Apparently, China remained passive in the global economic arena<sup>48</sup>.

The state of affairs underwent a major change when Deng Xiaoping came to power in 1978<sup>49</sup>. Thus “... in 1979, the sleeping giant awoke when it voluntarily opened its doors to foreign investment by adopting an open door policy”.<sup>50</sup> In addition to various economic reforms including privatization of agriculture and industry, the new leadership welcomed foreign investors with some constraints, and attempted to decentralize economic and political decision-making.<sup>51</sup> China’s decision to open its economy for foreign trade and foreign investment was thus an outcome of the fundamental shift in political leadership whose objective was to raise the living standards of the Chinese people through economic development<sup>52</sup>.

China’s prime motive in welcoming foreign investment was an attempt to improve its agriculture, science and technology, and national defense.<sup>53</sup> The process of economic liberalization gained momentum with the signing of foreign technology import contracts including some with the American companies.<sup>54</sup> Since then, China has made a remarkable transformation from being FDI-hostile to FDI-eager, attracting FDI by implementing significant

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<sup>44</sup> JAMES M. ZIMMERMAN, Esq, CHINA LAW DESK BOOK: A LEGAL GUIDE FOR FOREIGN-INVESTED ENTERPRISES 1 (2004) (hereinafter China Law Desk Book).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> VARMA, *supra* note 20 at 12.

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

<sup>49</sup> ZIMMERMAN, *supra* note 44.

<sup>50</sup> VARMA, *supra* note 20 at 6.

<sup>51</sup> *Id.*

<sup>52</sup> DANIEL C. K. CHOW, A PRIMER ON FOREIGN INVESTMENT ENTERPRISES AND PROTECTION OF INTELLECTUAL PROPERTY IN CHINA, 20 (2002).

<sup>53</sup> VARMA, *supra* note 20 at 11.

<sup>54</sup> *Id.* at 23.

changes in its economic and political structures.<sup>55</sup> Although, the road has been ‘bumpy’, Deng Xiaoping’s “open-door” policy has undoubtedly yielded impressive results.<sup>56</sup> Commencing with its economic reforms in 1978, the country’s annual growth rate has been, on average, anywhere from 7% to 13%<sup>57</sup>. In several peak years, the growth rate reached unprecedented record levels up to 13 percent.<sup>58</sup>

## B. The progress of law governing FDI

The headway towards developing a legal structure for governing foreign investment started with the Chinese government enacting the first piece of legislation on foreign investment law, the Sino-Foreign Equity Joint Venture Law in 1979.<sup>59</sup> Although it was a concise piece of legislation, the Sino-Foreign Equity Joint Venture law turned out to be significant in the adoption of legislation as a *modus operandi* rather than the traditional directives of the Communist party.<sup>60</sup> The Joint Venture law set out the basic procedure for permitting foreign companies to associate with Chinese companies, approved by the Chinese government, that were in accordance with the principle of equality and mutual benefit.<sup>61</sup> The local authorities did not have any power to decide upon grant of permits.<sup>62</sup> The main industries in which foreign investment was permitted were

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<sup>55</sup> *Id.*

<sup>56</sup> VARMA, *supra* note 20 at 48.

<sup>57</sup> *Id.*

<sup>58</sup> Z. Hu & M. Khan, *Why is China Growing So Fast?* INTERNATIONAL MONETARY FUND, ECONOMIC ISSUES NO. 8 (1997), available at <http://www.imf.org/external/pubs/ft/Issues8/>, (Last Visited July 20, 2005).

<sup>59</sup> DONG (SHIZONG), ET AL., *TRADE AND INVESTMENT OPPORTUNITIES IN CHINA: THE CURRENT COMMERCIAL AND LEGAL FRAMEWORK*, 147 (1992).

<sup>60</sup> Jian Zhou, Comment, *National Treatment in Foreign Investment Law: A Comparative Study From a Chinese Perspective*, 10 *Touro Int'l L. Rev.* 39, 51 (2000).

<sup>61</sup> VARMA, *supra* note 20, at 25.

<sup>62</sup> *Id.* at 32.

listed in the Sino-Foreign Equity Joint Venture law.<sup>63</sup> It further indicated that China did not contemplate to open its entire market for foreign investment.<sup>64</sup> As mentioned earlier, China had virtually no legal structure to act as a regulatory mechanism and no codified law or regulations pertaining to foreign investment.<sup>65</sup> The most important outcome of the Equity Joint Venture law was that it laid out the skeleton for foreign investment in China's legal structure.<sup>66</sup>

Another noteworthy decision made by the Chinese government in early 1980 was the establishment of the Special Economic Zones (SEZ's) in order to attract foreign capital and to promote economic cooperation with foreign companies<sup>67</sup>. Initially, four major commercial cities, Shenzhen, Zhuhai, Shantou and Xiamen were sketched out as SEZ's<sup>68</sup>. With a view to provide internationally competitive and hassle-free environment, the Chinese government offered special preferences to both the local and foreign companies in the SEZ's.<sup>69</sup> The SEZ's were considered as "the economic laboratories to test the feasibility and effectiveness of the economic reforms".<sup>70</sup> Subsequently, the SEZ's became the symbol of success of China's economic development.<sup>71</sup> With the revival of domestic industries, China opened up fourteen coastal cities thereby providing preferential treatment to foreign companies<sup>72</sup>. The establishment of SEZ's and provision of favorable conditions for investment and preferential treatment to foreign companies proved to be major steps towards attracting foreign investment<sup>73</sup>.

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<sup>63</sup> *Id.*

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

<sup>65</sup> KUI HUA WANG, CHINESE COMMERCIAL LAW 3.1.1, at 84 & n.5 (2000).

<sup>66</sup> VARMA, *supra* note 20, at 33

<sup>67</sup> *Id.* at 35.

<sup>68</sup> *Id.*

<sup>69</sup> GUIGUO WANG, BUSINESS LAW OF CHINA 23 (1993).

<sup>70</sup> SHIZONG, *supra* note 56, at 17.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

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

The Chinese government also enacted the Provisional Regulations on Foreign Exchange Control of the People's Republic of China (PRFEC) in 1980 to regulate foreign exchange transactions and to increase foreign exchange receipts<sup>74</sup>. Projects that would generate foreign exchange were given top priority.<sup>75</sup> This preferential treatment encouraged foreign investment and resulted in increased foreign exchange transactions<sup>76</sup>.

In 1982, the Chinese government recognized the positive effect of FDI on its economy and took a further important initiative to protect foreign investment.<sup>77</sup> The Chinese government amended its Constitution for allowing the foreign investors "to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other economic organizations in accordance with the laws of China".<sup>78</sup> The Constitution further provided that the "lawful rights and interests of foreign investors are protected".<sup>79</sup> It was yet another revolutionary step in building up a legal framework for foreign investment.

The enactment of Foreign Economic Contract Law of the People's Republic of China (FECL) in 1985 marked a remarkable progress in the law governing foreign investment in China<sup>80</sup>. The Chinese government adopted FECL in an attempt to make foreign investors more comfortable in making contracts with the Chinese companies.<sup>81</sup> All economic contracts between Chinese and foreign enterprises were governed by the FECL.<sup>82</sup> Important elements of a contract

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<sup>74</sup> VARMA, *supra* note 20, at 35.

<sup>75</sup> Deng Jianqin, *The Development and Impacts of Foreign Direct Investment in China*, GUOJI JINGJI HEZUO (INT'L ECO.). COOP.) No. 1 1996, at 17.

<sup>76</sup> *Id.*

<sup>77</sup> Daniel J. Brink & Xiao Lin Li, *A Legal And Practical Overview of Direct Investment And Joint Ventures in the "New" China*, 28 J. Marshall L. Rev. 569 (1995).

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> Mark C. Lewis, *Contract Law in the People's Republic of China-Rule or Tool: Can the PRC's Foreign Economic Contract Law be Administered According to the Rule of Law?*, 30 Vand. J. Transnat'l 508 (1997).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

such as the form and choice of law were included in FECL.<sup>83</sup> Thus, FECL assured the legality of the economic contracts entered into by the foreign investors.<sup>84</sup>

One of the major inclusions in China's legal structure for foreign investment was the creation of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). MOFTEC is responsible for the "administration of China's foreign trade and economic cooperation".<sup>85</sup> The primary duty of MOFTEC includes formulation of guidelines, policies, laws, regulations, reform plans and methods for administration in the foreign economic and trade sectors.<sup>86</sup> MOFTEC is also responsible for compiling the "Catalogue for The Guidance of Foreign Investment Industries" ("Catalogue"), which provides a clear roadmap to the foreign investment policy of China.<sup>87</sup>

Although statistics indicate that FDI flows into China have continued to increase annually, the growth was not achieved without any problems. Investors constantly predicated that the legal structure was "uncertain, risky and mired in red tape".<sup>88</sup> "There 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>89</sup> Thus, despite the formulation of basic laws for regulating the intricacies of FDI transactions, the actual implementation of the laws to facilitate

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<sup>83</sup> SHIZHONG, *supra* note 56 at 138.

<sup>84</sup> LEWIS, *supra* note 74.

<sup>85</sup> China Ministry of Foreign Trade & Economic Cooperation, *Information About MOFTEC* available at <http://www.chinaproject.de/Verbaende/MOFTEC.htm> (Last Visited June 17, 2005)

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> CHUANG, *supra* note 38, at 509, 510.

<sup>89</sup> *Id.*

investment lagged.<sup>90</sup> Notably, the different set of rules and regulations governing FDI resulted in confusion and inconsistency in the legal framework governing FDI in China.<sup>91</sup>

In a country where the Rule of Law was virtually absent, the constitutionality of unauthorized legislations affecting the rights of the foreign investors was never challenged until amendment of the new constitutional provision in 1993.<sup>92</sup> Article 15 of the 1982 Constitution was thus amended, thereby revoking the existing “planned-economy” and adopting a “socialist market economy”.<sup>93</sup> The Amendment pushed the economic reform forward, reflecting China’s departure from a very cautious and conservative economy and its move towards a market oriented economy.<sup>94</sup>

### C. Overview of the Current Legal Framework of FDI

China’s legal structure governing FDI has changed drastically in the past twenty-six years of reform and opening.<sup>95</sup> The legal sources of FDI law in China are multifarious and complex.<sup>96</sup> They are interwoven with constitutional directives, a vast number of national as well as local laws and implementation regulations. The role of Constitution is fundamental to any legal system. Democratic countries like the U.S and India generally consider their Constitutions as the supreme law of the land.<sup>97</sup> Evolving in a communist environment, the Constitution in China does not bear the same consideration.<sup>98</sup> China has adopted a continental legal system model that is

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> ZHOU, *supra* note 60, at 67.

<sup>93</sup> *Id.* at 68.

<sup>94</sup> *Id.*

<sup>95</sup> WANG, *supra* note 65.

<sup>96</sup> VARMA, *supra* note 20 at 57.

<sup>97</sup> *Id.* at 35.

<sup>98</sup> *Id.*

very different from the common law system.<sup>99</sup> In a common law system, court decisions are considered as binding precedential law, whereas, in a continental legal system, court decisions have no binding precedential value as well as no legal reasoning whatsoever.<sup>100</sup>

## 1. Constitution and the Legal System

The current Constitution promulgated in 1982 is acknowledged as the most comprehensive of all China's constitutions.<sup>101</sup> As mentioned earlier, the 1982 Constitution of China provides the following directive regarding foreign investment: "that the State shall allow the foreign investors to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other economic organizations in accordance with the laws of China".<sup>102</sup> The amendment also provided that the "lawful rights and interests of foreign investors shall be protected".<sup>103</sup> Furthermore, the 1982 Constitution brushed off the extremist policies of the communist regime reflected in the earlier versions and introduced "the authority of law as the fundamental law of the state".<sup>104</sup>

Unlike in the case of most other nations, the Constitution in China does not explicitly set out the structure and power of the Chinese state.<sup>105</sup> A brief review of the Chinese Constitution gives an impression that the political structure is in the form of a "pyramid" in which power is transferred from the general population granting authority upwards by electing representatives of the local government who in turn elect the representatives of the national government.<sup>106</sup>

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<sup>99</sup> DANIEL C.K. CHOW, *THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA* 211 (2003).

<sup>100</sup> *Id.* at 212.

<sup>101</sup> Daniel J. Brink & Xiao Lin Li, *A Legal And Practical Overview of Direct Investment And Joint Ventures in the "New" China*, 28 J. Marshall L. Rev, 569 (1995).

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> VARMA, *supra* note 20, at 45.

<sup>105</sup> CHOW, *supra* note 99 at 68.

<sup>106</sup> *Id.*

However, in reality, the power rests with a political party - a non-government organ called the Communist Party.<sup>107</sup> Neither the Constitution nor any other legal document in China specifies the plain role and powers of the Communist Party.<sup>108</sup> The extent of actual participation of the Communist Party in the business of political functioning is not transparent.<sup>109</sup>

Under Article 123 of the Chinese Constitution, the people's courts are the judicial organs of the state and are vested with the state's adjudicative powers.<sup>110</sup> The three-tier court system includes the Basic People's Courts in provinces, Intermediate People's Courts in autonomous regions followed by High People's Courts in the four cities.<sup>111</sup> The Supreme People's Court located in Beijing is the highest level of court in China's court structure.<sup>112</sup>

"Independence of judiciary" is explicitly specified in Article 126 of the Constitution which provides that the "people's courts exercise judicial power independently, in accordance with the provisions of the law, and are not subject to interference by any administrative organ, public organization or individual".<sup>113</sup> In addition, the "rule of law", a reportedly western concept was incorporated for the first time in Article 5 of the 1999 amendments to the Chinese Constitution, which provided that "China shall be governed according to the rule of law and shall be built into a socialist country based upon the rule of law".<sup>114</sup> Interestingly, researchers and scholars in China have noted that "Independence of Judiciary" in the Chinese context varies from the notion as held in other modern legal systems.<sup>115</sup>

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

<sup>108</sup> VARMA, *supra* note 20, at 48.

<sup>109</sup> *Id.*

<sup>110</sup> CHOW, *supra* note 99, at 125.

<sup>111</sup> *Id.* at 200.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 196.

<sup>114</sup> *Id.* at 78.

<sup>115</sup> *Id.* at 217.

Unlike many other legal systems in which the judicial branch is a co-equal branch of government, the people's courts in China are subordinate to the people's congresses at each level.<sup>116</sup> The Supreme People's Court is required by the Constitution to report on its work to the National People's Congress and the lower level courts are responsible to the organs of state power that created them.<sup>117</sup> The Constitution also provides that the national government shall supervise the work of the Supreme People's Court,<sup>118</sup> however, it does not define the supervisory authority of the national government.<sup>119</sup> Apparently, the administrative organs are considerably involved in the work of the courts.<sup>120</sup>

Apart from the influence of the government organs in the judiciary, the Communist Party also exercises influence over it.<sup>121</sup> The central level political-legal committee and several provincial level political-legal committees established by the Communist Party are involved in the work of the courts.<sup>122</sup> The degree of indulgence by the political-legal committees in the business of the courts has been changing over the years.<sup>123</sup> Initially, the political-legal committees exercised enormous authority in the courts by issuing instructions on how to decide cases.<sup>124</sup> In recent years, the Communist Party only sets out the overall policy guidelines to be adhered by the courts in deciding cases.<sup>125</sup> However, the Communist Party is also involved in the appointment of judges and other judicial personnel.<sup>126</sup> In addition, the Party exercises continuing influence in the work of the courts by "issuing normative documents that become part of the

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<sup>116</sup> *Id* at 195.

<sup>117</sup> *Id.*

<sup>118</sup> *Id* at 196.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> VARMA, *supra* note 20, at 68

<sup>122</sup> *Id.*

<sup>123</sup> CHOW *supra* note 99, at 198.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id* at 199.

internal handbook for judges”.<sup>127</sup> The foregoing facts raise doubts concerning procedural fairness and the rule of law even under an expanded notion of “judicial independence” by the Chinese Scholars.<sup>128</sup>

## 2. Foreign Investment Regime

Since 1979, the Chinese Government’s FDI policies have been major criteria for attracting huge amounts of foreign investment.<sup>129</sup> The framework of FDI policies they put in place was directed by the desire for a rapid economic growth.<sup>130</sup> As a result, the investment climate has opened up gradually.<sup>131</sup> China became a member of the World Trade Organization (WTO) on December 11, 2001.<sup>132</sup> China’s accession to the WTO has obligated the Chinese government to eliminate certain trade-related investment restrictions.<sup>133</sup> Accordingly, new laws and implementation regulations have been issued at a rapid pace.<sup>134</sup>

In the Chinese legal system, business undertakings for FDI are treated as special legal entities.<sup>135</sup> Consequently, FDI undertakings are distinguished from domestic undertakings that are governed under special provisions.<sup>136</sup> The Chinese Constitution vests the central-level legislative power with the National Government.<sup>137</sup> Currently, there are more than two hundred laws and regulations governing FDI at the national level.<sup>138</sup> The region-level legislative power is

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<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 218.

<sup>129</sup> *See* VARMA, *supra* note 20, at 21.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *See* CHOW, *supra* note 99, at 449.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *See* VARMA, *supra* note 20, at 43.

<sup>137</sup> *Id.* at 58.

<sup>138</sup> WANG, *supra* note 65, at 83 & n.1

vested with the provincial government.<sup>139</sup> Hence, a large number of local regulations enacted by the provincial governments also contribute in making the Chinese FDI system more comprehensive.<sup>140</sup> There is no uniform set of laws and regulations that govern the various types of FDI in China.<sup>141</sup> Each form is subject to its own set of laws and regulations.<sup>142</sup>

### **a. Principal Forms of Investment**

The main types of investment vehicles available to foreign investors are (i) Equity Joint Ventures (EJV)<sup>143</sup>, (ii) Contractual Joint Ventures (CJV)<sup>144</sup>, (iii) Wholly Foreign Owned Enterprises (WFOE)<sup>145</sup>, (iv) Holding Companies<sup>146</sup>, (v) Mergers and Acquisitions (M & A)<sup>147</sup> and (vi) Representative Offices.<sup>148</sup> Foreign Investors generally opt for a corporate form that appears similar to that in their native country.

#### **(i) Equity Joint Ventures (EJVs)**

In the Chinese legal system, a Joint Venture is generally defined as a business venture that is formed by a combination of two or more business entities into a third entity.<sup>149</sup> Of the various types of FDI in China, EJVs are the most preferred form by the foreign investors.<sup>150</sup> Consequently, the legal framework governing Equity Joint Ventures are more rigidly structured than any other form of FDI.<sup>151</sup>

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<sup>139</sup> VARMA, *supra* note 20, at 45.

<sup>140</sup> WANG, *supra* note 65.

<sup>141</sup> *Id.*

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

<sup>143</sup> *See* ZHOU, *supra* note 60, at 73.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *See* CHOW, *supra* note 99, at 370.

<sup>150</sup> 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. 474 (1995).

<sup>151</sup> *Id.*

China has published a substantial body of laws governing EJVs.

The important ones include Sino-Foreign EJV Law<sup>152</sup> (“EJV Law”) and Sino-Foreign EJV Law Implementing Regulations (“EJV Regulations”).<sup>153</sup> Under EJV law, an EJV is required to be registered as a Chinese legal person thereby taking the form of a limited liability company.<sup>154</sup> An EJV is created by agreements between Chinese investors and foreign investors.<sup>155</sup>

The EJV Law was basically designed to attract foreign investment and technical know-how<sup>156</sup>. EJVs were required to promote the development of China’s economy and to comply with at least one of the following four conditions: (1) adoption of advanced technical equipment and scientific management; (2) promotion of the technical renovation of enterprises; (3) production of export-oriented products; or (4) training of technical and managerial personnel.<sup>157</sup>

However, the Chinese government amended the EJV Law and the EJV Regulations in 2001, forecasting its accession to the WTO and in accordance with its commitments to conform to international standards.<sup>158</sup> Significant changes to the EJV Law include the removal of the requirement to use advanced technology in manufacturing goods.<sup>159</sup> The amendment also deleted the provision 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>160</sup>

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<sup>152</sup> See Equity Joint Venture Law of the People’s Republic of China, adopted by the 2<sup>nd</sup> Session of the 5<sup>th</sup> National People’s Congress on July 1, 1979. Amended on April 4, 1990, 1 CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶ 7, 801.

<sup>153</sup> See Regulations for the Implementation of the Equity Joint Venture Law of the People’s Republic of China, promulgated by the State Council on September 20, 1983. Article 100 was amended by the State Council on January 15, 1986, 1 CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶ 6-550.

<sup>154</sup> See EJV Law, *supra* note 144, at 7803.

<sup>155</sup> *Id.*

<sup>156</sup> See EJV Regulations, *supra* note 145, at 7913.

<sup>157</sup> *Id.*

<sup>158</sup> See EJV Law, *supra* note 152.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

Instead, it allowed sourcing from international market on the condition that the “procurement process is done in a manner that effectuates probity and impartiality”.<sup>161</sup> The revision further provided that an EJV can purchase its insurance plans from the insurance companies located in the territory where the EJV is functioning instead of from “Chinese insurance companies”.<sup>162</sup> All these changes provide better investment climate to potential foreign investors.

The other prominent features that apply to EJVs are (1) “the foreign investor must not contribute less than 25 percent of the venture’s registered capital<sup>163</sup>;(2) an EJV is required to distribute its profits and losses in proportion to the capital contributions of each of the joint venture partners<sup>164</sup>; (3) an EJV cannot reduce its capital after registration<sup>165</sup>; (4) a repayment of capital is considered as a reduction in the capital of the EJV, an action needing prior approval of the government<sup>166</sup>; (5) Similarly, an increase in the registered capital also requires approval of the EJVs Board of Directors and also by the examination and approving authority<sup>167</sup>; (6) if either of the party decides to transfer any portion of its registered capital, such transfer must be consented to by the other party and also approved by the examination and approval authority.<sup>168</sup>

***Monitoring and Screening of EJVs:*** Before establishing an EJV, it must be approved by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the relevant local authorities.<sup>169</sup> Each administrative level of the government has the authority to approve FDI projects.<sup>170</sup> The EJV law and EJV Regulations govern the establishment of an EJV.<sup>171</sup>

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<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> See WANG, *supra* note 46, at 95.

<sup>164</sup> See CHOW, *supra* note 99 at 372.

<sup>165</sup> Stephen C. Curley & Darren R. Fortunato, *Tax Considerations for Investors in China: A Preliminary Look*, 20 N.C.J. INT’L L. & COM. REG. 534 (1995).

<sup>166</sup> See EJV Law, *supra* note 152, at art. 4

<sup>167</sup> See Curley & Fortunato, *supra* note 154.

<sup>168</sup> See EJV Law, *supra* note 152, at art. 23.

<sup>169</sup> See HUANG, *supra* note 150, at 475.

<sup>170</sup> *Id.*

The EJV Regulations provide that the Chinese partner is obligated for submitting all required documents for the EJV approval process. The required materials are: (1) an application for the establishment of the EJV; (2) a EJV agreement and articles of association signed by agents of the proposed venture; (3) a feasibility study jointly prepared by the parties; (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 persons appointed by the parties to the board of directors of the joint venture, including the chairman and vice chairman of the board; and (7) various written opinions by local government agencies for the jurisdiction where the proposed EJV is to be established.<sup>172</sup>

The preliminary approval process is conducted by the authorized local authorities to ensure that the EJV project is economically viable.<sup>173</sup> Upon approval of the EJV project by local authorities, the Chinese party must then submit the formal EJV application and accompanying documents to MOFTEC.<sup>174</sup> The examining authorities will have three months from the date of the receipt of the formal application to make a decision on the approval.<sup>175</sup> However, the examining authorities could extend the approval time for administrative reasons.<sup>176</sup> Upon approval, an approval certificate will be issued to the parties.<sup>177</sup>

The examining authorities may also refuse to approve an EJV project if it does not meet the basic criterion for approval. The general reasons for rejection are (1) the proposed EJV project would be “detrimental to China’s Sovereignty”;<sup>178</sup> (2) “non-conformity with the

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<sup>171</sup> *Id* at 474.

<sup>172</sup> *Id* at 475.

<sup>173</sup> *See* CHOW, *supra* note 52, at 55.

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> *See* WANG, *supra* note 65, at 100.

<sup>177</sup> *See* CHOW, *supra*.note 52, at 55.

<sup>178</sup> *See* WANG, *supra* note 65, at 108-09

requirements for the development of China’s national economy”;<sup>179</sup> (3) the proposed EJV project “is in violation of Chinese law”;<sup>180</sup> (4) apprehension of environmental pollution due to the activities of the proposed EJV enterprise;<sup>181</sup> (5) the EJV agreement between the Chinese party and foreign party is “unconscionable”<sup>182</sup>.

Upon receipt of approval certificate from MOFTEC, the parties are required to submit the Approval Certificate to the appropriate level of the Administrative Bureau of Industry and Commerce (AIC) within one month to receive a business license.<sup>183</sup> AIC is the regulatory authority for both foreign enterprises and domestic enterprises.<sup>184</sup> If there are no irregularities in obtaining the approval certificate, a business license is usually easily approved.<sup>185</sup> The EJV thus comes into existence as a legal entity on the day of issuance of the business license and it begins to enjoy the protection of Chinese laws.<sup>186</sup> In all, the process takes six to twelve months from the beginning till obtaining a business license.<sup>187</sup>

The stipulation of a specific term in the contract is required for certain types of EJVs.<sup>188</sup> Extension of the stipulated term is subject to approval of the examining authorities.<sup>189</sup> An EJV could be wound up before the stipulated term in case of heavy losses, force majeure, or failure of a party to fulfill its obligations under the contract or articles of association by an agreement of the parties after obtaining approval for termination from the examining authorities.<sup>190</sup>

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<sup>179</sup> *Id* at 109.

<sup>180</sup> *Id.*

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

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

<sup>183</sup> *See* CHOW, *supra* note 52 at 55.

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

<sup>185</sup> *Id.*

<sup>186</sup> *See* EJV Regulations, *supra* note 148, at Art. 10.

<sup>187</sup> *See* HUANG, *supra* note 150, at 475.

<sup>188</sup> *See* EJV Law, *supra* note 152, at art.12.

<sup>189</sup> *Id.*

<sup>190</sup> *Id.*

Because an EJV is the most popular mode of FDI in China, there are procedural advantages in its establishment than any other form of FDI.

**(ii) Contractual Joint Ventures (CJVs)**

A CJV is a business venture whereby the Chinese and foreign parties co-operate in joint projects and activities according to the terms and conditions stipulated in a Joint Venture Agreement.<sup>191</sup> CJV's are also known as "Co-operative Joint Ventures".<sup>192</sup> CJVs are governed by the Contractual Joint Venture Law<sup>193</sup> (CJV Law) and Contractual Joint Venture Law Implementing Rules<sup>194</sup> (CJV Rules).

CJVs are popular for their flexibility in structure compared with EJVs.<sup>195</sup> Unlike EJVs, CJVs do not have restrictions in the initial financing of the joint venture.<sup>196</sup> Also, CJVs do not have to necessarily take the form of a limited liability company.<sup>197</sup> They have an option to take the form of various corporate structures such as a partnership, contractual relationship or limited liability company.<sup>198</sup> The CJV law requires that a CJV agreement must specify (1) conditions for cooperation<sup>199</sup>; (2) the distribution of profits or products<sup>200</sup>; (3) the sharing of risks and losses<sup>201</sup>;

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<sup>191</sup> GRUB & LIN, FOREIGN DIRECT INVESTMENT IN CHINA 67 (1991).

<sup>192</sup> *Id.*

<sup>193</sup> The Law on Contractual Joint Venture of the People's Republic, adopted by the 1<sup>st</sup> Session of the 8<sup>th</sup> NPC and promulgated by the President of China on April 13, 1988, 1 CHINA L. FOR. FOREIGN BUS.: BUS. REG. ¶ 6-100 (CJV Law)

<sup>194</sup> Regulations for the Implementation of the Law of Sino-Foreign Contractual Joint Venture of the People's Republic of China, reprinted in 1 CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶ 6-105 (CJV Rules).

<sup>195</sup> See Chow, *supra* note 99 at 372.

<sup>196</sup> *Id.* at art.43.

<sup>197</sup> *Id.* at art.4.

<sup>198</sup> *Id.*

<sup>199</sup> See CJV Law, *supra* note 193, at art.2

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

<sup>201</sup> *Id.*

(4) the management structures<sup>202</sup>; (5) ownership of the property at the time of termination of the CJV<sup>203</sup>. Management issues of CJVs are almost similar to those of EJV<sup>204</sup>.

The other prominent features of CJVs are (1) the form of investment contributed by the foreign party and Chinese party may include cash, right to use the land, industrial property rights, non-patent technology, or other property rights<sup>205</sup> (2) the parties to the CJV can determine the manner of sharing profits and losses as they choose<sup>206</sup> (3) the foreign investor of a CJV can recover his full investment during initial period of a CJV's operation by fulfilling a condition that all fixed assets of the CJV will be reverted to the Chinese partner upon termination of the CJV.<sup>207</sup>

CJVs are generally subject to similar requirements as EJV<sup>208</sup> for their establishment and approval.<sup>208</sup> A CJV may either register as a partnership or register its contract with the AIC.<sup>209</sup> Thus, in many respects CJV offers much more flexibility in setting up, operating as well as terminating the business enterprise.<sup>210</sup> Despite the flexibility, CJVs have never been a popular mode of FDI in China.<sup>211</sup> The passive trend could be attributed to some initial confusion relating to CJVs and a general positive opinion of foreign investors towards EJV<sup>212</sup> that they are well structured, predictable and certain.

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<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> *See* CHOW, *supra* note 99, at 372.

<sup>205</sup> *See* CJV Law, *supra* note 193, at 7553.

<sup>206</sup> *See* CJV Rules, *supra* note 194, at art. 43.

<sup>207</sup> *Id.* at art 44.

<sup>208</sup> *Id.*

<sup>209</sup> *Id.* at art 51, 52, 53.

<sup>210</sup> *See* CHOW, *supra* note 99, at 372.

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*

### (iii) Wholly Foreign-Owned Enterprises

As the name suggests, a foreign investor could establish a WFOE independently under Chinese law without a Chinese partner, and own the business enterprise completely unlike Joint Ventures.<sup>213</sup> WFOEs are governed by the Wholly Foreign-Owned Enterprise Law<sup>214</sup> (WFOE Law), Wholly Foreign-Owned Enterprise Law Implementing Rules<sup>215</sup> (WFOE Rules) and the Interpretations of Various Provisions of the Wholly Foreign-Owned Enterprise Law Implementing Rules<sup>216</sup> (WFOE Interpretations).

WFOEs generally take the form of a limited liability company, but may register as another form by obtaining special approval.<sup>217</sup> WFOEs possess corporate characteristics such as perpetual succession, centralized management and freely transferable interests.<sup>218</sup> They also have the freedom to follow the same corporate ideology as the parent corporation.<sup>219</sup> Disputes between a WFOE and a Chinese enterprise are subject to Chinese law.<sup>220</sup>

Like EJVs, WFOEs were required to use advanced technology, maintain their balance of foreign exchange receipts and expenditures, develop new products or export at least 50% of its products each year<sup>221</sup> prior to the 2001 amendments.<sup>222</sup> The Chinese government revised the WFOE Rules in 2001 thereby deleting the technology and export requirements in accordance

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<sup>213</sup> Gary J. Darnelle, *Direct Foreign Investment and Contractual Relations in the People's Republic of China*, 6 DePaul Bus. L.J. 331, 339 (1994).

<sup>214</sup> The Wholly Foreign-Owned Enterprise Law of the People's Republic of China, adopted by the 4<sup>th</sup> Session of the 6<sup>th</sup> NPC and promulgated by the President of China on April 12, 1986, 2 China L. for Foreign Bus. Reg. (CCH) ¶ 13-506. (WFOE Law).

<sup>215</sup> Detailed Rules for the Implementation of the Law of the People's Republic of China on Sole Foreign Investment Enterprises, Act of Oct. 28, 1990, art. 3, 2 China L. for Foreign Bus. Reg. (CCH) ¶ 13-507. (WFOE Rules)

<sup>216</sup> See CHOW, *supra* note 99, at 389.

<sup>217</sup> See WFOE Rules, *supra* note 215.

<sup>218</sup> 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 (1995).

<sup>219</sup> WEI JIA, CHINESE FOREIGN INVESTMENT LAWS AND POLICIES: EVOLUTION AND TRANSFORMATION 35 (1994).

<sup>220</sup> See WFOE Law, *supra* note 214, at art. 2

<sup>221</sup> See CHOW, *supra* note 99, at 390.

<sup>222</sup> "Decisions on Amendments to the Implementation Rules of the Law on Wholly Foreign-Owned Enterprises," issued by the State Council on April 23, 2001.

with their WTO commitments.<sup>223</sup> The current criterion specified for approving WFOEs is “the establishment of WFOEs must benefit the Chinese national economy”.<sup>224</sup> In the same vein, the Chinese government also specified that it encouraged “the establishment of technologically advanced WFOEs”.<sup>225</sup> It is not explicit whether the requirement of advanced technology is absolute for approval.<sup>226</sup> However, the restructuring of the legal framework governing WFOEs generally resulted in a drastic increase of FDI through WFOEs thereby fostering positive investor sentiment.<sup>227</sup>

***Monitoring and Screening of WFOEs:*** The approval and registration process for establishing WFOEs is similar to that for joint ventures.<sup>228</sup> However, the approval process for a WFOE is stricter compared to Equity and Contractual Joint ventures.<sup>229</sup> WFOE projects are approved by administrative authorities at different levels based on the sum of the investment.<sup>230</sup> The approval process starts with the foreign investor applying to the local government where the WFOE will be located.<sup>231</sup> The criterion for approval is based on two aspects: (1) whether the project is “economically viable”<sup>232</sup> and (2) whether the project will be “beneficial to the economy”<sup>233</sup>. Upon approval of the preliminary application, the foreign investor is required to apply for final approval.<sup>234</sup>

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<sup>223</sup> *Id.*

<sup>224</sup> *Id.* at art. 3.

<sup>225</sup> *Id.*

<sup>226</sup> *See* CHOW, *supra* note 99, at 390.

<sup>227</sup> *Id.*

<sup>228</sup> *Id.* at 391.

<sup>229</sup> *See* WANG, *supra* note 65, at 131.

<sup>230</sup> *See* CHOW, *supra* note 99, at 391.

<sup>231</sup> *See* WANG, *supra* note 65, at 131.

<sup>232</sup> *See* CHOW, *supra* note 99, at 392.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

The final approval process requires extensive documentation: (1) an application for the establishment of a WFOE<sup>235</sup>; (2) a feasibility study;<sup>236</sup> (3) articles of association of the enterprise;<sup>237</sup> (4) a list including name of the legal representative or the names of the board of directors of the enterprise;<sup>238</sup> (5) a legal certificate and evidence of the foreign investor's credit standing;<sup>239</sup> (6) the preliminary approval certificate;<sup>240</sup> (7) a list of materials needed to be imported;<sup>241</sup> (7) other relevant documents.<sup>242</sup>

The application comprises details such as: (1) "the purpose, scope and scale of operation";<sup>243</sup> (2) Nature of products and type of technology to be used;<sup>244</sup> (3) Size and location of the land<sup>245</sup>; (4) percentage of the expected production;<sup>246</sup> (5) specification of raw materials to be used for manufacture;<sup>247</sup> (6) foreign exchange balancing scheme<sup>248</sup>; (7) a report on employee hiring, wages and benefits<sup>249</sup>; (7) an assessment of environmental impact of the enterprises' operations;<sup>250</sup> (8) specific term of the enterprise.<sup>251</sup> Authorities issue the approval certificate or deny approval within ninety days from the date of the submission of the application.<sup>252</sup>

Upon approval by MOFTEC, the foreign investor must apply to AIC for a business license.<sup>253</sup> The enterprise must register with the local tax authorities within thirty days of

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<sup>235</sup> See WFOE Rules, *supra* note 215, art.10.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*

<sup>242</sup> *Id.*

<sup>243</sup> See WFOE Rules, *supra* note 215, art.14.

<sup>244</sup> *Id.*

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

<sup>246</sup> *Id.*

<sup>247</sup> *Id.*

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

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

<sup>252</sup> *Id.* at art.11

<sup>253</sup> See HUANG, *supra* note 150, at 479.

receiving the license.<sup>254</sup> It must be noted that the sum of registered capital must correspond with the scale and scope of operations.<sup>255</sup>

WFOEs were initiated as experimental ventures in the Special Economic Zones and gained immense popularity after the 2001 revision of the WFOE Regulations.<sup>256</sup> Remarkably, the Chinese government may not nationalize WFOEs.<sup>257</sup> Furthermore, they enjoy complete protection of the investment, repatriation of profits from the investment, and protection of rights and interests of the foreign investor under Chinese law.<sup>258</sup>

#### (iv) Holding Companies

Holding Companies are also referred to as “Investment-Oriented Enterprises”.<sup>259</sup> EJVs, CJVs and WFOEs that have “special scope of business clauses” are allowed to establish Holding Companies if they meet certain requirements.<sup>260</sup> “The Holding Companies act as the equity holder and foreign investor in each of the TNC’s joint ventures or WFOEs”.<sup>261</sup> The laws governing Holding Companies are the Tentative Provisions on the Establishment of Companies with an Investment Nature<sup>262</sup>, Explanation on Questions Relating to Tentative Provisions on the Establishment of Companies with an Investment Nature<sup>263</sup> and the Opinion on Directing the Examination and Approvals of Foreign-Invested Enterprises.<sup>264</sup>

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<sup>254</sup> *Id.*

<sup>255</sup> *Id.*

<sup>256</sup> Gene Linn, *More Foreign Investors Go It Alone in China*, J. COM. Oct. 9, 1998, at 4A.

<sup>257</sup> See WFOE Law, *supra* note 214, at 16,651.

<sup>258</sup> CHANG HUNG TAI, *INVESTMENT FACTORS IN CHINA’S INTERNATIONAL TRANSACTIONS: TRADE AND INVESTMENT* 19 (2000).

<sup>259</sup> See ZHOU, *supra* note 60, at 81.

<sup>260</sup> *Id.*

<sup>261</sup> See CHOW, *supra* note 99, at 397.

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> *Id.* at 398.

In order to be eligible for establishing Holding Companies, the investing companies must have (1) total assets of at least USD 400 million in the preceding year of the application;<sup>265</sup> (2) an aggregate registered capital of at least USD 10 million and have a three or more approved investment projects in China.<sup>266</sup>

In the light of these high requirements, most foreign investors are excluded from establishing Holding Companies.<sup>267</sup> U.S based TNC's such as Coca-cola, IBM and AT&T with huge investments have preferred Holding Companies for expanding their business in China.<sup>268</sup>

#### (v) Mergers & Acquisitions

M&As have become a key component of the recent surge of investment into China.<sup>269</sup> In its initial period, the Chinese law had no clear provisions for an M&A activity<sup>270</sup>. As a result, there existed ambiguity even in the most basic corporate restructuring of the enterprises.<sup>271</sup> In March 2003, China issued new M&A regulations permitting foreign investors to either purchase the shares of a domestic company or subscribe to newly issued shares of a domestic company<sup>272</sup>. The M&A regulations offer foreign investors a legal basis for the acquisition of assets and equity interests in the domestic companies.<sup>273</sup> The M&A regulations further provide that all M&A activities shall comply with the laws, rules and regulations of China on investor qualifications

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<sup>265</sup> The Provisional Regulations on Investment-Oriented Companies in China Established by Foreign Businesses, promulgated by MOFTEC on April 4, 1995, 2 CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶ 13- 400, art.2.

<sup>266</sup> *Id.* at art.4.

<sup>267</sup> See ZHOU, *supra* note 60, at 82.

<sup>268</sup> *Id.*

<sup>269</sup> HOWARD CHO, *CHINA TO SEE FEWER NEW PROJECTS BUT MORE M&A*, 21 NAT'L L. J. No.27, (1998).

<sup>270</sup> See VARMA, *supra* note 20, at 148.

<sup>271</sup> *Id.*

<sup>272</sup> Foreign M&A Regulations Regarding Foreign Investors' Merger with or Acquisition of Domestic Enterprises, jointly issued on March 7, 2003, by the Ministry of Foreign Trade and Economic Cooperation, the State Taxation General Office, the State Administration of Industry and Commerce, CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶, 13-625.

<sup>273</sup> See China Law Desk Book, *supra* note 44, at 788.

and industrial policies.<sup>274</sup> Thus, the approval process for acquisition of a Chinese or a foreign investment enterprise by a foreign investor involves the same cumbersome procedure as that of establishing a new foreign investment enterprise<sup>275</sup>.

As companies increasingly restructure their organization to meet the challenges of WTO and react quickly to the increasing competition, more and more of them are looking at M&A as a vehicle to finance their business development.<sup>276</sup> China has so far been liberal in approving most of the M&A projects.<sup>277</sup> By opting for an M&A method, foreign investors could bypass number of hassles such as avoiding lengthy application procedure, avoiding huge investment in human resources and transfer of technology compared to the other methods.<sup>278</sup> In light of the significant advantages, majority of American Investors favor M&A method of FDI.<sup>279</sup>

#### (vi) Representative Offices

Foreign Investors could also establish their presence in China by establishing a Representative Office<sup>280</sup>. Depending upon their nature of business, foreign investors should either get the approval for establishment from MOFTEC or other relevant authorities<sup>281</sup>. Upon approval, foreign investors should register the Office with AIC.<sup>282</sup> The representative offices can start their business operations after obtaining the business license.<sup>283</sup> Unlike the other

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<sup>274</sup> See M&A Regulations, *supra* note 273, art.4.

<sup>275</sup> See ZHOU, *supra* note 60 at 81.

<sup>276</sup> See VARMA, *supra* note 20, at 154.

<sup>277</sup> *Id.*

<sup>278</sup> *Id.* at 80.

<sup>279</sup> The U.S-China Business Council, *Foreign Investment in China*, available at [http://www.uschina.org/statistics/2005foreigninvestment\\_2.html](http://www.uschina.org/statistics/2005foreigninvestment_2.html), (last visited, Aug 9, 2005).

<sup>280</sup> See HUANG, *supra* note 150, at 480.

<sup>281</sup> Interim Regulations of the State Council of the People's Republic of China Concerning the Control of Resident Representative Offices of Foreign Enterprises, Act of Oct. 30, 1980, art. 4, 1 China L. for foreign Bus. Reg. (CCH) ¶ 7-500, at 9051 (hereinafter Interim Regulations).

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

mechanisms of FDI, Representative Offices do not have initial capital requirement.<sup>284</sup> However, they are required to confine their activities to promotion of their business to get a “feel” of the market or act as a channel on behalf of the parent company.<sup>285</sup> They are prohibited from engaging in any sort of “profit-making activities”.<sup>286</sup>

## **b. Sector Classification**

China regulates the direction of FDIs into China by enacting the Catalogue for Guiding Foreign Investment in Industries (“Investment Catalogue”).<sup>287</sup> The purpose of the Investment Catalogue is to “guide foreign investment, adapt foreign investments to China’s national economic and social development plan”.<sup>288</sup>

The Investment Catalogue provides a comprehensive road map to the industrial sectors in China and also provides insights into the areas of FDI growth in China.<sup>289</sup> Specifically, it sets out three categories for projects involving foreign investments in China: encouraged, restricted and prohibited.<sup>290</sup> Projects not included in the Investment Catalogue are considered permitted.<sup>291</sup> Sectors involving advanced technology or expansion of the overseas market are encompassed in the encouraged category<sup>292</sup>. On the other hand, if the projects do not conform to China’s “national economic and social development plan”, they are either restricted or prohibited.<sup>293</sup>

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<sup>284</sup> See HUANG, *supra* note 150, at 480.

<sup>285</sup> See Interim Regulations, *supra* note 281.

<sup>286</sup> *Id.*

<sup>287</sup> See WaiShang TouZi ChanYe ZhiDao MuLu, *Guide Catalogue of Industries for Foreign Investment*, promulgated on Dec. 29, 2000.

<sup>288</sup> See ZhiDao WaiShang TouZi FangXiang ZanXiang GuiDang, *Interim Provisions for Foreign Investment*, promulgated on June 20, 1995, art. 1.(Interim Provisions)

<sup>289</sup> See U.S-China Business Council, *supra* note 279.

<sup>290</sup> *Id.*

<sup>291</sup> *Id.*

<sup>292</sup> See VARMA, *supra* note 20, at 72.

<sup>293</sup> *Id.*

The ministry of commerce and the state development and reform commission revised the investment catalogue in November 2004.<sup>294</sup> In compliance with its WTO commitments, China has opened up a wide range of sectors that were previously restricted.<sup>295</sup> The favorable policy mainly comprises Hi-tech industry, agriculture, telecommunication, forestry, energy, and transportation along with some export-oriented sectors.<sup>296</sup> Although the encouraged projects vary between regions in China, the general emphasis is on infrastructure, agricultural developmental and mining projects<sup>297</sup>.

Important sectors that were previously restricted such as banking, insurance and real estate are also now open for foreign investment.<sup>298</sup> Also, the new policy has relaxed restrictions on the media sector that was previously tightly controlled.<sup>299</sup> It has drawn significant attention from major American companies such as Walt Disney Co. and Viacom International Inc. who have begun exploring the television production in China.<sup>300</sup>

Foreign Investors are also permitted to establish WFOE's in the advertising sector that was previously restricted.<sup>301</sup> WFOE's could also operate in the areas of courier services, freight forwarding, restaurants, technical testing and analysis.<sup>302</sup> Industries in which foreign investment is prohibited include national defense, firearms manufacturing and biotechnology seed production.<sup>303</sup>

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<sup>294</sup> See U.S-China Business Council, *supra* note 279.

<sup>295</sup> *Id.*

<sup>296</sup> See CHOW, *supra* note 99, at 374.

<sup>297</sup> *Id.*

<sup>298</sup> *Id.*

<sup>299</sup> See U.S-China Business Council, *supra* note 279.

<sup>300</sup> *Id.*

<sup>301</sup> *Id.*

<sup>302</sup> *Id.*

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

### c. Facilities and Incentives

To welcome foreign capital, China established “special areas”: SEZ’s, coastal areas and other zones providing favorable conditions for investment with preferential treatment to foreign companies.<sup>304</sup> China has developed and adopted a series of regulations governing investment incentives in the “special areas” over the last twenty-six years.<sup>305</sup> The SEZ’s, coastal cities and a large number of development zones promote investment with extraordinary packages of investment incentives.<sup>306</sup> For instance, foreign enterprises located in the SEZs are required to pay income tax at the rate of just 15 percent as against the national income tax rate of 33 percent.<sup>307</sup>

Furthermore, the SEZ Regulations and the Coastal Zone Regulations authorize the local government to work independently without interference of the national government in developing policies for promoting investment.<sup>308</sup> The incentives offered to the foreign enterprises located in the “special areas” include significant reductions in national and local income taxes<sup>309</sup>, custom duties<sup>310</sup>, import and export duties<sup>311</sup>, tax rebates for high-tech industries<sup>312</sup>, exemption on the payment of income tax on dividends remitted abroad<sup>313</sup>, special treatment on land use fees<sup>314</sup>, exemption from paying State subsidies to employees<sup>315</sup>, preferential treatment in

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<sup>304</sup> See China Law Desk Book, *supra* note 44, at 934.

<sup>305</sup> *Id.*

<sup>306</sup> *Id.* at 935.

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

<sup>308</sup> *Id.*

<sup>309</sup> Regulations Concerning the Encouragement of Foreign Investment, arts. 8, 9, 10 (hereinafter “Encouraging Regulations”).

<sup>310</sup> See China Law Desk Book, *supra* note 44, at 936.

<sup>311</sup> *Id.*

<sup>312</sup> *Id.*

<sup>313</sup> See Encouraging Regulations, *supra* note 310, art. 7.

<sup>314</sup> *Id.* at art. 4.

<sup>315</sup> *Id.* at art. 3.

securing basic infrastructures facilities<sup>316</sup> and exemption from turnover taxes for exported products<sup>317</sup>.

However, in line with the WTO's requirements, China has recently planned to eliminate preferential treatment for foreign investors by imposing same tax rates for both the foreign invested enterprises and domestic enterprises from 2007.<sup>318</sup> In fact, it is expected that foreign investors would pay more while domestic enterprises would pay less.<sup>319</sup> In addition to reducing its existing SEZs by fifty percent, China has also declared that the SEZ investment incentives will decrease over time.<sup>320</sup>

**d. Repatriation of Capital and Profits:**

All foreign investors in China are entitled to repatriate capital, profits, dividends and the like.<sup>321</sup> However, cumbersome procedures for transferring currency still exist.<sup>322</sup> Repatriation of funds is subject to a complex set of foreign exchange rules and regulations.<sup>323</sup> China promulgated regulations governing foreign exchange transactions by setting forth flexible standards thereby facilitating prompt processing of the transactions.<sup>324</sup>

A foreign investor is entitled to open and maintain foreign exchange accounts.<sup>325</sup> In order to do so, they are required to obtain approval from China's State Administration of Foreign

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<sup>316</sup> *Id* at art. 5.

<sup>317</sup> *Id* at art. 11.

<sup>318</sup> See CHINA DAILY (05/29/2005), Report - *China to Introduce Unified Corporate Income Tax Rate from 2007*, available at <http://www.forbes.com/business/feeds/afx/2005/05/29/afx2063417.html>.

<sup>319</sup> *Id*.

<sup>320</sup> See China Investment Climate, *supra* note 6.

<sup>321</sup> See China Law Desk Book, *supra* note 44, at 440.

<sup>322</sup> *Id*.

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

<sup>324</sup> *Id* at 442

<sup>325</sup> *Id* at 443.

Exchange (SAFE).<sup>326</sup> Currently, foreign exchange transactions are conducted through approved financial institutions.<sup>327</sup> The financial institutions are also required by law to examine the foreign exchange transactions to determine whether the account holders are operating the account in a manner consistent with the regulations.<sup>328</sup> In the event of termination, a foreign invested enterprise is required to close its foreign exchange account.<sup>329</sup> SAFE is reportedly taking continuous efforts to liberalize foreign exchange transactions.<sup>330</sup>

### 3. Applicable laws for U.S investors in China

Apart from the laws governing different forms of foreign invested enterprises, there are numerous other Chinese laws that are applicable to the U.S investors in China.

**Contract Law:** The Chinese government promulgated Contracts Law in 1999 thereby repealing the three earlier contract laws governing the domestic economic contracts and unifying them into one.<sup>331</sup> The Contract Law defines a contract as “an agreement among individuals, legal persons and/or other organizations as equal parties for the establishment, modification or termination of a relationship”.<sup>332</sup> The contract law comprehensively addresses the various aspects of a contract such as formation, validity of contract, performance, modification, assignment, termination, choice of law/forum and liability for breach.<sup>333</sup> A popular myth concerning contracts in china is that the parties to a contract are compulsorily required to choose Chinese law as

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<sup>326</sup> *Id* at 441.

<sup>327</sup> *Id* at 444.

<sup>328</sup> *Id* at 445.

<sup>329</sup> *Id*.

<sup>330</sup> *Id*.

<sup>331</sup> Contract Law, adopted at the 2<sup>nd</sup> Session of the 9<sup>th</sup> National People’s Congress on March 15, 1999, CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶, 5-650.

<sup>332</sup> *Id* at art.2.

<sup>333</sup> See China Law Desk Book, *supra* note 44, at 249.

applicable.<sup>334</sup> In reality, the parties are free to choose a law of jurisdiction other than Chinese law.<sup>335</sup> It can be observed that the Contract Law is generally in line with international legal norms.<sup>336</sup> However, the Chinese government still maintains close scrutiny on certain contracts subjecting them to government approval and registration.<sup>337</sup>

**Taxation law:** The principal tax laws applicable to foreign invested enterprises are value-added tax<sup>338</sup>, consumption tax<sup>339</sup> and business<sup>340</sup> tax, the enterprise income tax,<sup>341</sup> and the individual income tax.<sup>342</sup> Various tax regulations encompassing tax accounting, tax returns, penalties for violation and review procedures also make the tax law comprehensive.<sup>343</sup> However, the Chinese tax laws and regulatory system still appears to be very complex.<sup>344</sup>

**Tender Law and Government Procurement Law:** The Chinese Government enacted a Tender Law in order to standardize the tendering and bidding activities.<sup>345</sup> The purpose of the Tender Law was to ensure fairness and transparency in dealing with all the major contracts and public procurement procedures.<sup>346</sup> Subsequently, the Chinese government also enacted

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<sup>334</sup> *Id* at 255.

<sup>335</sup> *Id.*

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

<sup>337</sup> *Id* at 247.

<sup>338</sup> Provisional Rules of the People's Republic of China on Value-Added Tax, adopted Nov 26, 1993, by the 12<sup>th</sup> Session of the Standing Committee of the State Council, CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶, 31-736.

<sup>339</sup> Provisional Rules of the People's Republic of China on Consumption Tax, adopted Nov 26, 1993, by the 12<sup>th</sup> Session of the Standing Committee of the State Council, promulgated on Dec 13, 1999, CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶, 31-733.

<sup>340</sup> Provisional Rules of the People's Republic of China on Business Tax, adopted Nov 26, 1993, by the 12<sup>th</sup> Session of the Standing Committee of the State Council, promulgated on Dec 13, 1999, CCH REG. ¶, 31-740.

<sup>341</sup> Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, promulgated on April 9, 1991, by the 4<sup>th</sup> Session of the 7<sup>th</sup> NPC, CCH REG. ¶, 32-505.

<sup>342</sup> Notice of the State Administration of Taxation on Certain Issues Concerning the Calculation and Payment of Individual Income Tax by Individuals without Residence in the Territory of China, promulgated on April 3, 1995, by the SAT, CCH REG. ¶, 30-580.

<sup>343</sup> See China Law Desk Book, *supra* note 44, at 335.

<sup>344</sup> *Id.*

<sup>345</sup> Tender law of the People's Republic of China, adopted on Aug 30, 1999, at the 11<sup>th</sup> Meeting of the Standing Committee of the 9<sup>th</sup> National People's Congress, CHINA L. FOR FOREIGN BUS.: BUS. REG. ¶, 19-645.

<sup>346</sup> See China Law Desk Book, *supra* note 44, at 308.

Government Procurement Law<sup>347</sup> in order to generally comply with international standards and to specifically provide certainty in rules and standards, control favoritism for domestic suppliers and to deal with the transparency problems.<sup>348</sup>

The relevant laws include Labor and Employment Law,<sup>349</sup> Insurance Law,<sup>350</sup> Regulations on Environmental Protection,<sup>351</sup> Liquidation Procedures<sup>352</sup> and Bankruptcy Law.<sup>353</sup>

#### 4. Property Rights

**Immovable Property:** Since Chinese law specifies that all land is owned by “the public”, no private individual or enterprise can buy land for their use.<sup>354</sup> However, consistent with the policies of reform and opening to the outside, individuals, including foreigners, can hold long-term leases for land use. Ownership of buildings and structures on the land is allowed.<sup>355</sup>

**Intellectual Property:** In ancient China, knowledge was not considered as private property and therefore, copying was considered as showing the proper deference to the past.<sup>356</sup>

At the time when People’s Republic of China was constituted by the Communist party, communist ideals such as common ownership and collective pursuit were strongly stressed.<sup>357</sup>

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<sup>347</sup> Law of the People’s Republic of China on Government Procurement, promulgated on June 29, 2002, by the Standing Committee of the Ninth National People’s Congress, CHINA. L. & PRAC (July 2002).

<sup>348</sup> See China Law Desk Book, *supra* note 44, at 324.

<sup>349</sup> Labor Law of the People’s Republic of China, adopted July 5, 1994, by the 8<sup>th</sup> Session of the Standing Committee of the 8<sup>th</sup> NPC, CCH REG. ¶, 12-500.

<sup>350</sup> Insurance Law of the People’s Republic of China, adopted on June 30, 1995, by the 14<sup>th</sup> Session of the Standing Committee of the 8<sup>th</sup> NPC, CCH REG. ¶, 9-620.

<sup>351</sup> See China Law Desk Book, *supra* note 44, at 753.

<sup>352</sup> Measures on Liquidation Procedures for Foreign Investment Enterprises, promulgated on July 9, 1996 by MOFTEC, CCH REG. ¶, 13-608.

<sup>353</sup> Law of the People’s Republic of China on Enterprise Bankruptcy, adopted on Dec 2, 1986, by the 18<sup>th</sup> Session of the Standing Committee, CCH REG. ¶, 13-522.

<sup>354</sup> See China investment Climate, *supra* note 6.

<sup>355</sup> *Id.*

<sup>356</sup> See CHOW, *supra* note 99, at 410.

<sup>357</sup> *Id.* at 411.

Consequently, intellectual property was not treated as private property.<sup>358</sup> When China opened its economy to the outside, a number of modern laws and regulations governing three major areas of intellectual property: trademarks<sup>359</sup>, copyrights<sup>360</sup> and patents<sup>361</sup> were promulgated.<sup>362</sup> In spite of several laws and regulations, commercial piracy and infringement of intellectual property rights were two major problems that foreign investors in China faced.<sup>363</sup>

On April 26, 1991, U.S identified China as a “priority foreign country” that failed to provide adequate protection of intellectual property, with the greatest adverse impact on U.S products.<sup>364</sup> U.S further indicated that China had not made any significant progress in intellectual property negotiations.<sup>365</sup> In order to avoid U.S sanctions, China entered into various agreements with the U.S for the protection of intellectual property.<sup>366</sup> China further amended its criminal law in 1997 to include punishments for intellectual property infringements.<sup>367</sup> China has also signed various international intellectual property treaties including the World Intellectual Property Organization Convention in 1980 and Geneva Phonogram Convention in 1993.<sup>368</sup>

As a member of WTO, China is obligated to implement the WTO Agreement on Trade Related Intellectual Property Rights (TRIPS).<sup>369</sup> TRIPS lays down the minimum standards of

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<sup>358</sup> *Id.*

<sup>359</sup> Trademark Law of the People’s Republic of China, adopted Aug 23, 1982, at the 24<sup>th</sup> Session of the Standing Committee of the 5<sup>th</sup> NPC, revised in 1993 by the 30<sup>th</sup> Session of the Standing Committee of the 7<sup>th</sup> NPC and revised in 2001 by the 24<sup>th</sup> Session of the Standing Committee of the 9<sup>th</sup> NPC, art 43, CCH, REG.¶, 11-500.

<sup>360</sup> Copyright Law of the People’s Republic of China, adopted on Sep 7, 1990, at the 15<sup>th</sup> Session of the standing Committee of the 7<sup>th</sup> NPC, amended on Oct 27, 2001, at the 24<sup>th</sup> Session of the Standing Committee of the 9<sup>th</sup> NPC, CCH, REG.¶, 11-700.

<sup>361</sup> Patent Law of the People’s Republic of China, adopted Mar 12, 1984, at the 4<sup>th</sup> Session of the Standing Committee of the 6<sup>th</sup> NPC, amended Sep 4 1992, and amended on Aug 25, 2000, at the 17<sup>th</sup> Session of the Standing Committee of the 9<sup>th</sup> NPC, CCH, REG.¶, 11-600.

<sup>362</sup> See CHOW, *supra* note 99, at 416.

<sup>363</sup> *Id.*

<sup>364</sup> *Id* at 413.

<sup>365</sup> *Id.*

<sup>366</sup> *Id* at 415.

<sup>367</sup> *Id.*

<sup>368</sup> *Id* at 416.

<sup>369</sup> See China investment Climate, *supra* note 6.

protection of intellectual property to be provided by each member.<sup>370</sup> In addition, the agreement sets out general principles applicable to all Intellectual Property Rights enforcement procedures.<sup>371</sup> TRIPS also provides for dispute settlement procedures applicable to intellectual property disputes arising between the member nations.<sup>372</sup>

In line with its obligations to the WTO, China has been revising the laws on intellectual property rights extensively to include the various aspects specified in the TRIPS Agreement.<sup>373</sup> Hence, new laws, regulations and administrative measures aimed at implementing these obligations are being issued at a rapid pace.<sup>374</sup> At present, the major concern for the intellectual property owners in China is not with the insufficiency of the current laws, but largely with their enforcement.<sup>375</sup>

## 5. Investment Guarantees and Bilateral Arrangements with U.S

As mentioned earlier, foreign investments in China is governed by various Chinese laws. Chinese laws do not allow nationalization of foreign invested enterprises except under “special circumstances”.<sup>376</sup> However, Chinese laws do not specifically define the “special circumstances”.<sup>377</sup> The Chinese authorities have indicated that “special circumstances” include “national security considerations” and “large civil engineering projects”.<sup>378</sup> However, there is no precedent of outright expropriation of U.S investment by the Chinese government.<sup>379</sup>

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<sup>370</sup> WTO, *OVERVIEW-TRIPS AGREEMENT*, available at [http://www.wto.org/english/tratop\\_e/trips\\_e/intel2\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm), (last visited Aug 12, 2005).

<sup>371</sup> *Id.*

<sup>372</sup> *Id.*

<sup>373</sup> See CHOW, *supra* note 99, at 415.

<sup>374</sup> See China investment Climate, *supra* note 6

<sup>375</sup> See CHOW, *supra* note 99, at 418; See China investment Climate, *supra* note 6

<sup>376</sup> See China investment Climate, *supra* note 6.

<sup>377</sup> *Id.*

<sup>378</sup> *Id.*

<sup>379</sup> *Id.*

Multilateral Investment Guarantee Agency (MIGA), an organization affiliated with the World Bank, offers political risk insurance to foreign private investors in China against the risks of expropriation, transfer of currency restriction, breach of contract, and war and civil disturbance.<sup>380</sup>

In spite of the foregoing guarantees, foreign investors generally prefer to have additional guarantees such as those provided in bilateral or multilateral agreements.<sup>381</sup> The Chinese government does not have a bilateral investment agreement with the U.S.<sup>382</sup> They have signed a treaty on avoidance of double taxation.<sup>383</sup> Further, the two governments do have an investment guaranty agreement, which entered into force on October 30, 1980.<sup>384</sup> In addition to dealing with a guaranty as such, it is believed that an investment agreement between states provides a general framework that is complimented by specific investment contracts.<sup>385</sup>

## 6. International Investment Measures

China's accession to WTO has obligated China to implement the WTO Agreements relating to trade and investment.<sup>386</sup> The Agreement on Trade-Related Investment Measures (TRIMS) prohibits trade-related investment performance measures as a condition for foreign investment.<sup>387</sup> Such measures include local content requirements, technology transfer

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<sup>380</sup> REPORT BY WORLD BANK, *MIGA OPERATIONS IN CHINA*, available at [http://www.worldbank.org.cn/English/Overview/overview\\_brief\\_miga.htm](http://www.worldbank.org.cn/English/Overview/overview_brief_miga.htm), (last visited Aug 10 2005).

<sup>381</sup> JAMES BROWN, *TRADE & INVESTMENT RELATIONS BETWEEN NATIONS* 32 (1998).

<sup>382</sup> See China investment Climate, *supra* note 6.

<sup>383</sup> *Id.*

<sup>384</sup> *Id.*

<sup>385</sup> See BROWN, *supra* note 360.

<sup>386</sup> FUNG, *U.S. DIRECT INVESTMENT IN CHINA*, 35 (2004).

<sup>387</sup> *Id.*

requirements, foreign exchange balancing requirements, and export performance requirements.<sup>388</sup>

**Local Content:** The foreign invested enterprises were required to procure the required raw and semi-processes materials, fuels, auxiliary equipment, and the like from domestic sources and not from abroad.<sup>389</sup> In line with its commitments, China agreed to eliminate the requirement, however, the Chinese authorities still encourage using local materials.<sup>390</sup>

**Technology-transfer:** Chinese laws have always required importing of advanced technology as a major criterion for approving projects.<sup>391</sup> Even though China eliminated the requirement, foreign investors still encounter pressure from Chinese authorities to import new technology.<sup>392</sup>

**Export performance:** China required that foreign invested enterprises must re-export a certain, typically high, percentage of their production as a condition for investment.<sup>393</sup> Although, China agreed to eliminate the export–requirement in private contracts, in practice, the regulatory authorities have constantly encouraged the projects that stipulated export requirements in the contracts.<sup>394</sup>

## 7. Dispute Resolution

The conciliation process is the most preferred method of dispute resolution in China, “and has been the main method for settling disputes for thousands of years”.<sup>395</sup> When a problem

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<sup>388</sup> *Id.*

<sup>389</sup> See ZHOU, *supra* note 60, at 131.

<sup>390</sup> See China investment Climate, *supra* note 6.

<sup>391</sup> See ZHOU, *supra* note 60, at 133 .

<sup>392</sup> See China investment Climate, *supra* note 6.

<sup>393</sup> See ZHOU, *supra* note 60, at 133.

<sup>394</sup> See China investment Climate, *supra* note 6.

<sup>395</sup> Gary J. Dernelle, Direct Foreign Investment and Contractual relations in the People’s Republic of China, 6 DEPAUL BUS. L.J. 357 (1994).

arises between the foreign investor and a Chinese party on the FDI contract after negotiations or during the life of the investment venture, the Chinese party always prefers to settle the dispute by way of informal consultation.<sup>396</sup> In a conciliation process, both the parties must agree to “consult each other to determine the rights and liabilities and to obtain the truth from facts”.<sup>397</sup> Although, Chinese laws do not explicitly specify the procedures to be followed in a conciliation process, nevertheless, the process has proved to be an effective mechanism in resolving FDI disputes between the parties.<sup>398</sup>

The next preferred method of dispute settlement in China is the mediation process.<sup>399</sup> Generally speaking, mediation is considered as a “pre-arbitration or pre-litigation” process.<sup>400</sup> The mediation process is also quite informal.<sup>401</sup> The principal laws governing mediation in China are the Arbitration Law of the People’s Republic of China<sup>402</sup>, the China International Economic and Trade Arbitration Commission Rules<sup>403</sup> (CIETAC), and the Rules of the Beijing Conciliation Center<sup>404</sup>.

The next step of the process is either litigation or arbitration.<sup>405</sup> Litigation is generally not preferred by most of the parties.<sup>406</sup> They consider litigation as the last resort due to the negative image of Chinese courts.<sup>407</sup> Therefore, if the dispute is not resolved by both the conciliation and

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<sup>396</sup> 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).

<sup>397</sup> ERIC LEE, COMMERCIAL DISPUTES SETTLEMENT IN CHINA 9-10 (1995).

<sup>398</sup> *Id.*

<sup>399</sup> *Id.* at 12.

<sup>400</sup> *Id.*

<sup>401</sup> *Id.*

<sup>402</sup> Arbitration Law of the People’s Republic of China was passed by the Standing Committee of the NPC on Aug 31, 1994. Articles 51 and 52 sets out the rules for mediation process.

<sup>403</sup> China International Economic and Trade Arbitration Commission (CIETAC) Arbitration Rules, revised and adopted by China Chamber of International Commerce on September 4, 1995.

<sup>404</sup> See WANG, *supra* note 66 at 286-89.

<sup>405</sup> See China investment Climate, *supra* note 6.

<sup>406</sup> *Id.*

<sup>407</sup> *Id.*

mediation process, the parties then usually prefer arbitration as the formal mechanism to solve their problems.<sup>408</sup>

China is a member of the International Center for the Settlement of Investment Disputes (ICSID)<sup>409</sup> and has also ratified the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.<sup>410</sup> ICSID is affiliated to the World Bank and guarantees high competence in investment matters.<sup>411</sup> The aim of ICSID is to advance “international cooperation for economic development” in developing countries through private international investment<sup>412</sup> by promoting mutual confidence between governments of developing nations and foreign investors.<sup>413</sup> Although China is a member of the ICSID, enforcement of arbitral awards is not very common. Chinese courts may delay or fail to enforce the arbitral awards.<sup>414</sup> In some occasions when the courts attempt to enforce arbitral awards, the local authorities usually ignore the courts decisions with impunity.<sup>415</sup>

CIETAC is the principal international commercial arbitration commission in China.<sup>416</sup> CIETAC is an administrative body empowered to exercise its “delegated legislative power under the Chinese Constitution and the relevant regulations of the State Council”.<sup>417</sup> CIETAC has jurisdiction over international trade disputes<sup>418</sup> arising “between enterprises with foreign investment and disputes between an enterprise with foreign investment and another Chinese legal

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<sup>408</sup> See LEE, *supra* note 398, at 15.

<sup>409</sup> See China investment Climate, *supra* note 6.

<sup>410</sup> *Id.*

<sup>411</sup> The World Bank Group, About ICSID, available at <http://www.worldbank.org/icsid/pubs/treatbibl/main.htm> (Last visited Aug 10, 2005).

<sup>412</sup> *Id.*

<sup>413</sup> *Id.*

<sup>414</sup> See China investment Climate, *supra* note 6.

<sup>415</sup> *Id.*

<sup>416</sup> See WANG, *supra* note 66, at 297.

<sup>417</sup> MO, ALTERNATIVE DISPUTE RESOLUTION, INTRODUCTION TO CHINESE LAW 384 (1997).

<sup>418</sup> *Id.* at 383.

person or economic organization”.<sup>419</sup> In recent years, the American parties have tasted both bitter and sweet from the rulings of the CIETAC.<sup>420</sup> The dissatisfaction of the process was mainly based on the procedures followed by CIETAC.<sup>421</sup>

#### **D. Impact of FDI**

China’s objective in welcoming foreign investment was an attempt to improve its economy and to import science and technology into the country.<sup>422</sup> Undoubtedly, FDI has greatly contributed to China’s rapid economic development.<sup>423</sup> Since 1979, the annual growth rate of Chinese economy has been, on average, anywhere between 7% and 13%.<sup>424</sup> Declines in poverty have been equally dramatic, a steep fall from 60 percent of the population to 17 percent.<sup>425</sup> The progress made includes large increases in the per capita incomes.<sup>426</sup>

FDI has also increased the annual Gross Domestic Product (GDP) growth by adding an average of 0.4% to the total capital formation.<sup>427</sup> U.S direct investment contributed 0.5% to China’s GDP in 2001.<sup>428</sup> Even though the contribution of U.S direct investment to China’s GDP continues at a modest rate, its impact on China’s economic progress as well as legal environment is significant.<sup>429</sup> It has both directly and indirectly contributed to the development of China’s

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<sup>419</sup> *Id.*

<sup>420</sup> *See* China investment Climate, *supra* note 6.

<sup>421</sup> *Id.*

<sup>422</sup> *See* VARMA, *supra* note 20 at 11.

<sup>423</sup> Z. Hu & M. Khan, Why is China Growing So Fast?, INTERNATIONAL MONETARY FUND, ECONOMIC ISSUES NO. 8 (1997), available at <http://www.imf.org/external/pubs/ft/Issues8/> (last visited Aug 12 2005).

<sup>424</sup> *Id.*

<sup>425</sup> China online, *Investor Information*, available at [http://www.aabf.org/china\\_inv\\_guide.htm](http://www.aabf.org/china_inv_guide.htm) (Last visited August 12, 2005)

<sup>426</sup> *Id.*

<sup>427</sup> *Id.*

<sup>428</sup> *See* FUNG, *supra* note 386, at 152.

<sup>429</sup> *Id.*

legal structure.<sup>430</sup> As a result of constant pressure from foreign investors especially from the U.S investors, China has made significant reforms in its laws and regulations in order to keep up with the international standards.<sup>431</sup> The reforms in legal structure have given an impetus to domestic enterprises also.<sup>432</sup>

Another positive impact has been found in China's manufacturing sector, which has grown by leaps and bounds as a result of foreign capital invested by the TNCs. Yet another remarkable impact of FDI is the creation of employment opportunities.<sup>433</sup> The direct effect on employment generation can be witnessed in the special economic zones and coastal zones where large number of foreign invested enterprises is located.<sup>434</sup> China's market-oriented reforms have brought highly visible success and economic transformation, raising hundreds of millions of people out of poverty.<sup>435</sup>

China has been focusing on developing its economy by importing advanced technology from other countries.<sup>436</sup> TNCs have acted as excellent channels for transferring advanced technology into China through their direct investment, machinery and equipment exports and licensing activities.<sup>437</sup> In addition, FDI has imparted positive productivity and knowledge spillovers to Chinese enterprises.<sup>438</sup> Further more, China's national and provincial data have established a positive relationship between inward FDI and China's foreign trade, which are the two means of international integration.<sup>439</sup> Above all, China's economic development is so great

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<sup>430</sup> See CHOW, *supra* note 99, at 415.

<sup>431</sup> *Id.*

<sup>432</sup> *Id.*

<sup>433</sup> See China-Investor Information, *supra* note 424.

<sup>434</sup> *Id.*

<sup>435</sup> *Id.*

<sup>436</sup> See VARMA, *supra* note 20 at 4.

<sup>437</sup> See FUNG, *supra* note 386, at 149.

<sup>438</sup> YINGQI ANNIE WEI & V.N.BALASUBRAMANYAM, FOREIGN DIRECT INVESTMENT, SIX COUNTRY CASE STUDIES 26 (2004).

<sup>439</sup> *Id.* at 28.

that many scholars are arguing that China is likely to be the next economic super power and replace the U.S by year 2020.

Although FDI has greatly contributed to fast economic development in China, it is predicted that China's over-dependence on FDI may lead to economic losses also.<sup>440</sup> China holds about 500 billion US dollars of FDI, equivalent to 40 percent of its gross domestic product, which may lead to enormous opportunity cost for the country.<sup>441</sup> Since the foreign invested enterprises send huge amounts of profit abroad, it may result in capital and current account deficits for China.<sup>442</sup>

In addition, FDI is found to be concentrated in coastal areas and industrial sectors contributing to the imbalance of China's economic structure.<sup>443</sup> China has also been facing major environmental problems.<sup>444</sup> It has been reported that eight out of ten most polluted cities in the world are located in China and the annual rate of economic losses caused by environmental damages range between 3.5% and 7.7% of its gross domestic product.<sup>445</sup> Foreign invested industries account for a major portion of pollution-intensive industries.<sup>446</sup> It can be concluded that the major downside of FDI in China is the damages caused to its environment. Forceful enforcement of environmental policy is the only effective solution to reduce environmental pollution in China.

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<sup>440</sup> Report from China Business, *Foreign Investment also brings losses*, available at [http://english.china.com/zh\\_cn/business/investment/11021614/20050525/12342952.html](http://english.china.com/zh_cn/business/investment/11021614/20050525/12342952.html) (Last Visited Aug 12, 2005).

<sup>441</sup> *Id.*

<sup>442</sup> *Id.*

<sup>443</sup> *Id.*

<sup>444</sup> Zhang Shiqi, Center for Environmental Sciences, *FDI and Environment: Situation and Challenges in China*, available at <http://www.epe.be/fdi/fdidocuments/presentations/zsqfdi.pdf> (Last visited Aug 10, 2005).

<sup>445</sup> *Id.*

<sup>446</sup> *Id.*

## CHAPTER III

### FDI IN INDIA

India is now the world's second fastest growing economy<sup>447</sup>, providing lucrative opportunities for foreign investors to expand their business. As a leader of the developing world, India plays a significant role in global affairs.<sup>448</sup> Being the world's largest practicing democracy, it has a deeply rooted democratic system and a well-instituted legal system.<sup>449</sup> India is making strides in the area of Information Technology by reaching an apex position in development within a short span of time thereby drawing international attention on its high-tech centers.<sup>450</sup>

#### A. A Historical Review of Economic Liberalization

After attaining independence in 1947 from Britain, the Indian government was desirous in having a regulated, closed economy that followed the socialist pattern.<sup>451</sup> The economic

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<sup>447</sup> U.S Economic Research Service, *Briefing room – India*, available at <http://www.ers.usda.gov/Briefing/India/>, (Last Update June 9, 2005).

<sup>448</sup> See REDDY, *supra* note 1 at 4.

<sup>449</sup> *Id* at 6.

<sup>450</sup> Congressional Research Service, *India-U.S Relations*, available at <http://www.fas.org/sgp/crs/row/IB93097.pdf> (Last Update July 15 2005).

<sup>451</sup> See VARMA, *supra* note 20, at 14.

policies were directed towards a single ideology: “self-reliance”.<sup>452</sup> In fact, it was reported that when Prime Minister Jawaharlal Nehru visited U.S in 1948, a group of businessmen had asked him about the Indian Government’s policy towards foreign investment, he responded by looking out of the window and commented on the weather.<sup>453</sup>

Even though science and technology formed the centerpiece of prime minister’s national development strategy, development in that area was not achieved through opening of the economy to outside.<sup>454</sup> In fact, the economic policies were designed to shield the economy from any sort of foreign participation.<sup>455</sup> This was an outcome of India’s past experience with British colonialism.<sup>456</sup> Investments made during British-India were directed towards promoting the interests of Britain, which had only resulted in the shrinking of domestic industries and depletion of natural resources.<sup>457</sup>

The economic policy until 1991 explicitly emphasized import substitution to attain economic self-reliance.<sup>458</sup> The positive effect of such a policy was that it enabled India to create a diversified and self-sufficient industrial base.<sup>459</sup> The period also witnessed expansion of the domestic industry during which the Indian government was closely involved in protecting the domestic industry by imposing strict restrictions on import licensing and high tariffs on imports.<sup>460</sup>

However, the policy also resulted in serious negative effects.<sup>461</sup> Due to strict restrictions on import licensing, there was literally no import of latest technology into the country.<sup>462</sup> Local

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<sup>452</sup> *Id* at 15.

<sup>453</sup> *See* REDDY, *supra* note 1 at 9.

<sup>454</sup> *Id* at 13.

<sup>455</sup> *Id.*

<sup>456</sup> *Id* at 14.

<sup>457</sup> *Id.*

<sup>458</sup> *See* VARMA, *supra* note 20, at 18.

<sup>459</sup> SHANTA ACHARYA, *INVESTING IN INDIA* 8 (1998).

<sup>460</sup> *Id.*

<sup>461</sup> *Id.*

research in technology also had not picked up pace.<sup>463</sup> Hence, the country seriously lagged in the area of modern industrial technology.<sup>464</sup> Also, the Indian government's excessive control over the economy instead of actual market mechanisms resulted in the development of Indian industry in a highly protected environment.<sup>465</sup> The protectionist policy of the government thereby contributed to the lack of productivity and competition among domestic industries, which eventually led to the production of cheap quality products.<sup>466</sup> In addition, it fostered high levels of inefficiency and corruption in the regulatory system.<sup>467</sup> The dominant public sector was a total failure due to lack of managerial expertise, poor human resource development and under-investment in research and development.<sup>468</sup> All these factors further contributed to poor economic development.<sup>469</sup>

In 1969, Nehru delivered a speech in the parliament identifying the role of TNCs in the development of Indian industry and Indian economy as a whole.<sup>470</sup> The Indian government was nevertheless aware of the fact that domestic industries were not well equipped to handle the large TNCs.<sup>471</sup> Consequently, a more flexible approach towards foreign participation was taken.<sup>472</sup>

Although the headway towards liberalization of the economy started taking root in 1969, it gained momentum in 1984 under the leadership of Rajiv Gandhi, who stressed the significance of importing science and technology into the country for domestic industrial development.<sup>473</sup> In spite of pursuing a policy of export-led growth, India experienced a crisis in its balance of

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<sup>462</sup> See REDDY, *supra* note 1 at 18.

<sup>463</sup> *Id* at 19.

<sup>464</sup> *Id.*

<sup>465</sup> *Id.*

<sup>466</sup> U.S DEPT OF COMMERCE, INDIA-OVERSEAS MARKET REPOR, 2 (1992).

<sup>467</sup> See ACHARYA, *supra* note 433 at 8.

<sup>468</sup> *Id* at 9.

<sup>469</sup> *Id* at 12.

<sup>470</sup> See PANT, *supra* note 8, at 48.

<sup>471</sup> *Id* at 49.

<sup>472</sup> *Id.*

<sup>473</sup> YINGQI ANNIE WEI & V.N.BALASUBRAMANYAM, FOREIGN DIRECT INVESTMENT, SIX COUNTRY CASE STUDIES 51 (2004).

payments in early 1991, which threatened to destabilize the economy.<sup>474</sup> The Indian government under the leadership of Narasimha Rao swiftly responded to the major financial crisis by initiating solid economic reforms.<sup>475</sup> The Government implemented a program of structural reforms, aimed at stabilizing the economy and promoting reliance on market mechanisms, broadly referred to as “liberalization”.<sup>476</sup> Thus, the actual opening of the economy took place in 1991, when India made a complete move from centrally planned economy towards a mixed economy in its true sense, combining features of both capitalist market and socialist command economies.<sup>477</sup>

## **B. The progress of law governing FDI**

The legal framework for FDI in pre-1991 policy was characterized by a set of complex regulations for foreign investment.<sup>478</sup> Another feature was that the policy towards FDI was determined on a case-by-case basis.<sup>479</sup> The 1969 industrial policy specified three groups of industries in which: (i) FDI was allowed without technical collaboration, (ii) FDI was allowed only with technical collaboration and (iii) no foreign participation was allowed.<sup>480</sup> Although the number of foreign collaborations increased, by and large, foreign participation was kept out of most of the vital sectors.<sup>481</sup>

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<sup>474</sup> See ACHARYA, *supra* note 433 at 12.

<sup>475</sup> ASIA INVEST (EUROPE AID), GUIDEBOOK FOR EUROPEAN INVESTORS IN INDIA, 25 (2002). (hereinafter India Guidebook)

<sup>476</sup> See REDDY, *supra* note 1 at 34.

<sup>477</sup> See PANT, *supra* note 8, at 48.

<sup>478</sup> *Id.*

<sup>479</sup> *Id.* at 49.

<sup>480</sup> *Id.*

<sup>481</sup> *Id.*

In 1973, the Indian government under the leadership of Indira Gandhi adopted the Foreign Exchange Regulation Act (FERA) with an objective to dilute foreign equity participation in domestic industries.<sup>482</sup> Indira Gandhi's economic policy strategies were mainly based on political exigencies, in lieu of focused economic goals.<sup>483</sup> FERA was effective in turning away not only potential investors but also the existing large TNCs such as IBM and Coca-Cola and several pharmaceutical companies.<sup>484</sup> Another drawback of the system of control through FERA was that it perpetuated monopoly control of foreign and local capital.<sup>485</sup>

As mentioned earlier, the hostile FDI scenario changed drastically in 1984 when the Indian government implemented Technology Policy Statement of 1983 in order to promote FDI through technology collaborations.<sup>486</sup> FERA was also amended to provide a relaxation of the equity restriction for 100 percent export oriented firms.<sup>487</sup> The Indian government also took steps to liberalize trade restrictions by tariff reductions and eliminating license requirements for a large segment of import items.<sup>488</sup> Consequently, FDI picked up steadily during the decade.<sup>489</sup>

In 1991, the Indian government adopted a new industrial policy that opened up the doors widely for FDI.<sup>490</sup> The new policy practically unleashed the Asian tiger to establish its role in the international economy.<sup>491</sup> For the first time, the policy clearly referred to FDI as the preferred form of foreign assistance rather than loans.<sup>492</sup>

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<sup>482</sup> See WEI, *supra* note 473 at 50.

<sup>483</sup> *Id.* at 51.

<sup>484</sup> *Id.*

<sup>485</sup> See PANT, *supra* note 8, at 51.

<sup>486</sup> *Id.*

<sup>487</sup> *Id.* at 52.

<sup>488</sup> *Id.*

<sup>489</sup> *Id.*

<sup>490</sup> *Id.*

<sup>491</sup> See REDDY, *supra* note 1 at 24.

<sup>492</sup> See PANT, *supra* note 8, at 52.

The new economic reforms aimed at four principles to face the major financial crisis: (i) to reduce fiscal deficit and inflation; (ii) to allow market forces to determine resource costs; (iii) to manage external financing through investment rather than debt; and (iv) to generate sustained growth in export performance.<sup>493</sup> Another welcome feature of the new policy was that it emphasized on improving the regulatory system by reducing bureaucracy.<sup>494</sup>

The 1991 FDI policy also introduced novel procedures for FDI approval through Reserve Bank of India (RBI), the central bank of India.<sup>495</sup> RBI was empowered to grant automatic approvals up to 51 percent foreign equity in specified industries.<sup>496</sup> Approvals over 51 percent equity cap were to be granted by a discretionary mechanism through Foreign Investment Promotion Board (FIPB).<sup>497</sup> Thus, FIPB acted as a “single-stop” clearance for major foreign investment proposals, which did not meet the RBI’s automatic approval criteria.<sup>498</sup> The simplified approval procedures contributed to an enormous increase of FDI inflows into the country.<sup>499</sup> Another remarkable outcome was that it also de-bureaucratized the process of approval system.<sup>500</sup>

Statistics indicate that the 1991 economic reforms, a watershed in India’s economic development, were well paid off. The reforms contributed to a steep reduction in the inflation

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<sup>493</sup> See India Guidebook, *supra* note 449 at 25.

<sup>494</sup> See PANT, *supra* note 8, at 53.

<sup>495</sup> *Id* at 53.

<sup>496</sup> *Id.*

<sup>497</sup> *Id* at 54.

<sup>498</sup> Mark J. Riedy, Esq., *Legal And Practical Considerations In Structuring Business transactions In India For The Conference Entitled: India Power*, 3 Cardozo J. Int’l & Comp. L. 328.

<sup>499</sup> See PANT, *supra* note 8, at 54.

<sup>500</sup> *Id* at 55.

rate, an increase in GDP and a better Balance of Payments situation.<sup>501</sup> Since 1991, the average growth rate of the Indian economy has been 6%, which is amongst the highest in the world.<sup>502</sup>

### C. Overview of the Current Legal Framework of FDI

The legal framework governing FDI has undergone rapid transformation in the post-liberalization phase.<sup>503</sup> More laws and policies were adopted the lead towards further privatization and liberalization.<sup>504</sup> The role of Indian government has transformed from “regulating” to that of “facilitating” investment and technology flows into the country.<sup>505</sup>

#### 1. Constitution and the Legal System

India is a federated Union of States with a parliamentary system of government that closely resembles the British parliamentary model.<sup>506</sup> However, it varies in one major respect, the Constitution is supreme, not the Parliament.<sup>507</sup> Indian Constitution is a written Constitution that guarantees individual and property rights.<sup>508</sup> Under its political system, India has a reasonably stable government with diverse political parties.

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<sup>501</sup> See REDDY, *supra* note 1 at 26.

<sup>502</sup> Congressional Research Service, *India-U.S Relations*, available at <http://www.fas.org/sgp/crs/row/IB93097.pdf> (Last Update July 15 2005).

<sup>503</sup> See VARMA, *supra* note 20, at 67.

<sup>504</sup> *Id.* at 62.

<sup>505</sup> See REDDY, *supra* note 1 at 28.

<sup>506</sup> *Id.*

<sup>507</sup> See VARMA, *supra* note 20, at 65.

<sup>508</sup> *Id.*

India administers its legal system under a Constitution; statutes passed by legislators; regulations promulgated by administrative regulators; and customary law.<sup>509</sup> India has adopted the English common law system; therefore, court decisions have binding precedential value.<sup>510</sup>

India has a well-developed independent judiciary.<sup>511</sup> The Supreme Court of India, the apex judicial authority is located in New Delhi.<sup>512</sup> It is vested with extensive powers to enforce fundamental rights and act as guardian of the Indian Constitution.<sup>513</sup> In addition, the Supreme Court is vested with the authority to adjudicate on the constitutionality of any law passed by the Indian Parliament.<sup>514</sup> Apart from the Supreme Court, the Indian judiciary system has High Courts that are apex courts at the State level and lower courts at the district levels.<sup>515</sup> Indian courts enjoy considerable autonomy.<sup>516</sup> The courts provide adequate safeguards for the enforcement of property rights and contractual rights.<sup>517</sup> The judges of the Supreme Court and High Courts are appointed by the President.<sup>518</sup> The parliament is not empowered to remove judges from office without a presidential order.<sup>519</sup>

Despite such a well-developed legal system, the Indian courts suffer from a major handicap – it is enormously backlogged with unsettled dispute cases.<sup>520</sup> The congestion in Indian

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<sup>509</sup> See India Guidebook, *supra* note 449 at 21.

<sup>510</sup> *Id.*

<sup>511</sup> U.S Dept of State, Investment Climate Statement – INDIA, available at <http://www.state.gov/e/eb/ifd/2005/43031.htm>, (Last visited Aug 18 2005) (hereinafter “India Investment Climate”).

<sup>512</sup> See India Guidebook, *supra* note 449 at 21.

<sup>513</sup> See REDDY, *supra* note 1 at 13.

<sup>514</sup> *Id.*

<sup>515</sup> See India Guidebook, *supra* note 449 at 23.

<sup>516</sup> *Id.*

<sup>517</sup> See REDDY, *supra* note 1 at 15.

<sup>518</sup> See India Guidebook, *supra* note 449 at 23.

<sup>519</sup> *Id.*

<sup>520</sup> See India investment Climate, *supra* note 508.

courts makes it difficult to get court dates in quick succession.<sup>521</sup> Shortages of judges have made the situation even worse.<sup>522</sup>

## **2. Foreign Investment Regime**

FDI in India is subject to policy guidelines framed by the Indian government from time to time in accordance with its Industrial Policy.<sup>523</sup> Since the opening up of the economy, the Indian Government has taken several path-breaking reform measures. Many constraints that had historically been imposed on FDI have been lifted. The approval process for FDI has been thoroughly revamped. The continuity of commitment to reforms over the period is, in itself, a significant contribution to the development of a stable investment climate in the country.<sup>524</sup> Another remarkable feature is that Indian law does not differentiate between an Indian and foreign owned company once it has been incorporated in India.<sup>525</sup>

### **a. Principal Forms of Investment**

There are several strategies by which foreign enterprises can establish business operations in India. They can be broadly classified into two major types: (i) by directly setting up operations in India as foreign companies or (ii) by setting up operations through an Indian enterprise incorporated in India under Indian laws<sup>526</sup>.

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<sup>521</sup> See India Guidebook, *supra* note 449 at 23.

<sup>522</sup> *Id.*

<sup>523</sup> *Id.* at 25.

<sup>524</sup> OECD, Executive Summary, India Investment Round, available at [http://dipp.nic.in/oecd\\_backpaper/Executive%20Summary.pdf](http://dipp.nic.in/oecd_backpaper/Executive%20Summary.pdf), (last visited July 10, 2005).

<sup>525</sup> *Id.*

<sup>526</sup> Dept. of Industrial Policy & Promotion, Ministry of Commerce, *FDI-Policies & Procedures*, available at <http://www.ibef.org/Attachment/Investing%20in%20India.pdf> (Last Update Mar, 2005) (hereinafter “FDI Policy”).

The three different options for directly setting up operations in India are through a (i) Branch Office; (ii) Liaison Office/Representative Office and (iii) Project Office.<sup>527</sup> Foreign enterprises could also set up operations through an Indian enterprise either through (iv) Joint Ventures or (v) Wholly Owned Subsidiaries.<sup>528</sup>

**(i) Branch Office**

A foreign enterprise is allowed to directly establish a Branch Office if they intend to engage in the following activities: (i) representing the parent company in India and acting as buying/selling agents in India; (ii) carrying out research work, in which the parent company is engaged; (iii) export/import of goods; (iv) promoting technical or financial collaborations between Indian companies and the foreign company; (v) rendering professional or consultancy services; (vi) carrying out technical support; (vii) rendering services in information technology and development of software in India.<sup>529</sup>

A branch office is prohibited from carrying out manufacturing activities on its own.<sup>530</sup> It can do so by entering into a subcontract with an Indian manufacturer.<sup>531</sup> The Indian Government does not require foreign enterprises to obtain a prior permission to establish Branch Offices in the Special Economic Zones (SEZs).<sup>532</sup> However, such Branch Offices are prohibited from carrying out business activities outside the SEZs.<sup>533</sup> Branch Offices established outside SEZs are required to obtain prior permission from the Reserve Bank of India (RBI).<sup>534</sup> RBI normally

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<sup>527</sup> *Id* at 14.

<sup>528</sup> *Id.*

<sup>529</sup> *Id* at art.4.5

<sup>530</sup> *Id.*

<sup>531</sup> *Id.*

<sup>532</sup> *Id* at art.4.6

<sup>533</sup> *Id.*

<sup>534</sup> *Id.*

considers the operating history of the applicant company worldwide and its proposed activities in India for granting the approval.<sup>535</sup>

## **(ii) Liaison Office**

In specific circumstances when foreign enterprises wish to make an initial assessment of the market in India before establishing permanent operations, they may consider setting up a liaison office.<sup>536</sup> A liaison office acts as a channel of communication between the parent enterprise and entities in India for promoting technical or financial collaborations between them.<sup>537</sup> The function of the liaison office is limited to collecting information about the market and providing information about the company and its products to prospective Indian customers.<sup>538</sup> Such an office is also prohibited from engaging in any trading or commercial activity, therefore, cannot earn any income in India.<sup>539</sup> Approval from RBI is required before establishing a liaison office.<sup>540</sup>

## **(iii) Project Office**

The project office is the ideal method for foreign enterprises to set up a business presence in India, if the intention is to have a presence for a limited period of time with a limited purpose of executing a specific project.<sup>541</sup> Such an office is not allowed to undertake any other activity that is unrelated or not incidental to the execution of the specific project.<sup>542</sup> The permitted activities for establishing a project office are essentially the same as those allowed for setting up

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<sup>535</sup> *Id.*

<sup>536</sup> *Id.* at art.4.3

<sup>537</sup> *Id.*

<sup>538</sup> *Id.*

<sup>539</sup> *Id.*

<sup>540</sup> *Id.*

<sup>541</sup> *Id.* at art 4.4.

<sup>542</sup> *Id.*

Branch office. General permission for setting up project offices is now granted by RBI under certain conditions while according sanction.<sup>543</sup>

#### **(iv) Joint Venture**

Joint Ventures are the most popular mode for foreign enterprises to perform business operations in India.<sup>544</sup> They can do so by entering into alliance with existing companies incorporated in India.<sup>545</sup> A joint venture can also take the form of a new company in which both the foreign investor and the Indian partner hold equity stake.<sup>546</sup> Foreign investors choose to set up operations through joint ventures for the following reasons: (i) to take advantage of the established distribution/marketing set up of the Indian partners, (ii) available financial resources of the Indian partner, (iii) available local knowledge and expertise of the Indian partner that makes it easy to complete the process of setting up operations.<sup>547</sup>

#### **(v) Wholly Owned Subsidiaries**

The other investment option open to foreign investors is the setting up of a wholly owned subsidiary. This implies that the foreign company can own hundred percent shares of the Indian company.<sup>548</sup> They are permitted to do so in specific sectors where hundred percent of equity ownership is allowed under the FDI policy.<sup>549</sup> If the foreign enterprise is interested in holding

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<sup>543</sup> *Id.*

<sup>544</sup> See India investment Climate, *supra* note 508.

<sup>545</sup> Secretariat for Industrial Assistance (SIA), *Entry strategies for Investing in India*, available at <http://siadipp.nic.in/policy/entry.htm>, (Last Visited Aug 12, 2005).

<sup>546</sup> *Id* at 2.

<sup>547</sup> *Id* at 1.

<sup>548</sup> *Id* at 2.

<sup>549</sup> *Id.*

hundred percent of the equity stake in other sectors where there are specified equity caps, they may do so after obtaining approval from the Foreign Investment Promotion Board.<sup>550</sup>

**b. Monitoring and Screening of FDI**

A project for setting up business operations in India may or may not require prior regulatory approval depending on the FDI policy in the relevant sector. There are two modalities for FDI approval: (i) automatic route<sup>551</sup> and (ii) government approval route.<sup>552</sup> The Reserve Bank of India (RBI) is the authority that accords automatic approval.<sup>553</sup> The Foreign Investment Promotion Board (FIPB) grants other proposals that require government approval.<sup>554</sup> FDI in certain sectors specified in the Industrial Policy is permitted under automatic route.<sup>555</sup> Proposals eligible under automatic route do not require actual approval from RBI.<sup>556</sup> The investor is only required to submit the following details to RBI: (i) information on inward remittances within 30 days of such receipt and (ii) the prescribed documents after issue of shares to the foreign investor.<sup>557</sup>

Proposals not covered under the automatic route are required to be approved by FIPB.<sup>558</sup> Approvals are granted on the basis of sector-specific guidelines.<sup>559</sup> While considering the applications, FIPB gives priority to the following: (i) proposals that result in importing advanced technology into the country;<sup>560</sup> (ii) proposals for infrastructure development;<sup>561</sup> (iii) projects that

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<sup>550</sup> *Id.*

<sup>551</sup> *See* FDI Policy, *supra* note 526 at art 1.4.

<sup>552</sup> *Id.* at art 1.5

<sup>553</sup> *Id.* at art 1.4

<sup>554</sup> *Id.* at art 1.6

<sup>555</sup> *Id.* at art 1.4

<sup>556</sup> *Id.*

<sup>557</sup> *Id.*

<sup>558</sup> *Id.* at art 1.6

<sup>559</sup> *Id.*, *see generally* Annex. I at 45 listing the guidelines for consideration of FDI proposals for FIPB.

<sup>560</sup> *Id.*, Annex I at art 7(g)

generate large scale employment especially in rural areas;<sup>562</sup> (iv) items having scope for large scale exports<sup>563</sup> and (v) projects that have linkage with agro business/farm sector.<sup>564</sup>

The application made to FIPB should contain details whether the applicant had any previous operations in India in the relevant sector and if so, the applicant is required to submit a statement of justification for proposing the new venture.<sup>565</sup> The decision granting or denying approval is usually intimated within 30 days upon the receipt of application.<sup>566</sup>

The Foreign Exchange Management Act (FEMA) is the regulating law for foreign companies incorporated outside India intending to establish a place of business in India.<sup>567</sup> A foreign company for the purpose of FEMA is clearly “a resident of to the extent it has a branch, or agency in India owned or controlled by a person resident outside India”.<sup>568</sup>

The foreign company is required to register with the Registrar Of Companies of the State along with necessary documents.<sup>569</sup> The accompanying documents are: (i) a certified copy of the charter of the company or other instrument defining its constitution; (ii) the registered foreign address of the company; (iii) the list of directors and secretary of the company giving the particulars regarding them; and (iv) the names and addresses of any person resident in India authorized to accept on behalf of the company service of process/notices and other documents required to be served on the company.<sup>570</sup> The information submitted to the Registrar of

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<sup>561</sup> *Id* at art 7(b)

<sup>562</sup> *Id* at art 7(d)

<sup>563</sup> *Id* at art 7(c)

<sup>564</sup> *Id* at art 7(e)

<sup>565</sup> *Id*, FDI Policy at art 1.6 (a)&(b).

<sup>566</sup> *Id* at art 1.6

<sup>567</sup> *Id*, See Chap v: Exchange Control, art 5.1

<sup>568</sup> The Foreign Exchange Management Act of India, 2000, Sec. 6(6)

<sup>569</sup> *Id*, Sec. 592

<sup>570</sup> *Id*

Companies must be constantly updated.<sup>571</sup> In addition to the companies' duty to notify changes, it must also maintain proper books of accounts for the registrar to inspect.<sup>572</sup>

In the event a foreign company ceases to carry on business in India, it may simply wind up the company by applying to the relevant court, which carries out the process of winding up.<sup>573</sup> Such a company is then required to give notice of termination to the registrar of the companies of the State.<sup>574</sup> The obligation of the company to report to the registrar of the companies ceases from the date of which the notice is given.<sup>575</sup>

The Companies Act of 1956 is the governing law for the formation of a company in India.<sup>576</sup> The Companies Act provides for incorporation of different types of companies, the most popular ones being the public and private companies.<sup>577</sup>

A private company means, "a company which has a minimum paid-up capital of INR 100,000<sup>578</sup> or such higher paid-up capital as may be prescribed".<sup>579</sup> The other features of a private company are, it (i) restricts on the right to transfer its shares;<sup>580</sup> (ii) limits the number of its members to fifty;<sup>581</sup> (iii) prohibits any invitation to the public to subscribe for its shares or debentures;<sup>582</sup> and (iv) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.<sup>583</sup>

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<sup>571</sup> *Id.*, Sec. 593

<sup>572</sup> *Id.*, Sec. 600(3)

<sup>573</sup> *Id.*, Sec. 584

<sup>574</sup> *Id.*

<sup>575</sup> *Id.*

<sup>576</sup> FDI Policy, supra note 565, *See Incorporation of Company*, Chap. VII at art.7.1

<sup>577</sup> *Id.*

<sup>578</sup> INR 100,000 is equivalent to USD 2,217 approx.

<sup>579</sup> *See* FDI Policy, supra note 565, at art 7.2

<sup>580</sup> *Id.*, art 7.2(a)

<sup>581</sup> *Id.*, art 7.2(b)

<sup>582</sup> *Id.*, art 7.2(c)

<sup>583</sup> *Id.*, art 7.2(d)

A public company means, “a company, which is not a private company and has a minimum paid-up capital of INR 500,000<sup>584</sup> or such higher paid-up capital, as may be prescribed”.<sup>585</sup> A private company, which is a subsidiary of another company, which is not a private company, is also a public company.<sup>586</sup>

The company must be registered with the Registrar of Companies of the State in which the company is to be incorporated along with required documents.<sup>587</sup> The accompanying documents are: (i) memorandum of association, which is the charter of the company containing basic conditions for incorporating the company;<sup>588</sup> (ii) articles of association, which contains the rules, regulation and bye-laws for the general management of the company;<sup>589</sup> (iii) the agreement for appointing its managing director or manager or whole time director<sup>590</sup> and (iv) location of the proposed company.<sup>591</sup> Upon registration of the company, the registrar will issue the certificate of incorporation and thereupon, the company becomes a separate legal entity.<sup>592</sup>

The Securitization Act of 2002 requires the companies to obtain government permission in the event of winding up of some businesses, making it difficult for the companies to dispose off its assets quickly.<sup>593</sup>

### **c. Sector Classification**

FDI in India is subject to sector-specific policy guidelines framed by the Indian government from time to time in accordance with its industrial policy.<sup>594</sup> As mentioned earlier,

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<sup>584</sup> INR 500,000 is equivalent to USD 11,000 approx.

<sup>585</sup> See supra note 565, at art 7.3

<sup>586</sup> *Id.*

<sup>587</sup> *Id.*, art 7.9

<sup>588</sup> *Id.*, art 7.7

<sup>589</sup> *Id.*, t 7.8

<sup>590</sup> *Id.*, art 7.9(3)

<sup>591</sup> *Id.*, art 7.9(6)

<sup>592</sup> *Id.*, art 7.11

<sup>593</sup> See India investment Climate, *supra* note 508

FDI in certain sectors is allowed under automatic route.<sup>595</sup> Others proposals require approval from FIPB.<sup>596</sup>

FDI is currently permitted in all sectors except atomic energy<sup>597</sup>, agriculture and plantations (other than tea sector)<sup>598</sup>, and railway transport. FDI up to 100% is allowed under automatic route in most manufacturing activities, non-banking financial sectors, automobile, food processing, electronic hardware, software development, advertising and films, hospitals, exploration and mining of minerals, management consultancy, private oil refineries, petroleum products pipeline.<sup>599</sup> FDI in certain specified units such as industrial/software parks, export oriented units and special economic zones also fall under the automatic route.<sup>600</sup> In addition, FDI up to 100% is allowed in drugs and pharmaceuticals, which is another sector of significant importance to U.S enterprises.<sup>601</sup>

FDI up to 100% under automatic route is also allowed in key infrastructure sectors such as electricity, transports, ports and harbors, hotel and tourism and townships, housing, built-up infrastructure and construction development projects.<sup>602</sup> In the service sector, FDI up to 100% under automatic route is allowed in research and development, information technology, health related & social services.<sup>603</sup>

Another key sector in which the FDI limit has been increased is the banking sector. The equity limit has been increased to 74% falling under the automatic route.<sup>604</sup> In the insurance

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<sup>594</sup> See India Guidebook, *supra* note 449 at 25.

<sup>595</sup> See FDI Policy, *supra* note 525 at art 1.4.

<sup>596</sup> *Id.*, art 1.5

<sup>597</sup> *Id.*, Annex IV at 57

<sup>598</sup> *Id.*, Annex II at 47

<sup>599</sup> *Id.*, Annex III at 56

<sup>600</sup> *Id.*

<sup>601</sup> *Id.*, Annex II at 49

<sup>602</sup> *Id.*, Annex II at 57

<sup>603</sup> *Id.*, Annex V at 58

<sup>604</sup> *Id.*, Annex II at 53

sector, FDI up to 26% is allowed on the automatic route; however, it is subject to obtaining license from insurance regulatory & development authority.<sup>605</sup> Another significant policy initiative includes raising FDI equity limit in domestic airlines sector to 49% and placing it under the automatic route.<sup>606</sup> Approvals for foreign equity ownership over the specified equity cap in each sector and those involving areas outside of the specified twenty-three sectors have to be approved by Foreign Investment Promotion Board (FIPB).<sup>607</sup>

**d. Facilities and Incentives**

To attract foreign capital, India established Export Oriented Units (EOU)<sup>608</sup> and Special Economic Zones (SEZs),<sup>609</sup> providing favorable conditions for investment, offering various tax incentives and better infrastructure to set up business.<sup>610</sup> The Indian government also welcomes proposals for setting up industrial parks/model towns/growth centers.<sup>611</sup> The rules governing these schemes are separate and the benefits they offer are different.

In line with its economic policy, the Indian government has made substantial reductions in corporate tax, customs and excise duties.<sup>612</sup> In order to provide impetus for investing in the hi-tech industry, to increase its export capacity and to build efficient technology parks, the Indian government offers various schemes of incentives and facilities like duty free imports and export

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<sup>605</sup> *Id* at 50

<sup>606</sup> *Id* at 47

<sup>607</sup> *Id* at 2

<sup>608</sup> *Id*, Chap VII at 26

<sup>609</sup> *Id*

<sup>610</sup> *Id*

<sup>611</sup> *Id* at 27

<sup>612</sup> *Id*, Chap IX at 30

benefits in addition to providing tax holidays.<sup>613</sup> All knowledge-based proposals also enjoy a ten-year tax holiday.<sup>614</sup>

In addition, the state governments also compete with each other by offering various fiscal concessions and other incentives in order to attract investment to their state.<sup>615</sup> The benefits offered by the State government includes exemptions from sales tax, excise duty for a definite period or linked to the capital investment in the State, on goods manufactured in the State.<sup>616</sup>

SEZs are treated as foreign territories for the purpose of duties and taxes, and they also operate outside the domain of the custom authorities.<sup>617</sup> The number of SEZs have increased to thirty-four and they also enjoy relaxed regulatory requirements.<sup>618</sup> Additionally, SEZs are allowed to carry forward their losses for eight consecutive years.<sup>619</sup>

The EOUs are industrial companies that can be set up anywhere in India. The incentives offered for investing in EOU's include duty-free imports, a ten-year income tax holiday, exemption from excise tax and sales taxes.<sup>620</sup> Another notable feature is the Indian government does not impose any restriction for employing foreign nationals and there is also no requirement to employ Indian nationals.<sup>621</sup>

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<sup>613</sup> *Id*, Chap VIII art 8.13

<sup>614</sup> *See* India investment Climate, *supra* note 508.

<sup>615</sup> *Id*

<sup>616</sup> *See* India Guidebook, *supra* note 449 at 49.

<sup>617</sup> *See* India investment Climate, *supra* note 508.

<sup>618</sup> *Id*

<sup>619</sup> *Id*

<sup>620</sup> *Id*

<sup>621</sup> *Id*

### e. **Repatriation of Capital and Profits**

The Indian government has eliminated all requirements on repatriation that were previously imposed.<sup>622</sup> The law governing foreign exchange transactions is Foreign Exchange Management Act, 1999, (FEMA) which has replaced the earlier Act FERA.<sup>623</sup> FEMA was enacted to “facilitate external trade” and “promote the orderly development and maintenance of foreign exchange market in India”.<sup>624</sup>

Foreign nationals are allowed to open bank accounts in India and receive funds from abroad.<sup>625</sup> Under the new liberalized regime, free repatriation of any capital appreciation, free remittance of royalties, technical fees, dividends, interest etc., is allowed without approval from the Reserve Bank of India (RBI), however, it is possible only after payment of taxes.<sup>626</sup> Repatriation of capital is also permitted with the approval of RBI, provided the disinvestment has also been made with the approval of the RBI.<sup>627</sup>

### 3. **Applicable laws for U.S investors in India**

There are different bodies of law affecting foreign investment in India. They cover all aspects of trade, industrial activity, taxes, foreign exchange, competition, taxation and social security.<sup>628</sup> India is continuously amending its different laws and regulations, through a system of notifications<sup>629</sup>, to keep them in line with changing circumstances.

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<sup>622</sup> See REDDY, *supra* note 1 at 47

<sup>623</sup> See FDI Policy, *supra* note 526, art 5.1

<sup>624</sup> *Id*

<sup>625</sup> *Id*, art 5.7

<sup>626</sup> *Id*, art 5.7(ii)

<sup>627</sup> See India Guidebook, *supra* note 449 at 55

<sup>628</sup> *Id* at 33

<sup>629</sup> *Id*

**Labor Laws:** India has enacted extensive set of laws to provide a good working environment for labor/employees and to protect their interests.<sup>630</sup> However the management sector is largely governed by individual contracts.<sup>631</sup>

India is a member of the International Labor Organization and has also ratified number of labor conventions.<sup>632</sup> Disputes concerning industrial employees are heard by labor courts.<sup>633</sup> The civil courts handle the other categories of labor disputes.<sup>634</sup>

The key labor laws include: (i) Industrial Disputes Act, 1947, which governs the conduct of industrial relations and also provides for just and equitable settlement of disputes through arbitration, conciliation and negotiations;<sup>635</sup> (ii) Trade Unions Act that provides regulations to manage industrial relations on behalf of workers;<sup>636</sup> (iii) The Factories Act, 1948 for regulating working conditions in an industry;<sup>637</sup> (iv) the Payment of Wages Act, 1936 and Minimum Wages Act, 1948.

**Competition Law:** The Monopolies Restrictive Act, 1969 dealt with anti-competitive practices in a limited way.<sup>638</sup> In light of globalization and increased competition, the Indian government enacted the Competition Act in 2002 for the purpose of establishing a commission, to prevent practices that have adverse effects on competition and to promote competition in markets ensuring freedom of markets and to protect the interests of consumers.<sup>639</sup>

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<sup>630</sup> *Id* at 34

<sup>631</sup> *Id.*

<sup>632</sup> *See* VARADARAJAN, *supra* note 12 at 52

<sup>633</sup> *See* India Guidebook, *supra* note 449 at 34

<sup>634</sup> *Id*

<sup>635</sup> *See* VARADARAJAN, *supra* note 12 at 53

<sup>636</sup> *Id* at 54

<sup>637</sup> *Id* at 47

<sup>638</sup> *See* India Guidebook, *supra* note 449 at 38

<sup>639</sup> The Gazette of India, Ministry of Law and Justice, *The Competition Act of 2002*, available at [http://www.competition-commission-india.nic.in/Act/competition\\_act2002.pdf](http://www.competition-commission-india.nic.in/Act/competition_act2002.pdf) at 1 (Last Visited Aug 20, 2005)

The Competition Act focuses on agreements entered into between enterprises that may restrict competition.<sup>640</sup> The agreements may be between buyers and sellers (horizontal) relating to exclusive distribution or they may be between competitors (vertical) relating to issues such as price fixing and production controls.<sup>641</sup>

The Act also deals with activities involving abuse of dominance by enterprises such as restricting the quantity of supply.<sup>642</sup> Further, schemes for restructuring an enterprise such as mergers & acquisitions are required to be notified if they are beyond a specified threshold limit.<sup>643</sup>

**Taxation laws:** In India, taxes are levied both at Central and State levels.<sup>644</sup> The two categories of taxes are: (i) direct taxes that generally apply on income such as personal income tax, wealth tax and gift tax;<sup>645</sup> and (ii) indirect taxes that generally relate to commercial transactions such as, customs tariffs, excise duty, sales tax, service tax, property tax.<sup>646</sup>

In India, domestic and foreign companies are treated differently in administering tax rates.<sup>647</sup> The domestic companies are taxed on their worldwide income, whereas the foreign companies are taxed only on the income derived from Indian operations.<sup>648</sup>

Since 1991, the Indian government has made significant changes in tax laws.<sup>649</sup> It has made substantial reductions in corporate tax, customs and excise duties to mention a few.<sup>650</sup> It has also been widening the tax base and strengthening up the tax administration.<sup>651</sup>

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<sup>640</sup> *Id*, sec. 3

<sup>641</sup> *Id*

<sup>642</sup> *Id*, sec. 4

<sup>643</sup> *Id*, sec. 5

<sup>644</sup> *See* FDI Policy, *supra* note 525 at Chap. IX

<sup>645</sup> *Id*, art 9.1

<sup>646</sup> *Id*

<sup>647</sup> *See* India Guidebook, *supra* note 449 at 44

<sup>648</sup> *Id*

<sup>649</sup> *See* FDI Policy, *supra* note 525 at 9.1

<sup>650</sup> *Id*

Nevertheless, foreign investors have found the tax regime complex.<sup>652</sup> The Indian government has been working towards simplifying tax laws, reducing tax rates and providing greater transparency in tax administration.<sup>653</sup> An important reform made in the tax regime recently is the launching of the value-added tax (VAT) with an aim to bring out worldwide uniformity in tax system and curb rampant tax evasion.<sup>654</sup> It is also aimed at replacing a web of sales taxes across the states that had led to duplicate taxation.<sup>655</sup>

The other applicable laws include the Indian Contracts Act, the Sale of Goods Act, Consumer Protection Act, Negotiable Instruments Act, Information Technology Act, Air Prevention and Control of Pollution Act and the SEBI Act.

#### 4. Property Rights

**Immovable Property:** The legal system does not impose any restriction for buying and selling lands and buildings by foreign investors for the purpose of carrying out business in India.<sup>656</sup> Nevertheless, there are a number of requirements to be fulfilled in the event of the transfer of land, resulting in unclear titles and making it difficult to use property as collateral or to foreclose against such property.<sup>657</sup>

**Intellectual Property:** Before joining the WTO, India did not have adequate laws to protect intellectual property rights.<sup>658</sup> Infringement of intellectual property rights was a major

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<sup>651</sup> *Id*

<sup>652</sup> *See* India Investment Climate, *supra* note 508

<sup>653</sup> *Id*

<sup>654</sup> India Finance and Investment Guide, *Taxation – VAT in India*, available at <http://finance.indiamart.com/taxation/> (Last Visited Aug 22, 2005)

<sup>655</sup> *Id.*

<sup>656</sup> *See* India Investment Climate, *supra* note 508

<sup>657</sup> *Id*

<sup>658</sup> *See* India Guidebook, *supra* note 449 at 36

concern for foreign investors.<sup>659</sup> After India became a member of the WTO<sup>660</sup>, it was compelled to bow to the conditions of the WTO. India is also a member of the World Intellectual Property Organization and UNESCO.<sup>661</sup>

Agreement on the TRIPS required India to enact new legislation as well as make significant changes in existing laws on trademarks, patents and copyrights.<sup>662</sup> The government of India subsequently enacted extensive laws and regulations to protect intellectual property rights in accordance with the standards laid out by WTO.<sup>663</sup>

The Trade Marks Act, 1999 and the Trade Marks Rules of 2002 are the applicable laws for trademarks in India.<sup>664</sup> The salient features of the new trademark laws are it provides for registration of trademarks as well as service marks, multi-class application, rectification of applications, single register, and register for collective marks. It also presents simplified procedures for registration and an Appellate Board for speedy disposal of appeals.<sup>665</sup>

Trademark protection is generally considered good by the foreign investors.<sup>666</sup> Another remarkable feature is that the law accords national treatment for trademark owners.<sup>667</sup> A few U.S investors have nevertheless faced problems in exercising their rights under trademark law in India.<sup>668</sup>

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<sup>659</sup> Embassy of India, *Policy Statements: Intellectual Property Rights in India*, available at [http://www.indianembassy.org/policy/ipr/ipr\\_2000.htm](http://www.indianembassy.org/policy/ipr/ipr_2000.htm) (Last Visited Aug 14 2005)

<sup>660</sup> WTO, *India became a WTO member on Jan. 1 1995*, available at [http://www.wto.org/english/thewto\\_e/countries\\_e/india\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/india_e.htm) (Last Visited Aug 14 2005)

<sup>661</sup> See India Investment Climate, *supra* note 508

<sup>662</sup> See TRIPS Agreement, *supra* note 371

<sup>663</sup> See India Investment Climate, *supra* note 508

<sup>664</sup> See REDDY, *supra* note 1 at 154

<sup>665</sup> *Id* at 156

<sup>666</sup> See India Investment Climate, *supra* note 508

<sup>667</sup> *Id*

<sup>668</sup> *Id*

The copyright laws in India are also comprehensive, however, enforcement still remains ineffective.<sup>669</sup> India is a member of number of international conventions pertaining to copyrights such as Berne Convention for the Protection of Literary and Artistic works, Universal Copyright Convention, Convention for the Protection of Producers of Phonograms against unauthorized Duplication of their Phonograms and Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties.<sup>670</sup> Infringement of copyright is an offense punishable by imprisonment under the Copyright Act, 1957.<sup>671</sup>

India has amended its Patent Act in April 2005 to comply with TRIPS through a presidential ordinance.<sup>672</sup> The new laws provide for expanded protection of both the products patent and process patent.<sup>673</sup> Before the amendments, many U.S drug companies were frustrated over slack patent protection in India because ‘process patent’ encouraged reverse engineering to manufacture the same product under a different process.<sup>674</sup> India finally yielded to the mounting pressure from the U.S by expanding its ‘product patent’ coverage to include pharmaceuticals and agro-chemicals, sectors of major concern to the U.S firms.<sup>675</sup>

In sum, India has updated its intellectual property laws conforming to international standards. The major concern of the U.S investors now is regarding the enforcement of the laws.<sup>676</sup>

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<sup>669</sup> *Id*

<sup>670</sup> Dept. of Secondary Education and Higher Education (Govt. of India), *A Handbook of Copyright Law*, available at <http://www.education.nic.in/htmlweb/copyright.htm> (Last Visited Aug 14, 2005)

<sup>671</sup> *Id*

<sup>672</sup> Ministry of Law and Justice, *The Patent (Amendment) Act 2005*, available at [http://www.ipindia.nic.in/ipr/patent/patent\\_2005.pdf](http://www.ipindia.nic.in/ipr/patent/patent_2005.pdf) (Last Visited Aug 14, 2005)

<sup>673</sup> See REDDY, *supra* note 1 at 159

<sup>674</sup> See India Investment Climate, *supra* note 508

<sup>675</sup> *Id*

<sup>676</sup> *Id*

## 5. Investment Guarantees and Bilateral Arrangements with U.S.

The U.S and India signed an Investment Incentive Agreement<sup>677</sup> in 1987 to promote and protect U.S investments in India by facilitating investment support to U.S investors through the Overseas Private Investment Corporation (OPIC).<sup>678</sup> The OPIC support covers “any debt or equity investment, any investment guarantee, any investment insurance or reinsurance” provided in connection with a project in India.<sup>679</sup> The agreement provides insurance for risks relating to, “the conversion of currency, loss of investment due to expropriation, war, revolution, insurrection or civil strife etc.,”<sup>680</sup> The sectors covered by the OPIC in India are energy and power, telecommunications, manufacturing and services.<sup>681</sup>

The Agreement is based on the principle of reciprocity between the governments of both the nations.<sup>682</sup> The Agreement also provides for dispute resolution mechanism for disputes between the two Governments in matters covered under the agreement and specifies recourse to international arbitration.<sup>683</sup> In 2004, OPIC filed for arbitration for a contractual dispute relating to the Dabhol Power Plant<sup>684</sup> in India claiming repayment by the Indian government due to expropriation.<sup>685</sup>

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<sup>677</sup>The Investment Incentive Agreement is referred to as the “Agreement” in this subchapter

<sup>678</sup> Indian embassy, *Statement-U.S and India sign investment agreement*, available at <http://www.indianembassy.org/indusrel/iia111997.htm> (Last Visited Aug 14, 2005)

<sup>679</sup> *Id*

<sup>680</sup> *Id*

<sup>681</sup> *See* India Investment Climate, *supra* note 508

<sup>682</sup> *See* Statement by Indian embassy, *supra* note 678

<sup>683</sup> *Id*

<sup>684</sup> Dabhol Power Plant was a large electrical power development project in India under an agreement between a number of U.S enterprises and the Indian government. The project became highly controversial in the relevant state and resulted in multibillion dollar losses to investors, *See* John R. Crook, *U.S Initiates Arbitration Against India Over OPIC Claims For The Dabhol Power Project*, 99 Am. J. Int’l L. 271 (2005).

<sup>685</sup> *Id* at 272

India is also a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA)<sup>686</sup> that covers political risk insurance to foreign private investors in India against the risks of expropriation, transfer of currency restriction, breach of contract, war and civil disturbance.<sup>687</sup>

Taxations matters between the two nations are covered under the Indo-U.S Double Taxation Avoidance Treaty.<sup>688</sup> The Treaty considerably reduces the withholding tax in India for royalties, fees for technical services, and for interest paid to the U.S banks and financial institutions.<sup>689</sup> The disputes covered under the treaty are regularly addressed by authorities of both the nations.<sup>690</sup>

## 6. International Investment Measures

Under the Trade Related Investment Measures (TRIMS) of the WTO, the member countries are required to phase out performance requirements especially in regard to the local content requirement, export restrictions and trade balance requirement.<sup>691</sup> Accordingly, India notified three inconsistent TRIMS: (i) that relating to local content (mixing) requirements in the production of the news print; (ii) that relating to local content requirements in the production of certain pharmaceutical products; and (iii) dividend-balancing requirement in the case of investment in 22 categories of consumer goods.<sup>692</sup> Subsequently, the Indian government

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<sup>686</sup> India became a member of the MIGA in 1993, See IEO, *The World Bank In India*, available at <http://www.ieo.org/world-c1-p4.html> (Last Visited Aug 16 2005)

<sup>687</sup> *Id*

<sup>688</sup> See Statement by Indian embassy, *supra* note 678

<sup>689</sup> *Id*

<sup>690</sup> See India Investment Climate, *supra* note 508

<sup>691</sup> DEPT OF COMMERCE (INDIA), *The Agreement On Trade related Investment Measures: India notified TRIMS*, available at <http://commerce.nic.in/wtotrims.htm#h4> (Last Visited Aug. 15, 2005)

<sup>692</sup> *Id*

removed measures previously requiring local content and foreign exchange balancing in key sectors including automobile sector.<sup>693</sup>

## 7. Dispute Resolution

The Indian Contracts Act of 1872 is comprehensive, encompassing principles and areas covered under U.S common law, the Uniform Commercial Code and the Restatement of Contracts (Second).<sup>694</sup> However, some U.S investors are dissatisfied with the lack of “sanctity of contracts” in India.<sup>695</sup> In spite of Indian courts being independent, the lengthy mainstream adjudication process has prompted foreign investors to opt for alternative dispute settlement mechanisms.<sup>696</sup>

In order to bring greater uniformity between its law and the needs of international arbitration over commercial disputes, the Indian government enacted the Arbitration & Conciliation Act in 1996, based on the UNCITRAL (United Nations Commission On International Trade Law).<sup>697</sup>

Some of the key features of the Act are: (i) it includes both the domestic and international commercial arbitration; (ii) it recognizes the finality of the arbitration awards and severely limits the judicial review of the award; (iii) the Civil Procedure Code and the Indian Evidence Act are not applicable in the conduct of arbitral proceedings as the procedures specified therein may delay the decision; (iv) the nationality of the arbitrators is open, except where the parties have

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<sup>693</sup> See India Investment Climate, *supra* note 508

<sup>694</sup> See RIEDY, *supra* note 498 at 349

<sup>695</sup> See India Investment Climate, *supra* note 508

<sup>696</sup> See India Guidebook, *supra* note 449 at 71

<sup>697</sup> *Id*

agreed otherwise; and (v) foreign awards can be enforced in India, against proof of such awards.<sup>698</sup>

India is a signatory of Geneva Convention on the Execution of Foreign Arbitral Awards<sup>699</sup> and has also ratified the New York Convention of 1958.<sup>700</sup> India is not a member of the ICSID (International Center for the Settlement of Investment Disputes).<sup>701</sup> The Indian government established the International Center for Alternative Dispute Resolution (ICADR) to promote settlement of domestic and international disputes through different modes of alternate dispute resolution.<sup>702</sup>

#### **D. Impact of FDI**

In July 1991, the tides of the Indian economy were at their lowest ebb. Inflation was running at an all time high of nearly 17 percent.<sup>703</sup> The foreign exchange reserves were so less that India was in danger of being, for the first time, declared a defaulter in the timely payment of its foreign debts.<sup>704</sup> India was also largely isolated from the world markets in order to protect its fledging economy and achieve self-reliance.<sup>705</sup>

Stimulated by the government's economic reform initiatives and its increasingly welcoming stance towards foreigners, India's economy has averaged 6 percent growth per year

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<sup>698</sup> *Id*

<sup>699</sup> *See* India Investment Climate, *supra* note 508

<sup>700</sup> *Id*

<sup>701</sup> *Id*

<sup>702</sup> *Id*

<sup>703</sup> *See* VARMA, *supra* note 20 at 78

<sup>704</sup> *Id* at 80

<sup>705</sup> *Id*

over the last fifteen years as against 2.9 percent in 1970s.<sup>706</sup> India's FDI inflows accounted for 2.3 percent of its Gross Fixed Capital Formation in 2000 as against 0.6 percent over 1985-95.<sup>707</sup>

The substantial volume of FDI inflows into the country has contributed to a steep reduction in inflation and better balance of payments situation. India's reliance on external assistance and commercial borrowings has remarkably decreased and since 2002, it has been repaying them.<sup>708</sup> India's debt service ratio decreased to 14.1% in 2001-02 from 35.3% in 1990-91.<sup>709</sup> Another positive indicator of the external sector is reflected in a rising involvement of Indian companies abroad.<sup>710</sup>

U.S direct investment, particularly in the non-traditional export sector have led to higher exports and therefore helped in diversifying Indian exports.<sup>711</sup> As in China, the impact of U.S investment on India's economic policy and legal framework is significant. The economic and legal reforms have also provided striking impetus to domestic industries resulting in high levels of productivity and competition among them.<sup>712</sup>

FDI in India is found concentrated in high technology intensive industries leading to a quality growth. Such industries have greatly benefited by the transfer of modern technology from investor nations.<sup>713</sup> Economic studies indicate that spillovers of technology are significant source of growth and technical change and FDI has proved to be a major source of such spillovers in India.<sup>714</sup>

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<sup>706</sup> Id at 87

<sup>707</sup> UNCTAD, *World Investment Report 2002*, available at <http://www.unctad.org/Templates/Page.asp?intItemID=1465&lang=1> (Last Visited Aug 23 2005)

<sup>708</sup> WIKIPEDIA, *Economy of India*, available at [http://en.wikipedia.org/wiki/Economy\\_of\\_India#Corruption](http://en.wikipedia.org/wiki/Economy_of_India#Corruption) (Last Visited Aug 23 2005)

<sup>709</sup> *Id*

<sup>710</sup> See REDDY, *supra* note 1 at 33

<sup>711</sup> *Id* at 42

<sup>712</sup> *Id*

<sup>713</sup> See WEI, *supra* note 473, at 59

<sup>714</sup> See World Investment Report, *supra* note 706 at 46

Further, FDI has resulted in creation of employment opportunities in various sectors. Especially, the services sector that has steadily attracted huge volumes of FDI has provided employment to 23 percent of the work force.<sup>715</sup> Further more, statistics indicate that employment opportunities have been steadily growing in SEZs/EOU and industrial parks where large number of foreign invested companies are located.<sup>716</sup>

The services sector has become India's primary engine of growth accounting for more than 50 percent of India's GDP, marking a watershed in the evolution of the Indian economy.<sup>717</sup> A notable feature of the service sector is the tremendous growth of the Indian software industry. The strength of the software sector can be indicated by the fact that the Indian software and services exports have managed to grow by leaps and bounds over the past few years despite the economic downturn that swept the worldwide markets.<sup>718</sup> The increasing demand for Business Process Outsourcing (BPO) operations in India has caught worldwide attention. BPO industry is now significantly contributing to employment and service exports in India.<sup>719</sup> Thus, FDI has proved to be a major reason for India's increasing integration with the world economy.

FDI in India has nevertheless concentrated in few states such as Maharashtra, Gujarat, Karnataka, Tamil Nadu and Andhra Pradesh and around few industrial towns, which are better placed with infrastructure like well developed ports, urbanization and an educated and skilled work force that attract manufacturing and service sectors.<sup>720</sup> India still being an agrarian economy with almost 70 percent of the population depending on this sector, the sharp and

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<sup>715</sup> See WIKIPEDIA, *Services Sector*, supra note 708

<sup>716</sup> *Id*

<sup>717</sup> ASIA TIMES, *Manufacturing catches up in India*, (Mar 15 2005) available at [http://www.atimes.com/atimes/South\\_Asia/GC15Df05.html](http://www.atimes.com/atimes/South_Asia/GC15Df05.html)

<sup>718</sup> EMBASSY OF INDIA, *India's Software Industry*, available at [http://www.indianembassy.org/indiainfo/india\\_it.htm](http://www.indianembassy.org/indiainfo/india_it.htm) (Last Visited June 14 2005)

<sup>719</sup> See WIKIPEDIA, *Services Sector*, supra note 708

<sup>720</sup> *Id*, See Regional Imbalance in India

increasing disparity among different states/sectors is hindering the overall balanced development of the Indian economy.<sup>721</sup>

Another downside of FDI in India can be witnessed in the BPO industry where employees are facing serious health hazards due to odd work schedule and endless night shifts in order to serve the needs of customers from different time zones.<sup>722</sup> Government's action for regulating work hours in such industry is the biggest requirement of the hour.

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<sup>721</sup> *Id*

<sup>722</sup> BBC NEWS, *Greying of India's Call Centres* (Aug 5, 2004), available at [http://news.bbc.co.uk/1/hi/world/south\\_asia/3534672.stm](http://news.bbc.co.uk/1/hi/world/south_asia/3534672.stm)

## CHAPTER IV

### **AN ANALYSIS OF ADVANTAGES AND DISADVANTAGES OF INVESTING IN CHINA AND INDIA**

The similarities between China and India in the initial economic conditions is striking. Both the nations started development around 1950 with sizable populations and agricultural based economies. Both the nations adopted a policy of closed economy, emphasizing on import substituting industrialization.<sup>723</sup> However, China ventured into the path of liberalization in 1979 whereas India initiated the liberalization process only in 1991. Hence, China has been wrestling with the complexities of FDI longer than India. Furthermore, China's experience with FDI has been a historic success story providing valuable lessons for India and other developing nations. In China, the successors of Deng Xiaoping have faithfully followed the path of economic liberalization laid by him, whereas in India, even in 1990s, either the ruling party or the opposition harbored a hostile attitude towards economic liberalization, which has hence taken place only amidst heated political debate.

China has been able to attract huge sums of FDI inflows by gradually relaxing the FDI regulations and by offering super national treatment for the foreign invested enterprises. India has also followed a similar path by slowly lifting its FDI restrictions and making other significant reforms in its policy to attract huge volumes of FDI. However, the reform process in

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<sup>723</sup> See VARMA, *supra* note 20, at 34

India was evolutionary rather than revolutionary as in China.<sup>724</sup> The investment strategies used by the Indian government in attracting FDI was less dramatic than those used by the Chinese government.

However, significant shifts have taken place in recent years. The Indian government has also been pursuing a revolutionary programme of structural economic reforms and has taken major initiatives such as industrial decontrol, simplification of investment procedures, liberalization of trade policy, financial sector reforms, liberalisation of exchange regulations etc., in order to provide a liberal and investor friendly investment climate.

There has been a popular presumption that China's FDI policy, being more liberal than that of India's is the reason for the super-magnetic attraction of huge FDI inflows.<sup>725</sup> In fact, it has been reported that FDI regime in India is much more liberal than that of China.<sup>726</sup> India allows 100 percent foreign equity participation in many key sectors including airports and mass transport systems and 51 percent foreign equity participation under automatic approval in most sectors.<sup>727</sup> On the other hand, China prohibits wholly owned foreign enterprises in 31 sectors.<sup>728</sup> Yet another 31 sectors are open only to those foreign invested enterprises that hold a majority of equity from chinese partners.<sup>729</sup> Thus, compared to China, which has restricted foreign investment in targeted key sectors, the Indian market could offer greater possibilities.

Another dimension is the distinct political environment in the two nations. Academic literature acknowledges the fact that the political system and the economy will be not be in synchronization if both are not based on principles of complete freedom.<sup>730</sup> In this respect, India

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<sup>724</sup> *Id* at 78

<sup>725</sup> *See* WEI, *supra* note 441 at 55

<sup>726</sup> *Id*

<sup>727</sup> *Id*

<sup>728</sup> *Id*

<sup>729</sup> *Id*

<sup>730</sup> *Id*

has no inherent conflict between its political system that is based on complete freedom of thought and expression and its economic system that is focused on principles such as globalization, liberalization and privatization. On the other hand, China's political system is based on communist dictatorship that lacks overall freedom as well as transparency in the political process. China's political ideologies hence are in striking contrast to its economic ideologies.<sup>731</sup> Thus, China remains major political risk for investors given its complex and integrated political environment.<sup>732</sup>

The legal environment in India is also highly conducive to FDI. The administration of legal system under the Constitution, statutes passed by the legislators and precedents' arising out of court decisions is akin to the American legal system. The judicial system in India is also well developed and the functioning of courts is transparent. Judiciary in India is an independent organ with extensive powers. All these features are lacking in the Chinese legal system where the extent of influence exerted by the Communist Party in its political and judicial functioning is simply large.

Many writers have argued that India's tax rates are much higher than that of China. They have added that this is a major reason for India's relatively low FDI inflows. This situation may change soon as China has announced elimination of the super national treatment of foreign invested enterprises in tax assessment.

Many economists have attributed stringent labor regulations in India as a cause for low investment in the manufacturing sector. They argue that labor regulations in China have been relatively flexible resulting in huge FDI inflows in the manufacturing sector. However, it has also been reported that working conditions in the manufacturing industry in China are very

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<sup>731</sup> See VARMA, *supra* note 20, at 65

<sup>732</sup> *Id*

tough; workers stay in cramped rooms and work long hours. They are also prohibited to form their own unions/associations. This situation is likely to change in the near future as workers are increasingly becoming aware of their rights. Although the WTO has not dealt with labor issues so far, it may do so in near future. In China, foreign invested enterprises are required to give priority in hiring to Chinese citizens over foreign nationals,<sup>733</sup> whereas in India, there is no such requirement.

Both China and India are notorious for infringement of intellectual property rights. Although, both the nations now have adequate laws for protection of intellectual property, the implementation of the laws is a major concern of TNCs. As noted above, the recent efforts by governments of both the nations aiming at executing the reforms made in this area is likely to change the situation.

Recent reports have revealed that India and China suffer from another major problem that significantly threatens U.S investment -- Corruption. Under the Foreign Corrupt Practices Act ("FCPA"), the U.S business enterprises are prohibited from bribing government officials of other countries in order to obtain or retain business.<sup>734</sup> The FCPA provides serious civil and criminal penalties to those U.S enterprises and their executives who engage in such corrupt behavior.<sup>735</sup>

The 2004 Corruption Perceptions Index<sup>736</sup> indicates that corruption is rampant in the public sector and has listed India as number 90 and China as number 71, putting them among countries with widespread corruption.<sup>737</sup> The bureaucratic structure of both China and India itself facilitates corruption. U.S investors have constantly complained that the powerful bureaucracy

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<sup>733</sup> See China Law Desk, *supra* note 44 at 383

<sup>734</sup> 15 U.S.C. S 78dd-1, et seq. (2004)

<sup>735</sup> Bruce M. Boyd, *Governmental Corruption In China: Application of the Foreign Corrupt Practices Act*, 3 Santa Clara J. Int'l L. 235.

<sup>736</sup> The TI Corruption Perception Index ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians.

<sup>737</sup> Transparency International – *2004 Corruption Perceptions Index*, available at [http://www.transparency.org/cpi/2004/dnld/media\\_pack\\_en.pdf](http://www.transparency.org/cpi/2004/dnld/media_pack_en.pdf) (Last Visited Aug 26 2005)

with broad discretionary powers in both the nations serve as a major hindrance to U.S businesses. Both the nations are gearing up to stem this menace and bring order and transparency in business by instituting significant legal and institutional changes.<sup>738</sup> The 2003 Implementation Guidelines for the Government Procurement Law and the enactment of new regulations on Party Supervision and Disciplinary Policy in February 2004 are two significant reforms for regulating bureaucracy in China.<sup>739</sup> India enacted the Central Vigilance Commission Bill in September 2003 that permits inquiries into corruption offences committed by certain categories of public servants.<sup>740</sup> Effective implementation of the anti-corruption laws is the biggest requirement of the hour.

According to A.T. Kearney's FDI Confidence Index-2004, the global investors view China and India as distinctly different markets. They perceive China as the world's leading manufacturer and fastest growing consumer market and India as the leader for research and development, business process and information technology services provider.<sup>741</sup> They favor China for its market size, favorable cost structure, access to export markets, infrastructure and macroeconomic climate.<sup>742</sup> However, they have also indicated that India's highly educated workforce, management talent, rule of law, transparency and regulatory environment as favorable to what China offers.<sup>743</sup>

Thus, in spite of some pitfalls as noted above, these two nations dominate the leading positions for most positive investor outlook. With the current international attention on India's tremendous potential for FDI, implementation of specific reforms addressing the pitfalls will

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<sup>738</sup> Global Corruption Report, Country Reports, Legal and Institutional changes by China and India, available at [http://www.globalcorruptionreport.org/gcr2005/download/english/country\\_reports\\_a\\_j.pdf](http://www.globalcorruptionreport.org/gcr2005/download/english/country_reports_a_j.pdf) (Last Visited Aug 26 2005)

<sup>739</sup> *Id.*, at 130

<sup>740</sup> *Id.*, at 156

<sup>741</sup> See Kearney, *India and China spar over FDI like David and Goliath*, *supra* note 2, at 4.

<sup>742</sup> *Id.*

<sup>743</sup> *Id.*

only lead to more FDI inflows and sustained economic development. The rest of the world will face severe competitive pressures from these two rapidly evolving economies.

## CHAPTER V

### CONCLUSION

FDI is good for India: first for its economic growth rate; second for transmitting technology and know-how into the country, third for integrating with the world economy and fourth because it is not debt creating and is relatively resistant during financial crisis. In any case, a huge volume of FDI is not the only means to achieve healthy development. “The optimum level of FDI a country should aspire to is conditioned by the history and the stage of its industrialization, the sources of FDI it has ease of access to, and its endowments of co-operant factors and the sort of institutions it possesses to facilitate and monitor the operations of foreign firms.”<sup>744</sup> Nevertheless India should identify lessons from China’s infrastructure planning and government incentives to increase its FDI inflows. With the aim of encouraging investment, the present Indian government under the leadership of Dr. Manmohan Singh, an outstanding economist himself, has formulated a set of policy reforms that are in the interests of foreign investors. The recent policy changes are remarkable, however quick implementation in both letter and spirit is essential for the success of these policies. By doing so, India will move in the right direction towards attracting optimum levels of FDI for quality development.

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<sup>744</sup> See WEI, supra note 441, at 66.

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