FOREIGN INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA: COMPENSATION TRADE, JOINT VENTURES, INDUSTRIAL PROPERTY PROTECTION AND DISPUTE SETTLEMENT*

**Table of Contents**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION</td>
<td>234</td>
</tr>
<tr>
<td>II. FRAMEWORK FOR INVESTMENT</td>
<td>236</td>
</tr>
<tr>
<td>A. Compensation Trade</td>
<td>236</td>
</tr>
<tr>
<td>1. Forms of Compensation Trade</td>
<td>237</td>
</tr>
<tr>
<td>2. Examples of Compensation Trade Agreements</td>
<td>239</td>
</tr>
<tr>
<td>a. Initial Steps</td>
<td>240</td>
</tr>
<tr>
<td>b. Inspection Requirements</td>
<td>240</td>
</tr>
<tr>
<td>c. Delivery of Goods</td>
<td>241</td>
</tr>
<tr>
<td>d. Transfer of Title on Capital Goods</td>
<td>242</td>
</tr>
<tr>
<td>B. Joint Ventures</td>
<td>242</td>
</tr>
<tr>
<td>1. General Guidelines</td>
<td>243</td>
</tr>
<tr>
<td>a. Equality and Mutual Benefit Requirements</td>
<td>243</td>
</tr>
<tr>
<td>b. Authorization</td>
<td>243</td>
</tr>
<tr>
<td>c. Board of Directors</td>
<td>243</td>
</tr>
<tr>
<td>2. Dispute Settlement</td>
<td>244</td>
</tr>
<tr>
<td>3. Protection of Investments and Profits</td>
<td>246</td>
</tr>
<tr>
<td>4. Permissible Forms of Business Organizations</td>
<td>247</td>
</tr>
<tr>
<td>5. Capital Contributions</td>
<td>248</td>
</tr>
<tr>
<td>6. Profit Distribution, Repatriation, and Taxation</td>
<td>249</td>
</tr>
<tr>
<td>a. Determination of Income Tax and Net Profit</td>
<td>249</td>
</tr>
<tr>
<td>b. Incentives for Modern Technology Project and Profit Re-Investment</td>
<td>250</td>
</tr>
<tr>
<td>c. Repatriation Rights</td>
<td>251</td>
</tr>
<tr>
<td>d. Methods of Financial Transactions</td>
<td>252</td>
</tr>
<tr>
<td>7. The Chinese View of Written Legal Documents</td>
<td>252</td>
</tr>
<tr>
<td>8. Concluding Observations</td>
<td>254</td>
</tr>
<tr>
<td>III. PROTECTION OF PATENTS AND OTHER INDUSTRIAL PROPERTY</td>
<td>255</td>
</tr>
<tr>
<td>A. Current Legal Framework</td>
<td>255</td>
</tr>
<tr>
<td>1. Existing Regulations</td>
<td>255</td>
</tr>
<tr>
<td>2. Protection and the Contract</td>
<td>255</td>
</tr>
<tr>
<td>B. Policy on Post-Investment Technological Development</td>
<td>257</td>
</tr>
<tr>
<td>C. Concluding Observations</td>
<td>258</td>
</tr>
<tr>
<td>IV. COMMERCIAL DISPUTE SETTLEMENT</td>
<td>259</td>
</tr>
<tr>
<td>A. Chinese Perspective on Commercial Disputes</td>
<td>259</td>
</tr>
<tr>
<td>B. Methods of Dispute Settlement</td>
<td>262</td>
</tr>
<tr>
<td>1. Friendly Negotiations</td>
<td>262</td>
</tr>
<tr>
<td>2. Consultation</td>
<td>263</td>
</tr>
<tr>
<td>3. Conciliation</td>
<td>265</td>
</tr>
<tr>
<td>4. Arbitration</td>
<td>267</td>
</tr>
<tr>
<td>V. CONCLUSION</td>
<td>270</td>
</tr>
</tbody>
</table>

*Research for this Note was conducted while the author was a Law Intern at the Georgia World Congress Institute, Atlanta, Georgia. Results of that research were published as Commercial Transactions and Investment in the People's Republic of China: A Guide to the Current Legal Environment, 1 INT'L BUS. SERIES 1 (Sept. 1979).
I. INTRODUCTION

The People's Republic of China recently has embarked on an ambitious effort to modernize in the areas of agriculture, industry, defense and technology in a plan known as the Four Modernizations Program. As part of this effort, the Chinese concurrently are seeking to attract foreign investment and technology, for they are now aware that if the modernization goals are to be met, it will be necessary to participate in international commerce to a greater extent than in the past. The attempt to attract foreign investment should be seen as part of a general move toward economic realism and pragmatism which is currently taking place, a move away from the radicalism of the Gang of Four and their predecessors.

The Chinese government has begun to allow a limited amount of private enterprise in the domestic economy. Thousands of small private businesses, operating under licenses, have begun to appear in recent months. In certain cities, one can now find hawkers, door-to-door salesmen and small shopkeepers, unheard of since the heated days of the Cultural Revolution. Farmers on the communes are now allowed to operate small private plots of land on their own time and may sell the products in the cities for personal gain. A group of former capitalists in Shanghai has been authorized to form a private construction company to build and repair apartments and office buildings. This move to let limited private enterprise become a part of the Chinese economy is supported by two present concerns: a need to cope with a growing urban unemployment problem and a desire to let private businesses provide services which the state-run economy cannot handle as efficiently.¹

While all of this shows that today's Chinese political leaders are economic realists, it does not mean that they are abandoning their Marxist-Leninist-Maoist ideology. The economy will remain a socialist one, run for the most part by central economic planners. Chinese leaders are simply doing what they perceive as objectively correct for the present stage in the evolution of the socialist society. They see the need for limited domestic private enterprise and believe that foreign investment and technology can speed up the modernization process. They know that to attract this foreign investment a reasonable profit margin and other incentives will have to be offered to Western firms.

¹ See Kramer, China Allowing Limited Return of Capitalism, Asian Wall St. J., Aug. 16, 1979, at 1, col. 6.
Thus, the Chinese have taken great steps toward building a good trade and investment relationship with developed countries. Trade agreements have been signed with Japan, the United States and the European Economic Community. A joint venture law was enacted in July, 1979. The massive task of drafting a commercial code has begun and other laws, such as tax codes, foreign exchange regulations and a patent law are expected in the coming months. These laws are being enacted primarily for the benefit of Western firms, which feel they will need legal protection for any investments made in China, since the Chinese are able to operate internally without a written commercial code. Until these legal codes are in place, the Chinese are willing to grant by means of contracts the protection which the foreign investor would normally find in the legal systems of other countries. As evidence of their realism, the Chinese agree to write all contracts in English, knowing that insistence on Chinese language contracts would be an insurmountable barrier for most Western firms.

While taking these steps to attract foreign investment, the Chinese insist that in developing foreign trade and investment they will adhere to three principles: continuing independence, equality of treatment, and observation of international pacts. The Chinese are particularly concerned with preventing violations of Chinese independence and sovereignty. It also should be noted that the Chinese are as ethnocentric as Europeans and Americans, perhaps even more so. In many ways, the Chinese still see themselves as Zhongguo, the "middle Kingdom," with a culture and history which predates that of any Western nation. This should not be overlooked by one seeking to do business in China.

Historically, the Chinese have had bitter experiences in dealing with the West. In the nineteenth century, the Opium War with the resulting Unequal Treaties, trade concessions and extraterritoriality in effect amounted to an attempted colonization of China. Much of the past isolation and xenophobia of the Chinese was in response to these bad experiences with Western business practices.

---

1 See, e.g., Agreement on Trade Relations Between the United States of America and the People's Republic of China, July 7, 1979, reprinted in 18 INT'L LEGAL MATERIALS 1046 (1979).


3 The PRC Affairs Division, Bureau of East-West Trade, U.S. Dep't of Commerce, notes that while this legislation is expected soon, as of April, 1980, none has been enacted. Interview with Commerce Dep't officials (April 24, 1980).
Thus, while the Chinese currently are very much interested in increased trade and investment from the West, they are concerned that they do not let the West, through trade again impinge upon Chinese sovereignty. Successfully dealing with the Chinese requires sensitivity to their past. The capitalist ideal that free trade and competition unfettered by government control will ultimately solve society's problems was foreign to traditional Chinese thought and is contrary to modern thinking as well. Consequently, one who does business in China must be willing to do so on Chinese terms, which means dealing directly with the Chinese government and fitting one's operations into the overall economic modernization program.

For example, negotiations for investment opportunities are carried out through the Chinese Foreign Trade Corporations, which are government organizations under the Ministry of Foreign Trade and which are responsible for all imports and exports, and with the China Council for the Promotion of International Trade. When dealing with these organizations, it is important to remember that they are not as concerned with the maximization of immediate profit as with the long-term growth and modernization of the Chinese economy. Hence, it will be necessary to convince the Chinese that one's plan for investment will not only generate profits for the foreign partner, but also will be beneficial to the Chinese in generating foreign exchange or acquiring modern technology.

This does not mean, of course, that the foreign investor should hide his desire for profit. As economic realists, the present Chinese leaders are fully aware of the fact that the profit incentive is the motivating force behind Western companies. What it does mean is that successful investment will allow the development of these mutually beneficial investment relations on a long-term basis. China's success or failure in the present effort will turn on its ability to attract foreign investors and on the ability of both the Chinese and foreign partners to adapt to the needs and goals of the other. For the investor willing to make such a commitment, China offers an exciting new area of investment opportunity.

II. FRAMEWORK FOR INVESTMENT

A. Compensation Trade

What is termed "compensation trade" has emerged as one of the most promising means of investment in the People's Republic of China. The compensation trade formula is applied to both proc-
essing and assembly operations. The basic arrangement involves an agreement whereby foreign firms import capital equipment into China, which is paid for in installments with low-cost goods produced on the equipment. While some problems have been encountered, most of the firms involved in compensation trade have been satisfied with the arrangements and many have reported higher than expected profit returns. The Chinese government is likely to continue to favor compensation trade agreements for several years. As Cohen and Nee point out, the arrangements are "an end-run around the problem of how to acquire the foreign exchange necessary to finance essential imports. The standard compensation trade contract enables China to pay for capital imports with future deliveries of goods; there is never any outflow of foreign exchange." This is of particular importance, since it is Chinese policy to avoid foreign debt as much as possible.

1. **Forms of Compensation Trade**

While most Western businessmen refer to both processing and assembly operations as compensation trade, the Chinese prefer to distinguish assembly, processing and "pure" compensation trade. Processing operations involve the importation of raw materials and packaging into China, which are processed by the Chinese according to specifications. The Chinese charge a processing fee which is purposely kept low compared to other Asian areas, such as Hong Kong, Singapore, Taiwan and South Korea, since the Chinese intend to remain competitive with other labor markets in order to attract foreign exchange. Arrangements also are made whereby the Chinese supply the raw materials and produce goods based on specifications or samples provided by foreign businessmen. Again, a processing fee is charged, which usually includes the costs of the materials supplied by the Chinese. If any equipment is supplied by the foreign partners, it is paid for by subtracting its cost from the processing fees. The Chinese also have on occasion agreed both to place private brand names or labels on the processed goods and to honor trademarks.

---


7 If the cost of the materials is not to be included in the processing fee, then a separate payment must be made.
Assembly operations work in much the same way. A foreign businessman supplies component parts to be assembled in China for an assembly fee. There are also cooperative production agreements in which both the Chinese and foreign partner supply part of the components to be assembled. In these operations, the foreign partner is granted an exclusive right to the output of the cooperative production and pays an assembly fee plus part of the profits from the sale of the product as payment for the parts supplied by the Chinese. As in processing agreements, the fees charged by the Chinese are very competitive; any equipment supplied by the foreign party will be paid for by deducting its cost from the processing fees owed to the Chinese.

Pure compensation trade involves the importation of capital equipment which is paid for in installments by commodities produced with the equipment. A type of indirect product compensation formula is used occasionally, in which case the payments are made in the form of goods or commodities not produced on the capital equipment itself, or in the form of raw materials. The Chinese technically consider compensation trade as an installment loan, with payment in goods instead of currency; thus, interest should be considered in the calculation of the amount of product the foreign partner is to receive as payment for the equipment. The total amount of the loan is the assigned value of the equipment (usually negotiated on the basis of the original supplier's invoice) plus the interest, with three years as the usual repayment period. The price the foreign buyer pays per product unit is also negotiated in the contract and only a portion of the product price can be set off, so that the Chinese can earn foreign exchange at the same time that the foreign partner gets lower cost goods.

It should be noted that the Chinese usually insist on a clause in the contract which states that they are free to repay the loan (in product) prior to its maturity. This conceivably could cause a problem in two ways. First, some of the anticipated interest payments would be lost. Second, and more important, one could perhaps find oneself with a glut of the product. This point should be negotiated, especially in arranging an indirect compensation agreement, where this could create an especially serious problem.

* The author is not aware of any such problems being reported as yet. It seems unlikely that production on newly acquired capital equipment could move so far ahead of schedule as to present too great of a problem.
2. Examples of Compensation Trade Agreements

An example of successful compensation trade is found in an agreement between Mego International, Inc., a New York toy manufacturer, and the factory of a Chinese commune in Pingzhou, near Canton. Under this agreement, the Chinese produce Superman doll costumes for Mego. Mego has provided the Pingzhou commune with industrial sewing machines valued at approximately $40,000 and has sent employees from its Hong Kong subsidiary to train the Chinese factory workers in the use of the machines, making of doll costumes and routine maintenance. Mego sends pre-cut fabric to Pingzhou from Hong Kong and pays a fee for each costume produced—two cents for each Superman costume, eight cents for more elaborate lacy doll costumes. While the factory is Chinese managed, Mego officials say that the quality of the costumes has been very good and feel that productivity will be as good as or better than that of Hong Kong products in time. The Pingzhou workers were slow at first, but productivity is increasing with experience, so that one hundred-thirty workers are producing three hundred thousand costumes per month at the moment.

Oxford Industries, Inc. is also involved in compensation trade. Oxford supplies German-made pressing equipment needed by a Chinese factory, installs it and trains workers in its use. Oxford is compensated for its capital investment by a reduced price for the goods produced in the factory, in this case, men’s suits. Oxford officials have also stated that they are very pleased with the quality of the Chinese product.

Compensation trade agreements such as these are becoming more common. The Chinese Xinhua News Agency reports that as of June 1979, over three hundred contracts have been signed with Hong Kong and Macao businessmen for the manufacture of products in Guangdong (Kwangtung) Province in southern China. Most of these contracts involve processing and assembly work, believed to be primarily in the field of light industrial products such as electronic components. Because wages in Chinese factories are very low by Western standards (about one dollar for an eight-hour day), the businesses involved here expect high profit margins.

---

9 See Kramer, East Meets West, Wall St. J., July 5, 1979, at 1, col. 1 [hereinafter cited as Kramer].
These profits should be realized when Chinese workers gain ex-
perience and productivity reaches planned levels.

3. **Major Contract Issues in Compensation Trade Agreements**

   a. **Initial Steps**

   In order to set up a compensation trade agreement, one must first contact both the Foreign Trade Corporation (FTC) which is responsible for the product to be manufactured and the China Council for the Promotion of International Trade. Various types of Chinese officials, including Local, Provincial, District and Municipal officials, have been given authority to negotiate agreements, but the agreements also must be signed by the FTC concerned. Approval of the provincial branch of the FTC is needed for assembly and processing agreements in particular. If equipment or assembly lines are to be imported, then the approval of the State Planning Commission, the Foreign Trade Ministry and the Peking office of the FTC are all required.\(^\text{12}\)

   In negotiating such an agreement, one must keep in mind that generally the law governing the operation will be the contract itself. The Chinese are strict constructionists in their approach to contracts, so it is important to state the terms of the agreement as simply and clearly as possible in the contract. Contract terms dealing with protection of industrial property rights and dispute settlement procedures will be dealt with in detail in Sections III and IV, *infra*.

   b. **Inspection Requirements**

   While the Chinese will allow the foreign partner’s technical staff to inspect the goods before accepting delivery, the inspection must take place within China. Inspections usually will be followed with inspections by the Chinese Commodities Inspection Bureau (CIB), which has the responsibility for inspection of all goods going into or out of China. The CIB has gained a reputation for meticulousness and objectivity in its inspection procedures, with respect to both Chinese-made and foreign-made goods.\(^\text{13}\) Once the goods leave China, one will not be able to return them or to make a claim based on

---

\(^{12}\) See note 5 *supra*.

non-conformity. Thus, one must decide whether to trust the CIB inspection; if not, then one will face the expense of sending technical staff to China for inspections.

Cohen and Nee suggest specifying in the contract a permissible percentage of non-conforming goods in order to avoid disputes over the issue. They also point out that the Chinese will agree in their contracts to destroy any non-conforming goods, unless one allows them to sell them within China or by export to other buyers without a trademark or tradename. The Chinese also are very concerned about promoting their own exports to earn the foreign exchange necessary for importing whole plants and modern technology. This in itself provides a great incentive for the CIB to ensure that non-conforming goods are not allowed to pass inspection, since a reputation for low quality products would undermine their program.

c. Delivery of Goods

Delivery delays have been reported as another possible problem. Delays which have occurred usually have two causes; low productivity due to worker absenteeism, and transportation bottlenecks. Absenteeism, it is reported, presents a problem in some factories because the wages are so low. Workers see no reason to work for the capitalists if they must work harder than at their usual jobs for the same pay. This has been somewhat of a problem at the Pingzhou commune factory, mentioned earlier, but the government has been trying to solve the problem by offering bonuses and better benefits to the most productive workers in those factories which meet their contract requirements. Delays also have occurred due to the lack of a well developed transportation system. The Pingzhou commune is only ninety miles from Hong Kong, but one shipping delay of fourteen days was reported. To deal with the problem, Chinese officials have told the Transportation Ministry that it may be required to pay any claims for late delivery due to shipping delays.

These problems should not cause great concern. Mego International, Oxford Industries and others involved in compensation trade have been pleased with their arrangements in spite of these problems. Many Hong Kong businessmen have reported high

---

14 See note 5 supra.
15 See note 9 supra.
16 Id.
17 See note 5 supra.
profits. It is advisable, however, to include in the contract a clause which covers delayed deliveries, in order to establish grounds for a claim if necessary. The contract clause would be the primary evidence used in settling the claim.

d. **Transfer of Title on Capital Goods**

Another area of potential legal concern which should be dealt with in the contract concerns the time at which title to equipment is transferred. In pure compensation trade, the equipment is paid for by the product produced on the equipment. Thus, it is important to determine who shall be responsible for the maintenance, service, and provision of spare parts for the equipment until it is fully paid for. The parties also should state in the contract who is the owner of the equipment and who should bear the loss in the event of damage to or destruction of the equipment by natural forces (such as fire and flood) before the transaction is completed and the equipment is paid for in full. Further, it should be specified in the contract who is responsible for the maintenance of equipment set up in China.  

Compensation trade should be a good approach to investment in China for small and medium-sized firms, since the amount of capital investment required can be small (as with Mego International), while the profit margin on the sale of the low-cost goods obtained can be quite high. As long as there is a stable market demand, the Chinese probably will consider the compensation trade approach for almost any manufactured item which they feel will sell well enough to generate foreign exchange.

B. **Joint Ventures**

The Fifth National People's Congress of the People's Republic of China enacted a law on joint ventures, effective July 8, 1979, which for the first time provided a legal framework for equity joint ventures with the Chinese. The fifteen article law, while not as specific as some Western businessmen had hoped it would be, offers guidelines under which management procedures as well as procedures for the employment and discharge of staff and workers can be negotiated and stipulated in detail in the joint venture contract or articles of association. It also gives legal protec-

---

19 See note 6 supra.
tion for a foreign partner's assets and profits and provides general principles for the organization and operation of joint ventures.

1. General Guidelines

a. Equality and Mutual Benefit Requirements

The guiding principle which will control all joint ventures is that of "equality and mutual benefit." Indeed, this is to be the principle upon which all investment and trade with China is to be based. One should become accustomed to the phrase, for it is used often in the joint venture law, the recently signed United States-China Trade agreement and in many contracts. It is a principle which the Chinese take quite seriously, especially in light of historic pre-revolutionary attempts by Western concerns to subjugate China to a quasi-colonial economic status. The principle does not grant protection solely to the Chinese, however. It also protects the foreign investor, who operates in a foreign country which has a centrally planned economy and who must deal not with private individuals but with government organizations which are authorized to do business by the central planners.

b. Authorization

All joint venture contracts and articles of association must be authorized by the Foreign Investment Commission of the People's Republic of China. If approved, the joint venture must then be registered with the General Administration for Industry and Commerce before it can begin operation under license. Approval or rejection will be given within three months of application. The Foreign Investment Commission should become an important body which is influential in determining the form of day to day operations of joint ventures. The patterns established by the Foreign Investment Commission for the approval or disapproval of contracts will be particularly significant indicators of the climate for investment, since contracts will control the procedures of management decision making as well as employment policies.

c. Board of Directors

Businessmen have expressed disappointment over the vagueness of the new law regarding management and employment/dis-
charge procedures. As a result, many investors state that they will wait for more specific legislation before investing, due to concern over the protection of the foreign interest.\(^2\) For example, under article 6, joint ventures are to have a board of directors with a chairman appointed by the Chinese side and one or two vice-chairmen appointed by the foreign partner. The actual composition of the board remains to be stipulated in the contracts between the parties and in the articles of association. The law states that each director will be appointed or removed by his own side.

Although the power of the board under article 6 is rather broad, encompassing the power to act on "all fundamental issues concerning the venture"\(^3\) subject to the provisions of the articles of association, the law states only that "the board of directors shall reach decision through consultation by the participants on the principle of equality and mutual benefit." This lack of specificity concerning the actual decision making process which the board will follow and the lack of detail concerning its actual composition give rise to hesitancy on the part of some potential investors. The vagueness of the law on these points, however, need not cause concern. Indeed, attorneys experienced in dealing with the Chinese point out that the absence of detail may, in fact, be advantageous in that it preserves a certain amount of flexibility in negotiating effective management control in individual contracts and articles of association.

2. Dispute Settlement

a. General Considerations

Should disputes arise, they are to be settled under article 14 through consultation by the board of directors. There appear to be few serious problems here. Since this affects both parties, they will consult each other readily to settle any problems which may arise. However, if there is a dispute which cannot be settled by consultation, article 14 provides for "consultation or arbitration by an arbitral body of China or through an arbitral body agreed upon by the parties."

\(^2\) *China Joint Ventures Law is Expected to be Vague*, Asian Wall St. J., June 28, 1979, at 1, col. 3.

\(^3\) The areas of power specifically enumerated are "expansion projects, production and business programs, the budget, distribution of profits, plans concerning manpower and pay scales, the termination of business, the appointment or hiring of the president, vice-presidents, the chief engineer, the treasurer and the auditors as well as their functions and powers and their remunerations, etc." *LAW ON JOINT VENTURES* art. 6.
Section 4 provides a more thorough treatment of Chinese dispute settlement procedures. Note that, while recently more and more third party arbitration clauses have been appearing in Chinese import and export contracts, no actual arbitration in third countries has been reported (except for maritime arbitration). Of the approximately 100 cases in which the Chinese Foreign Trade Commission (FTAC) has been consulted, only a very few have gone as far as a final arbitral award.⁴

A strong cultural incentive remains to settle disputes by "friendly negotiations," "consultation," or "conciliation." The Chinese can be expected to be reluctant to agree to third country arbitration, unless a high priority technology is involved. The major complaint about these settlement methods has been the expense in both money and time of sending staff to Peking for negotiations. This should not be as much of a problem with joint ventures since foreign staff already would be stationed in China. In any event, dispute settlement procedures should be established clearly in the contract.

b. Breach of Contract

Article 13 of the new law offers protection to the foreign partner against any attempts by the Chinese side to breach their agreements. If any party breaches the contract, then that party must bear the financial responsibility for any losses caused by the breach. What the clause means is that if the Chinese side were to breach, then the injured party would have a sound legal basis for a claim for damages. Note, however, that this clause could also be used against a foreign investor should his side breach.

c. Premature Termination of the Contract

Article 13 allows the premature termination of the joint venture contract "in cases of heavy losses, the failure of any party to a joint venture to execute its obligations under the contract or the article of association of the venture, force majeure, etc." Termination would require the consultation and agreement of both parties, authorization by the Foreign Investment Commission and registration with the General Administration for Industry and Com-

⁴ A delegation of the American Arbitration Association which visited Beijing (Peking) in 1975 was told that in all of 1974 only one dispute has been settled by arbitration, twelve by consultations and over one hundred by friendly negotiations. Torbert, The American Lawyers' Role in Trade with China, 63 A.B.A.J. 1117 (1977).
merce. This probably means that should the joint venture turn out to be highly unprofitable there would be a legal avenue open for dissolving the venture, one which would preclude any later claims of breach for premature termination. This clause also protects the foreign partner from premature termination by the Chinese, since unilateral termination would constitute a breach giving the foreign partner a legal claim for any losses sustained. Article 13 also provides protection against nationalization, since termination without consent would be a breach for which the Chinese side would be required by law to bear the financial responsibility for any loss.

3. Protection of Investments and Profits

Protection of the foreign investment is also found in article 2, which states that “the Chinese government protects, by the legislation in force, the resources invested by a foreign participant in a joint-venture and the profits due him . . . as well as his other lawful rights and interests.” This clause obviously is intended to assure potential foreign partners that their investments will be safeguarded. The Chinese are well aware that if their drive to induce foreign investment is to be successful, they must quell any concerns about nationalization, sequestration, or freezing of assets. Consider the following excerpt from a speech delivered by Zhang Jinfu, Chinese Minister of Finance:

Our friends can rest assured about the protection of the rights and interests of foreign partners in economic cooperation. We Chinese always mean what we say and live up to our words. In future as always, we will keep good faith with regard to both foreign investments and bank or government loans. So far as joint ventures are concerned, we have enacted law safeguarding foreign investment in China and its legitimate interests.25

Perhaps the greatest protection for the foreign partner is the knowledge, on the part of the Chinese, that without protection it will be difficult, if not impossible, to attract the foreign investment and technology needed for the Four Modernizations Program. Even without legal protection, the knowledge that infringements would deter other parties from investing in China provides

---

strong motivation for fairness in dealing with foreign partners. Although only time will tell, there now seems little reason for real concern unless there is a political transformation with the return of more radical elements to power.

4. **Permissible Forms of Business Organizations**

a. **Limited Liability Company**

Joint ventures are to take the form of a limited liability company, with the profits, risks and losses of the venture to be shared in proportion to each party's contribution to the registered capital. While generally the foreign partner's share will be a minimum of 25%, the law sets no maximum percentage of foreign participation. The percentage of foreign participation will be negotiated on a case-by-case basis according to economic circumstances. It is unlikely that a maximum limit will be imposed at a later stage. As Vice-Premier Li Xiannian has stated: "China does not confine itself to the established international practice of 51% (for the local partner) and 49%. The proportion of investment from foreign companies can be higher than 50%."²⁶

b. **Limitations of Majority Control**

Majority control of assets does not assure foreign control of the venture. Control may be somewhat undermined by the necessity of having management procedures in the contract and the articles of association approved by the Foreign Investment Commission and the presence of a Chinese board chairman. The Chinese have repeatedly stated that there will be no extraterritoriality in China and article 2 makes it clear that "all the activities of a joint venture shall be governed by the laws, decrees, and pertinent rules and regulations of the People's Republic of China." There is also a clause in article 9 which states that "the production and business programs of a joint venture shall be filed with the authorities concerned." While this does not say that joint venture projects will actually have to be approved by Chinese government organizations, it does seem to indicate that joint ventures will be expected to cooperate with government organizations in working within the

²⁶ LAW ON JOINT VENTURES art. 4.
centrally planned economy. As Cohen and Nee put it, "only time will tell how much autonomy the venture will enjoy."\(^2\)

5. **Capital Contributions**

Under article 5, each party's investment contribution may be in the form of cash, capital goods, industrial property rights, etc. Also, the Chinese partner may contribute the right to the use of a site. The specific contribution to be made by each side is to be stipulated in the contract and articles of association of the venture, with the value of each contribution (except for the Chinese site) to be ascertained by the parties through joint assessment. The Chinese will determine unilaterally the value of the site. Negotiations on the value of particular contributions are sure to be detailed and arduous, especially in relation to technological contributions which are difficult to value. The Chinese can be expected to be reasonable, however, since one of the primary goals of organizing joint ventures is the acquisition of the foreign technology. Just as in the West, as long as the foreign investor has something the other side wants, a good deal can be negotiated.

Article 5 states that:

The technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China's needs. In cases of losses caused by deception through the intentional provision of outdated equipment or technology, compensation shall be paid for the losses.

This implies that foreign investors should not attempt to import old equipment or technology, as has often been done in developing countries, since substantial penalties may be imposed. If a foreign partner wishes to provide older equipment or technology out of a sincere belief that it is more appropriate for China's present needs than more advanced technology, he should be sure to negotiate the point clearly and specify in the contracts just what quality of equipment and technology is to be provided. As long as the nature of the capital is kept above board and appropriate reasons are given for the use of less advanced technology, it is doubtful that there will be disputes later, provided the Chinese agree with the assessment.\(^3\)

---


\(^3\) With languages as different as Chinese and English, communication is a potentially serious problem. Mr. John Hunter, of Oxford Industries, says that the few minor disputes
In negotiating a proposal for a joint venture it should be remembered that the Chinese seek long-term partnerships. The law places no limit on the length of joint ventures, stating merely that "the contract period of a joint venture may be agreed upon between the parties to the venture according to its particular line of business and circumstances." Chinese officials report that "the duration may be ten years, twenty years, or even longer." If this is the case, it may not be advisable to offer old equipment and technology as the foreign investor's share of the capital since its future replacement might prove difficult.

It has been pointed out that one of the main incentives for the Chinese to form joint ventures is that they gain access to Western international marketing expertise. This view is reflected in article 9, section 3, which states that "a joint venture is encouraged to market its products outside China," either directly, through authorized affiliated agencies outside China, or through China's foreign trade establishments. If one does not wish to become involved to such a degree in the long term international marketing of the product and is looking instead for a shorter term investment, then compensation trade arrangements would be more suitable.

As enterprises are encouraged to export, joint ventures will be primarily resource seeking, as opposed to market seeking, investments (although products may also be distributed on the Chinese market). In recognition of this, article 9 attaches first priority to Chinese sources in the acquisition of required raw and semi-processed materials, fuels, auxiliary equipment, etc. If unavailable in China, materials can be purchased on the international market, but the ventures' own foreign exchange funds must be used.

6. Profit Distribution, Repatriation, and Taxation

a. Determination of Income Tax and Net Profit

The net profit of a joint venture is to be distributed proportionately according to each party's share in the registered capital of the venture.
[a]fter the payment of a joint venture income tax on its gross profit pursuant to the tax laws of the People's Republic of China and after the deductions therefrom as stipulated in the articles of association of the venture for the reserve funds, the bonus and welfare funds for the workers and staff members, and the expansion funds of the venture. 33

Both the unofficial English translation and the Chinese text of the law are unclear on the formula for determining net profits; i.e., whether the above mentioned deductions from gross profits are to come before or after the imposition of the income tax.

To illustrate, there are two possible formulas: \((GP - Tax\%) - Deduction = NP\), or \((GP - Deduction) - Tax\% = NP\). This is a question of considerable significance, as can be seen from the following example. Suppose a venture grosses $100,000 in profit, with a 10% joint venture income tax and a total of $20,000 in deductions for reserve funds, bonus and welfare funds, and expansion funds. If the income tax is levied before the deductions, the net profit would be \((100,000 - 10\%) - 20,000\), or a total of $70,000. On the other hand, if the tax is levied after the deductions are taken, then net profit would be \((100,000 - 20,000) - 10\%\), or a total of $72,000.

The difference in net profits could add up quickly over the years. Legal experts believe that the latter method (deductions before tax) will be used and see this as an incentive for foreign investors, since expansion funds normally come from after-tax retained earnings in the West. 34 It remains to be seen, however, how the guidelines of article 7 will be interpreted and applied. The formula to be used and the tax rate itself will not be known until the enactment of a comprehensive tax law. 35 Until such legislation is in place, the tax rate and formula should be negotiated and included in the contract and articles of association.

b. Incentives for Modern Technology Project and Profit Re-investment

Clearer incentives are offered for foreign partners who supply modern technology or reinvest net profits in China. Under article 7, a joint venture with up-to-date technology (by world standards)

33 Law on Joint Ventures art. 7.
35 Although expected soon, tax codes governing foreign investors have not been enacted as of April, 1980. See note 4 supra.
will be allowed to apply for a reduction in or exemption from the joint venture income tax for the first two to three profitable years. Similarly, a foreign partner who reinvests any part of his share of net profit may apply for restitution of a part of the income taxes paid. Details with regard to application procedures, criteria for acceptance and rejection, and the rates of reduction or restitution are still in the formative stage. It also remains to be seen whether or not the domestic industrial and commercial consolidated tax will be applied to joint ventures. No mention of this tax is made in the new law, so this would lead one to assume that it will not be applicable. These questions should be answered when a tax code is enacted. Given China's drive to attract foreign partners and technology, tax rates probably will be kept low to avoid discouraging potential investors.\(^{36}\)

\(c.\) Repatriation Rights

The foreign partner will be allowed to have net profits, funds obtained upon the liquidation of the venture, and other funds as well, remitted abroad through the Bank of China (BOC) in accordance with foreign exchange regulations (yet to be enacted) and in the currency or currencies specified in the contract of the joint venture. "Encouragements" will be provided to a foreign participant who deposits in the Bank of China any part of the foreign exchange he is entitled to remit abroad, although no mention is made of what form these encouragements will take.\(^{37}\) Earlier drafts have stated that if remittable foreign exchange is deposited in the BOC, the accrued interest could be deducted in part from the income tax which has been paid. It also has been stated that the interest earned on personal income deposited in the BOC would be free of any income tax.\(^{38}\) Similar encouragements may emerge in the near future. Personal income in the form of wages, salaries, or other legitimate income earned by a foreign worker or staff member of a joint venture may also be remitted abroad.

---

\(^{36}\) Randall Edwards, Professor of law at Columbia University, notes that the Chinese now want to attract foreign investment and know that certain incentives and guarantees must be offered in order to do so. It is his opinion that the Chinese will avoid tax measures which are clearly disincentives such as the consolidated tax. He also points out that ten American tax specialists have been attending an international tax seminar being held in Beijing for the Chinese. Thus, it seems clear that the Chinese should be aware of which tax policies are considered incentives and which disincentives. Interview (August 9, 1979).

\(^{37}\) Law on Joint Ventures art. 10.

through the Bank of China after the payment of a personal income tax. This latter tax has not been enacted.38

d. Methods of Financial Transactions

Most financial transactions will involve the Bank of China. Joint ventures are required by article 8 to open an account with the BOC or with a bank which has been approved by the BOC. This perhaps is to ensure that foreign exchange regulations are followed and to enable the Chinese government to monitor financial transactions in general. A joint venture will be allowed to obtain funds from foreign banks for sole use in its business operations. This indicates that the joint venture will be able to borrow some funds directly from foreign banks without going through the BOC.

7. The Chinese View of Written Legal Documents

Luo Xin, with the Commercial Section of the Embassy of the People's Republic of China in Washington, D.C., points out that while the concept of written law is traditional for the United States and most other Western nations, it is something quite new for the Chinese.40 For example, nearly all aspects of American life are in some way related to a specific written law. Even in such a mundane affair as going to a nearby restaurant, one encounters the law in the form of a sales tax. By contrast, in China the average citizen never encounters law personally, except when getting married or where a criminal offense is committed. It has not been thought necessary to have a comprehensive set of laws to guide people's daily conduct, because the people know through their general cultural and social education what are proper and improper modes of conduct.41

38 LAw ON JOINT VENTURES art. 11.
41 The difference in conceptual frameworks here is subtle yet basic. The different methods of addressing a letter is an illustration common to students of the Chinese language. In Chinese, letters are addressed from general to specific, naming the country, province, county, city, street number, and finally the person in that order. In English, by contrast, the person is named first, then the number, the street, the city, the state, and finally the country, going from specific to general. A parallel is found in the attitudes regarding government officials. The Chinese attitude is reflected in both the traditional attitude that if a government official were trained generally in the Confucian virtues, his particular daily actions would be proper, and in the modern view that cadres should first have proper political understanding before they can be correct in their analysis of particular economic problems. Contrast this to the Western attitude, where government
However, Mr. Luo notes that China realizes the need for developing a written commercial code if China is to deal with foreign countries in the Four Modernizations Program now under way. The joint venture law is only a beginning in the development of written commercial law and as such is meant to be a statement of general principles. The Chinese have had no experience with joint ventures. Thus, they presently do not know just where problems may lie.

The hope is that the new law will allow for the step-by-step development of good business relationships with foreign countries. Quoting a Chinese saying, "It is always more difficult to make a good beginning," Mr. Luo is of the opinion that, while some foreign companies will hesitate and take a wait-and-see attitude before investing in China, other companies will be willing to take a step forward and work with the Chinese in mutually developing and learning from the experience of joint ventures. To reassure those who may be thinking of engaging in joint ventures with the Chinese, Mr. Luo stresses that the Chinese will strictly honor their contracts, and will abide by the agreements reached between the parties concerning management and employment procedures.\(^4\)

When questioned specifically about management procedures regarding the means of protecting the foreign or minority interest, Mr. Luo stated that there is no need for the foreign partner to worry because the venture will be operated by both parties. He stressed that the proper people will be selected from the foreign side to fill management positions, that the Chairman of the Board of Directors will not monopolize his position, and that the Chairman will not follow a policy of putting foreign personnel only in minor posts.\(^4\) It will be important to maintain a "spirit of coopera-

---

\(^2\) It should be noted that the Chinese have a good reputation for strictly honoring their contracts. A statement commonly heard from businessmen with experience in trade with China is that the Chinese FTC negotiators are very tough, but once they have agreed to include a particular item in a contract, willful noncompliance is rare.

\(^3\) A. Jackson Rich of the PRC Affairs Division of the U.S. Department of Commerce notes that in a few contractual joint operations which have been going on in China near Shanghai and Canton since April 1979, the foreign partner has been allowed authority to hire and fire workers and to manage factories on a day-to-day basis. According to Mr. Rich, no worker-management committees have been set up in these joint operations, and in their day-to-day operation the factories are similar to capitalist joint ventures. These few joint operations involve Hong Kong and Japanese foreign partners. Interview with A. Jackson Rich at the Department of Commerce in Washington, D.C. (July 25, 1979).
tion" in the daily affairs of the enterprise. In order to run a factory properly, both parties must rely on and have confidence in each other. Mr. Luo believes that if both parties have this cooperative spirit, both will do what is best for the enterprise as a whole, since that is naturally what is best for both parties. While the reliance on a cooperative spirit may seem to Western businessmen to be a naive approach to international business, it is seen by the Chinese as a prerequisite to developing long-term business relationships. The Chinese have little interest in potential partners who do not show this willingness to cooperate in the development of the enterprise.

8. Concluding Observations

One can see that although the new law on joint ventures is not as detailed as those in other countries, it reflects careful thought. The Chinese have taken a major step in reaching out to Japan and the West for the acquisition of modern technology. Since the goal of allowing joint ventures is to modernize the economy and raise the people's standard of living, it follows that joint ventures should provide a framework in which both the Chinese and foreign partners can develop a mutually beneficial relationship. The key to success will be the negotiating stage; if clear agreements are reached concerning areas which are not covered in detail in the law, then the law should prove to be adequate. Important areas for negotiation include: management procedures; personnel employment and discharge practices; the type, age and quality of technology and equipment to be offered; and issues of profit determination and taxation.

Those firms willing to undertake investment negotiations at this initial stage would, of course, have an increased opportunity to assist the Chinese in their economic development and to make potentially high profits on what should be very competitively priced products of Chinese joint ventures. Risks are involved, of course, the largest being the possibility of subsequent political changes giving rise to rule by groups which are opposed to foreign investment. This possibility appears remote if present efforts to attract foreign investment prove successful and if that investment in turn is successful in modernizing China's economy.
III. PROTECTION OF PATENTS AND OTHER INDUSTRIAL PROPERTY

A. Current Legal Framework

1. Existing Regulations

When investing or importing into a developing country such as China, one naturally is concerned about the protection of one's industrial property, such as patents, know-how and trademarks. This concern is particularly important in view of the fact that one of the primary goals of China's present economic drive is the acquisition of modern technology. At present there exists no patent law in the People's Republic of China to protect the supplier of this technology. Two domestic regulations passed in October, 1963, termed "Regulations on Awards for Inventions and Regulations on Awards for Technical Improvements," are of some value to the importer. Under these regulations a party may apply to the Chinese government for recognition of an invention or a technological improvement. If the state finds the invention or improvement useful, it will award a registration certificate and possibly a cash bonus. A foreigner may apply for these certificates, though they are of questionable legal value."

The problem which these regulations pose for the foreign private investor is that they make the Chinese state the owner of all new inventions and technology. The state may sell that technology to foreigners through the Ministry of Foreign Trade if the State Scientific Commission approves. This must be seen in light of China's socialist political and economic system. There is a basic antagonism between the Western view, which encourages the granting of patent rights to private individuals who may exploit the patented technology for their own economic advantage, and the Chinese viewpoint, in which new technology is to be communally used by the masses for the benefit of the masses. In short, the Chinese do not believe in the sanctity of private property in the same way as the West; this is especially true regarding intellectual property.

2. Protection and the Contract

In contrast to their ideological aversion to patents, however, is found a willingness on the part of the Chinese to contractually
grant protection of industrial property rights to foreign importers and investors. Thus, it becomes imperative that appropriate language be included in the contract which will restrict the duplication, disclosure or unlicensed transfer of any patented technology provided by a firm. Until recently, most transfers of technology were in the form of whole plant or turnkey projects. In such cases, it would be necessary to negotiate with the China National Technical Import Corporation for the inclusion of such a contract clause. Due to the growth of assembly and processing operations in recent months, it is now necessary to negotiate with the other Foreign Trade Corporations on the matter. A typical clause in a turnkey contract reads as follows:

Within ___ years after signing the ________ contract, the buyers shall not disclose in whole or in part to any third party the know-how, Technical Documentation and other information of the process obtained under the Contract. The secrecy does not apply to those parts of the know-how, Technical Documentation or other information of the process which become part of the public knowledge or literature. The license, know-how, Technical Documentation and other information are to be used only for the construction, operation, and maintenance of the Contract Plant.

The Chinese are now working on a patent system which they hope to have completed by the end of 1980, according to reports from the International Patent Office of the United States Department of Commerce. The International Patent Office has been impressed with the level of Chinese expertise in discussions on patent matters which have taken place and predicts that once enacted the Chinese patent system will be sophisticated. Until a patent system is actually in place, however, the contract will continue to be the source of any industrial property rights.

An important question for investors concerns the nature and

---

48 See note 5 supra.

47 Clark, China's Changing Views on Project Contracts—A Lawyer's Appraisal, in WORLDWIDE PROJECTS 49 (February-March, 1979).

46 Trainees have been sent to Japan, West Germany, Yugoslavia and other countries to learn techniques of patent examination, and patent documents from various countries have been gathered for study in Beijing. The most contact has been with Japan. There have been several exchanges of delegations between the Chinese and the Japanese Patent Offices and, in April of 1979, it was announced that an agreement on Sino-Japanese cooperation in patent work had been reached whereby the Japanese would help train Chinese patent personnel. Tentative plans have been made to send Chinese patent trainees to the United States in September 1980 to study patent examination. Interview with officials of the International Patent Office of the U.S. Dep’t of Commerce in Washington, D.C. (June 26, 1979).
scope of this contractual protection. The recently signed United States-China Trade Agreement, when ratified, will offer assurance by the Chinese that patent protection will be given which is “equivalent” to that given by the United States. The Trade Agreement also states that “both Contracting Parties shall permit and facilitate enforcement of provisions concerning protection of industrial property in contracts... and shall provide means... to restrict unfair competition involving unauthorized use of such rights.”

One expert who accompanied a recent American Bar Association (ABA) delegation to China feels that purely contractual protection is sufficient for the moment, even though as an attorney he would prefer to see a patent law in place. The Chinese stressed to the ABA delegation that China will abide strictly by the patent protection clauses in contracts and emphasized that contractual protection was “as good as any patent law.” The present need of foreign technology also offers a certain degree of protection in itself. The Chinese are aware that if disclosures or misappropriation of technology or know-how takes place, then it will become difficult to find other foreign companies which are willing to import their technology and thus would be harmful to them in the long run.

B. Policy on Post-Investment Technological Development

The Chinese recognize the Western concern for patent protection. Just as they see the need for a written joint venture law and commercial code, they see the need for patent and know-how protection if they are to attract foreign investment and technology. Thus, instead of arguing against the recognition of patents as many developing countries do, China has begun developing a comprehensive patent system and gives assurances that industrial property rights will be protected.

For the most part, the record bears out this interpretation of the Chinese approach to the question. Most attorneys and busi-

---

49 Agreement on Trade Relations Between the United States of America and the People's Republic of China [hereinafter cited as Trade Agreement], July 7, 1979, art. VI, § 3 states, “Both Contracting Parties agree... to ensure to legal or natural persons of the Party protection of patents and trademarks equivalent to the patent and trademark protection correspondingly accorded by the other Party.”

50 Interview with Donald O. Clark, senior partner with the Atlanta firm of Hurt, Richardson, Garner, Todd, and Cadenhead (June 29, 1979).
nessmen involved in trade with China are unaware of any cases of Chinese copying or re-exporting technology. Indeed, it is difficult to find any cases of misappropriation of technology reported anywhere. It should be remembered, however, that if the Chinese were to copy patented technology, it would be difficult if not impossible for a foreigner to find out about it as long as the copied projects or plants are kept in areas which are still off-limits to foreigners. Thus, if the Chinese really wish to copy, it may prove difficult to stop them, with or without statutory or contractual protection.

At the same time, it is usually not worthwhile for the Chinese to copy foreign products, due to the lack of a modern technological base in terms of material and skilled manpower. Of the two cases of copying which are known, both were unsuccessful for this reason. The first case involved a steel processing plant sold to the Chinese by a West German firm in the late 1960's. The plant was reportedly partially reproduced in another area of China, which, of course, angered the Germans who had hoped to sell another plant. The copy, however, was not successful. Thus, the Chinese continue to buy whole steel plants instead of building their own. The second case is a recent one, involving Chinese attempts to make a copy of urea fertilizer plants being built in China by an American firm. Again, the copy did not work. The American firm chose not to press a claim due to a desire not to disrupt work that was being done on other plants.

C. Concluding Observations

At the moment, there would appear to be little need for concern about protection of industrial property rights, due both to the Chinese awareness of the long term difficulties misappropriations would entail and the lack of the necessary technological base to copy technology successfully. But what of the investor who is still worried about potential problems of misappropriation and the general conflict between developed and developing countries on the question of technology transfer? What course should be taken?

Perhaps the answer is to be found in the model of certain Japanese companies, since Japan has had the most experience and success in trading with China. As an example, a senior official of Nippon Steel, U.S.A. points out that his firm does not see the transfer of high technology in turnkey projects as a problem. Instead, the firm's policy is to promote that very transfer by sending hundreds of Japanese technicians to China to train Chinese
NOTE

steel workers. The approach taken is to transfer the most modern steel technology, train the PRC engineers in its use, and get a substantial fee in return for this "technical service." In a 1977 sale of a steel mill, such a fee came to $17 million on a $217 million sale. This in effect represents a substantial payment for the industrial property rights acquired. One can conclude that the best solution may be to promote the appropriation and transfer of technology, being sure first to negotiate a good price for it in the contract.

One aim of the present four modernizations campaign is to speed the economic modernization of the country through the acquisition of foreign technology. If the patent and know-how question is approached with this in mind, it should be possible for "mutually beneficial" technology transfers to take place with a minimum of friction. A negotiated sale of technology would be preferable to an attempt to exercise patent rights, even if a patent system was in place. The foreign supplier of the technology could receive a profitable fee, while the Chinese could receive the technology for immediate use in economic development, without having to rent the technology for only selected use until the patents expire. This approach would also remove doubts about later misappropriations by the Chinese partner in joint investments. It also would go a long way towards convincing the Chinese that one's firm truly is interested in a mutually beneficial long-term relationship which will aid China's development.

IV. COMMERCIAL DISPUTE SETTLEMENT

A. Chinese Perspective on Commercial Disputes

As in any commercial relationship, disputes are bound to arise from time to time in the course of foreign investment in China. What will determine the success or failure of the drive for foreign investment will not be the number and nature of disputes which arise, but rather the manner in which they are settled. If disputes are dealt with in a fair and reasonable manner, then foreign investors will be attracted to China. However, if commercial disputes are settled in an arbitrary manner which favors the local partner, then foreign firms obviously, will not see the climate for investment as a favorable one.

One must understand that commercial disputes will not be settled judicially. There are at present no courts in existence in

---

China for litigating commercial disputes, and even if there were, it is doubtful that the Chinese would agree to a contract clause naming litigation as an avenue of dispute settlement. The Chinese are simply not a litigious people, as evidenced by the old Chinese maxim that "it is better to enter a tiger's mouth than a court of law."52

Instead of litigation, the Chinese prefer one of four methods of settlement. In order of preference they are: "friendly negotiations"; consultation (friendly negotiations assisted by the Chinese Foreign Trade Arbitration Commission—FTAC); conciliation (negotiations with non-binding recommendations given by the FTAC or some other party); or arbitration. No decisions reached under these procedures may be reviewed by a court of law, either foreign or domestic. Note the following typical contract clause on dispute settlement:

> All disputes in connection with this Contract or the execution thereof shall be settled through friendly negotiations. In case no settlement can be reached through negotiation, the case may then be submitted for arbitration to the Foreign Trade Arbitration Commission of the China Council for the Promotion of International Trade. The decision of the Arbitration Commission shall be final and binding upon both parties; neither party shall seek recourse to a law court or other authorities to appeal for revision of the decision.53

Although the Chinese will use the above clause in contracts, very few cases actually go to a final arbitral award. In fact, some scholars suggest that arbitration clauses are included in contracts solely for the purpose of avoiding the jurisdiction of foreign courts, there being no intent to arbitrate disputes.54 The Chinese seem to view litigation in foreign courts as an affront to their sovereignty. More importantly, however, they embrace a strong cultural preference for the use of friendly negotiation or discussion, the most common vehicle for reconciling commercial disagreements.

The Chinese are willing to take the time and expense involved in what have often become long and drawn out negotiations, since

---

53 Section 31 of the Provisional Rules of Procedure of the Foreign Trade Arbitration Commission of the CCPIT also states: "The award given by the Arbitration Commission is final and neither party shall bring an appeal for revision before a court of law of any other organization."
54 See Henderson & Matsuo, Trade with Japan, in Law and Politics in China's Foreign Trade 54 (V. Li ed. 1977).
such settlement allows the parties to reach an agreement without either side being declared right or wrong by a third party. They prefer to settle disputes within the context of building a mutually beneficial long-term relationship. They seek compromise solutions reached through friendly negotiation as opposed to settlements reached through the more adversarial posture found in formal arbitration. In short, the Chinese desire reconciliation reached in such a manner that the business relationship is allowed to continue in a cooperative spirit. It is not uncommon to find that disputes which arise in the sale of goods are settled by one party giving the other a better deal in a later transaction. For example, in a somewhat typical case, a Chinese food product sold to an American company proved to be defective. The American firm had an insurance contract to cover the loss, but a clause in the contract stated that no insurance could be collected without the American firm first pressing a claim. The Chinese did not respond to letters from the American firm which stated a claim for the defects. Nevertheless, a settlement was reached when the Chinese, without admitting that anything had been wrong with the shipment, gave a price on the next order which was low enough to compensate the American firm for its loss. Some American companies also follow this procedure when the Chinese buy American commodities and press claims for non-conforming goods; they give lower prices in subsequent transactions without admitting liability.

This could be seen merely as a means of saving face for both parties, but in fact the cultural attraction to non-adversary dispute settlements runs deeper. As noted above, the Chinese tend to settle disputes within the context of building long-term relations. Thus, the object of dispute settlement is to reach a reconciliation which will further promote a good business relationship, rather than by judging the parties. Even when cases are submitted to the FTAC for formal arbitration, the Chinese arbitrators will strive for a reconciliation prior to the arbitral proceedings or before an arbitral award is granted, instead of acting as judges as do American arbitrators. When a formal arbitration proceeding is requested, the parties usually first go through the successive stages of friendly negotiation, consultation and conciliation, rather than proceeding directly to adjudicatory proceedings.

---

B. Methods of Dispute Settlement

In order to judge the effectiveness of the settlement procedures, it is necessary to examine actual cases of dispute settlements which have utilized them. Although the following examples are drawn from experiences with the sale of goods or turnkey projects and not direct investments, they should serve to illustrate the legal principles which will be followed by the Chinese.

1. Friendly Negotiations

Friendly negotiations are conducted directly between the parties to a dispute, either by correspondence or in person in China (usually at the Beijing Office of the FTC involved). The basic difference between these negotiations and those of a similar sort in the West is that, in the case of China, one will be dealing with a government organization located in its own territory. As the following cases show, however, the Chinese do not usually exploit this advantage in terms of the legal principles involved, although they will be willing to go on with negotiations without reaching a settlement longer than most Western firms would like. In any event, just as in the West, if one has something the other side wants or needs, he will be in a better negotiating position and able to reach a settlement more quickly.

This method of negotiation was utilized in a 1975 United States-China grain transaction. A dispute arose when the Chinese cancelled two orders for approximately one million tons of American wheat and 233,000 bales of cotton.\(^5\) After negotiations, an amicable settlement was reached when the Chinese agreed to pay the difference between the contract price and the much lower market prices prevailing when the contract was cancelled. This remedy was the same as that which would have been reached under the Uniform Commercial Code in the United States. By negotiating the settlement, the time and expense of litigation was avoided.

Another recent case involved the construction by Nippon Steel Corporation of a steel works complex at Paoshan. In the spring of 1979, the contract was frozen, the Chinese wishing to change the settlement terms to deferred payments.\(^6\) Deferred payments

---

56\(^{5}\) Hsiao, supra note 51, at 155.

57\(^{5}\) Journal of Commerce, June 6, 1979, at 1, col. 4. At the same time, over twenty other deals were frozen by the China National Technical Import Corporation for renegotiation. The Chinese sought reductions in the scale of industrial plants which had been ordered (perhaps due to a shortage in the supply of electric power), delays in construction starts, guarantees that a large portion of the building materials would be obtained locally, and revised payment terms.
would reduce Nippon Steel's profit on the one billion dollar deal, so Nippon Steel asked that the price be raised 5.66% to cover the additional costs of financing. After negotiations in Peking, Nippon Steel President Eishiro Saito and Chinese Metallurgical Minister Tang Ke reached an agreement whereby payments would be deferred for five years at 7.25% interest per annum, and construction of the steel complex was resumed.\(^5\)

According to a Nippon Steel official, there were actually two issues involved in the Paoshan payments dispute.\(^5\) The first issue was whether payment would be in Japanese yen or United States dollars. As the dollar was depreciating against the yen at the time, the Chinese wanted payments to be in dollars and the Japanese preferred yen, neither party wanting to bear the risk of exchange fluctuations. A settlement was reached when the parties agreed to half yen, half dollar payments, so that both would equally bear the exchange risk.

The second issue involved the interest rate which the Chinese would pay on the deferred payments. Nippon Steel was willing to give a lower interest rate backed by Japanese governmental assistance in the financing. The Chinese refused the offer, however, based on their policy of maintaining financial independence from foreign governments. Nippon Steel then offered to settle by getting the lowest interest rate obtainable from private sources, but this rate was too high for the Chinese. A settlement was finally reached when Nippon Steel offered an interest rate which was slightly lower than that available from private sources. Nippon Steel took a slight loss here resulting from the gap in the rate available from private sources and that given to the Chinese, but it was satisfied with the settlement since it still made a large profit on the overall deal. Thus, though a claim could have been pressed for breach of the contract, Nippon Steel was able to reach an amiable settlement through friendly negotiations which benefited both sides.

2. Consultation

In case a settlement cannot be reached through friendly negotiations, one or both parties may request the assistance of the Foreign Trade Arbitration Commission.\(^6\) A letter stating the names


\(^6\) See note 32 supra.

\(^6\) Holtzmann, Resolving Disputes in U.S.-China Trade, in Legal Aspects of Doing Business with China 102-03 (1976).
and addresses of the parties involved and the nature of the claim is sufficient action to initiate this process. Once assistance is requested, the Foreign Trade Arbitration Section of the Department of Legal Affairs of the China Council for the Promotion of International Trade will begin its own fact finding process. Both parties will be asked to submit an analysis of their positions (by correspondence or in person), along with all relevant documents and other pertinent information. The FTAC may also conduct its own investigation, getting information from other sources in China or abroad. All information obtained will be disclosed to both parties in order to attempt a reconciliation.

After the fact-finding process is completed, the parties will be helped in analyzing the facts. The strengths and weaknesses of each position will be pointed out to them, and both will be asked to reconsider their positions in order to negotiate a friendly settlement. If no agreement is reached, the process will be repeated again, with the typical case requiring about six months to settle.

The contract will be the basis of any analysis of commercial disputes. Note the following statement from Foreign Trade Practice, a principal text of the Institute of Foreign Trade in Beijing: "In foreign claims it is necessary to proceed strictly on the basis of the contract, accepted business documentation or other effective proof, because the contract is produced on the basis of the authority and obligations of both sides."

Consultation was used to settle a dispute which occurred when a contract was made by a foreign seller for the shipment of several cargoes of cocoanuts to China from a South Asian port. Because cocoanut shrinks as it dries in transit and weighs less on delivery than at loading, common trade practice is to consider the contract as fulfilled if the delivered weight is within 96% of the weight specified in the contract. The seller noted this in his preliminary correspondence, but nothing was said about the matter in the contract, which specified the exact delivery weight and stated "payment shall be on the basis of finally landed quantities." Upon delivery, the cocoanuts were only 96% of the specified delivery weight, but the seller demanded full payment on the basis of his preliminary correspondence. The Foreign Trade Corporation involved said it would pay only 96% of the contract price,

---


62 See H. HOLTZMANN, LEGAL ASPECTS OF DOING BUSINESS WITH CHINA 100-01 (1976).
since there was no shrinkage allowance in the contract itself. The dispute was referred to the FTAC for assistance in friendly negotiations.

After investigation, the FTAC found that although it was the established trade practice to allow 4% shrinkage for long voyages to Europe, this was not the case for the much shorter voyage to China. It also found that due to market conditions, the seller would sustain a sizeable loss if forced to deliver 100% weights at the contract price. Both parties were informed of these findings and of the fact that the contract was binding over any preceding correspondence. The parties were then able to negotiate a settlement themselves. The Chinese buyer paid only 96% for the shipments already made (thus following the principle of strictly honoring the contract), but at the same time agreed to excuse the seller from making any further deliveries under the contract terms, preventing a loss to the seller. The parties were then able to renegotiate their contract to deal with the shrinkage problem, while continuing their business relationship.

3. Conciliation

If negotiations or consultation fail to achieve a settlement, the parties may then ask the FTAC to make nonbinding recommendations. If not satisfied with the recommendations, the parties may continue their negotiations or proceed to arbitration. Conciliation is a natural outgrowth of consultation. The FTAC will already be familiar with the case, from its extensive fact-finding and analysis in consultation, when conciliation becomes necessary. One expert reports two cases of settlements reached through conciliation.\(^6\) The first involved the purchase of Chinese plush by a foreign buyer. The buyer claimed the plush was not of the proper texture, having been flattened by improper packing by the Chinese Foreign Trade Corporation. After both parties had agreed to conciliation, the China Council for the Promotion of International Trade appointed a textiles expert to investigate. He reported that the plush would regain its proper texture if it were steamed. After watching a demonstration, the FTAC members involved approved the solution and recommended it to the buyer. The buyer accepted and withdrew his claim.

The second case reported involved a mistake in a cabled price quotation. Receiving a request by telegram from a foreign buyer for a price quotation on a Chinese commodity, the FTC responded by cable quoting a price to the buyer. The buyer then made a counter-offer. Meaning to quote a price between the original offer and the counter-offer, the Chinese seller mistakenly cabled a price lower than the buyer's counteroffer. The buyer immediately cabled his acceptance and increased the quantity of his order.

The buyer was notified when the error was discovered. He asserted a claim, arguing that he already had sold the goods and would suffer a loss if the quoted price was changed. The solution proposed by the FTAC (and accepted by the parties) was that the FTC should bear the responsibility for its error. At the same time, since the buyer was clearly aware that a mistake had been made (as evidenced by his increasing the quantity of his order), he should not be allowed to take advantage of the error. The price was fixed at that of the buyer's counter-offer, but only for the original quantity requested. The foreign buyer fared better here than he would have under American contract law, where the acceptance probably would have been invalid and hence no contract made since the buyer should have been aware of the error in the cabled price quotation.

There has been one dispute settled by obtaining non-binding recommendations from a body other than the Chinese FTAC. An American firm, a seller of cotton, pressed a claim for storage charges when the Chinese buyer delayed in designating a vessel to pick up the cargo. One American conciliator was appointed by the American Arbitration Association (Walter Surrey, General Counsel for the National Council for U.S.-China Trade), and one Chinese conciliator from the China Council for the Promotion of International Trade. Meeting in Beijing, the conciliators were able to reach an amicable settlement within ten days, possibly a record for Chinese dispute settlements. Third-party conciliations such as this may be used in the future for disputes over transactions covering the sale of goods. However, if article 14 of the Law on Joint Ventures is to be taken at face value, then there will be no nonbinding recommendations given by anything other than Chinese bodies in the case of joint ventures. As the law states, disputes "... may be settled through conciliation or arbitration by an arbitral body of China or through arbitration by an arbitral body agreed upon by the parties." The Chinese text lends itself to the interpretation that any conciliation or mediation which takes
place will be conducted solely by a Chinese body and not by any foreign concern. It is doubtful, then, that non-Chinese conciliators will become much of a force in dispute settlements involving joint ventures. Friendly negotiation, consultation, and conciliation with non-binding recommendations from the Chinese FTAC will probably continue as the predominate means of resolving disputes.

4. Arbitration

As noted earlier, although most Chinese contracts contain arbitration clauses, very few cases of formal arbitration have actually taken place. The question for the potential investor, then, is to what extent formal arbitration can be expected to play a role in future dispute settlements. Of course, the tremendous cultural incentive to use friendly negotiations, consultation and conciliation will remain. Therefore, the mere inclusion of an arbitration clause should not be taken to mean that disputes will be arbitrated. In recent months more and more agreements authorizing arbitration in third countries have appeared in contracts. However, no cases of arbitration proceedings in a third country have been reported (other than the special case of maritime arbitration which, by tradition, takes place in London).

The real importance of a third country arbitration clause lies in the bargaining position in which it places the foreign party. One expert hypothesizes that the Chinese will settle a contract dispute more quickly if the contract contains a third-country arbitration clause. This is because of the general Chinese desire to avoid formal arbitration and the particular desire not to be bound by a decision rendered by a foreign body. If a third-country arbitration clause is in the contract, the Chinese will be contractually bound to arbitrate outside of China if negotiations fail to settle the dispute. Thus, they would be under pressure to reach a compromise and settle more quickly before foreign arbitration becomes the only remaining method of settling the dispute. Obviously this gives the foreign company a stronger negotiating stance.

A case in which Chinese-made shirts shrank after being purchased by an American company provides a good example of the problems surrounding arbitrations. The contract between the parties contained a standard arbitration clause providing for arbitration in China under the rules of the FTAC. This placed the

---

4 Interview (June 20, 1979).
4 Id.
American company in a poor bargaining position because it did not want arbitration by the Chinese officials in Beijing and under Chinese rules. The American company had no leverage to shorten the process of negotiation and to reach a more favorable compromise. Had the investor been able to negotiate a third-country arbitration clause in the contract, his bargaining position would have been enhanced.

The United States-China Trade Agreement and the Law on Joint Ventures both reinforce the idea that arbitration is to be a measure of last resort, coming only after negotiations, consultation and conciliation have failed. Whether arbitration will take place in China or a third country will continue to be a matter of negotiation at the outset of the commercial relationship, although arbitration outside of China is authorized if agreed to by both parties. The Trade Agreement states:

The Contracting Parties encourage the prompt and equitable settlement of any disputes . . . through friendly consultation, conciliation or other mutually acceptable means. If such disputes cannot be settled promptly by any one of the above-mentioned means, the parties to the dispute may have recourse to arbitration for settlement in accordance with provisions specified in their contracts or other agreements to submit to arbitration. Such arbitration may be conducted by an arbitration institution in the People's Republic of China, the United States of America, or a third country.66

In a similar vein, article 14 of the Law on Joint Ventures states that disputes which cannot be settled by negotiation or consultation "may be settled through conciliation or arbitration by an arbitral body of China or through arbitration by an arbitral body agreed upon by the parties." Even with these legal sanctions for third-country arbitration, the problem will still remain that the Chinese are reluctant to agree in the contract to non-Chinese arbitration. Actual third-country arbitrations will probably continue to be extremely rare, although the possibility of seeing them increases as the Chinese sign more and more contracts with third-country arbitration clauses.

It is likely that cases of arbitration in China will increase more than third-country arbitration, although even Chinese arbitration should not be expected to increase sharply, for the cultural reasons mentioned. If such formal arbitration does occur, the

66 Trade Agreement, supra note 48, at art. VIII.
FTAC can be expected to be reasonable and fair, basing decisions on the facts of the case in question, as illustrated by the following settlement. The plaintiff in the dispute was a foreign company with a contract to buy 3,000 tons of agricultural produce from a Chinese Foreign Trade Corporation. The Chinese FTC was to deliver in three 1,000 ton installments, with the first bill of lading to be sent to the buyer between November and December of 1973. The Chinese company failed to deliver and in January 1974 cabled a request to the foreign buyer for a time extension. In February of 1974 the foreign buyer claimed damages for breach of the contract to deliver and requested arbitration. The FTAC began its fact-finding process, the seller submitted a defense, and an arbitration Tribunal was appointed. The arbitration began in October 1974 and was completed in November, with the plaintiff attending.

The Tribunal found that although there was a reasonable excuse for non-delivery, the buyer was justified in refusing to grant an extension, since the seller did not communicate the reason for non-delivery until after the time for delivery. The award consisted of the difference between the contract price for the goods and the international market price prevailing when delivery was to have taken place. The seller also had to pay the full costs of the arbitration. The full award was paid about ten days after its announcement and the plaintiff's fee deposit was returned in full.

The fact that the defendant was a Chinese company did not seem to prejudice the Chinese arbitrators in this case. The remedy granted (i.e., the difference between the contract price and the market price), is the same as would have been reached in

---


68 Under §§ 4-7 of the Provisional Rules of Procedure of the Foreign Trade Arbitration Commission of the China Council for the Promotion of International Trade, each party selects one arbitrator from the Chinese Arbitration Commission. These two arbitrators in turn select an umpire from the same Arbitration Commission to form a Tribunal. If both disputing parties agree, a sole arbitrator may be selected to form a Tribunal. An application for arbitration must contain: (a) the names and addresses of the plaintiff and defendant, (b) the claim of the plaintiff and the facts upon which the claim is based, (c) the name of the arbitrator chosen or authorization for the Chairman of the Arbitration Commission to appoint an arbitrator, (d) the original documents such as the contracts which are relevant to the application or certified duplicates or copies thereof, and (e) a fee deposit equal to 0.5 percent of the amount of the claim. The application and related documents must be in duplicate for each defendant named. See Decision of the Government Administration Council of the Central People's Government Concerning the Establishment of a Foreign Trade Arbitration Commission Within the China Council for the Promotion of International Trade, reprinted in Arbitration and Dispute Settlement in Trade with China, Special Report No. 4 (1974). See also Torbert, China's Joint Venture Law: A Preliminary Analysis, 12 VAND. J. TRANSNAT'L L. 819, at 882 n.214.
a judicial proceeding in the United States under the Uniform Commercial Code. Of course, since arbitration is conducted solely by Chinese there is perhaps the potential for prejudice against the foreign party to a dispute. Certainly this will be a question in the minds of foreign investors contemplating a move into China. The record, however, should assuage such apprehensions.

In summary, it seems that in order to reach satisfactory solutions to contract disputes, the foreign investor in China must follow the old adage, "When in Rome, do as the Romans." This will mean learning to handle problems within the context of the overall business relationship, and learning to rely on friendly negotiations, consultation and conciliation as the primary modes of reaching settlements. This should be beneficial to the investor in the long run in terms of developing a good working realtionship with the Chinese partner and building an enterprise which is mutually beneficial to both partners. Attempts to force the Chinese into American-style adjudicatory proceedings should be avoided, if for no other reason than that it would be culturally offensive.

V. CONCLUSION

While the legal framework discussed above could best be described as emerging and incomplete, its very existence makes China an interesting prospect for the foreign investor. Although the Chinese have gotten along well for centuries without this form of law, they are aware that many potential foreign investors require legal assurances that their investments will be protected. As Professor Li has pointed out, law and lawyers in China are a relatively recent phenomenon. To the extent that it has developed in China, commercial law exists as a means of facilitating the current modernization drive and attracting foreign investment and technology. At this early stage, investors should not be overly concerned with the details of the laws, but should be encouraged by the willingness of the Chinese to enact legislation designed to promote foreign investment.

Kevin K. Maher

---