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This Chapter provides an overview of the contract law system in the People's Republic of China ("PRC"). The central theme of this chapter is: while the black letter contract law in China has indicated a trend of confusion with the contract laws of other jurisdictions, adding some fundamental features of other legal systems' contract laws and international conventions, enforcement of the contract law shows an opposite direction, moving towards a hybrid enforcement regime combining some features in both informal and formal enforcement mechanisms. This process indicates the complexity in China's contract law, commercial law or even rule of law development in a broader sense. The endogenous and indigenous elements in a Party-state society have a combined effect on this dynamic process.

¶3-010 Legislative History and Background, Legislative Style, Organisational Structure, Types of Contracts

¶3-011 Legislative History and Background

Before the reform and opening-up era, in the PRC there were contractual practices but no legislating activity on contracts. It was not until the early 1980s did China start to enact laws on contracts, beginning with the promulgation of the Law on Economic Contracts (1981), followed by the Law of Foreign-related Economic Contracts (1985) and the Law of Technology Contracts (1987), each dealing with particular types of contracts based on the nature of business as well as the identity of parties. In addition, the General Principles of Civil Law, promulgated in 1986, are also applicable to the contracts. As a significant development, the Contract Law (1999) replaced the three earlier statutes to unify the nation's contractual legislative framework which had been fragmented for almost two decades.[1] The Contract Law achieved a degree of uniformity in China's contract law regime. Stepping in the 21st century, China further enacted two other contractual statutes the Law of Rural Land Contracts (2002) and the Law of Labour Contracts (2007).

* Part of this chapter contains a portion of a draft paper prepared by the author together with Professor Leng Jing for the Symposium on the Evolution of Private Law in China and Taiwan at the 2014 Annual Conference of Asian Law & Economics Association held at Taiwan National University from 20 to 21 June 2014.

1 See generally Liming Wang, "China's Proposed Uniform Contract Code", (1999) *31 St Mary's Law Journal* 7; Bing Ling, *Contract Law in China* (Hong Kong, Singapore, and Malaysia: Sweet & Maxwell Asia 2002).

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As the Contract Law is the centerpiece of China's legislative output in the field, it is worthwhile to recount its historical background, which offers a glimpse into the socio-economic settings of China's transition into the market economy where the legislative efforts were situated. As the fragmented structure of the contractual legislation had increasingly been proven as costly and outdated, there was a strong need for a unified contract law to remove discrepancies and inconsistencies among various contract codes. In 1993, building a socialist market economy was formally endorsed by the China Communist Party with the goal of deepening economic reforms. This heightened the agenda for legislative endeavors on contracts.

The initial drafting work was undertaken by scholars in twelve research institutions, including established universities and the China Academy of Social Sciences (CASS), upon the entrusting of the National People's Congress Standing Committee (NPCSC) in 1993.[2] The draft statute was polished several times after heated discussions and debates amongst legislators and academics before settling as a final text. The NPC passed the law in 1999, which, signaling a high degree of legislative sophistication and foresight, has remained unchanged since.

There were several important considerations underlying the meticulous drafting process.[3] Firstly, under the then fragmented framework of contractual legislation, domestic economic contracts, foreign-related economic contracts, and technology transfer contracts were governed by different sets of legal rules. The stratification easily created a gap in application and enforcement, reinforced by broad-brushed stipulations which lacked operative details. Secondly, there was a need for additional rules to combat the increasing contractual frauds in market transactions which had infringed the interests of the state, collective units and citizens. Thirdly, previous legislation had omitted some types of contracts, such as contracts on financial leasing, commission and brokerage, calling for a significant expansion of the legislating scope. Finally, as contents in the previous three statutes corresponding to the characteristics of a planned economy had become obsolete when the country was moving toward a market economy, a unified new contract law was expected to remove those outdated provisions. In particular, the legislative purpose was clarified as upholding the lawful rights and interests of parties, not ensuring the execution of economic plans. This goal was enshrined in the principles of freedom of contract, fairness, as well as honesty and good faith, as opposed to emphasising government oversight of contracting activity through administrative monitoring and sanctions.[4]

[2] Huixing Liang, "Unsettled Questions in the Process of Drafting PRC Contract Law", (1996) 2 *Legal Science* 13-15.

[3] Kangsheng Hu (ed), *Explanatory Texts on PRC Contract Law* (Beijing: Law Press 2010) 2.

[4] Huixing Liang, "The Unified Contract Law: Advances and Inadequacies", (1999) 3 *China Legal Science* 26.

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¶3-012 Legislative Style

The development of the socialist market economy has given rise to the concept of commercial law as a relatively distinct area of the law, contract law being one of its core elements. A widely shared consensus in the academic circles is that China practices the fusion of civil law and commercial law (*minshang heyi*) in legislative activity, in the sense that there need not be a commercial code in addition to a civil code (although the enactment of a long awaiting Civil Code has been protracted for many years). Instead, it is believed that the general principles and rules of civil law provide the foundation for commercial law, which builds on the basis of the more specialised principles and rules in the civil law applicable to the relationships and the activities among profit-making business entities of equal legal status.[5] As a result, in PRC there is no Commercial Code but only a quasi-civil code titled the General Principles of Civil Law ("GPCL"), which spells out baseline principles and rules on regulating personal and property relations arising from all kinds of civil acts, including contracting. The GPCL consists of three central elements – subjects of civil law (including individuals and legal persons), ownership and "obligations" (*zhaiquan*), and supplementary elements concerning "legal acts," proprietary rights, agency, limitation periods, and compensation for loss.[6] The part on "obligations" provides some basic guidelines governing contractual relationships, but is very general and scanty in substantive prescriptions. The vast room left unaddressed by the GPCL for regulating contracts is primarily filled by the Contract Law.

¶3-013 Organisational Structure

In the aspect of organisational style, the Contract Law follows the regular pattern of Chinese legislative practice by dividing the main text into three basic components: the General Provisions, the Specific Provisions, and the Supplementary Provisions.

¶3-014 Types of Contracts

In the Specific Provisions, 15 types of contracts are addressed separately, which are called "named contracts" ("typical contracts" in Taiwan), each occupying an individual chapter. The 15 types of named contracts are on the following areas: sales, supply and use of electricity, water, gas and heating, donation, loans, lease, financial leasing, work, construction, transportation, technology, storage, warehousing, commission, brokerage, and intermediation.[7]

[5] Albert Chen, *An Introduction to the Legal System of the People's Republic of China* (Hong Kong: LexisNexis 4th edn. 2011) 316-317.

[6] Ibid. 318.

[7] Mo Zhang, *Chinese Contract Law: Theory and Practice* (Leiden/Boston: Martinus Nijhoff Publishers 2006) 11, footnote 42.

Types of contracts not covered in the Specific Provisions are nevertheless recognised as "unnamed contracts," which are less frequently used in practice. Unnamed contracts are also subject to the Law on Contracts through the practice of "application by analogy." [8] According to Art 124, if there is a certain type of contract that is not listed in the Specific Provisions or in other laws, it shall be governed by the General Provisions, as well as by articles in the Specific Provisions or in other laws that are most closely related to such contracts.

¶3-020 Influence of Foreign Law and International Conventions; Contents Reflecting Local Characteristics

¶3-021 Influence of Foreign Law

Legislative techniques and particular institutions from both civil law and common law systems were incorporated in the drafting of the Contract Law. This attitude of openness to advanced overseas experience permeates the text.

For example, the law has instituted the mechanism of "unrest defense" traditionally used in the civil law system on one hand,[9] and the notion and practice of "anticipated repudiation" (or "anticipated breach") originating from the common law system on the other.[10] This, however, has prompted the need for filling gaps in contractual institutions between the two legal traditions.

Another example is the marked deviation in the Contract Law from the principle of liability at (presumed) fault in attributing liability for breach of contract. This principle has traditionally been used in civil codes across civil law jurisdictions, including France, Germany, Japan and Switzerland. Unlike other civil law jurisdictions, China instead adopts the principle of strict liability to protect the interests of the innocent party via extended scope of liability for breaches.

¶3-022 Influence of International Conventions

The first of the guiding principles on legislating for contract law made it clear that PRC should make broad references to successful practices, judicial precedents and scholarship in advanced market economies, participate in international markets, adopt common rules underlying the inner workings of the modern market economy, and stay consistent with international conventions and commercial customs. [11] Here, "international

[8] Ibid,12.

[9] Contract Law, Arts 68 and 69.

[10] Contract Law, Art 94, para (2) and Art 108.

[11] Huixing Liang, *A Study of Theories, Cases and Legislation in Civil Law, Volume 2* (Beijing: Chinese Academy of Governance Press 1999) 121.

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conventions" primarily refer to the United Nations Convention on Contracts for the International Sale of Goods ("CISG"), which has been in effect in China since 1 January 1988.

There are several aspects of the influence of the CISG on the Contract Law.

Firstly, the law has incorporated key contents in the CISG relating to the formation of contract, such as the following:

- Definition of offer (CISG, Art 14, papa (1); Contract Law, Art 14),
- Definition of invitation for offer (CISG, Art 14, para (2); Contract Law, Art 15),
- Validity of offer upon arrival (CISG, Art 15, para (1); Contract Law, Art 16, para (1));
- Revocation of offer (CISG, Art 16, para(1); Contract Law, Art 18),
- Restrictions on revocation of offer (CISG, Art 16, para(2); Contract Law, Art 19);
- Expiration of offer (CISG, Art 17; Contract Law, Art 20, para(1));
- Definition of acceptance (CISG, Art 18, para(1); Contract Law, Art 21);
- Validity of acceptance upon arrival (CISG, Art 18, para(2); Contract Law, Art 26, para(1));
- Validity of late acceptance (CISG, Art 21; Contract Law, Arts 28 and 29);
- Revocation of acceptance (CISG, Art 22; Contract Law, Art 27);
- Formation of contract upon acceptance coming into force (CISG, Art 23; Contract Law, Art 25);
- Recognition of both written and oral (vocal) contracts, as well as contracts reached in other formats (CISG, Art 11; Contract Law, Art 10, para(1)).

Secondly, on conditions triggering termination of contract, the Contract Law (Art 94, item(2) to item (4)) has accepted the doctrine of "fundamental breach" prescribed in the CISG (Art 25), although with minor variations in wording. [12] The law also follows the CISG in recognising the validity of amendments to, or termination of, contract by consensual agreement (CISG, Art 29, para (1); Contract Law, Arts 77, para(1) and Art 93, para(1)). There is also no difference in the prescriptions on consequences of termination of

[12] Shiyuan Han, "PRC Contract Law and CISG", (2011) 2 *Jinan Journal* (Section of Philosophy and Social Sciences) 11.

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contract between the CISG and the Contract Law (CISG, Art 81, para (1) and para(2); Contract Law, Arts 97 and 98).

Thirdly, on liability for breach of contract and exemptions from liability, there are also signs of convergence with the CISG. For example, while the CISG incorporates both notions of "anticipatory breach" (anticipatory repudiation) at common law (CISG, Arts 71 and 72) and "unrest defense" (Unsicherheitseinrede) in the civil law tradition (CISG, Arts 71), the Contract Law recognises these notions to the same effect (Art 68, Art 69, Art 94, and Art 108), as mentioned earlier. Under the CISG, the establishment of liability of the breaching party for compensating losses suffered by the other party does not require fault, but comes with possibilities of exemptions from liability. Such a system is called "strict liability" and has been written into the Contract Law as it is widely regarded as one of the overwhelming tendencies for contract law development around the world. In addition, in calculating losses as the basis of damage compensation, the Contract Law follows the CISG in adopting the rule of foreseeability (CISG, Art 74; Contract Law, Arts 113, para(1)).

¶3-023 Reflections on Local Characteristics

The Contract Law is heavily reflective of the transitional environment and dynamism during the economic and social reforms in the PRC. It shows clear signs of trying to deal with a distinct set of problems and conflicts faced by contracting parties in the country's gradual transition to a market economy.

For example, the "right of subrogation" (Art 73) is especially instituted for mitigating the problem of "triangular chains of debts" (*san jiao zhai*) in practice where the difficulty of collecting debts is colored by multiple, intermingling contractual relationships. A common scenario is that A is the creditor to B who in turn is the creditor to C, with C being the creditor to A. This problem of resolving debts had been pervasive in the early years of the reform of state-owned enterprises ("SOEs") when the double identity of both creditor and debtor was so commonly observed in the state sector.

Other examples include the following:[13]

- The "right of cancellation" targets debtors who tried to evade or repudiate debts by transferring properties to a third party (Art 74);
- The obligation of the seller to transfer ownership of the subject matter to the buyer is aimed at remedying previous mishandling of cases by authorities (courts or administrative agencies) where

[13] Huixing Liang, "The Unified Contract Law: Advances and Inadequacies", (1999) 3 *China Legal Science* 27.

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a sales contract was nullified due to lack of formal registration of ownership transfer (Art 135);

- Multiple assurances for overseeing the formation and performance of construction contracts triggered by the particular difficulty in ensuring high quality projects in a business environment where honesty and professionalism are often overshadowed by a thirst for profit. The requirement of an open tender for the formation of construction contracts and the adoption of a compulsory supervision system are responses to the serious social problem of poor quality construction projects that had resulted in personal injuries and property damages (Art 271 and Art 276). Provisions for the same purpose also include Art 272, para(2) (prohibition on subcontracting to several developers), Art 272, para(3) (prohibition on dividing the project into separate parts to assign to third parties under the guise of subcontracting), Art 282 (liability of the contractor for compensating losses from personal injuries and property damages caused by the project during its reasonable usage period).
- To address abuses of attribution of liability to third parties for breach of contract in adjudicative practice, the law enshrines the doctrine of "privity of contract" by holding the breaching party liable despite of a third party's culpability (Art 121).

Another of the unique mechanisms specific to the country's transforming social and economic settings is the set of rules for establishing validity of contracting acts by "legal representatives" of legal persons and other organisations in the context of ultra vires (Art 50). Unless the counterparty knows or ought to know that the legal representative had overstepped his or her authorised scope of powers, the contract so concluded shall be valid.[14]

¶3-030 Civil Contracts vs Commercial Contracts; Concept of Consumer Contracts; Protection of Consumers

¶3-031 Civil Contracts vs Commercial Contracts

As a matter of legislative practice, there had been a distinction between civil contracts and commercial contracts before the Contract Law was promulgated in 1999. Civil contracts were governed by the GPCL while commercial contracts were subject to specialised commercial enactments such as the Law on Economic Contracts (1981), the Law of Foreign-related Economic Contracts (1985) and the Law of Technology Contracts (1987). Such a distinction no longer existed after the Contract Law unified the legislation on contracts and the previous three statutes were superseded.

[14] Huixing Liang, "The Unified Contract Law: Advances and Inadequacies: Part I", (1999) 3 *China Legal Science* 27.

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Since then, "civil contracts" and "commercial contracts" have become fused in their joint subjection to the regulation of the Contract Law.[15]

That said, the Contract Law is nevertheless attentive to typical attributes of commercial contracts and tries to accommodate to them. For example, the law has separate chapters on typical types of commercial contracts, such as financial leasing contracts and construction contracts.[16]

It is interesting to note that due to the lack of differentiating treatment of civil and commercial contracts under the law, there are signs of extended application of rules suitable only for commercial contracts to civil contracts. This has attracted criticism. The same situation applies in Taiwan as discussed in Chapter 4.

For example, Art 157 extends the buyer's obligation of inspection of the subject matter upon receipt to all kinds of sales contracts, oblivious to the fact that buyers under civil contracts do not command an adequate level of professional knowledge and skill possessed by business players and commercial entities to make competent inspection and give prompt notice. It appears that the law places a rigid expectation on buyers who are not versed in commerce, which runs counter to prevailing international practice in other countries where commercial law usually only requires an obligation for inspection when both parties are involved in commercial acts.[17]

Another example of the downside of treating civil and commercial contracts alike under the Contract Law is its stance on whether remuneration should be paid under a commission contract. Art 405 dictates that payment shall be made by the principal to the agent if there is no special agreement on fees. By comparison, however, in other countries, such as in Germany, remuneration is only applicable under commercial commissions, not civil commissions (German Civil Code, Art 662).

It is undeniable that commercial contracts display a number of distinctive features not observed in civil contracts, such as a purpose for profit-making and the requirement for considerations.[18] It is therefore exciting that there seems to be vast unchartered water in academic research on commercial contracts, which calls for serious efforts of exploration.

[15] Youtu Qin, *Studies on Commercial Law* (Beijing: China University of Political Science and Law Press 2011).

[16] Min Ye and Junpeng Zhou, "On Special Attributes of the Right to Revoke Commercial Contracts", (2007) 4 *Social Sciences in Xinjiang* 79-82.

[17] Tao Fan, "Analyses and Reconstruction of the System for Commercial Contracts in China", (2008) 6 *Contemporary Law Review* 23-29.

[18] Kaibin Liang, "Identifying the Subjects to Trials on Disputes over Commercial Contracts", (2009) 5 *Commercial Research* 175-177.

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¶3-032 Concept of Consumer Contracts and Protection of Consumers

The Contract Law does not contain specific provisions on consumer contracts. This does not mean, however, that such contracts are not protected. Because of their weaker position in negotiating and concluding contracts for receiving goods and services from business operators, consumers are vulnerable to infringements of their rights and interests and deserve special protection. This task is primarily performed by the Law on the Protection of Consumer Rights and Interests (1993, amended 2013, LPCRI). There are other laws and regulations protecting consumer rights by areas of business and nature of transactions, such as the Product Quality Law (1993, amended 2000, PQL), the Anti-unfair Competition Law (1993), the Anti-Monopoly Law (2007), and the Food Safety Law (2009).

While there is no space here to elucidate the comprehensive framework for consumer protection under the LPCRI, some essential elements of the law which indicate a clear legislative tendency to deviate from the ordinary principle of equality in allocating rights and responsibilities among contracting parties are worth highlighting. In other words, consumers are empowered with more rights while businesses are burdened with more obligations, as well as more deterring liability for breach.

For example, Chapter II of the LPCRI establishes basic rights of consumers, such as the right to personal and property safety, the right to receive truthful information, the right of free choice, the right of a fair deal, the right for compensation resulting from personal injury or property damage, the right to form consumer associations. In the recent amendments to the LPCRI which significantly expanded the scope of consumer rights and strengthened the forcefulness of consumer protection, consumers who shop online or through televisions or telephones are afforded a new right of regret for seven days without cause (Art 25).

The LPCRI also imposes obligations upon business operators and the state. Chapter III of the law contains an expansive list of business operators' obligations to consumers, including complying with the Law on Product Quality ("LPQ"); listening to consumers; guaranteeing that goods and services meet requirements for personal or property safety; providing accurate information and avoiding false or misleading propaganda; using real names and marks; providing invoices; and avoiding insult or slander of consumers or intrusions into consumers' personal freedom. Regarding product quality, the LPCRI establishes a guarantee (warranty) mechanism (Art 22).

The LPCRI also prohibits businesses from attempting to limit their obligations toward consumers by contract or otherwise (Art 24).[19] Although

[19] Under Art 24, business operators may not "impose unfair or unreasonable rules on consumers or reduce or escape their civil liability for their infringement of the legitimate rights and interests of consumers."

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Chapter 5 Lending and Financing

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The legal rules governing the financing of companies are the primary focus of this chapter. The purpose of this chapter is to outline the basic components of the capital structure of a company. This chapter considers some factors which may be taken into account by the management of a company when making financing choices.

There are generally three ways for a company to finance its operations: equity financing; debt financing; and retained profits. Together, these constitute the concept of "corporate finance". The focus of this chapter is debt financing, whereby a company raises funding through borrowing either from a lender or a shareholder. Borrowing capital from a lender is a typical way of debt financing whereas borrowing capital from a shareholder is often termed as a "shareholder loan". In addition, corporate bonds and initial public offerings are also discussed in the context of corporate finance. In the Chinese context, given the dominance of Chinese banks in the market, bank financing is the major form of corporate borrowing. Technically, there is no substantial difference between a bank loan and a shareholder loan.

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The starting point of understanding debt financing in the context of Chinese law is to distinguish domestic companies and foreign-invested enterprises, which are governed by two parallel and autonomous company law regimes.

For details, please refer to Chapter 7 of this book.

¶5-010 Debt Finance Terminology

Companies can borrow from banks or other lenders such as existing shareholders. A company can also tap capital markets by issuing debt securities to investors. In China, companies are rarely able to issue debt securities due to an underdeveloped bond market. Before 1986, the only debt securities traded in China were treasury bills. Corporate bonds were issued for the first time in 1986 with an average amount of RMB8 billion.[1] There are three types of Chinese corporate bonds: state investment company bonds; financial bonds; and enterprise bonds. Even compared to its weak equity market, China's bond market is still relatively underdeveloped. It is not likely that corporate bond issues will increase significantly in the near future. First, the bond market is not fully open and is still dominated by the Government; second, bond coupon rates are low and are subject to various restrictions set by the Government; third, the protection for the bondholder's rights in the bankruptcy proceeding is still not clear.

The size of bond issuance in China is only a small fraction of equity issuance, largely due to the underdevelopment of infrastructure such as credit derivatives and credit ratings, which are less advanced than those of equity markets, and partly because the entire financing channel has been skewed towards banks. Currently, China's bond market is only 30% of total borrowings, compared with 70% in the United States.[2] Most borrowers are overly reliant on bank loans. Expansion of the bond market would create business for currency swaps, collateralised loan obligations, and credit default swaps and would in turn benefit investors as these products can be used to hedge the risks associated with interest rates default and duration.

"Shareholder loan" is only a concept. In practice, it is difficult for shareholders to lend money to their company. The reason is related to the concept of business scope. Unlike some common law jurisdictions which allow companies to have unlimited objects clauses under which companies can engage in any lawful business unless the specific business require special approval or permit, the Chinese Company Law requires all companies to have very narrow and specific business scope clauses. In addition, lending, as the key element in the business scope of a financial institution, requires

1 Anjali Kumar, Kwang Jun, Anthony Saunders, Susan Selwyn, Yan Sun, Dimitri Vittas and David Wilton, "China's Emerging Capital Markets", *Financial Times* (1 January 1997) (online).

2 Ray Chan, "UBS China Pins Hopes on China Bond Market, Derivatives", *South China Morning Post*, 20 May 2013 (online).

special approval from the banking regulator. Therefore, it is not realistic for a shareholder, a company, to lend money to another company into which it has invested as a shareholder.

Regulation of debt financing covers the types of financing, use of proceeds, and foreign exchange control. The financial crisis intensified the Government's efforts to strictly control foreign currency.

The most common sources of foreign exchange debt financing for FIEs are bank loans and shareholder loans.

Foreign exchange controls still make a clear distinction between foreign exchange and renminbi loan financing.

A distinction between a foreign exchange loan and a renminbi loan depends on whether the lender is a PRC lender or a foreign lender. A PRC lender includes PRC commercial banks that have been invested in by strategic foreign investors but still remain as domestic banks. Foreign lenders include branches of foreign banks in the PRC and Chinese-foreign joint venture banks. Both domestic banks and branches of foreign banks can now make renminbi loans to their PRC corporate customers.

Foreign exchange borrowing from overseas lenders, foreign-invested financial institutions, or other foreign entities is treated as foreign debt. "Foreign debt", here, is defined similarly to the term "international commercial loan" so the two terms are functionally equivalent.[3] By contrast, foreign exchange borrowing from Chinese banks is not considered as foreign debt and is subject to less strict foreign exchange control.

SAFE's approval is required for a foreign exchange loan. Each company shall have, within fifteen days of entering into a "foreign debt" loan agreement, submitted a copy of the loan agreement to the local SAFE bureau for examination and obtained a "foreign debt registration certificate".[4] The foreign debt registration certificate may become void if the borrower fails to conform to the terms of the loan agreement within three months from its date of issue.[5]

Although the term is "foreign debt registration", it is effectively an approval procedure. SAFE will check the borrower's contribution of registered capital according to the articles of association and shareholders' agreement (or a joint venture contract) and relevant capital verification reports. A legal opinion is also required to confirm the legality of the terms

[3] Provisional Regulations for the Statistical Monitoring of Foreign Debt 1987, Art 3.

[4] Provisional Regulations for the Statistical Monitoring of Foreign Debt 1987, Art 5; Implementing Rules for the Statistical Monitoring of Foreign Debt 1998, Art 8; Interim Procedures for the Administration of Foreign Debt, Art 22.

[5] Notice of Relevant Questions Concerning Prohibiting the Purchase of Foreign Currency to Prepay Loans 1998, Art 1(2).

of the loan agreement. The foreign debt registration also ensures that the interest rate is not higher than the interest rate for loans of a similar tenor on international financial markets. Where the borrower is a joint venture or a wholly foreign-owned enterprise, SAFE needs to be satisfied that the borrower's medium and long-term foreign debt does not exceed the difference between its total investment and registered capital.[6]

Late registration is possible but a penalty may be imposed.[7] Non-registration, on the other hand, may make the loan agreement ineffective.[8]

Unlike domestic companies, FIEs may borrow foreign exchange loans without SAFE's approval. However, foreign borrowings are subject to registration requirements that include mandatory loan agreement provisions.

The borrower is required to file periodic reports with SAFE giving prescribed particulars of each loan, including details of draw-downs and the repayment of principal and interest.[9]

The regulation of foreign exchange loans depends on the type of lender. The key legislation and regulations governing loans by PRC domestic financial institutions (including foreign-invested financial institutions as well as their overseas branches) are the PRC PBOC Law, the PRC Commercial Banking Law, and PBOC Lending General Provisions. Loans by foreign financial institutions (including branches of domestic banks), PRC branches of foreign financial institutions, and Chinese-foreign joint venture banks are regulated by the Commercial Banking Law and the Administration of Taking Out of International Commercial Loans by Organisations in China Procedures.

¶5-020 Foreign Exchange Bank Loans

Foreign exchange bank loans can be arranged within the PRC or offshore from foreign banks or overseas branches of PRC banks. PRC banks have become increasingly important sources of foreign exchange loan facilities. Bank of China, for instance, as early as in the 1980s, made foreign exchange loans available for short-term foreign exchange requirements as well as short to medium-term foreign buyers' credits. The other Big Four banks also engage in foreign exchange business now. The scope of foreign

[6] Notice of Relevant Questions Concerning Prohibiting the Purchase of Foreign Currency to Prepay Loans 1998, Art 1(1); Interim Procedures for the Administration of Foreign Debt 2003, Art 18.

[7] Notice of Relevant Questions Concerning Prohibiting the Purchase of Foreign Currency to Prepay Loans 1998.

[8] Interim Procedures for the Administration of Foreign Debt 2003, Arts 22 and 40.

[9] Administrative Procedures for Domestic Entities Borrowing International Commercial Loans 1998, Art 10.

exchange loans have been extended to overdrafts against foreign currency accounts, documentary credits, and packing credits. Foreign exchange loans can be syndicated.

Foreign banks and their PRC branches can also provide loans to FIEs as well as domestic enterprises. These banks often want to obtain guarantees from foreign investors or PRC financial institutions. Chinese financial institutions' provision of guarantee to foreign exchange loans needs to be approved by SAFE.

International commercial loans, as defined in the Administration of Taking Out of International Commercial Loans by Organisations in China Procedures, is defined as "loans contractually repayable in foreign currency that are taken out by an organisation in the PRC from a financial institution, enterprise, individual or other economic entity outside the PRC or from a foreign-funded financial institution in the PRC".[10] This definition is close to the definition of "foreign debt".[11] The definition is framed to include various forms of indebtedness. Technically, international commercial loans encompass export credits, international financial leases, foreign exchange payments in connection with compensation trade, foreign exchange deposits from overseas entities and individuals (but excluding foreign exchange deposits in approved offshore banking departments of PRC banks), project finance, trade-related finance with terms exceeding 90 days and foreign exchange loans in other forms.

The Administration of Taking Out of International Commercial Loans by Organisations in China Procedures distinguish between short-term international commercial loans and medium and long-term international commercial loans. Short-term international commercial loans usually have a term of one year or less while medium or long-term loans have a term longer than one year. Short-term loans include outward documentary bills, packing credits and usance letters of credit with terms of over 90 days and under 365 days. The proceeds of short-term loans may not be used for long-term investment projects, fixed asset loans, or other improper uses.

Non-financial institutions or enterprises are prohibited from lending in foreign exchange to other FIEs or domestic enterprises. This rule generally is reflective of the prohibition by non-financial institutions stated in the Lending General Provisions.

The International Commercial Loan Procedures allow FIEs to obtain international loans merely with SAFE's registration (other than SAFE's approval). FIEs are not subject to thresholds such as at least three years' profitability, specified net asset ratios, and adequate foreign exchange

[10] Administration of Taking Out of International Commercial Loans by Organisations in China Procedures, Art 2.

[11] Provisional Regulations for the Statistical Monitoring of Foreign Debt 1987, Art 3.

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revenues. Nevertheless, FIEs are still subject to some restrictions even if it is relatively easier for them to obtain foreign exchange debt. For instance, FIEs still need to satisfy the foreign debt registration requirements and the prohibition on depositing loan proceeds in overseas accounts.

What borrowers and lenders need to consider in relation to loans are the necessary formalities they have to go through with competent Government authorities. For instance, they need to be concerned of what approvals they need to secure for the borrowing, the opening of the bank account to receive proceeds of a draw-down, the conversion of renminbi into a foreign currency, the remission of a foreign currency abroad, the provision of a security (in particular, offshore security) for a loan.

Essentially, SAFE's approval is required for most of the steps that are required to be taken when domestic entities take foreign currency loans. SAFE's approval is necessary where: the loan is a foreign currency loan; the borrower is a domestic entity; and the lender is a foreign entity or a foreign-funded financial institution in the PRC. The branch of a foreign bank in China is treated as part of a financial institution outside of the PRC even though it is physically located in China. However, a Chinese-foreign joint venture bank is a foreign-funded financial institution in China.

A company that owes a foreign debt is required to register the foreign debt. Each company shall have submitted a copy of the loan agreement to the local SAFE bureau for examination within fifteen days of entering into a foreign debt loan agreement, and obtain a "foreign debt registration certificate". Although the procedure is termed as "foreign debt registration", SAFE's approval is effectively required. SAFE will check if the borrower's registered capital has been contributed, and inspect the relevant capital verification reports. A company's borrowing capacity is the difference between this company's total investment and registered capital. Reviewing the borrower's capital verification report can help SAFE confirm the borrower's borrowing capacity, that is, its aggregate medium and long-term foreign debt being no more than the difference between the approved total investment and registered capital. A legal opinion is also necessary to confirm the validity of the loan agreement terms. In particular, SAFE wants to ensure that the interest rate is not higher than the interest rate for loans of a similar tenor in international financial markets.

Late registration for a "foreign debt registration certificate" is possible but may lead to a penalty. Failure to duly register an international commercial loan with SAFE can result in severe legal liabilities and consequences. For example, the loan agreement will not be treated as a valid agreement. Banks are prohibited from opening foreign exchange accounts for repayment of the principal and interest. In other words, FIEs will encounter difficulty in remitting money offshore. It is worth noting that SAFE's registration itself does not guarantee repayment even though the registration is a prerequisite.

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¶5-021 Foreign Exchange Shareholder Loans

Shareholder loans are an important source of financing for FIEs as well as domestic enterprises. Even though the source of funding is different for bank loans and shareholder loans, the regulatory regime is the same for both types of loans. Put simply, SAFE registration is required for foreign exchange shareholder loans.

Shareholders of an FIE need to decide how to fund the FIE's capital needs, either in the form of a shareholder loan or registered capital.

It is convenient to compare some basic features of capital contribution with those of shareholder loans. By contributing registered capital (equivalent to shares in a common law jurisdiction) to the company, shareholders can maintain their equity percentage in the company. In other words, shareholders' existing equity will not be diluted. Otherwise, the company may have to attract some new shareholders by allowing them to contribute more registered capital to the company. Raising funding through debt financing creates more security over assets, which may put the company at risk of losing a degree of control over its assets as lenders may have a say on certain matters of the company.

Commercial lenders usually demand subordination of shareholder loans. Where commercial lenders are not willing to lend more money to the company, shareholder loans may be the last resort. Shareholders may ask for a higher interest rate to compensate for any additional risks. The higher rate must not exceed the market rate for a similar loan. The International Commercial Loan Procedures require borrowers to ensure that their costs of funding are competitive with enterprises of the same credit rating in international financial markets.[12]

¶5-030 Export Credit and Supplier Financing

A number of foreign export credit agencies help finance the purchase of imported equipment by FIEs through foreign exchange loans, loan guaranties, and export insurance. Credit may be provided through supplier financing.

¶5-031 International Finance Corporation Loans

International Finance Corporation, the private sector financing arm of the World Bank Group, can also provide foreign exchange loans. IFC is willing to provide financing on a limited recourse basis as it is in a better position to control political risks involved in lending to enterprises in China. More often, IFC's loans are lent through syndicates. Commercial

[12] International Commercial Loan Procedures, Art 9.

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banks are willing to participate in the projects in which IFC is the leading lender or participant.

¶5-032 Working Capital Loans

The other way of obtaining renminbi for working capital is by having a foreign investor open a letter of credit with a foreign bank, a PRC branch of a foreign bank in favour of a PRC bank, or a PRC branch of a foreign bank in favour of a PRC bank as credit support for renminbi loans made by the PRC bank to an FIE. To secure the FIE's reimbursement obligations, the foreign investor needs to deposit foreign exchange in a cash collateral account of the foreign bank issuing the letter of credit. The foreign investor and the FIE are to enter into a reimbursement agreement according to which the FIE must reimburse the foreign investor should the bank act against the foreign exchange deposit or if the FIE fails to make required payments under the renminbi loan. The renminbi loan would be repaid by the FIE. During a loan repayment, the corresponding amount of cash collateral is released to the foreign investor.

The difficulty of this arrangement is to obtain SAFE registration. SAFE may view this as an attempt to circumvent the restrictions on foreign exchange capital loans. When an FIE needs to convert renminbi into foreign exchange for repayments, the FIE will not be able to produce the relevant documentation to a PRC bank for verification purposes. Eventually, the FIE may encounter difficulties in effecting such conversion.

A swap contract between a PRC bank and an FIE can be an alternative option. The FIE must first open an offshore bank account for deposits and repayments with the PRC bank.[13] To do so, the FIE must first obtain SAFE's approval. The foreign investor will remit a specified amount in foreign exchange into this account. The PRC bank will then lend an equivalent amount of renminbi to the FIE in China. In terms of repayments, the FIE will make them to the PRC bank, and then the PRC bank will make corresponding payments in foreign exchange plus an interest at a lesser rate to the offshore account. In this swap arrangement, a reimbursement agreement may also need to be entered into. According to this reimbursement agreement, the FIE agrees to reimburse the foreign investor for any loss if the FIE fails to make the required renminbi payments to the PRC bank. While this arrangement may help the FIE obtain working capital loans, it actually violates the legal prohibition on the conversion of foreign exchange loans into renminbi.[14]

[13] FIE needs SAFE approval to establish and maintain an offshore bank account. Provisions on the Administration of Offshore Foreign Exchange Accounts, promulgated by SAFE on 11 December 1997 and effective as of 1 January 1998.

[14] International Commercial Loan Procedures, Art 12.

¶5-040 Registration of Foreign Debt

"Foreign debts" are defined to include the following:

- international syndicated loans (excluding the portion held by Chinese banks) are included in the category of "loans of foreign banks and financial institutions";
- debt obligations of FIEs to their parent and subsidiary companies (excluding accounts receivable) are included in the category of "loans from foreign entities"; and
- negotiable instruments (including convertible foreign currency bonds and commercial bills of exchange) are included in the category of "issue of foreign currency bonds ".[15]

Foreign debt must be registered with SAFE. Registration must be carried out within fifteen days after the execution of a loan agreement. The lender is under the legal obligation to ensure that the registration has been completed, which shall be a condition precedent to disbursement of loan proceeds.[16]

SAFE will issue a foreign debt registration certificate upon registration. A foreign debt status report and a foreign debt variation feedback report will be also issued. The borrower must ensure that any change to the loan contract is also duly registered.[17] Certain borrowers such as Governmental organisations, commissions and domestic banks must make periodic reports of a foreign debt contract status form.[18] The borrower must make periodic reports of all loan activity including each drawdown and repayment by means of a foreign debt contract status form that must be submitted during the first five days of each month.

The borrower must comply with other debt registration requirements such as:

- a foreign debt contract must state that it is only effective upon registration of the debt with the SAFE and that the debtor will handle procedures for the payment of principal and interest on foreign debt in accordance with the PRC exchange control regulations; and

[15] Administrative Measures on the Issuance of Foreign Currency Bonds by Domestic Institutions, Art 3.

[16] International Commercial Loan Procedures, Art 4.

[17] Implementing Rules for Statistical Monitoring of Foreign Debts (promulgated by SAFE on 24 September 1997 and effective as of 1 January 1998), Art 14.

[18] Ibid, Art 5.

- after foreign debt registration is complete, if the first drawdown does not occur within three months after the first drawdown date stipulated in the contract, the foreign debt registration certificate shall be revoked.

After the full repayment is made, the foreign debt registration certificate will be automatically voided and must be surrendered to SAFE for cancellation within fifteen days after the special foreign exchange account for the debt has been cancelled.

¶5-050 SAFE Procedures for Principal Repayments and Interest Payments

The renminbi was made convertible on the current accounts in December 1996. However, it remains unconvertible in the capital account. Repayment of principal is a capital account item that requires SAFE's confirmation for repayment. Interest payments require verification by the designated foreign exchange bank in which the FIE maintains its foreign debt account. An FIE must present its foreign debt registration certificate, the loan contract, and notices of repayment of principal issued by the foreign lender to SAFE. All FIEs are required to undergo an annual SAFE verification for compliance with exchange controls.

¶5-051 Penalties

Various penalties are imposed on violators of foreign debt registration requirements. A lender may invalidate a loan contract. The borrower may be fined up to 3% of the amount of the foreign debt involved for:

- failure to carry out foreign debt registration;
- failure to file the status report, feedback form and other reports and information with SAFE;
- forgery or alteration of the foreign debt registration certificate or other certification documents;
- opening, maintaining or cancelling a foreign debt account not in accordance with applicable regulations; or
- making repayments of principal without SAFE's authorisation.

¶5-052 Term of Loans

Foreign exchange loans are usually for a period of more than six months. SAFE requires borrowers to provide a statement by their counsels confirming the genuineness of their loan and their purpose if the loan is for a period of less than six months.[19]

[19] Notice of Relevant Questions Concerning Prohibiting the Purchase of Foreign Currency to Prepay Loans 1998, Art 1(1).

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transparent, and independent judiciary is still the goal of further judicial reform, which will give more confidence to investors, domestic and foreign.

Given the infancy of the Chinese securities market, speculative activities have been widespread not only in the stock exchanges but also in future markets as well as bonds market. The Chinese securities market is still dominated by individual investors. In the early years of its development there were some occasions that the individuals took to the street and rioted against police for the scare opportunity to obtain subscription forms so that they were able to subscribe for shares. Starting from the 1990s, individual investors relied more on civil litigation for their claim of losses from the false statements. This sort of litigation is likely to involve a large number of investors in the marketplace and may have a negative impact on the social stability. Both the regulatory watchdogs and courts have been careful in dealing with and having a mixed attitude towards such cases. In addition to the investor education campaign, the involvement of foreign investors may also help raise the investor community's sophistication level. In post-WTO China, along with China's further opening to foreign investors and fulfilment of its WTO commitments, it is reasonable to expect more and more foreign securities investments to come into China. Further legislative, institutional and judicial reform of China's securities market and regulatory system will help strengthen the investors' confidence and market efficiency.

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Chapter 10 Foreign Investment Law

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¶10-010 Foreign Investment Law in China - History and Background

The history of foreign investment in the People's Republic of China (PRC)[1] is brief. In its first three decades PRC adoptedthe "self-reliant" policy, a forced choice due to Chinabeing isolated by both the United States and theSoviet Union. The "self-reliant" policy in Maoist China is an alternative to the capitalist and Stalinist approaches to economic growth.[2] The failure of this policy triggered the dramatic yet logical adoption of the "open door" policy in 1978, which demonstrated the Chinese leadership's recognition of the importance of foreign investment in pursuit of economic growth. This also signifies PRC government's commitment to a more pragmatic and engaging approach for future development. Starting from 1978, China began transforming its economic and political structures with the goal of promoting international trade and utilising foreign investments.[3]

A main driving force behind economic reform was the urgent need to improve living standards[4] The transformation from the "self-reliant" policy (dependency approach) to "open-door" policy (neoclassical approach) has not been smooth due to the sharp contrast between the ideological and philosophical foundations underlying these two approaches.[5] The "open door" policy and the economic reform indicated China's determination to use market mechanisms and foreign resources to accelerate the modernization and economic growth. One of the difficulties is the tension between

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1 For the purpose of this chapter, the PRC or China refers to the People's Republic of China excluding Hong Kong Special Administrative Region, Macau Special Administrative Region and the territory of Taiwan.

2 Alexander Eckstein, *China's Economic Revolution* (Cambridge: Cambridge University Press 1977) pp123ff.

3 Todd Kennith Ramsey, "China: Socialism Embraces Capitalism? An Oxymoron for the Turn of the Century: A Study of the Restructuring of the Securities Markets and Banking Industry in the People's Republic of China in an Effort to Increase Investment Capital" (1998) *Houston Journal of International Law* 20, 451, 477.

4 The Communique of the 1978 Third Plenum of the Eleventh Communist Party Congress in December 1978, p21.

5 This contrast also appeared in the economic development in other East Asian countries. See generally Stephen Haggard, *Pathways From the Periphery: The Politics of Growth in the Newly Industrialized Countries* (Ithaca & London: Cornell University Press 1990); Anis Chowdhury and Iyanatul Islam, *The Newly Industrializing Economies of East Asia* (London & New York: Routledge 1993).

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encouraging foreign investment and maintaining state control over foreign business activities. This also influenced the implementation and structures of foreign investment law and policy in the PRC. Despite the strong criticisms raised by theorists of law and development, it is inevitable that China's future development is going to be shaped by the tension between the state, foreign investors and domestic commercial elites, and to be marked by a combination of state control and rampant free market capitalism.[6]

Of all the legal institutions that were rebuilt or created in the past three decades, those related to foreign investment have developed the fastest. The urgency of attracting foreign investment and satisfying foreign investors' needs to have their investments well protected triggered the tremendous effort to create and grow a foreign investment regime. Against this background, it is not surprising to see the first piece of legislation enacted right after the adoption of the "opening door" policy was the law on joint ventures in 1979.[7] This piece of law was intended to encourage foreign participation in China's modernisation program. Other primary legislation and secondary implementing regulations in subsequent years allowed foreign companies to set up representative offices,[8] wholly foreign owned enterprises ("WFOEs")[9] and contractual joint ventures[10] in China. The Fourth Constitution revised in 1982 contains a critical provision offering the promise to protect "the lawful rights and interests of foreign investors."[11] These laws represented a break with both the rhetoric and the practices of China's first thirty years when China often condemned foreign investment as expropriation of developing countries. A large body of laws centring on the encouragement and protection of foreign investments were promulgated later on. Tax rules, foreign exchange controls, customs regulations and intellectual property laws were drafted and promulgated. Nonetheless, the foreign investment policy at the early stage was primitive and inconsistent, moving between two extremes of openness to restriction. A widespread lack of uniformity, consistency and self-contradiction occasionally endangered the foreign investment community's confidence on China. Although the legal institutions and infrastructure rebuilt after the Cultural Revolution cannot fulfil their supposed role, function and goal of defining and helping to vindicate legal rights, they have already contributed considerably to the economic and societal development in the past three decades.

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6 John Gapper, "China's Business Elite Is Free Enough," *Financial Times*, 21 October 2010, p13 (arguing that the young generation of Chinese entrepreneurs have the acceptable level of freedom and the state is able to continue to grow while the state remains totalitarian).

7 The PRC Equity Joint Venture Law 1979.

8 Interim Regulations concerning the Control of Resident Offices of Foreign Enterprises (promulgated on 30 October, 1980).

9 The Law on Enterprises with Sole Foreign Investment (adopted on 11 April, 1986).

10 The Law on Sino-Foreign Co-operative Enterprises (adopted on 13 April, 1988).

11 PRC Constitution 1982, Art 18 (adopted on 4 December, 1982).

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A unique Chinese characteristic or regulatory ethic of the foreign investment law regime in China is the centrality of the state's role as the primary agent for economic and social development. The fundamental role of the state in Chinese society and economy is articulated in the PRC Constitution 1982.[12] The subsequent amendments to the Constitution in 1993, while replacing the state planned economy with a socialist market economy, did not dilute the state-centric function in the economic development. The state's critical role for development appeared to be positive and constructive in the East Asia economies,[13] with the state playing a multiple faceted functions ranging from being the catalyst for development,[14] the force transforming national industrial structures[15] to mediating relations between foreign capital and local entrepreneurship.[16] Notwithstanding its sharp contrast with critical approaches in most Western nations that tend to view the state as the source of problems, inefficiencies and dysfunctions, the state-centric model of economic growth and development well explains the key features of the foreign investment law regime in China that pursue policies of import substitution, export-led growth and other development strategies such as encouraging foreign investment into infrastructure, high-tech and environment friendly sectors and channelling foreign investment towards the achievement of long-term social development goals. The state-centric theme of China's economic development, or more specifically, its foreign investment regime also well explains the success of the labour-intensive and export-oriented industries during the past three decades.

While the theories of dependency may be flawed in overlooking local political and policy causes for underdevelopment,[17] they have offered useful approaches to understanding the relationship between the state and foreign capital in developing economies.[18] The dependency perspectives are able to reveal the partnering relationship between the state and foreign investment in that the state acts as a corporatist ally of foreign capital by offering policy, economic and tax incentives to foreign investors whereas the foreign investors provide capitals, managerial skills and technologies to the host state which facilitates substituting short-term parochial goals for the long-term development priorities of building the infrastructural and technological foundations for long-term economic growth.[19]

Unlike some jurisdictions where the so-called corporatist states made use of formalistic and authoritarian legal systems to retain power,[20] the Chinese government has been making reformist efforts not only to modernise its national economy but also to upgrade its law, legal infrastructure and legal system. One line of critique of law and development claimed that liberal economic policies may be the source of underdevelopment.[21] This fortunately is not the case in China where liberal economic policies effectively limit or reduce state involvement and intervention in economic and commercial activities aimed at developing a free market system supported by private law rules and institutions. Nonetheless, neither the "open door" policy nor the liberal economic policies truly undermine the state's regulation of foreign investment albeit the inhibitive effect on the state's control given the transnational character of foreign business. Different from the critical studies perspectives and dependency theories,[22] the use and growth of the liberal private law system in China does not seem to contribute to weakening the state's capacity to control economic activities, which evolves into a development model opposite to the US free market model. The multi-layers of China's economic success remind us the difficulty and complexity in understanding and justifying Chinas' development efforts. In this sense, the foreign investment regime in the PRC demonstrates both prospects and dilemmas, which are complexly and paradoxically related to the state.[23]

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[12] PRC Constitution 1982, Art 18.

[13] Chalmers Johnsons, *MITI and the Japanese Miracle: The Growth of Japanese Industrial Policy 1925-1975* (Stanford: Stanford University Press 1982); David Friedman, *The Misunderstood Miracle: Industrial Development and Political Change in Japan* (Ithaca & London: Cornell University Press 1988) Ch 5; Robert A. Scalapino, Seizaburo Sato and Jusuf Wanandi (eds), *Asian Economic Development: Past and Future* (Berkeley: Institute of East Asian Studies 1985);

[14] Stephen Haggard, *Pathways From the Periphery: The Politics of Growth in the Newly Industrialized Countries* (Ithaca & London: Cornell University Press 1990) Ch 2; Lee Soo Ann, *Industrialization in Singapore* (Melbourne: Longman's 1973); Lim Chong Yah, *Economic Restructuring in Singapore* (Singapore: Federal Publication 1984).

[15] Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press 1991) (offering considerable evidence of the central role of the state in developing South Korea's industrialised economy).

[16] Thomas B. Gold, "Entrepreneurs, Multinationals and the State" in Edwin A. Winckler and Susan Greenhalgh (eds), *Contending Approaches to the Political Economy of Taiwan* (Armonk, NY: M.E. Sharpe 1990), pp175-205.

[17] Stephen Haggard, *Pathways From the Periphery: The Politics of Growth in the Newly Industrialized Countries* (Ithaca & London: Cornell University Press 1990) pp19-22.

[18] Robert A. Packenham, *The Dependency Movement: Scholarship and Politics in Development Studies* (Cambridge, MA: Harvard University Press 1992); Paul A. Baran, *The Political Economy of Growth* (New York: Monthly Review Press 1968); Celso Furtado, *Development and Underdevelopment: A Structural View of the Problems of Developed and Underdeveloped Countries* (Berkeley: University of California Press 1964); Charles K. Wilber (ed), *The Political Economy of Development and Underdevelopment* (New York: Random House 1979 2nd ed).

[19] Mark Singer, *Weak States in a World of Power: The Dynamics of International Relationships* (New York: Free Press 1972).

[20] James A. Gardner, *Legal Imperialism: American Lawyers and Foreign Aid in Latin America* (Madison: University of Wisconsin Press 1980) pp187ff.

[21] Francis G. Snyder, "Law and Development in the Light of Dependency Theory," (1980) 14 *Law and Society Review* p722.

[22] Richard W. Bauman, "Liberalism and Canadian Corporate Law" in Richard F. Devlin (ed), *Canadian Perspectives on Legal Theory* (Toronto: Emond Mongomery 1991) 75-97; Mark Kelman, *A Guide to Critical Legal Studies* (Cambridge, MA: Harvard University Press 1990) 249; Alan Stone, "The Place of Law in the Marxian Structure-Superstructure Archetype" (1985) 19(1) *Law & Society Review* 40-67.

[23] Edward Friedman, "Theorizing the Democratization of China's Leninist State" in Arif Dirlik and Maurice Meisner (eds), *Marxism and the Chinese Experience* (Armonk, NY: M.E. Sharpe 1989) p179 (discussing the difficulties facing China in cloning the East Asian development experience).

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The growth and overall trend in foreign investment in China is positive. The first decade starting from 1979 witnessed an uneven but steady growth. In the first half of the period, an annual average of foreign investment was over US$2 billion. The figure jumped to US$6.3 billion in 1985. There was a decline in 1989 and 1990 due to the Tiananmen accident. The volume of foreign investment soon resumed and was nearly US$12 billion for 1991.[24] It climbed up very quickly and the contracted foreign investment reached US$57.2 billion and US$122.7 billion in 1992[25] and 1993[26] respectively.[27] Foreign direct investment ("FDI") declined again in 1997-1999 largely due to the Asian financial crisis. FDI inflows increased in the new millennium: the utilised FDI amounts were US$40.72 billion, US$46.88 billion and US$52.74 billion in 2000, 2001 and 2002 respectively. FDI inflows were in the explosive growth after China's accession to the WTO and the utilised amounts reached US$53.51 billion, US$60.63 billion, US$60.33 billion, US$69.47 billion and US$82.66 billion in 2003, 2004, 2005, 2006 and 2007 respectively.[28] FDI to China was US$92.4 billion in 2008, an increase of 23.6% from 2007.[29] These statistics indicated that China became an attractive target for foreign capital in the past three decades. The foreign investment projects played a constructive and positive role in China's economic development: the foreign invested enterprises ("FIEs") accounted for 52% of China's total exports in 2002 and 57% in 2007.[30] The surge of FDI has made China the world's largest capital-importing country.[31] Foreign-invested enterprises represented 16% of the total economy and 48% of exports.[32] China's limitless consumer market, impressive production capacity and rich natural resources make it an indispensible market for multinational companies and foreign investors.

[24] "China Data", *China Business Review*, May-June 1992, p19.

[25] "China Data", *China Business Review*, May-June 1993, p57.

[26] "Statistical Communique of the State Statistical Bureau of the PRC on the 1993 National Economic and Social Development," *China Economic News*, Supplement No.3, 14 March 1994, p5.

[27] It must be pointed out that there was a gap between contract value and actually used amounts. For instance, US$57.2 billion foreign investment was contracted but only US$10.1 billion was used in 1991, and US$122.7 billion was contracted but only US$36.77 billion was used. See "Analysis of China's Use of Foreign Funds for 1992", *China Economic News*, 24 May 1993, p11; 1993 Statistical Communique, supra note 26, p5.

[28] China Trade Performance, US-China Business Council, available at http://www.uschina.org.

[29] US-China Business Council, Foreign Direct Investment in China, available at http://www.uschina.org/statistics/fdi_cumulative.html

[30] Ibid. Import & Export Statistics by FIEs from January to December 2007, Invest in China, http://www.fdi.gov.cn/pub/FDI_EN/Statistics/FDIStatistics/IEExpressbyFIEs/t20080126_89210.htm

[31] "China to Draw US$50 billion FDI, to be World's No.1 Recipient", *People's Daily*, 5 December 2002.

[32] Jonathan R. Woetzel, *Capitalist China: Strategies for a Revolutionized Economy* (New York: John Wiley & Sons 2003) 2.

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¶10-020 Government's Policy towards Foreign Investment: A Chronological Review

The foreign investment regime in China has evolved significantly since its inception immediately after the adoption of the "open door" policy in 1978.[33] Policy plays a very critically important role in this regime. Unlike other jurisdictions, policy in China not only affects the content and application of laws but also the day-to-day life of individuals and corporates. Another feature of policy in China is its constant (and somehow unpredictable) change. The underlying rationale of these features is that policy as well as law are regarded and used as an instrument to accomplish long- or short-term objectives and reflect the CCP's ideology in ruling the country. The Chinese government repeatedly stressed the importance of attracting foreign investment into China and the necessity to change orientation from self-reliance and economic restrictiveness to economic openness. However, during the economic opening process, the way of attracting and using foreign investment has always been a hot issue in the policy-making process. Gradually, the government becomes more concerned with guiding investment flows and influencing foreign investment projects to match the state economic or developmental needs.

(a) First Ten Years: 1978-1989

From 1978 to 1988, the overall objective was to attract foreign investment while limiting the scale and scope of foreign investment. The Chinese government made a great effort to establish legal and institutional infrastructure to welcome foreign investment. To this end, the Chinese government enacted the Regulations on Encouraging Foreign Investment in 1986 which created a favourable environment to foreign investment, and established special economic zones and coastal economic opening regions where more preferential and flexible economic and legal policies were offered in order to attract foreign investment. The first government organ, the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC"), was formed within the government structure with the specifically designated duties to approve and supervise foreign-invested projects. Subsequently, an approval hierarchy was established to facilitate the approval of joint ventures. The first piece of legislation governing foreign investment was the PRC Equity Joint Venture Law in 1979,[34] which was no more than a statement of general principles governing equity joint ventures (EJVs). Later on implementing rules were passed to provide additional detail to the general law.[35] The government gradually approved other forms of foreign investment including contractual (or cooperative) joint ventures and

[33] The Third Plenum of the 11th Central Committee of the Chinese Communist Party formally, though scantly, introduced the "open door" policy.

[34] PRC Law on Joint Ventures Using Chinese and Foreign Investment (1979, as amended 1990).

[35] Implementing Regulations for the Law on Joint Ventures Using Chinese and Foreign Investment (1983, as amended 1986).

WFOEs. Other basic laws were also enacted on contract,[36] taxation,[37] foreign exchange,[38] employment[39] and others. As a result, the foreign exchange system was reformed very early and, consequently, the dual currency system eliminated.[40]

During this period, the Chinese government sent a strong signal to foreign investors indicating its strong willingness to attract foreign investment. The Chinese government renewed attention to induce foreign investment by offering more regulation and tax incentive packages. Although some initial progresses were made during this period, policy inefficiencies and shortcomings were also obvious. In particular, the Chinese government imposed controls and restrictions over foreign investment and tried to separate foreign investment from the local economy.[41] The overall policy over foreign investment was still very restrictive. As a result, greenfield foreign invested projects were less significant compared to foreign loans. For instance, from 1979 to 1982, 85.82% of foreign capital was raised in the form of foreign loans, and in 1985 foreign loans accounted 57.84% of the total amount of actually utilised foreign capital.[42] Overall, the first few years after the adoption of the "open door" policy witnessed a growing enthusiasm of the foreign investment community.

(b) Second Ten Years: 1990-1999

The decade of 1990s was a complicated period in terms of Chinese policies towards foreign investment. China's "open door" policy toward foreign investment has shifted back and forth in the spectrum from the extreme of restriction to the extreme of openness[43] largely due to the Tiananmen accident in 1989. The State Council's effort in the first decade to boost the foreign investment was soon doomed by

[36] PRC Economic Contract Law (1981) and PRC Foreign Economic Law (1985), which were later unified under the Contract Law 1998.

[37] PRC Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment (1980); Detailed Rules for the Implementation of the PRC Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment; PRC Foreign Enterprise Income Tax Law (1980).

[38] Provisional Regulations of the PRC Governing Foreign Exchange Control (1980); Rules for the Implementation of Foreign Exchange Controls Relating to Enterprises with Overseas Chinese Capital and Chinese-Foreign Equity Joint Ventures (1983).

[39] For details, see Chapter 6 of this book.

[40] The Announcement of the People's Bank of China on Further Reforming the Foreign Exchange Management System (28 December 1993).

[41] Pitman Potter, Foreign Business Law in China: Past, Progress and Future Challenges (San Francisco, The 1990 Institute 1995) 35.

[42] Xiujun Guo, *China's WTO Accession and New Strategies for Foreign Capital Utilization* (Economic Daily Publishing House 2002) 153.

[43] Jerome A. Cohen & Stuart J. Valentine, "China Business – Progress and Prospects", in William P. Streng and Allen D. Wilcox, *Doing Business in China: People's Republic of China* (Hunting, NY: Juris Pub 1990) Introduction.

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the Tiananmen accident and the subsequent economic downturn. The domestic politics became a source of influence: the government and CCP feared corruption from abroad which may erode the CCP's ruling in China. The retrenchment policies caused the disappointment of foreign investors.[44] Deng Xiaoping's southern tour in 1992 played a critical driving role engineering China to a socialist market economy. While the foreign business community resumed optimism thereafter, they also experienced frustration due to the lack of the functioning legal system and judiciary, and a multitude of practical obstacles.[45]

The entire 1990s witnessed differential liberalisation dominance as well as a departure from the conventional state planning system of the old days to a more market-oriented macro-economic regulation and control.[46] The conceptual approach drove the Chinese government to rely up industrial policies in regulating and directing foreign investment. The then State Planning Commission issued the Foreign Investment Industrial Guidance Catalogue in June 1995. The Catalogue is a list of investment guidelines that classified foreign-invested projects into four categories: "encouraged," "permitted," "restricted," and "prohibited." The "restricted" category limited the equity share that foreign firms could have in certain industries. The Catalogue signalled the state policies in attracting foreign investment. The State Council approved a revised Guidance Catalogue on 9 December 1997 and the new Catalogue came into force on 1 January 1998. The 1997 Catalogue removed barriers to foreign participation in some restricted sectors such as distribution, infrastructure, energy and power generation. The Catalogue also favoured those enterprises that were willing and able to bring high technology to China or promote exports and offered tax exemptions and other benefits to FIEs. In the category of "encouraged" investments an emphasis was placed on high technology and some industries were moved to the "restricted" category. This differential liberalisation policy de facto disfavoured SOEs and domestic private enterprises, which effectively gave FIEs a super-national treatment. Against this background, China's openness became a dominant theme again. By 1994, for instance, FDI comprised 78.14% of China's total actually utilised foreign capital.[47] Greenfield FIEs were the major mode of foreign invested projects. Among others, the first batch of foreign mergers and acquisitions also appeared in the Chinese market, which however only occupied a very small portion of

[44] Martin Weil, "The Business Climate in China: Half Empty or Half Full?" in Joint Economic Committee of US Congress, *China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence* (Washington, DC: US Government Printing Office 1991) 770-784.

[45] Lynn Chu, "The Chimera of the China Market," (1990) *The Atlantic Monthly*, October, 56-78.

[46] Final Version of the 14th CPC National Congress Report, *FBIS Daily Report – China*, 21 October 1992.

[47] Xiujun Guo, *China's WTO Accession and New Strategies for Foreign Capital Utilization* (Economic Daily Publishing House 2002) 153.

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total foreign investments.[48] At this period, some doubts over the concessions made to FIEs appeared in the policy and law marking circles. The enactment of the Company Law in 1993 heralds a partial effort to unify the corporate law regime hosting both foreign and domestic businesses.[49]

(c) Third Ten Years: 2000-2010

China's accession to the WTO on 11 December 2001 marked a new chapter of foreign investment in China. The significance of this event was to outline a legally binding roadmap for China to further liberalise and modernise the economy and foreign investment regime per se. As a result, many remaining restrictions on foreign investment were removed, the principle of national treatment was more expansively implemented, and the regulation and supervision of foreign investment activities were more subject to legal rather than administrative means. Other significant changes to foreign investment policies included repealing the requirements for foreign exchange balance and nationalisation of foreign investment, eliminating non-tariff barriers, improving market access to foreign goods and services, offering more protections to intellectual property rights, improving transparency, and establishing a legal framework more compatible to the requirements and principles of WTO. China's accession to the WTO brought positive impacts on FDI activities in China. For instance, American exports to China shot up by 118% from 2001 to 2005.[50] More fundamentally, China's accession to the WTO has been deepening China's integration into the world investment and trading system and facilitating China's institutional reform along with its economic reform. China's accession to the WTO also transformed China's governance or regulatory system. It has made laws and policies more transparent and publicly available. It has revised laws to reflect the principle of national treatment. It has reduced tariffs and quotas. It has increased market access in key industries. Overall China has by and large lived up to its WTO commitments. The WTO Director General gave China an "A+" for fulfilling its WTO undertakings in September 2006.[51]

During the first decade of the 21st century, other economic and governance infrastructure has also been reformed, i.e., the foreign exchange regulatory regime towards internal convertibility of the renminbi. As a result, the foreign investment regime departed from the previous route placing more emphasis on export and foreign exchange generation, and focused on the

48 UNCTAD, "Promoting Linkages" (2001) *World Investment Report* 341.

49 The corporate law regimes for FIEs and domestic enterprises remain parallel. Only when the FIEs laws and regulations are silent or contradictory to the Company Law, do the provisions in the Company Law apply. Otherwise, in most cases, the formation, operation and termination of an FIE need to comply with the FIEs laws and regulations.

50 Kenneth Lieberthal, "Completing WTO Reforms," *China Business Review*, September/October 2006.

51 "Lamy: China Fulfilling WTO Commitments Well," *China Daily*, available at http://english.cri.cn/3130/2006/09/06262@135641.htm.

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importation of technology and managerial skills. The Guidance Catalogue was further amended in 2002 to solidify China's WTO commitments, which reflected a liberalising trend.[52] As far as the FIEs are concerned, the approval, capitalisation, market access and financing have been reformed as well. The State Council further reformed the investment system, which raised the threshold on local government approvals of investment projects from US$30 million to US$100 million for projects failing within the "encouraged" and "permitted" categories in the Catalogue.[53] Foreign investment projects that did not utilise state funds only need to be verified rather than examined or approved. A wide range of foreign investment related matters have been addressed by new or revised legislation such as taxation, labour, customs, bank lending and guaranties, import and export licenses, intellectual property protection, environmental protection. Some Western types of business models have been introduced into and utilised in the Chinese market. Recent years have seen a surge of mergers and acquisitions activities, which fostered the need for a regulatory structure dealing with the transfer of corporate control. The 2006 Provisions on Acquisitions of Domestic Enterprises by Foreign Investors, issued by the MOFCOM, SAIC and other four ministries, superseded earlier scattered regulations and constituted a concrete legislative development in the field of foreign investment.[54] A new takeover code, the Acquisition of Listed Companies Administrative Procedures, was issued by the China Securities Regulatory Commission in 2006 and repealed the old one of 2002. The new takeover code aimed to boost domestic and cross-border mergers and acquisitions activities involving PRC-listed companies. The regulatory framework facilitated cross-border mergers and acquisitions transactions. During the period from 2000 to 2007, there were over 1,500 reported deals with a total disclosed value of over US$200 billion.[55] Given the size of its domestic market, vast human resources and capacity for low-cost manufacturing, and its economic potential, China has become and will continue to be the magnet of foreign investment and global economic growth. With US$90.03 billion of foreign direct investment inflows in 2009,[56] China has become the largest capital absorbing country in the world.

52 The liberalising trend was not extended to most publishing activities. Also, genetically modified organisms were also moved to the "prohibited" category.

53 The Decision of the State Council on Reforming the Investment System, issued by the State Council on 16 July 2004, available at http://en.ndrc.gov.cn/policyrelease/t20060207_58851.htm.

54 The regulations also addressed "round-tripping" investment activities, forbade the hiding of affiliations, legislated protection of key industries, introduced the umbrella concept of "national security" to supervisor foreign investment.

55 Monique Ho and Molly Qin, "Important Legal and Strategic Considerations When Investing in China," McDermott Will & Emery Newsletter, Inside M&A (March/April 2008).

56 See www.mofcom.gov.cn/aarticle/tongjiziliao/v/201002/20100206785656.html.

(d) Some Recent Trends in the Aftermath of China's Accession to the WTO

It appears that there is a retrenchment in China placing a greater emphasis on industrial policy and regulatory regime to review the impact of foreign investment projects on national economic and security interests, which coincided with a notable trend toward a rising nationalism seeking to push back globalisation[57] as well as a switch from fast economic growth to a new harmonious society policy.[58] This trend was evidenced by the latest revision of the Guidance Catalogue,[59] and more recently, the Anti-Monopoly Law. The 2007 Catalogue demonstrated the new policy switch. For instance, the Catalogue places more emphases on environmental protection, trade imbalances and high-technology. Accordingly, the Catalogue decreases support for export-oriented industries, promotes foreign investment in high-tech and environment friendly sectors, and restrict foreign investment in manufacturing and mining industries which were once welcomed foreign investment. These policy changes have been viewed as a new round of attempts to disadvantage foreign investors,[60] on the one hand, limiting market access by non-Chinese origin goods, and on the other hand, offering more resources and protections to domestic players that are less competitive in the marketplace.[61] The role of law is ambiguous in balancing control of foreign investment against facilitating the activities of foreign-invested enterprises.

China's policy making process and environment in the field of foreign investment is complex and dynamic. Commentators were of the opinion that the Chinese foreign investment policy has been a product of bargaining

[57] Peter Hays Gries, *China's New Nationalism: Pride, Politics, and Diplomacy* (Berkeley: University of California Press 2004); Suisheng Zhao, "We Are Patriots First and Democrats Second: The Rise of Chinese Nationalism in the 1990s" in Edward Friedman, Edward McCormick and Barret McCormick (eds), *What If China Doesn't Democratize? Implications for War and Peace* (New York: ME Sharpe 2000).

[58] See generally, http://en.wikipedia.org/wiki/Harmonious_society, and Maureen Fan, "China's Party Leadership Declares New Priority: 'Harmonious Society'," The Washington Post, 12 October 2006. A harmonious society is of higher standards, not only trying to fill in the gap between the wealthy and poor but also providing an opportunity to the people for the self-fulfilment, which is akin to the capabilities approach advocated by, i.e., Martha C. Nussbaum, *Frontiers of Justice: Disability, Nationality and Species Membership* (Cambridge, MA: Belknap Press Harvard University Press 2007) Chs 3, 5 and 7; Amartya Sen, *Developments as Freedom* (Oxford: Oxford University Press 1999).

[59] Guidance Catalogue (amended in 2007), available at http://www.chinalawandpractice.com/Article/1853571/Channel/9950/Foreign-Investment-Industrial-Guidance-Catalogue-Amended-in-2007.htm.

[60] China Market Intelligence, China's 2007 Foreign Investment Guide, http://www.chinabusinessreview.com/public/c0801/cmi.html.

[61] United States Trade Representative, Report to Congress on China's WTO Compliance 6 (2005), http://www.ustr.gov/assets/Document_Library/Reports_Publications/2005/asset_upload_file293_8580.pdf.

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dynamics,[62] personalities and clientelism,[63] and bureaucratic processes.[64] This process is now more contested than before among various domestic and foreign interest groups and constituencies as well as champions of global capitalism, notwithstanding the CCP's reliance upon a continuous growth for legitimacy, new goal of realising a harmonious society and urgent needs to protect socially and economically vulnerable groups. The debate in China, that is, economic nationalism vs. liberal treatment towards foreign investment, has been ongoing for decades[65] which may explain, if not rationalise, the policy change wavering. In contrast to the growing liberalisation, a Chinese economic nationalism appeared in recent years. The legislation, i.e., the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors, which block foreign purchases of Chinese companies involving "key industries" described as those whose operations influence or might influence "state economic security,"[66] gradually shows concerns that foreign interests are acquiring domestic assets at undervalue,[67] seizing control of strategic industrial sectors,[68] and market share in China without adequate oversight and control.[69] The debate of liberalism vs economic nationalism also mirrors the objective and direction of reform itself in a larger context. The foreign investment policy has also been an ad hoc and incremental response to continuous changes in the global and domestic economy. For instance, the intensity of the negotiation for the 1989 and 1992 intellectual property agreements and the 1992 market access agreement, and later, the China's WTO accession agreement, between the US and PRC governments shows the extent of the business interests at stake in foreign commercial community's constant efforts to bring about reform of China's foreign economic law and legal protection regime. As a matter of fact, the content of these agreements closely mirrors the demands put forward by

[62] Susan L. Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press 1993).

[63] Lucian Pye, *The Mandarin and the Cadre* (Ann Arbor, University of Michigan 1988).

[64] Kenneth Lieberthal and Michael Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton: Princeton University Press 1988).

[65] Yong Wang, "China's Domestic WTO Debate", (2000) 27(54) *China Business Review* 54.

[66] To be more detailed, these industries refer to machinery, automobiles, telecommunications, construction, iron and steel, and non-ferrous metals. Control Over Key Industries "Crucial," *China Daily* (19 December 2006), available at http://english.people.com.cn/200612/19/eng20061219_333839.html.

[67] For details, Wei Shen, "Is SAFE Safe Now? – Foreign Exchange Regulatory Control over Chinese Outbound and Inbound Investment and a Political Economy Analysis of Policies," (2010) 11(2) *Journal of World Investment and Trade* 227, 245-250.

[68] Mure Dickie, "Chinese Takeover Fears Grow", *Financial Times* (4 August 2006), p6; Geoff Dyer, Sundeep Tucker and Tom Mitchell, "Forbidden Country? How Foreign Deals in China are Hitting Renewed Resistance", *Financial Times*, (8 August 2006), p11.

[69] The most high-profile and lasting battle was Carlyle's bid to take stake in Xugong, China's leading machinery maker, which was finally defeated. Sundeep Tucker, "Carlyle Concedes Defeat in Battle to Take Stake in China's Xugong", *Financial Times* (23 July 2008).

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