

# JOINT VENTURE INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA: A CONTINUING CHALLENGE

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*The author in this article examines the emerging and evolving legal framework for equity joint venture investment in the People's Republic of China (PRC). Problems that lawyers, investors and businessmen will encounter in the establishment of the joint venture in China are highlighted. The article focuses on the establishment, management and control of the joint venture; pricing and marketing constraints; transfer of technology; labour laws and regulations; loan and banking provisions; insurance; and taxation. Related areas such as China's massive bureaucracy and dealing with the Chinese government are explored. The author concludes that despite the many uncertainties that still surround investment in China and the problems that the legal framework poses, the Chinese have made a serious effort to structure a legal climate that will be conducive to foreign investment. The potential access to one billion consumers and the PRC's proximity to southeast Asian markets suggests that notwithstanding the legal and business problems encountered, in the long run investors will be richly rewarded.*

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*L'auteur de cet article, Me Selma Lussenburg, examine le cadre juridique des investissements dans les entreprises en coparticipation tel qu'il apparaît sous sa forme naissante et tel qu'il semble se développer en République Populaire de Chine. Elle y insiste sur les problèmes auxquels auront à faire face les avocats, les investisseurs et les hommes d'affaires qui essayeront d'établir en Chine des entreprises en coparticipation. Elle s'intéresse en particulier à la façon d'établir, de gérer et de maintenir une mainmise sur les entreprises en coparticipation, aux contraintes concernant l'établissement des prix et la mise en vente, au transfert de la technologie, aux lois et règlements du travail, aux dispositions sur les prêts et les banques, aux assurances et aux impôts. Elle y explore les domaines apparentés tels que l'énorme bureaucratie et les relations avec le gouvernement chinois. L'auteur en conclut que, malgré les incertitudes nombreuses qui existent encore dans le domaine de l'investissement et les problèmes que pose le cadre juridique, les Chinois ont fait un grand effort pour créer un climat juridique favorable aux investissements étrangers. L'accès à un milliard de consommateurs en puissance et la faible distance qui sépare la République Populaire de Chine des marchés du sud-est asiatique garantit aux investisseurs persistants, malgré les difficultés commerciales et juridiques qu'il leur faudra résoudre, de riches bénéfices.*

## Introduction

Since the death of Mao Zedong in 1976, the People's Republic of China (PRC) has embarked on an ambitious national development programme

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in the areas of agriculture, industry, defense and technology.<sup>1</sup> To achieve its development goals it has consciously entered the mainstream of international commerce. Cognizant that its internal economic and legal structure was not attractive to foreign investors, the PRC has since 1976 set out to reform these structures.<sup>2</sup>

The promulgation in 1979 of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investments (JVL)<sup>3</sup> marked the beginning of a series of laws to be enacted in the PRC to encourage foreign investment and to establish a foreign investment framework. It was one of the first indications to investors of China's desire to open its doors to external investment and technology. Even though the concept of joint state-capitalist enterprises is not a new one for China,<sup>4</sup> the enactment of the JVL marks the beginning of a new investment era. The underlying socialist nature of the PRC has not changed, but the means by which ends are to be achieved have been altered dramatically. Individual merit and economic incentives are now recognized as necessary evils to enable China to achieve its ambitious development goals.<sup>5</sup>

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<sup>1</sup> For a succinct overview of China's current five year plan see M. Weil, The sixth 5 year plan (1983), 10 China Bus. Rev. (March-April) 18.

<sup>2</sup> Rong Yiren, head of China's International Trade and Investment Corporation (CITIC), explained, *inter alia*, why the PRC had adopted the Joint Venture Law (JVL). In an interview with China Business Review (1979), 6 China Bus. Rev. (Sept.-Oct.) 4, at p. 5 he said:

China is well aware that, in order to achieve our four modernizations, first of all we must rely on ourselves, but we also need to import foreign capital, technology, equipment and know-how to accelerate the pace of modernization. Some socialist countries have found that joint ventures with developed country enterprises is an effective way of doing this in a practical and well-planned manner. We expect joint ventures to contribute to the socialist modernization of our country and bring closer the day when we will have our own highly developed enterprises.

<sup>3</sup> Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, and made effective July 8, 1979. Hereinafter cited and referred to as the JVL. Reproduced at (1979), 18 I.L.M. 1163.

<sup>4</sup> For a discussion of investment in China pre-1979, see P.M. Torbett, J.A. Thomson, China's Joint Venture Law: A Preliminary Analysis (1979), 12 Vand. J. Trnl. L. 819, at pp. 822-831; D.M. Bosco, The Law of the People's Republic of China on Joint Ventures Using Foreign Investment (1980), 6 Brooklyn J. Int'l. L. 217, at pp. 222-223.

<sup>5</sup> See for example, Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure of October 20, 1984, reproduced in (1984), 27 Bej. Rev. (#44) I-XVI wherein it is said at p. xii:

In the enterprises, the difference between the wages of various trades and jobs should be widened, so as to apply fully the principle of rewarding the diligent and good and punishing the lazy and bad and of giving more pay for more work and less pay for less work as well as to fully reflect the differences between mental and manual, complex and simple, skilled and unskilled, and heavy and light work . . . common prosperity cannot and will never mean absolute equalitarianism or that all members of society become better off at the same speed.

Although state-owned and collectively-owned enterprises are still of paramount importance, and the economy continues to be subject to state planning, the 1982 Constitution explicitly provides for individual business and foreign companies as component parts of the economy.<sup>6</sup> That these changes are perceived as enduring changes is evident from the Chinese leadership's repeated affirmation of China's open door policy. Economic policy speeches are replete with references to the doors opening wider still and to the continuation of China's open door policy for another fifty to seventy years.<sup>7</sup> Even though the Joint Venture Law (JVL), or perhaps more accurately, the opportunity to do business with the PRC was welcomed by the western business community, the influx of foreign investment anticipated by the Chinese has not yet become a reality.<sup>8</sup> The recalcitrance of investors can largely be attributed to the many uncertainties that still surround investment in China,<sup>9</sup> the recent enactment of the

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<sup>6</sup> Reproduced in News from the Xinhua News Agency, Monday December 6, 1982, 3ff (bound vols. 703-723). Article 18 of the Constitution provides:

The PRC permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other economic organizations in accordance with the law of the PRC. All foreign enterprises and other foreign economic organizations in China, as well as joint ventures with Chinese and foreign investment, located in China that abide by the law of the PRC, their lawful rights and interests are protected by the law of the PRC.

<sup>7</sup> See for example: Deng: Open Policy Will Never Change (1984), 27 *Bej. Rev.* (#43), 6-7; Xiau Yongzhen, Legislation Firmly Holds Open China's Doors, *ibid.*, at pp. 16-17; speech of Premier Zhao Zuyang to the Royal Institute on International Relations of Belgium, Expanding Economic Exchange and Promoting Common Prosperity, Brussels, June 5, 1984 (Press release).

<sup>8</sup> In May 1983 there were forty-eight approved joint ventures representing a total investment of U.S. \$223 million, of which U.S. \$102.5 million represents foreign capital; (1983), 21 *China Tr. Rep.* 8. It has been estimated that financial contributions to joint ventures on a unit basis actually decreased in the mid-1981 to mid-1983 period, while investment in co-production has been increasing; see J.B. Stepanek, Direct Investment in China (1982), 9 *China Bus. Rev.* (Sept.-Oct.) 20, at p. 21. Major policy changes were announced in May 1983; see, *infra*, text accompanying footnotes 71-73. Official U.S. and PRC sources estimated in September of 1983 that there were eighty-nine equity joint ventures with a total of U.S. \$715.4 million invested of which U.S. \$305.2 million was contributed by foreign sources; J. Chiang, What Works and What Doesn't (1983), 10 *China Bus. Rev.* (Sept.-Oct.), 26, at p. 28; see also Li Ling, Swell and Swelling Opportunities (1984), (PRC) *Intertrade* (May) 61, at pp. 62-64; C.L. Brehnm, Flex Trade (1983), 10 *China Bus. Rev.* (Sept.-Oct.), at pp. 21-25. In view of the long gestation period of joint ventures it would be incorrect to surmise that the upswing in joint venture participation is solely attributable to the policy changes initiated; they, however, without a doubt facilitated and expedited investment deliberations.

<sup>9</sup> For example, the need to obtain approval from several levels of government and the different departments before basic joint venture matters can proceed, and the existence of unpublished Regulations that are said to be applicable to foreign investors and enterprises; M. Oksenberg, China's Economic Bureaucracy (1982), 9 *China Bus. Rev.* (May-June) 22. See also: J. Cohen, Equity Joint Ventures (1982), 9 *China Bus. Rev.* (Nov.

legislation,<sup>10</sup> and the relative lack of access to the Chinese domestic market.<sup>11</sup>

This article examines the emerging and evolving legal framework for equity joint venture investment in the PRC.<sup>12</sup> Potential problems that lawyers and businessmen encounter in the establishment of a joint venture in China are highlighted. The following specific matters are discussed: the establishment, management and control of the joint venture, pricing and marketing constraints, transfer of technology, applicable labour laws and regulations, loan provisions, insurance, banking, and taxation. The protection afforded by the JVL and the Chinese government, and China's massive bureaucracy are also considered. A preliminary matter that must be dealt with is the position of law and the role of lawyers in the PRC.

## II. *The Position of Law and Lawyers in the PRC*

From 1949 until the enactment of the JVL in 1979, Chinese legal history was marked by an absence of legislation. Legislation, aimed at attracting and facilitating foreign investment, in the first instance operated in a vacuum.<sup>13</sup> Further legislation is needed and many of the initial laws are

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-Dec.) 23. at p. 26; M. Weil, *Tightening Up* (1982), 9 *China Bus. Rev.* (May-June) 32; A. Dicks, *Legal Opinion* (1982), 20 *China Tr. Rep.* (July) 11; R. Goodwin, *The Evolving Legal Framework* (1983), 10 *China Bus. Rev.* (May-June) 42, at p. 43; J. Cohen, J. Horsely, *The New Joint Venture Regulations* (1983), 10 *China Bus. Rev.* (Nov.-Dec.) 44. Legislation yet to be enacted includes a bankruptcy law, commercial code, corporations law, and transfer of technology laws. See generally, W.P. Alford, D.E. Birenbaum, *Ventures in China Trade: An Analysis of China's Emerging Legal Framework for the Regulation of Foreign Investment* (1981), 1 *Nw. J. Int'l. L. & Bus.* 56, at pp. 73-78.

<sup>10</sup> Very little legislation in place today in China has been "tested". The Chinese admit that in many instances their legislation is ambiguous and needs clarification. They have demonstrated a willingness to cooperate with investors, and it is apparent that they are desirous of ensuring that investors receive a reasonable return on their investment; F.D. Rich, *Joint Ventures in China: The Legal Challenge* (1981), 15 *Int. Lawy.* 183, at pp. 186-189. See also Rong Yiren interview, *supra*, footnote 2. Examples of recent legislation include: Rules Concerning the Levy and Exemptions of Custom Duties and Consolidated Industrial and Commercial Tax on Imports and Exports from Chinese and Foreign Cooperative Exploitation of Offshore Petroleum; Provisional Articles on Control and Advertising; Economic Contracts Law; Foreign Economic Contracts Law; Trademark Law; Patent Law; Joint Venture Law Regulations; Regulations on Controlling Technology Import Contracts. See M. Graham, *Principal Laws Governing Foreign Investment in China* (1982), 9 *China Bus. Rev.* (Sept.-Oct.) 22; *China's Major Trade and Investment Laws* (1983), 10 *China Bus. Rev.* (Sept.-Oct.) 30.

<sup>11</sup> See, *infra*, text commencing at footnote 71; and: China grants cuts for joint ventures (1983), 26 *Bej. Rev.* (#19) 7.

<sup>12</sup> The economic merits of equity joint venture investment compared to coproduction, compensation trade or other forms will not be addressed in this article.

<sup>13</sup> On the paucity of legislation pre-1979, see S. Lubman, *New Developments in Chinese Law in the People's Republic of China* (1979), 1 *Nw. J. Int'l L. & Bus.* 122, at pp. 122-128; S. Lubman, *On Understanding Chinese Law and Legal Institutions* (1976), 62 *A.B.A.J.* 597; Tao-Tai Hsia, *Sources of Law in the People's Republic of China:*

best characterized as "enabling legislation",<sup>14</sup> that require supplementary legislation and regulations. Approximately forty new laws and regulations have been promulgated since 1979.<sup>15</sup> These represent a significant step forward and address many of the concerns that have been raised by investors. Even though their enactment fails to provide a comprehensive commercial framework, they do provide substantive parameters and legal protections within which businesses can be established and operated in the PRC.

In view of the secondary position of the law during the past three decades, it is not surprising that few trained lawyers existed in 1979, and today this scarcity persists. More important, however, for investors is the fact that foreign lawyers have only a very limited capacity to act and are, strictly speaking, not recognized in the PRC. Foreign lawyers may not appear in Chinese courts or legal proceedings as lawyers *per se*. The provisional Regulations of the People's Republic Regarding Lawyers<sup>16</sup> require that lawyers be citizens of the PRC. Foreigners who appear in People's Courts have traditionally only been able to appoint Chinese lawyers to represent them.<sup>17</sup> The two arbitration commissions that operate within the China Council for the Promotion of International Trade (CCPIT) have in the past permitted foreign parties to appoint either Chinese or foreign agents who may be lawyers. However, the Law of Civil Procedure, promulgated for trial implementation on October 1, 1982, provides that "[f]oreign nationals, stateless persons and foreign enterprises and organisations must entrust their cases to lawyer agents of the PRC if they want legal representation in taking or responding to an action".<sup>18</sup> "Action" has been broadly interpreted by experts to include arbitration.<sup>19</sup> It

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Recent Developments (1980), 14 *Int. Lawy.* 25, at pp. 28 *et seq.*; D.J. Hoffheimer, *China and the International Legal Order - An Historical Introduction* (1979), 11 *Case W. Res. J. Int'l L.* 251.

<sup>14</sup> Alford, Birenbaum, *loc. cit.*, footnote 9.

<sup>15</sup> Graham, *loc. cit.*, footnote 10.

<sup>16</sup> Adopted August 26, 1980, entered into force January 1, 1982; reproduced (1980), 19 *I.L.M.* Article 8 of the Regulations provides that lawyers must be "citizens who have an ardent love for the People's Republic of China, who uphold the system of socialism, and who are qualified to vote . . .". For a general discussion of the role of lawyers in China, see Shiu-fan, *The Role of Lawyers in the Chinese Legal System* (1983), 13 *Hong Kong L.J.* 157. For an overview of China's legal institutions see: S. Lubman, *Emerging Functions of Formal Legal Institutions in China's Modernization* (1983), 2 *China L. Rev.* 195.

<sup>17</sup> A. Dicks, *Legal Opinion* (1982), 20 *China Tr. Rep.* (Feb.) 11.

<sup>18</sup> Approved March 8, 1982, promulgated for trial implementation October 1, 1982, reproduced in *News from Xinhua News Agency*.

<sup>19</sup> E. Theroux, *Arbitration in China? You may need a Chinese Lawyer* (1982), 9 *China Bus. Rev.* (May-June) 38. Theroux quotes professors Yao Zhun and Jerome Cohen. It appears however that foreign lawyers may be able to attend as legal agents on behalf of a foreign party so long as they do not call themselves the lawyer of the disputing party. Whether additional Chinese counsel must be retained is unclear.

would thus seem that a foreign party must retain Chinese lawyers not only as counsel in the courts, but also in arbitration proceedings held within China.<sup>20</sup>

The PRC has established "Legal Advisory Offices" where Chinese lawyers are employed and may accept cases, charge fees, and thus advise foreign parties.<sup>21</sup> Concern has been voiced over the independence of such advisors, and their capacity or willingness to act as true advocates against a Chinese party. The Provisional Regulations call on lawyers to serve the cause of socialism, and judges have asserted that lawyers are workers of the state. Lawyers must be "truth seekers", and where they believe that their client is incorrect they may refuse to represent him; on appeal, they must remain silent if they think the lower court decision was correct.<sup>22</sup> From a western perspective the independence, and hence quality, of such legal advice becomes questionable.

### III. *The Joint Venture Legal Framework*

#### A. *The Nature of Equity Joint Venture Investment*

Three characteristics distinguish equity joint venture investment from other forms of direct investment; namely, pooled assets, shared losses and profits, and joint management.<sup>23</sup> These features imply a common board of directors, officers directly employed by the entity, joint use of financial resources, a specific purpose, and relatively complex documentation establishing the enterprise structure. What makes this form of investment attractive in the Chinese context is that it represents a means of ensuring some political protection through linkage with local interests,

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<sup>20</sup> *Ibid.* This proscription that Chinese counsel must be used for arbitration proceedings held in China must be kept in mind when drafting the arbitration clause in the joint venture contract. Other concerns include the requirement that the official language of the arbitration be Chinese, and that arbitrators are selected from the Foreign Economic and Trade Arbitration Commission. It has been suggested that bias may be inevitable.

<sup>21</sup> *Ibid.* The Chinese government has consciously been trying to strengthen the quality of judicial work and to increase the number of lawyers in the PRC; see, Peking Boosts Legal Services (1981), 19 China Tr. Rep. (March) 6.

<sup>22</sup> P.S. Allen, M.A. Palay, Economic Courts (1981), 8 China Bus. Rev. (Nov. -Dec.) 44, at p. 48.

<sup>23</sup> M.F. Klingenberg, J.E. Pattison, Joint Ventures in the PRC; The New Legal Environment (1979), 19 Van. J. Int'l L. 807. Joint ventures in China must be distinguished from other trade arrangements, namely: licensing, turn key arrangement, technical service agreements, simple sales agreements, management contracts, compensation trade, and counter trade. See also F. de Bauw, B. Dewit, Les formes d'investissement étranger en République Populaire de Chine (1983), 9 Dr. & Pr. Comm. Int. 511. On joint venture structures in general, see J.G. Scriven, Joint Venture Legislation in Eastern Europe: A Practical Guide (1980), 21 Harv. Int. L.J. 633, at pp. 637-642; Holt, Rules for Eastern Multinationals in Eastern Europe (1973), 8 Col. J.W. Bus. 131.

access to resources otherwise unavailable in the open market, access to a local low-cost labour force and, in some instances, a guarantee of supply.<sup>24</sup>

Potential access to the Chinese domestic market and the PRC's proximity to the South East Asian markets also makes joint venture investment more appealing than other forms of investment. Access to the domestic market to date has been limited. Since the volume and number of joint ventures has fallen short of PRC expectations, the leadership has found itself obliged to make changes in joint venture investment policy. As a result, foreign exchange self-sufficiency requirements have been relaxed, access to some materials at domestic prices is now assured, and the marketing of joint venture products within the PRC has been facilitated.<sup>25</sup> With a population of over one billion people that is showing increasingly signs of western consumerism, investors cannot afford to ignore the business potential that the PRC represents.

### B. Creation, Registration, and Approval of the Joint Venture

The JVL provides for the establishment of equity joint ventures between "foreign companies, enterprises and other economic entities" and "Chinese companies, enterprises and other economic entities".<sup>26</sup> The terminology employed, and in particular the use of the term "economic entities", underlines the broad focus of the legislation. Potential joint venture parties thus include higher level companies and foreign trading corporations in the PRC as well as factories and communes.<sup>27</sup>

An obvious preliminary organisational step for the investor is that of finding a Chinese joint venture partner. This may be arranged through the China International Trust and Investment Corporation (CITIC), with provincial development groups or governments, or with individual Chinese enterprises.<sup>28</sup> The creation of the CITIC was announced at the time that

<sup>24</sup> Klingenberg, Pattison, *ibid.*, at p. 814. Rong Yiren, *supra*, footnote 2, at p. 5, presents the Chinese perspective:

Many foreigners have already expressed keen interest in investing in China, and many millions of dollars of investment have been agreed to, so there is obviously great interest. Objectively speaking, China has abundant natural resources, a hardworking people quick to learn, and a leadership determined to carry out the people's wish to modernize. Also while joint venture wages will be appropriately higher than those of state owned enterprises in the same locality, because a higher educational and technical level will be required for joint venture workers, they will be lower than those in Western Europe, the United States, Japan, Hong Kong and other places.

<sup>25</sup> As to each of these three points see, *infra*, footnotes 72 and 73.

<sup>26</sup> JVL, *supra*, footnote 3, art. 1.

<sup>27</sup> For an excellent literary interpretation of the terms used, see Torbett, Thomson, *loc. cit.*, footnote 4, at pp. 841-842.

<sup>28</sup> Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, (hereinafter cited and referred to as JVL Regulations), promulgated and effective September 20, 1983, art. 8; repro-

the JVL was enacted. Its purpose is to "introduce, absorb and apply foreign investment, advanced technology and advanced equipment" to the PRC, and to "coordinate initial contacts between foreigners and their Chinese partners".<sup>29</sup> If necessary, CITIC will assist with the preliminary negotiation of contracts, the raising of foreign loans, and will generally act as an intermediary between foreign and Chinese entities.<sup>30</sup>

Once such contact has been established, then a project proposal and preliminary feasibility study of the proposed joint venture must be submitted by the Chinese partner to the appropriate authorities.<sup>31</sup> Who the appropriate authorities are will depend on the nature and location of the joint venture. Although initially all joint venture proposals and approvals were funnelled through the Ministry of Foreign Economic Relations and Trade (MOFERT) and the Foreign Investment Control Commission (FICC), initiatives to decentralize the PRC bureaucracy and to give increased autonomy to provincial and local authorities, has implied that MOFERT approval is no longer needed in the early stages of joint venture establishment decisions.<sup>32</sup>

Once both sides agree that the joint venture is a viable business proposition, the next step is to apply for the establishment of the joint venture. The Chinese partner is again responsible for obtaining approval. Documents that must be submitted to the examining and approval authority include: an application for the establishment of the joint venture, the joint feasibility study report, the joint venture agreement, contract and articles of association, a list of candidates for the board of directors, and the opinion of the local authorities involved in the joint venture establish-

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duced (1983), 22 I.L.M. 1033. See also Rich, *loc. cit.*, footnote 10, at p. 192. Examples include the Beijing Development Corporation, the Fujian Investment and Enterprise Corporation, and the Shanghai Municipal Organization.

<sup>29</sup> Rich, *ibid.*, at p. 191.

<sup>30</sup> JVL Regulations, *supra*, footnote 28, art. 12. See also P. N. Decker, *The Joint Venture Law of the PRC in a Legislated and Negotiated Tax Climate* (1980), 8 *Syr. J. Int'l. L& Comm.* 227. With regard to domestic loans from the Bank of China, see *infra*, text accompanying footnotes 117, 118.

<sup>31</sup> *Ibid.*, art. 9. The JVL Regulations do not say who is to assume the cost of the feasibility study. Clearly this is a matter for negotiation between the parties. Canadian businesses should be aware that the Industrial Development Branch of Canadian International Development Agency (CIDA) may in certain circumstances be able to provide financial assistance. For a very brief delineation of the CIDA's programme in this regard see: *Industrial Cooperation Program of CIDA* (1984), 4 *Cda-China J.* 12.

<sup>32</sup> The recent announcement of more favourable investment conditions for fourteen coastal cities, in addition to the already existing Special Economic Zones (SEZ), points to further administrative decentralization. These fourteen coastal cities like the SEZs will have increased autonomy and depending on the city they will be able to approve projects up to U.S. \$30 million. For example, Shanghai and Tianjin can now approve projects up to U.S. \$30 million, while Dalian can approve projects up to U.S. \$10 million. See Shen Xingfen, *Coastal Cities Stride Ahead* (1984), *PRC Intertrade* (August) 47.



ment.<sup>33</sup> At this stage approval must be obtained not only from the local officials but also from MOFERT.<sup>34</sup> The Regulations provide that such approval must be forthcoming within three months.<sup>35</sup> Within one month of approval, the project must be registered with the administrative bureau of the General Administration for the Control of Industry and Commerce (GACIC) of the province, autonomous region or municipality within which the joint venture will operate.<sup>36</sup> Once registered, it may begin operations under licence; without such a licence the entity does not legally exist.<sup>37</sup>

The Regulations of the People's Republic of China on the Registration of Joint Ventures Using Chinese and Foreign Investment (JVRR) establish which documents must be produced, what joint venture particulars are to be submitted, the effective date of operation, the obligation to open a bank account with the Bank of China or another approved bank, the taxation registration requirements, the relocation and operational changes of which the appropriate authorities must be advised, fees, the right to inspect the joint venture for violations, the imposition of penalties, and, finally termination procedures.<sup>38</sup>

A practical caveat that must be raised in any discussion of equity joint venture establishment in the PRC is that investors must be prepared

<sup>33</sup> JVL Regulations, *supra*, footnote 28, art. 9(2).

<sup>34</sup> The JVL, *supra*, footnote 3, art. 3 provides that approval must be obtained from the Foreign Investment Control Commission (FICC). The FICC was a new entity that was created for the administration of the JVL. The more recent JVL Regulations, *supra*, footnote 28, arts. 8,9,10, only make reference to MOFERT and the local authorities. The latter reflects the organizational restructuring that took place in March 1982 when the FICC in fact became part of MOFERT. See N.H. Ludlow, China's New Foreign Trade Structure (1982), 9 China Bus. Rev. (May-June) 30.

<sup>35</sup> JVL Regulations, *supra*, footnote 28, art. 10. This represents a continuation of the preexisting practice under the FICC. The criteria for approval have not been explained. It has been suggested that the Yugoslav law on joint ventures which integrates authorization and registration be used as a parallel; Klingenberg, Pattison, *loc. cit.*, footnote 23, at pp. 820-821. The criteria specified in the Yugoslav joint venture decree include: compliance with applicable laws and regulations, economic benefit, adequacy of participants resources to carry out the proposals, fairness of terms by customary international standards, realistic valuation of foreigners' contribution, furtherance of current national trade and finance policies; Rich, *loc. cit.*, footnote 10, at p. 193.

<sup>36</sup> JVL, *supra*, footnote 3, art. 3. The Regulations of the People's Republic of China on the Registration of Joint Ventures Using Chinese and Foreign Investment (hereafter referred to as JVRR), promulgated and effective July 26, 1980, art. 2; reproduced (1980), 19 I.L.M. 1453. JVL Regulations, *supra*, footnote 28, art. 11. For an overview of the nature and structure of the GACIC see R.E. Lutz, The General Administration for the Control of Industry and Commerce (1983), 10 China Bus. Rev. (March-April) 25.

<sup>37</sup> JVRR, *ibid.*, art. 5.

<sup>38</sup> *Ibid.*, arts. 3-10. See also, as to banking JVL Regulations, *supra*, footnote 28, art. 74; and as to taxation the Joint Venture Income Tax Law, discussed, *infra*, text commencing at footnote 152.

to devote a substantial amount of time and energy to preliminary negotiations. Although it may take as little as six months to negotiate a joint venture, it is more accurate to count on three years.<sup>39</sup> A joint venture investment must be seen as a long term one, that will with time provide sizeable rewards.

It is relevant to note in this regard that the concept of "equality and mutual benefit" permeates all of the joint venture legislation that has been enacted to date. This principle has been incorporated in the JVL and its attendant legislation and Chinese officials insist that all joint venture operations must adhere to this precept.<sup>40</sup> This principle reflects the Chinese historical distrust of the west and Chinese skepticism of western capacity and willingness to consistently deal fairly with the PRC.<sup>41</sup> As a result, the Chinese modernization drive places a heavy emphasis on self-reliance.<sup>42</sup> The importance of "equality and mutual benefit" and the Chinese reluctance to deviate from it must be continually kept in mind by investors when negotiating their joint venture contracts; otherwise they are likely to meet with strong resistance and risk jeopardizing future business relationships.

### C. Capital and Investment Contributions

The joint venture must take the form of a limited liability company.<sup>43</sup> Under the JVL a foreign investor is not permitted to invest in an existing entity. The JVL provides that the "proportion of investment contributed by foreign participants shall in general not be less than 25%". Because no maximum limit on foreign investment has been set there has been speculation that one hundred per cent foreign investment might be possible, but

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<sup>39</sup> For a discussion of negotiation strategy, see W.D. Edwards, *Legal and Economic Considerations on Doing Business with the People's Republic of China* (1982), 12 Cal. W.L.J. 353, at pp. 382-385.

<sup>40</sup> For a literal interpretation of the meaning of "equality and mutual benefit" see Torbett, Thomson, *supra*, footnote 4. For a Chinese perspective, see Wu Chao, *Embodiment of the Principle of Equality and Mutual Benefit* (1984), *China's Foreign Trade* (March) 14.

<sup>41</sup> J.K. Lockett, *Dispute Settlement in the People's Republic of China* (1982), 16 *Geo. Wash. J. Int'l L. & Eco.* 239, at p. 242. This perception is rooted in China's "bad experiences" in the past with the West; for an elaboration see, *ibid.*, at pp. 242-244.

<sup>42</sup> For a Chinese perspective on this see Zheng Hongquing, *Opening to the Outside World and Self-reliance* (1983), 26 *Bej.R.* (#11) 15.

<sup>43</sup> JVL Regulations, *supra*, footnote 28, art. 19. In light of the lack of company law what is to be implied from the use of the term "limited" company is still unclear. Pending new legislation, it would appear that the 1929 company law may still be applicable. It provides that a limited company is organized by two or more shareholders who are liable to the extent of their capital contribution. See Torbett, Thomson, *supra*, footnote 4, at pp. 852-853. This parallels the JVL art. 3 provision which states that profits and losses are shared in proportion to capital and contribution; see Torbett, Thomson, *ibid.*

the practice to date does not support such a conclusion.<sup>44</sup> It is also not consistent with the partnership philosophy that underlies the joint venture concept. Business profits, risks and losses are to be shared in proportion to contributions made to registered capital; capital contributions must be clearly specified in the joint venture contract or articles of association.<sup>45</sup>

Joint venture contributions may be either in the form of cash or buildings, premises, equipment or other materials, industrial property, know-how or the right to use a site. The value of these contributions, except the right to use a land site, may be established either through consultation between the parties or by a third party appointed by the joint venture participants.<sup>46</sup> A foreign party's contribution in the form of services or training of personnel is not included in the capitalization of the venture.<sup>47</sup> As this is likely to represent a substantial investment by the foreign party, it is essential that the value of the such services not be overlooked in negotiations, and that separate compensation arrangements be made. The Regulations permit the inclusion of machinery, equipment or other materials as part of the foreign investors contribution only if they are indispensable to joint venture production, are not available in China, or if available in China, are too costly or technically inadequate.<sup>48</sup> The JVL provides that "technology and equipment contributed by foreign participants" must be "truly appropriate to China's needs".<sup>49</sup> To be acceptable, the industrial property or know how contributed by the foreign joint venture partner must be "capable of manufacturing new products urgently needed in China" or products suitable for export; must raise performance, productivity and quality of existing products; or generate "notable savings in raw materials, fuel or power".<sup>50</sup> This type of contribution must be supported by patent certificates, trademark registration certificates, and other appropriate documents, and must be approved by local officials and MOFERT.<sup>51</sup>

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<sup>44</sup> Foreign equity ownership has varied from 75% in the Hainan Autonomous Prefectural Seawater Breeding Development Corporation with the Toko Company of Japan, to 55% in the International United Shipping and Investment joint venture, to 25% in the China-Shindler Elevator Co. In most cases foreign participation lies in the 40-60% range; see Brehm, *loc. cit.*, footnote 8, at pp. 21-25. As to speculation on 100% foreign ownership, see Rich, *loc. cit.*, footnote 10, at p. 196. One hundred percent direct investment is contemplated by the PRC in the future; legislation permitting such investment is however still in the drafting stages.

<sup>45</sup> JVL, *supra*, footnote 3, arts. 4,5.

<sup>46</sup> JVL Regulations, *supra*, footnote 28, art. 25.

<sup>47</sup> This information has been obtained from discussions with Canadian federal and provincial government officials who have been involved in joint venture negotiations.

<sup>48</sup> JVL Regulations, *supra*, footnote 28, art. 27. The price fixed for such contributions may not exceed the international market price.

<sup>49</sup> JVL, *supra*, footnote 3, art. 4.

<sup>50</sup> JVL Regulations, *supra*, footnote 28, art. 28.

<sup>51</sup> *Ibid.*, art. 29.

Significant difficulties have arisen with regard to valuation of the capital contributions by joint venture partners; a particularly vexatious issue has been the valuation of land sites. Where the Chinese joint venture partner already has the right to the use of a land site it may form part of its capital contribution. Its value is determined unilaterally by the Chinese government. Despite broad criteria, such as the use of the land, geographic and environmental conditions, the lack of an open market to determine site values makes such designations arbitrary. In such instances to avoid future misunderstandings, the site value should be carefully investigated, negotiated and then expressly stipulated in the joint venture contract or articles of association.<sup>52</sup> Where a new site is required, the joint venture as an entity will have to negotiate with local authorities for the right to use a particular site. Normally an annual users fee will be set; where a joint venture is engaged in animal husbandry or agriculture the fee may be a percentage of annual revenues.<sup>53</sup>

The stipulation found in the JVL that foreign investors provide "truly advanced technology and equipment" may also pose a valuation problem. Although it is arguable that the above noted criteria<sup>54</sup> are in fact guidelines for such a standard, the matter should be carefully explored by investors. The JVL provides that foreign participants must pay for any losses incurred through the failure to provide advanced technology and equipment.<sup>55</sup> The establishment of an appropriate evaluation standard poses a difficult and at times political problem. The Chinese are not interested in outdated or used equipment, but the developing nature of the PRC's economy means that the most advanced technology and equipment is not necessarily suited to the PRC's needs. The enactment of the Regulations on Controlling Technology Import Contracts in May, 1985 may provide investors with some guidelines on what is acceptable to the Chinese.<sup>56</sup> The lapse in time between the negotiations and the date of

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<sup>52</sup> See generally, JVL Regulations, *supra*, footnote 28, arts. 48, 49; J.E. Pattison, China's Developing Framework for Foreign Investment (1981), 13 L.&P. Int'l B. 89, at p. 110. Note that in China state enterprises do not pay for or include the value of a site or its rental value or costs in their bookkeeping/accounts; Torbett, Thomson, *loc. cit.*, footnote 4, at p. 856. If similar policies are used in joint ventures, this may result in a heavier tax burden than originally anticipated.

<sup>53</sup> JVL Regulations, *ibid.*, arts. 47, 50. Rates will remain constant for five years. Thereafter they are subject to review every three years; art. 51.

<sup>54</sup> See the text following footnote 48, *supra*.

<sup>55</sup> JVL, *supra*, footnote 3, art. 5.

<sup>56</sup> MOFERT is responsible for determining what is appropriate for "China's needs"; but this may not relieve the investor of the obligation posed under art. 5 of the JVL of providing "truly advanced technology and equipment", and from the penalties for a failure to provide the same. R.C. Goodrich Jr., Joint Ventures in the PRC: A Legal Analysis in the Context of Current Chinese Economic and Political Considerations (1982), 15 Vand. J. Trnl. L. 521, at p. 531. For a brief comment on the TIC Regulations see the text following footnote 95, *infra*. The Regulations are reproduced in (1985), 24 I.L.M. 801.

operation of the enterprise may require a re-evaluation of technological or equipment input. When assigning values to these inputs in the joint venture contract, the prohibition in the joint venture income tax Regulations on the deduction of expenditures for technical reform of fixed assets must be considered.<sup>57</sup> Where extensive changes are anticipated, parties should ensure that such costs may be capitalized and thus depreciated, or that the original valuation of the assets contributed reflects the true and cumulative cost of such inputs.

The JVL Regulations provide that renminbi are to be used as the standard currency and that any currency conversion be according to the rate of exchange announced by the State Administration of Foreign Conversion of the People's Republic of China.<sup>58</sup> It is not mandatory that all contributions be valued in renminbi. It is wise for a foreign investor to consider a valuation in a hard currency, if only because a joint venture is likely to be operating in an international economy and this would facilitate accounting, cost of sales and other procedures.<sup>59</sup> Should the joint venture be purchasing most of its supplies within China and be extensively involved in the Chinese domestic market, then accounting in renminbi would be more attractive.

#### D. Control and Management

The JVL distinguishes between equity participation and joint venture control. The composition of the board of directors is a matter to be negotiated between the parties and stipulated in the joint venture contract and articles of association.<sup>60</sup> Although each party has the right to appoint and revoke its own directors pursuant to the negotiated agreement, the JVL provides that the chairman, who is the legal representative of the joint venture, is to be determined by the Chinese party, while one or two

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<sup>57</sup> The Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, (hereinafter cited as JVITR), art. 14. Promulgated December 14, 1980; effective retroactively to September 10, 1980. Reproduced (1981), 20 I.L.M. 384.

<sup>58</sup> JVL Regulations, *supra*, footnote 28, art. 26.

<sup>59</sup> Klingenberg, Pattison, *loc. cit.*, footnote 23, at p. 816. The problems inherent in a fluctuating exchange rate must also be considered. It is unlikely that the value of the investment in the PRC will reflect inflationary prices overseas; *ibid.* See also JVL Regulations, *supra*, footnote 28, art. 86.

<sup>60</sup> JVL, *supra*, footnote 3, art. 6. The JVL Regulations however provide some parameters for such negotiations. A minimum of three directors must be on the board, with the total number of directors stipulated in the joint venture contract and articles of association; JVL Regulations, *supra*, footnote 28, arts. 14, 16, 34. Directors are appointed for a period of four years; this term is renewable; *ibid.*, art. 34. Board meetings must be held annually and are presided over by the chairman; *ibid.*, art. 35. An interim meeting may be convened where one third of the directors request the same and a quorum is two thirds of the directors present; *ibid.*

vice-chairmen may be nominated by the foreign investor. These provisions prevail regardless of the level of equity participation. The initial Chinese position was that the chairman would have to be an ethnic Chinese. Practice has however shown that the Chinese have been flexible on this point; they have been willing to appoint foreign chairmen. They have also been predisposed to the appointment of a foreign general manager.<sup>61</sup>

The matter of control should be carefully considered by prospective investors. This is particularly relevant in light of the acknowledged lack of Chinese management expertise, especially within the high technology context.<sup>62</sup> This concern must be balanced against the procedures and requirements for board decision making. Numbers alone do not determine effective control. According to the JVL, decisions are to be made on the basis of "equality and mutual benefit"; this may serve to bridge the gap between equity interest and control. The desirability of consensus decision making has been repeatedly affirmed by the Chinese leadership. This is consonant with the Chinese approach to business and the partnership nature of a joint venture.<sup>63</sup> The following require the unanimous consent of all the directors present at a board meeting: the amendment of the articles of association; termination and dissolution of the joint venture;

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<sup>61</sup> See generally JVL, *ibid.*; JVL Regulations, *supra*, footnote 28, arts. 34, 37. The Chinese leadership has insisted that the appointment of the chairman be their prerogative. They emphasize that "a Chinese chairman will enjoy the advantage of an easy approach to the Chinese people either vertically or horizontally": P.R. Brown, China's New Joint Venture Law: Analysis and Economic Review (1981), 4 Bost. Coll. Int. Comp. L.R. 115, at p. 138, n184. An examination of four Japanese joint ventures, reveals that in each instance the chairman is a Chinese appointee, see JTO, (1983), 44 China News Letter 8. A Hong Kong shipowner was appointed to chair the International Shipping and Investment joint venture: Pattison, *loc. cit.*, footnote 52, at p. 114, n133. In the now suspended Sanyo refrigerating manufacturing joint venture, the Chinese chairman was given responsibility for dealing with government authorities, while the Japanese president had general management authority. Despite 75% Japanese equity participation, only six out of ten directors were Japanese appointees; *ibid.* As to foreign general managers see Chao, *loc. cit.* footnote 40.

<sup>62</sup> See for example, within the patents context, the comments of F. Yungchun, director of the Patent Agency, CCPIT, Foreign-related Patent Business in China (1984), PRC Intertrade (September) 46.

<sup>63</sup> JVL, *supra*, footnote 3, art. 6. See *supra*, text accompanying footnotes 40-42; Pattison, *loc. cit.*, footnote 52, at p. 114; Rong Yiren interview, *supra*, footnote 2, at p. 6. A concept familiar to Anglo-American lawyers that authority be divided between shareholders and directors is noticeably lacking in the JVL. It has been suggested that the failure to provide for shareholder rights and meetings as part of the corporate structure is directly related to the consensus style of management decision making; Torbett, Thomson, *supra*, footnote 4, at pp. 857-858. As Board decisions are envisaged to be unanimous and unrelated to voting rights, with each party having an implied veto power, the two-tiered management approach is considered inappropriate; *ibid.* It might be noted however that trade union representatives, who may be considered analogous to shareholders within the Chinese context, are entitled to attend Board meetings as nonvoting members. This too is consonant with the Chinese style of consensus management; JVL Regulations, *supra*, footnote 38, art. 98.

and a merger with another economic organization.<sup>64</sup> Where a dispute does arise between joint venture parties that can not be resolved through joint consultation, then resort may be had to conciliation and arbitration.<sup>65</sup>

The JVL delineates in broad terms the areas in which the board is empowered to use its discretion. These matters include:<sup>66</sup>

. . . all fundamental issues concerning the venture, namely, expansion projects, production and business programmes, the budget, distribution of profits, plans concerning manpower and pay scales, the termination of business, the appointment or hiring of the president, the vice-president(s), the chief engineer, the treasurer and the auditors as well as their functions and powers and their remuneration, etc.

The generality of the foregoing implies that most of the fundamental issues that concern joint venture operations are the board's responsibility.

The JVL provides that a president or vice-president (or general or assistant general manager) is to be appointed. Although the JVL envisages that such an appointment is to be made from amongst the parties to the joint venture, the JVL Regulations expand this and call for the establishment of a management office staffed by a general manager and one or more deputy general managers. They are to be appointed by the board and may be drawn from the board's membership. Although a dual role for a board director as general or deputy general manager is expressly provided for in the Regulations, it appears that senior management is no longer restricted to joint venture parties. There is no restriction on the citizenship of these officers. The general manager is subject to board decisions and instruction, and is empowered to handle routine business matters. He is further authorized to represent the board in dealings outside the joint venture, may appoint and dismiss subordinates, and may exercise any other rights entrusted to him by the board.<sup>67</sup>

Since it is the prerogative of each joint venture party to appoint and remove its nominees on the board, careful consideration should be given to how such key management figures be chosen. Both continuity of management and expertise should be taken into consideration. It may be best to provide in the articles of association that one be appointed by each joint venture party, with provision to change this if the board members

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<sup>64</sup> JVL Regulations, *ibid.*, art. 36.

<sup>65</sup> JVL, *supra*, footnote 3, art. 14. Parties may have recourse to conciliation or arbitration by an arbitral body in China or one agreed upon by the joint venture parties; JVL Regulations, *supra* footnote 28, art. 110. See *infra*, text accompanying footnotes 202-208.

<sup>66</sup> JVL, *ibid.*, art. 6.

<sup>67</sup> On the above paragraph see JVL, *ibid.*; JVL Regulations, *supra*, footnote 28, arts. 39,40. A general manager or deputy-manager may however not hold a post concurrently as a manager or deputy-manager in other economic organizations and is precluded from having connections with any economic organization that may be competitive with the joint venture; *ibid.*

agree; alternatively, a system of rotation might be established. Finally, as regards control and management by the board, it is noteworthy that employment and discharge of workers and staff members of the joint venture do not fall within the purview of the board's discretionary powers; this is regulated by Chinese law, and by the terms of the joint venture contract.<sup>68</sup>

One area of management that should be of concern to investors is that of accountants and auditors. China has no independent certified accountants. Organizations such as enterprises, banks or schools, all establish internal accounting departments. The JVL Regulations require that an auditor be appointed. It has been suggested that in China, a public accountant's responsibility, like that of a lawyer, is not to his profession but to the state. Although foreign law firms have not been permitted to establish offices in China, foreign accountancy firms have been permitted. The JVL Regulations provide that all vouchers, accounts and similar documentation be prepared in Chinese. The concurrent use of a foreign language is permitted. Investors are thus well advised to specify the appointment of auditors and the use of a second language in the articles of association. This is particularly important for taxation matters, and for the eventual dissolution of the joint venture.<sup>69</sup>

#### E. Supply, Pricing and Marketing

There has been considerable concern expressed amongst foreign investors about possible shortages in the supply of raw materials and energy, and about the artificially high costs of materials, labour and energy, which may lead to a decrease in profits and international market competitiveness. The promulgation of the JVL Regulations represents the first major step taken by the PRC leadership to establish a uniform policy on pricing and supply. Similarly, the Regulations for the first time officially sanction sales by joint ventures on the domestic market.

The JVL and JVL Regulations provide that in its purchase of "semi-processed materials, fuels, auxiliary equipment etc.", the joint venture should, all other things being equal, give first priority to Chinese sources.<sup>70</sup> There is no prohibition on purchasing supplies from overseas. A practical constraint, however, is the possibility of insufficient foreign exchange to support such purchases of foreign supplies. In many instances the purchase of supplies and materials within the PRC may be more financially attractive. In fact, for some investors this, coupled with a guarantee of supply, may be a key consideration in their decision to locate in the PRC. The Regulations establish through which domestic agencies materials and supplies may be purchased.<sup>71</sup> Materials are normally purchased through

<sup>68</sup> JVL, *ibid.*, art. 6; JVL Regulations, *ibid.*, art. 91.

<sup>69</sup> On the above paragraph see JVL Regulations, *ibid.*, arts. 82,84; Torbett, Thomson, *loc. cit.*, footnote 4, at pp. 861,862; Dick, *loc. cit.*, footnote 9.

<sup>70</sup> JVL, *ibid.*, art. 9; JVL Regulations, *ibid.*, art. 57.

<sup>71</sup> JVL Regulations, *ibid.*, art. 58.



contracts with state enterprises. Prices have frequently been higher than those charged domestically and this had led to artificial increases in costs of production.

The JVL Regulations establish guidelines for the purchase of materials and services in the PRC. The so-called "six raw materials" (gold, silver, platinum, petroleum, coal and timber), if used directly in production for export, will be priced at international market prices, and may be paid for in renminbi or foreign currency. The price of imported commodities or goods that would otherwise be exported must be negotiated with reference to the international market price, and be paid for in foreign currency. A significant change in policy is that the cost of all other materials, including the price of coal used as fuel, oil for motor vehicles needed in the production of goods destined for the domestic market, as well as fees for water, electricity, gas, heat, goods transportation, engineering and consulting services and advertising, will be the same as that charged state owned enterprises and may be paid in renminbi.<sup>72</sup> This represents important and welcome changes in PRC policy and should facilitate joint venture investment. It will, moreover, serve to make joint venture investment more competitive with similar investment schemes outside of the PRC.

On the production and sales side, the JVL Regulations are a welcome addition for joint venture investors. Although the possibility of access to the domestic market had been held out to investors, such access had not been forthcoming. Faced with lagging joint venture participation in its economy, the PRC has consciously improved the investment environment. Joint ventures are still encouraged to sell their products on the international market. They may now, however, sell products on the Chinese market that the PRC urgently requires or presently imports. This does not mean that a joint venture will be able to market its products freely. Products subject to a state plan will be purchased by a state agency; any excess may be sold by the joint venture independently. Where Chinese foreign trade companies already import the goods, the joint venture may sell directly to the trade company and be paid in foreign currency. The prices paid for domestic sales will normally be state-set and may vary according to the quality of goods supplied. Prices are set and paid in renminbi. A joint venture may request that items be valued with reference to the international market; whether compensation will then be paid in renminbi or in foreign currency is still unclear. The joint venture may establish its own prices for export goods. The relaxation of the requirement that joint ventures be foreign exchange self-sufficient should further facilitate joint venture sales within China.<sup>73</sup>

<sup>72</sup> *Ibid.*, art. 65(1),(2),(3).

<sup>73</sup> On the above see JVL Regulations, *ibid.*, arts. 60, 61, 63,64, 65(3), 66,75.

Direct state intervention, or indirect intervention through one of China's many economic institutions, may play havoc with carefully concluded arrangements. Joint venture partners should carefully examine the Chinese joint venture partner's position in the state economic plan with regard to pricing of raw material inputs and production outputs, and, if at all possible, secure an understanding guaranteeing a certain level of supply and output.<sup>74</sup> The ramifications of a joint venture integrated into the economic plan through economic contracts may be substantial. Such integration may preclude the joint venture from purchasing independently;<sup>75</sup> or may preclude a joint venture from meeting its external supply demands.<sup>76</sup> Conversely, when supplies are scarce and guaranteed through the state plan it may be advantageous to the joint venture to be integrated in the state plan.<sup>77</sup> If upstream suppliers do not produce, then the joint venture may be still forced to wait while shortages last. Provision should thus be made to permit the joint venture to use alternate sources of supply in such instances.<sup>78</sup> Similarly, an export pricing agreement ensuring that a certain percentage of supply be marketed overseas, and non-discrimination clauses providing for equal access to supplies with Chinese enterprises, are advisable.<sup>79</sup> That China is as desirous as the foreign investor to make joint ventures profitable<sup>80</sup> should reassure investors that extensive interference of this nature is not likely to occur.

#### F. *Labour Relations and Responsibilities*

While the JVL provides little guidance on labour matters, the JVL Regulations and the Regulations on Labour Management in Joint Ventures Using Chinese and Foreign Investment<sup>81</sup> (JVLLMR) provide substantive parameters for joint venture operations. The separate labour regulations that apply in the PRC's Special Economic Zones (SEZ) are also discussed below.

The JVL provides that joint venture activities are to be governed by PRC laws, and that conditions for employment and discharge of employ-

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<sup>74</sup> Cohen, *loc. cit.*, footnote 9, at p. 26.

<sup>75</sup> JVL Regulations, *supra*, footnote 28, art. 58.

<sup>76</sup> Pattison, *loc. cit.*, footnote 51, at p. 128.

<sup>77</sup> Torbett, Thomson, *loc. cit.*, footnote 4, at p. 876.

<sup>78</sup> *Ibid.* The authors cite instances when during work stoppages due to a lack of supplies, social, educational, political and welfare objectives have been pursued during working hours. Clearly for joint venture operators, economic viability and not political education are of paramount importance.

<sup>79</sup> Cohen, *loc. cit.*, footnote 9, at p. 26.

<sup>80</sup> See Rong Yiren, *supra*, footnote 2, at p. 5.

<sup>81</sup> Promulgated and effective July 26, 1980; reproduced (1980), 19 I.L.M. 1454. (Hereafter cited as JVLLMR).

ees must be included in the joint venture contract.<sup>82</sup> The right to establish trade unions is specifically recognized in the JVL Regulations.<sup>83</sup> Pursuant to the JVL Regulations, worker employment, dismissal and resignation, employment tasks, wages, working hours, vacations, insurance, protection and discipline must all be stipulated in the labour contract. Signed labour contracts must be submitted for approval to the labour management department of the appropriate government subdivision. Workers will either be recruited by the local authorities or, with the consent of the authorities, by the joint venture management. The qualifications of all prospective workers must be assessed through examinations. Merit is thus the basis for employment.

The JVL Regulations require joint ventures to "make efforts to conduct professional and technical training" of staff.<sup>84</sup> These provisions redress some of the early difficulties encountered with low productivity and inefficient workers.<sup>85</sup> It should be noted that recent changes in economic policy support the western philosophy of pay according to work. JVL Regulations provide that salary and bonuses are to be distributed according to the principle of "each according to his work, and more pay for more work".<sup>86</sup> This should give joint venture management greater control over employee efficiency.

Where there is a "surplus" of workers as a result of production or technical changes, or where workers are unsuitable after training and not suitable for other positions, then they may be discharged. Such dismissal must be carried out in accordance with the labour contract and compensation must be paid. Action may be taken against employees where there has been a violation of enterprise rules or regulations which result in "bad consequence". Where disciplinary action results in the discharge of the employee, local authorities in charge of the joint venture must be advised; dismissal is further subject to the labour management department's approval. Since the "authorities in charge" may consist of numerous government departments, bureaucratic delays may be inevitable. A trade union has the right to object if it considers the action taken unreasonable. It may send representatives and seek consultation with the board of directors. Where consultation fails, parties have recourse to arbitration by the

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<sup>82</sup> JVL, *supra*, footnote 3, art. 2. It is a noticeable exception to the Board's broad management powers that labour relations do not fall within the purview of its responsibilities.

<sup>83</sup> JVL Regulations, *supra*, footnote 28, art. 85.

<sup>84</sup> On the preceding text see JVL Regulations, *supra*, footnote 81, art. 2; JVL Regulations, *supra*, footnote 28, art. 92.

<sup>85</sup> Rich, *loc. cit.*, footnote 10, at p. 205. Furthermore, provision is made to establish workers' schools or training courses to train skilled and management personnel; JVL Regulations, *supra*, footnote 81, art. 3.

<sup>86</sup> JVL Regulations, *supra*, footnote 28, art. 93. As to the changing philosophy generally see, *supra*, footnote 5.

labour management department of the appropriate government subdivision. If either party disagrees with the outcome of the arbitration, a suit may be filed in the People's Court. When workers and staff members resign through the trade union in accord with the labour contract on account of "special conditions", the enterprise is expected to give its consent. What constitutes a "special condition" is not defined. It is noteworthy that the State Bureau of Labour has the exclusive right to interpret these Regulations. This may make the right to seek redress through the courts an empty one.<sup>87</sup>

The JVLLMR distinguish between Chinese workers and staff members, and foreign workers and staff members. For example, labour insurance, medical expense and other government subsidies must be paid for and provided for Chinese workers on a similar basis and level as is found within state-owned enterprises.<sup>88</sup> A similar obligation does not exist for foreign workers and staff. These provisions reflect the desire of the Chinese leadership to ensure that Chinese joint venture employees be treated in a manner at least equal to that found in state-owned enterprises. Although the costs of such benefits are said to be designed to keep the PRC competitive with other countries, it is estimated that the costs of these benefits is 130% of the actual wage cost.<sup>89</sup> It is the responsibility of the board of directors to establish wage standards, the forms of wages paid, and the bonus and subsidy system. This however is subject to the stipulation that the wages for Chinese workers and staff members be 120% to 150% of similar wages paid in state-owned enterprises. For foreign workers and staff members, employment, resignation, dismissal, pay, welfare, social insurance and other matters must be provided for in the employment contract.<sup>90</sup>

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<sup>87</sup> On the preceding text see JVLLMR, *supra*, footnote 81, arts. 4,5,6,7,11,14,15. On proceedings in the People's Court, see also JVL Regulations, *supra*, footnote 28, arts. 109-111. Under the 1979 Law of the People's Courts, an economic court division was established, and started operation in some areas in 1980. These "courts" address not only disputes between Chinese and foreign joint ventures and labour, but also foreign trade disputes, and contractual disputes between Chinese foreign economic departments; Goodrich, *loc. cit.*, footnote 56, at p. 569, n396. These courts will attempt to promote a settlement through conciliation. If this fails the Court will then act as a mediator: Pattison, *loc. cit.*, footnote 52, at pp. 140-141, nn279-282. There is little evidence to suggest that the Chinese have created or used the formal adjudicative procedures found in western civil or common law jurisdictions;*ibid.*.

<sup>88</sup> JVLLMR, *ibid.*, art. 11.

<sup>89</sup> Cohen, *loc. cit.*, footnote 9, at p. 27. The JVL Regulations provide that the joint venture must provide 2% of total salaries to the joint venture's trade union funds. It must also provide housing and facilities for the trade union's office work, cultural, sport and welfare activities; JVL Regulations, *supra*, footnote 28, art. 99.

<sup>90</sup> On wage standards and fringe benefits see JVLLMR, *supra*, footnote 81, arts. 8,9,12.

A difficult problem that has arisen is that of attracting and hiring foreign management. The issue is one of equal pay for equal work. Conceptually, few business men will have difficulty with this principle but in practical terms it has become a stumbling block in negotiations. In the words of one commentator:

If one has to pay US \$60,000 to get a competent foreigner to become a Vice-President of a joint venture in China, does it mean that the venture must pay a Chinese Vice-President US \$60,000 even though the individual may only keep US \$1,500 (the remainder going to the Chinese government), and even though he lacks the training and experience of the foreign manager? In principle, the Chinese answer, so far is: "Yes".<sup>91</sup>

Various compromises have been negotiated,<sup>92</sup> many of them not wholly satisfactory from the foreign investor's perspective.

The interrelationship between the Guangdong Special Economic Zone (SEZ) Labour Regulations<sup>93</sup> and the JVLLMR is not clear; nor has it been elaborated upon by the Chinese leadership. It is suggested that where the JVLLMR and the SEZ Labour Regulations conflict in the SEZ, then the latter will prevail, and that the former will in general serve to complement it. Although the application of the SEZ Regulations is geographically restricted, they are not limited to joint ventures but apply to all foreign companies and enterprises.

The Labour Management provisions found in the SEZ Regulations<sup>94</sup> provide that labour service companies are to be set up in each special

<sup>91</sup> Cohen, *loc. cit.*, footnote 9, at p. 24.

<sup>92</sup> E.g. by paying the Chinese president a modest amount, and the two vice-presidents (one being foreign) higher wages than the president; by permitting substantial differences in salary at the outset, but only on the express understanding that the wage gap would be removed over time. Other issues to consider and carefully negotiate include fringe benefits such as travel and holiday costs necessary to attract competent foreign personnel; see Cohen, *ibid.*

<sup>93</sup> The three economic zones in Guangdong province are Shenzhen, Zhuhai and Shanton. There is a fourth SEZ in Xiamen located in Fujian province. Moreover the fourteen coastal cities that have recently opened to foreign investment will also be subject to the SEZ or similar rules. Whether the SEZ Regulations will apply *mutatis mutandis* to joint ventures or whether further rules will be implemented is still unclear. Similarly the special investment rules promulgated in January of 1980 for the Shedou Industrial Zone in Guangdong province have not been dealt with. Whether the latter Regulations prevail is unclear; see J.B. Lewis, B.L. Ottley, *China's Developing Labour Law* (1981-82), 59 Wash. U.L.Q. 1165, at pp. 1167-1213.

It has been suggested that the SEZ Regulations supersede the JVLLMR, and that in fact the JVLLMR do not operate within the SEZ; S. Nishitateno, *China's SEZ: Experiments in Economic Reform* (1983), 32 Int. & Comp. L.Q. 175, at p. 180. There is nothing in the SEZ Regulations or in the JVLLMR that would substantiate this position.

<sup>94</sup> Regulations on Special Economic Zones in Guangdong Province, (hereafter cited as SEZR), approved August 16, 1980. On the following paragraph see arts. 19,20,21.

zone. The Chinese staff and workers of these companies are to be recommended by local labour service companies. With the consent of the provincial administration, staff may be recruited separately by investors. Rights of enterprises include the right to sign individual employment contracts, to test employees before employment, and to dismiss employees in accordance with the provisions of the labour contracts. The labour contract must set out pay scales and wage forms, award methods, labour insurance and other state subsidies, in accordance with the stipulations of the provincial administration of the SEZ. What the latter entail, and whether they allude to further responsibilities, is unclear.

The SEZ Regulations leave many questions unanswered. When compared to the JVLLMR they may be considered more liberal, but only because of their lack of specificity and their failure to address many issues; as a result joint ventures are given more latitude to negotiate their labour relations.

### G. *Transfer of Technology*

One aspect of China's goal to modernize is its desire to import foreign expertise through joint venture operations. Industrial property rights therefore may form part of the foreign joint venture partner's capital contribution. The JVL stipulates that technology or equipment contributed by the foreign participant must be truly advanced and appropriate to the PRC's needs. Tax concessions and exemptions are available for joint ventures equipped with up-to-date technology by world standards. Should outdated technology or equipment be provided, then suppliers must pay compensation for the losses incurred.<sup>95</sup>

Despite this emphasis on modern technology the level of protection that is available for trademarks, copyrights and patents is a serious concern for investors, both in terms of legislation and official attitudes. The PRC joined the World Intellectual Property Organization in March 1980, and acceded to the Paris Convention for the Protection of Industrial Property Rights in March, 1985. The guarantees offered under existing Patent, Trademark and Copyright laws are often noticeably inferior to those in Western countries.<sup>96</sup>

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<sup>95</sup> JVL, *supra*, footnote 3, arts. 5.7. The requirement that compensation be paid has been considered "unorthodox" by western business men, who expect that penalties for fraud be imposed through criminal rather than commercial legislation: Rich, *loc. cit.*, footnote 10, at pp. 205-206.

<sup>96</sup> For a historical overview of industrial and intellectual property rights protection in China, see Tao-Tai Hsi, K.A. Huan, *Laws of the PRC on Industrial and Intellectual Property (1973-74)*, 38 *Law & Con. Pr.* 274; Kirk, *Chinese Intellectual Property and Technology Acquisition (1981)*, 13 *Int. Pty. L.R.* 175. As to the Paris Convention see Hudspeth, *loc. cit.*, footnote 12, at p. 733. The Chinese assert that the new Patent Law refers to the Paris Convention and on this basis appear to justify their failure to accede to it; Liu Gushu, *China's First Patent Law (1984)*, 7 *China's Foreign Trade* 9.

The Regulations on Controlling Technology Import Contracts, enacted in May 24, 1985, govern the importation and transfer of patents, technological processes, prescriptions, products, designs and technical services, and establish parameters for what constitutes "advanced and practical" technology. While the regulations clarify the rules for transfer of technology in China, their provisions severely limit the investor's scope to negotiate the terms and conditions of any transfer. Moreover, contracts must be approved by MOFERT or another designated approved organ. It is evident that the Chinese do not wish to be bound by what they perceive to be "unreasonable terms and conditions". Some comfort may perhaps be derived from the fact that article 7 of the Regulations requires Chinese recipients to keep secret the classified portion of the technology. Nonetheless, investors should take care to be sure that they are fully aware of the exact terms on which any transfer of technology takes place.

In 1978 the New Invention Law and Regulations were promulgated. New patent legislation came into effect in April of 1985, but it did not supersede the 1978 legislation. Since each offers a different standard of protection, investors are well advised to examine both laws carefully.<sup>97</sup> The 1978 legislation focuses on "major new scientific and technological achievements which have never been achieved before, are more advanced than that which is presently available, and that prove useful through practice".<sup>98</sup> Chinese nationals must report such inventions through a series of bureaucratic levels, while foreigners may report directly to the State Scientific and Technological Commission. Financial rewards are granted by the state, but no ownership right or protection is granted.

The new patent legislation, Patent Law of the PRC,<sup>99</sup> provides in article 2 that patents for inventions, utility models and designs will be protected. Under article 45 the duration of the patent right varies with the type of "invention creation"; inventions are protected for fifteen years, utility models and designs are protected for five years. Article 22 requires

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<sup>97</sup> For a brief comparison of the two pieces of legislation, see F. Leung, A Legal Opinion (1984), China Tr. Rep. (May) 13.

<sup>98</sup> Kirk, *loc. cit.*, footnote 96, at p. 181; and see Kirk for the remainder of this paragraph.

<sup>99</sup> Patent Law of the People's Republic of China, adopted March 12, 1984 effective April 1, 1985. Reproduced WIPO, Ind. Pty. (1982), (#4), and PRC Intertrade, (May) 1984. For a Chinese perspective on this law see L. Gushu, Industrial Property Protection in China (1984), PRC Intertrade (August) 16; H. Kung, The Birth of the First Patent Law of the PRC, [1984] Ind. Pty (#4) 152. On January 15, 1985, the Regulations on Implementing the Patent Law of the People's Republic of China were approved; they are also effective April 1, 1985. These Regulations expand the Patent Law and deal, *inter alia*, with the procedural requirements for a patent application, examination and approval of patents, invalidation, rewards, the establishment of a Patent Register and Gazette, and fees. The Regulations are reproduced in (1985), 28 Bej. Rev. 7-8 I-XIV.

that to be patentable any invention or utility model must possess "novelty, inventiveness, and practical applicability",<sup>100</sup> and article 22 that designs must not be "identical or similar to any design which...has been publicly disclosed in publications" either in the PRC or abroad. Article 25 prohibits the grant of patent rights for "scientific discoveries; rules and methods for mental activities; methods for diagnosis or for the treatment of diseases; food, beverages and flavourings pharmaceutical products and substances obtained by means of chemical process; animal and plant varieties; or substances obtained by means of nuclear transformation".<sup>101</sup>

The Patent Law establishes general procedures to be followed for the application, examination and registration of the patent. It adopts, *inter alia*, a unitary system of patent protection, early publication, deferred examination, and the first to file and national treatment principles.<sup>102</sup>

Licencees must contract with the patentee for a fee for the exploitation of the patent.<sup>103</sup> While this reflects standard practice, the Patent Law imposes an obligation on patentees to either make the patented product or to use the patented process or to otherwise authorize others to use it. Failure to abide by this provision without just reason within three years of the grant of patent, makes the grant of a licence to another party requesting the use of the patent in the PRC mandatory. Applicants for a compulsory licence must, however, first furnish proof that negotiations with the patentee for a licence contract for exploitation were unsuccessful; an exploitation fee must still be paid.

When patent rights are infringed the patentee or other interested party may request the administrative authority for patent affairs to stop the infringement and to order payment of compensation. A patentee may also seek redress directly through the People's Courts. Any legal proceedings must be initiated within two years.<sup>104</sup>

In March 1983 China's new Trademark Law took effect, replacing the 1963 Trademark Control Act and Regulations.<sup>105</sup> The pre-existing

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<sup>100</sup> Protection is given to ensure that the novelty requirement will still be met where the invention or utility model has been exhibited at a recognized international exhibition, made public at an academic or scientific meeting, or disclosed without permission; art. 24.

<sup>101</sup> The processes used in producing food, beverages, flavourings, pharmaceutical products and substances, and animal and plant varieties are patentable; art. 25.

<sup>102</sup> *Ibid.*, Ch. III & IV, arts. 26-44. Note that patent applications from non-residents businesses and individuals are subject to a reciprocity qualification; arts. 18, 19.

<sup>103</sup> On this paragraph see Patent Law, *ibid.*, arts. 51, 52, 54, 57. The fee on compulsory licencing will be established through consultation between the parties; failure to reach an agreement results in an adjudication by the Patent Office. The patentee has a right to appeal the compulsory licence and fee in the People's Courts.

<sup>104</sup> Patent Law, *ibid.*, arts. 60, 61.

<sup>105</sup> Reproduced Syme Publications, Collection of Laws and Regulations of China Concerning Foreign Economic and Trade Relations (1982). Hereinafter cited and referred



system of protection through registration, not usage, was maintained. Trademark protection is only available to foreigners if a reciprocal agreement on the registration of trademarks exists between the applicant's country and the PRC; further, the trademark must already be registered in the "home" country. Applications for registration are to be made to the GACIC, whose Trademark office has authority to accept or reject applications. Once registered, the trademark will be valid for ten years, and may be renewed for another ten years. Assignment of the trademark is possible but only with GACIC approval; licencing contracts must be reported to the Trademark Office. The focus of the legislation is to protect consumer interests, ensure trademark exclusivity and to maintain the product quality implied by the trademark. Its greatest weakness is its failure to protect unregistered trademarks and service marks. Trademark disputes are generally handled internally in the GACIC, but infringement of the right of exclusive use of the trademark may be taken directly to the People's Courts.<sup>106</sup>

There is no copyright law in the PRC. It is thus not surprising then that the PRC has not signed the Berne Convention for the Protection of Literary works or the Universal Copyright Convention.<sup>107</sup> In 1982 Interim Provisions on the Management of Audio Visual Manufactures were promulgated; these provide rudimentary copyright protection in this area. The PRC has, however, been willing to negotiate copyright protection for products manufactured and distributed within China.<sup>108</sup> The enactment of a copyright law is envisaged, but it is unlikely to materialize in the immediate future.

Given this rather uncertain legal picture, investors are naturally concerned about the degree of protection that will be afforded them. The best advice that can be given is that they should try to protect themselves by contract. Even then, in light of present official attitudes there may still be cause for concern. It is true that the Chinese are aware of this concern, and have stressed that the principles of "equality and mutual benefit" will prevail in the absence of protective legislation. They have agreed to enter into detailed negotiations regarding technical licences, and patent rights. They have, however, also noted that severe restrictions preventing the acquisition of similar technology from other sources, preventing the improvement and development of acquired technology, restricting sales of goods made with acquired technology and high licence fees, are all

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to as TML. The 1963 Act is reproduced (1964), 62 Pat. & Trmk. R. 247. For a discussion of the pre-existing regime see H. Dawid, Trademark Protection in the PRC (1980), 9 Den. J.L. Pol. 217.

<sup>106</sup> On the specifics of this paragraph see TML, *ibid.*, arts. 91,23,25,29,39. See also Lutz, *loc. cit.*, footnote 36, at p. 25.

<sup>107</sup> Rich, *supra*, footnote 10, at p. 206.

<sup>108</sup> Note, Copyright Relations Between the United States and the People's Republic of China (1984), 10 Brookl. J. Int. L. 403, at pp. 424,425.

considered inconsistent with "equality and mutual benefit".<sup>109</sup> This sentiment has been recently codified in the JVL Regulations and the TIC Regulations.<sup>110</sup>

The Chinese appear to be willing only to agree not to disclose the technology imported to third parties "outside" of China; this leaves the investor free to infer that technology may be transferred within China to third parties. There may be a dozen other factories under the same ministry that produce the same product or are in the same business; fears that the confidentiality provisions of the joint venture contract may not be adhered to may be well founded. A joint venture contract binds only the enterprise and not the state; and thus negotiations with the relevant ministerial authorities are also essential. Fears have been expressed that the Chinese joint venture party may be ordered to subvert to other Chinese enterprises secretly.<sup>111</sup> Nonetheless, China's policy makers and authorities are fully aware that if confidences are broken ultimately no foreign investor will be willing to transfer technology. Such an approach falls far short of the express guarantees that western investors and lawyers would like to receive: it is, however, probably the best available under current conditions.

#### H. Banking, Loan and Foreign Exchange Provisions

Since 1979 the Provisional Regulations on the Bank of China's Handling of Loans to Joint Ventures Using Chinese and Foreign Investment (JV Loan Regs), the Provisional Regulations for Exchange Control of the People's Republic of China (ECR), Rules for the Implementation of Exchange Control Regulations (EC Rules), Penal Provisions for Violation of Exchange Control Regulations (Exchange Violation Regulations), the Bank of China Regulations (BoC Regs.) and the JVL Regulations have all been promulgated.<sup>112</sup> These fill in some of the legislative gaps that existed in the original JVL. They deal primarily with the role of the Bank of China (The Bank), foreign and domestic borrowing and exchange regulation.

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<sup>109</sup> Pattison, *loc. cit.*, footnote 52, at p. 124.

<sup>110</sup> JVL Regulations, *supra*, footnote 28, art. 46; TIC Regulations, *supra*, footnote 56, art. 9.

<sup>111</sup> On the above issues see Cohen, *loc. cit.*, footnote 9, at pp. 27-28; S. Lubman, A Question of Confidentiality (1983), 10 *China Bus. Rev.* (July-Aug.) 28; T.A. Gelatt, P. Weiss, China's bid for Foreign Technology (1985), *Asian and Pacific Law & Tax Review* 173.

<sup>112</sup> JV Loan Regs: reproduced 19 C.T.R. October 1981, 14; ECR: promulgated December 18, 1980; effective March 1, 1981; reproduced 19 C.T.R. January 1981 Supplement; EC Rules: approved July 19, 1983, and effective August 1, 1983; reproduced (1983) 22 I.L.M. 1049; Exchange Violation Regulations, approved March 25, 1985, effective April 5, 1985; reproduced (1985), 24 I.L.M. 804; BoCR: reproduced (1980), 7 *China Bus. Rev.* (Nov.-Dec.) 45.

The JVL and Regulations require that a joint venture must open an account with the Bank of China or an approved bank. The BoC Regulations clarify the Bank's position as the state's special foreign exchange bank, and give the Bank authority to engage in various loan transactions, to issue foreign currency bonds and other securities, and to participate in international financial activities. It is relevant to note that these Regulations now permit the Bank to officially secure or guarantee foreign loans.<sup>113</sup>

The JVL Regulations reaffirm that joint ventures may obtain funds directly from foreign banks. They must file a report with the State Administration of Exchange Control (SAEC); though what must be included in these reports is not specified.<sup>114</sup> The PRC has not yet enacted any legislation to limit foreign loan transactions. Who other than the Bank can guarantee loans, and in what circumstances, is still far from clear. It appears that increasingly, ministries, government agencies and local investment corporations may act as guarantors.<sup>115</sup> When the first joint ventures were contemplated, the PRC authorities apparently expected the foreign joint venture party to accept full responsibility for funds borrowed.<sup>116</sup> Although this attitude has now changed significantly, it still serves as a warning to foreign joint venture partners to ensure that they clearly understand what is expected of them. If overseas borrowing is contemplated then joint ventures may find that they will be subjected to close scrutiny by the Chinese authorities. In keeping with its policy of self-reliance, it is anxious not to overextend itself on international financial markets.

The Joint Venture Loan Regulations focus on domestic borrowing from the Bank. This alternate source of financing has been welcomed by joint venture operators and makes PRC investment more attractive. It signals that the PRC is willing to absorb some of the risks associated with joint venture operations. Joint ventures that have been approved by the FICC, are registered with the GACIC, and have been granted a business licence, are qualified to apply for loans from the Bank. Loan applicants must abide by the laws of the PRC, have opened a deposit account with the BoC or approved bank, have a good credit standing and sound management, and have sufficient resources to repay the loan plus interest. Borrowers must provide collateral security or a security bond with bank approval. Three types of loans are envisaged; self-liquidating loans to meet production and marketing requirements; loans to finance joint ventures while accounts receivable are outstanding; and loans to finance long term investments (i.e. fixed assets expansion or technical renovation).

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<sup>113</sup> *Ibid.*, arts. 1,2,5. These Regulations change the internal management structure; arts. 8, 12.

<sup>114</sup> JVL Regulations, *supra*, footnote 28, art. 78.

<sup>115</sup> Cohen, *loc. cit.*, footnote 9, at p. 25.

<sup>116</sup> This information was obtained from discussions with Australian Government Trade Officials, Canberra, October 1983.

Loans may be granted in renminbi or foreign currency, interest and principal to be repaid in the same currency.<sup>117</sup>

The documentation required to support a loan application and the final loan agreement are straight forward. The only caveat that should be raised is that borrowers must accept the supervision and examination by the Bank as to the use of loans, and must submit reports on the joint venture's programmes of marketing, production, finance and capital construction. So long as the Bank does not pursue an active supervisory or investigative role, these provisions need not alarm borrowers. It is evident that the Bank must protect its investment, and that in a socialist state such supervision is likely to be more stringent than in its western counterpart. Violations of the loan agreement permit the Bank to take disciplinary action which may consist of a suspension of the loan, or recalling the loan before maturity. Default provisions include a right of set-off for overdue amounts against the bank account that the borrower must open with the Bank. The Bank may sell collateral on default and impose an interest surcharge of twenty to fifty per cent.<sup>118</sup>

The Foreign Exchange Regulations (ECR) and Rules provide parameters for joint venture foreign exchange transactions. They are complemented by the Rules for the Implementation of Exchange Control Relating to Foreign Representations in China and their Personnel, the Rules Governing the Carrying of Foreign Exchange, Precious Metals, and Payment Instruments in Convertible Currency into or out of China, and the Detailed Rules and Regulations Relating to Individuals on Exchange Control and the Exchange Violation Regulations.<sup>119</sup>

The ECR and Rules govern foreign exchange activities of state organizations, collective economic units, individuals and foreign enterprises, including joint ventures. They are administered by the SAEC and the Bank. The SAEC appears to focus on domestic matters to a greater extent than the Bank. Joint ventures must open separate renminbi and foreign exchange deposit accounts; all foreign exchange disbursements must be made from the foreign exchange account. The SAEC must be provided with periodic reports and statements of foreign exchange business and transactions; it has an ancillary power of inspection.<sup>120</sup>

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<sup>117</sup> On this paragraph see, JV Loan Regs., *supra*, footnote 112, arts. 2,3,4. The BoC determines the rate of interest on loans in renminbi and with the approval of the People's Bank of China (i.e. central bank), it fixes the interest on loans in foreign currency; art. 6.

<sup>118</sup> On this paragraph, see JV Loan Regs., *ibid.*, arts. 4,7,8,9.

<sup>119</sup> The first two sets of rules are reproduced (1981), 19 China Tr. Rep. (Sept.) 13; the third in (1982), 20 China Tr. Rep. (April) 15.

<sup>120</sup> ECR, *supra*, footnote 112, art. 22; EC Rules, *ibid.*, arts. 4,7,9. Art. 9 provide, *inter alia*, that the following documents must be submitted: balance sheet, profit and loss statement, statement of receipts and payments of foreign exchange and an auditors report of the preceding year; and a budget of foreign exchange receipts and payments for the next year.

The Bank is obliged to observe the contract provisions of foreign personnel working in domestic organizations with regard to the remittance or the taking of foreign exchange outside of the PRC.<sup>121</sup> The Regulations do not indicate what constraints, if any, are imposed on domestic organizations negotiating with foreigners on such matters. In contrast to this, the Regulations do expressly stipulate that with respect to foreign personnel in Chinese and foreign joint ventures and Enterprises, an amount not exceeding fifty per cent of net wages, and other legitimate after tax earnings may be remitted or taken out of the country.<sup>122</sup> The more recent foreign exchange rules (1983) appear to imply that a remission of amounts exceeding fifty per cent is permissible; a separate application for this must be brought to the SAEC. The Chinese government has however stated that all reasonable repatriation applications, even those exceeding fifty per cent, will be granted.<sup>123</sup> It is evident that careful salary planning may be necessary. It has been suggested that, where generous salaries must be paid to attract high calibre personnel, part of the salary be paid outside of China. It is likely, however, that in such instances the foreign joint venture partner will have to bear the full cost of such payments.<sup>124</sup> Until investors are certain that the Chinese will permit total repatriation of salaries, they should exercise care in negotiating wage packages with non-nationals, and should consider including food costs, and lodging as employment benefits.

Joint ventures may remit abroad their net profits after tax and other legitimate earnings, by debiting their foreign exchange deposit accounts. An application for such remittances must be filed with the SAEC, and must be approved by the Bank.<sup>125</sup> The ECR and Rules extend the JVL provisions that permit the joint venture to remit funds upon termination and winding up. Preconditions for such remittances are that joint ventures wind up operations in accord with legal procedures, that all outstanding liabilities and taxes due in China be paid, and that such winding up be carried out under the joint supervision of the relevant departments in charge and the SAEC.<sup>126</sup> The remaining foreign exchange may then be remitted. Since the language of the Regulations is permissive, it does not constitute a solid guarantee that such remittances will be allowed. To date no serious difficulties have been encountered in this regard.

Although the general rule is still that all transactions within the PRC between joint ventures and other enterprises or individuals must be carried out in renminbi, this policy has been recently relaxed. Joint ventures

<sup>121</sup> ECR, *ibid.*, art. 19.

<sup>122</sup> *Ibid.*, art. 25; JVL, *supra*, footnote 3, art. 11 contains a similar provision.

<sup>123</sup> EC Rules, *supra*, footnote 112, art. 15; Cohen, *loc. cit.*, footnote 9, at p. 24.

<sup>124</sup> Cohen, *ibid.*

<sup>125</sup> ECR, *supra*, footnote 112, art. 33; EC Rules, *ibid.*, art. 13.

<sup>126</sup> ECR, *ibid.*, art. 26; EC Rules, *ibid.*, art. 18.

are no longer required to be fully self-sufficient in all foreign exchange transactions, and in some circumstances they may be paid by government agencies or departments in foreign exchange.<sup>127</sup> In the following four instances foreign exchange may be used. Where the products manufactured by the joint venture are import substitutes, foreign currency may be used for pricing and payment; prices are to be commensurate with current international prices. Where products are purchased for the production of goods that would otherwise be exported or imported by Chinese trade corporations, then international prices may be used and payment may be made in a foreign currency. Foreign currency may be used in payment for and in the settlement of accounts related to construction work carried out by Chinese entities for joint ventures. The fourth exception is a broad exemption for items designated by State Council regulations or approved by the SAEC. This is an avenue that joint ventures may be able to utilize to improve their market position. In all of the above instances a special arrangement must be entered into by the buyer and seller, and prior approval must be obtained from either the foreign trade authorities responsible (i.e. MOFERT) or the SAEC.<sup>128</sup>

The recent enactment of the Exchange Violation Regulations highlights the fact that investors should ensure that they have received approval from the relevant authorities for the remittance of foreign exchange. The Exchange Violation Regulations establish substantial penalties for the evasion of the ECR. The Exchange Violation Regulations impose *inter alia* penalties for: payments in renminbi for imports or other items that should have been paid for in foreign exchange; payments in renminbi by domestic organizations to defray expenses in China of foreign organizations in China and joint ventures where foreign exchange is retained and not sold to the state; payments for joint ventures and personnel thereof to pay for the expenses of others in return for reimbursement in foreign exchange by domestic organizations against import costs. Under article 3, penalties include restitution of foreign exchange or renminbi unlawfully used, and fines ranging from ten to thirty per cent of the amount of foreign exchange misused. Article 7 of the regulations also imposes strict penalties for the evasion of exchange control.

### I. Insurance

The JVL provides that insurance appropriate to the joint venture must be furnished by Chinese companies.<sup>129</sup> Insurance is supplied by the

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<sup>127</sup> JVL Regulations *supra*, footnote 28, art. 75. Where a joint venture sells most of its products on the domestic market pursuant to its approved feasibility study and contract then any imbalance in the foreign exchange account will be solved by the government of the relevant province, autonomous region, or municipality directly under the central government; if they are unable to resolve the imbalance the application can be made to MOFERT.

<sup>128</sup> EC Rules, *supra*, footnote 112, art. 12.

<sup>129</sup> JVL, *supra*, footnote 3, art. 8.

People's Insurance Company of China (PICC).<sup>130</sup> As well as offering a wide spectrum of domestic coverage, the PICC also offers political risk insurance to cover foreign investments in the PRC.<sup>131</sup> The contradiction that this presents is readily apparent. It is not difficult to envisage a situation where the PRC government is the cause of the political upheaval against which such insurance would operate. It would seem unlikely that in such circumstances the PICC, a state-owned entity, would give back through its insurance that which the state has deliberately taken away.<sup>132</sup> However, in the SEZ there has been insurance issued against construction delays due to unspecified "political hazards". Areas that are likely to be covered by Chinese political risk insurance include "war, actions similar to war, strikes, riots and confiscation".<sup>133</sup> On the other hand, confiscation and expropriation will not to be covered by the PICC.

Investors should consider purchasing political insurance outside of the PRC from private or public insurance companies. Canadian investors should be aware that the Canadian government, through the Export Development Corporation (EDC), offers foreign investment insurance against losses arising from the risks of inconvertibility, expropriation, war, revolution and insurrection.<sup>134</sup> Present EDC policy is to make such insurance available to parties investing in the PRC. To be eligible, the proposed investment must be of some economic advantage to Canada and to the host country. Formal PRC government approval for the joint venture must be obtained before preliminary insurance papers will be issued; and an application for insurance must be filed before the investor becomes irrevocably committed to the investment.

### J. Taxation of Joint Ventures<sup>135</sup>

The Joint Venture Income Tax Law (JVITL) consists of only eighteen articles; three months after its promulgation it was supplemented by

<sup>130</sup> It has three affiliates; the China Insurance Co. Ltd., Taiping Insurance Co. Ltd., and Ming An Insurance Co. incorporated in Hong Kong; A. Dicks, *Legal Opinion* (1983), 21 *China Tr. Rep.* (May) 13.

<sup>131</sup> J.B. Stepanek, *Insurance in China* (1981), 8 *China Bus. Rev.* (March-April) 37, at pp. 40-41.

<sup>132</sup> Cohen, *loc. cit.*, footnote 9, at p. 29.

<sup>133</sup> Stepanek, *loc. cit.*, footnote 131, at p. 40. The author gives an example of "political risk" insurance written by PICC Guangzhou branch covering a deluxe \$10 million development.

<sup>134</sup> EDC Information Circular, *Foreign Investment Insurance*, No. 80-2 (revised Sept. 1983), where fuller details of the coverage may be found. In the United States similar insurance is available through the Overseas Private Investment Corporation.

<sup>135</sup> Taxation of joint ventures is sufficiently complex to warrant a separate article. Only an outline of the major provisions is given here. For more detail see, *e.g.*, R.D. Pomp, T. Gelatt, S.S. Surrey, *The Evolving Tax System in the PRC* (1981), 16 *Tex. Int. L.J.* 11; R.D. Pomp, S.S. Surrey, *The Tax Structure of the PRC* (1979), 20 *Va. J. Int'l.*

a set of regulations (JVITLR).<sup>136</sup> While providing a broad framework for joint venture taxation, neither the JVITL nor the JVITLR address the interrelationship of the law and regulations with the pre-existing tax laws.<sup>137</sup> The JVL specifies that net profits may be distributed after the payment of "joint venture income tax", and that all activities of the joint venture are governed by the "laws, decrees and pertinent rules of the PRC".<sup>138</sup> These provisions point to the application of pre-existing taxes; this interpretation has been supported in the literature<sup>139</sup> and by the recently promulgated JVL Regulations. Two tax statutes which warrant attention in addition to the JVITL and the JVITLR are the Consolidated Industrial and Commercial Tax (CCIT) and the Industrial and Commercial Income Tax Act (ICITA).

(1) *Consolidated Industrial and Commercial Tax (CICT)*

The CICT is a form of sales tax levied at successive stages of production and manufacturing. The JVL provides that in computing taxable income a joint venture may "deduct any taxes on sales".<sup>140</sup> This suggests that the CICT applies to joint ventures; this interpretation is supported by the announcement in 1983 of a series of reductions in rates under the CICT for joint ventures.<sup>141</sup>

The CICT was adopted in 1958 and consists of nineteen articles and a schedule of over forty rates applicable to over 100 items.<sup>142</sup> A further

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L. 1; D.R. Simon, *Taxation of Joint Ventures in the PRC* (1982), 15 *Vand. J. Tr. L.* 513; P.D. Reynolds, *Doing Business with the PRC: Tax Considerations* (1980), 14 *Int. Lawy.* 49; D.R. Castleman, *Taxation in the PRC: The System and its Function* (1982), 46 *Alb. L. R.* 777; Pattison, *loc. cit.*, footnote 52, at pp. 141-155; Decker, *loc. cit.*, footnote 30.

<sup>136</sup> The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment. Promulgated and effective September 10, 1980; reproduced (1980), 19 *I.L.M.* 1452. Hereafter cited and referred to as JVITL. As to the JVITLR, see *supra*, footnote 57.

<sup>137</sup> When the JVITL was enacted there were nine pre-existing taxes: real estate tax, agricultural tax, vehicle licence tax, consolidated and industrial tax, slaughter tax, salt tax, foreign shipping tax, customs duties, industrial and commercial income tax. Pomp, Gelatt, Surrey, *loc. cit.*, footnote 134, at pp. 14-16 provide an excellent discussion of these taxes; see also Castleman, *ibid.* Of greatest importance to joint ventures are the real estate tax, vehicle tax, and consolidated industrial and commercial tax.

<sup>138</sup> JVL, *supra*, footnote 3, arts. 7,2.

<sup>139</sup> See Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at pp. 30,39; L. Lew, *Recent Legal Developments in U.S.-China Relations* (1981), 36 *Bus. Lawy.* 1699, at p. 1724.

<sup>140</sup> JVL, *supra*, footnote 3, art. 8.

<sup>141</sup> China Grants Tax Cuts for Joint Ventures (1983), 26 *Bej. R.* (#19) 7. These changes have been embodied in the JVL Regs., *supra*, footnote 28, arts. 69-72.

<sup>142</sup> This paragraph is based primarily on Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, especially pp. 15-19. See also Lew, *loc. cit.*, footnote 139, at p. 1724; Simon, *loc. cit.*, footnote 135, at p. 532. The tax is modelled on the Russian turnover tax; Reynolds, *loc. cit.*, footnote 135, at p. 56. A final version of the CICT has never been released.



thirty five regulations have been enacted to support the tax. The tax has been described as a "broad based turnover tax" or a combination of a "cascading sales and excise tax".<sup>143</sup> The tax is imposed at each level of production or fabrication when goods or services are transferred from one entity to another. All businesses engaged in the production of industrial products, purchase of agricultural products, importation of foreign goods, commercial retailing, communications and transport, and the rendering of services are subject to the tax. Obviously, most joint ventures will be caught under this broad tax. The tax is also levied at the retail level. When goods are sold to the ultimate user no credit is given for tax already paid on the same product. There is no exemption for further resale.

Tax rates vary from one and one-half to sixty nine per cent of the stated price when goods are transferred. Special rules apply for the sale of processed products and imported goods. As the CICT would favour vertically integrated enterprises, the law provides that further production within the entity will be taxed at each stage. Exemptions exist for state banks, insurance enterprises, agricultural machinery centres, hospitals and medical centres, scientific research units, and, most recently, for joint ventures.<sup>144</sup>

In May 1983 it was announced that custom duties and commercial and industrial tax would not apply to machinery, equipment and other material imported by foreign investors as part of their share capital; machinery and equipment and other materials imported with funds that are part of the joint venture's registered capital; and equipment and supplies that are not available in China and are imported as additional capital in accordance with the joint venture contract. Moreover, raw materials, auxiliary materials, parts and component packaging materials for manufacturing export products will be exempt. The JVL Regulations formalize these exemptions. The JVL Regulations further provide that products produced by joint ventures for export will be exempted; this is subject to Finance Ministry approval and does not apply to restricted export items. Joint ventures that suffer a loss from manufacturing export products under normal operations may be exempted from the CICT or pay at reduced rates.<sup>145</sup> It is too early to assess the impact of these liberalizing provisions, but clearly they represent a welcome relief from the tax burden that the CICT imposes.

The taxation period for payment and the date that tax liability arises varies with the nature of the enterprise. Failure to pay or late payments

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<sup>143</sup> Pomp, Gelatt, Surrey, *ibid.*, at p. 15.

<sup>144</sup> For a more comprehensive review of the rates applicable by category under the CITC see Pomp, Gelatt, Surrey, *ibid.*, at pp. 22-26; Reynolds, *loc. cit.*, footnote 135, at pp. 57-58. As to vertically integrated enterprises see Simon, *loc. cit.*, footnote 135.

<sup>145</sup> JVL Regulations, *supra*, footnote 28, art. 72. As to the May 1983 announcement see, *supra*, footnote 141.

are subject to penalties. Only after the assessed amount of tax is paid, may parties appeal the tax decision.<sup>146</sup>

### (2) *The 1950 Industrial and Commercial Income Tax Act (ICITA)*

Whether or not joint ventures are taxable under the ICITA has been the subject of much academic debate. It appears that the reference in the legislation making the tax applicable not only to all public and private enterprises, and cooperatives, but also to joint public and private enterprises<sup>148</sup> would make the tax relevant to joint ventures. The prohibition found in the JCITLR against the deduction of "income tax payments" would suggest that the ICITA encompasses joint ventures.<sup>149</sup> To date the ICITA has not been applied to joint ventures, but Chinese officials have stated that the ICITA could indeed be applied.<sup>150</sup> Moreover, the fact that the ICITA has not been amended subsequent to the promulgation of the JVITL and JVITLR would support its imposition.

The ICITA imposes a progressive tax rate that varies according to the nature of the enterprise taxed. Categories include permanent industrial and commercial enterprises, temporary commercial enterprises, and street peddlers. Rates vary from seven to sixty-two per cent, and with the application of surtaxes may be as high as eighty-six and six-tenths per cent. State enterprises and impoverished peddlers have traditionally been exempted from taxation; approved entities may also be exempted. The taxable period is the calendar year, and payments are due quarterly. Penalties for non-payment are severe, and the ICITA impose a duty on everyone to report tax evasion.<sup>151</sup>

### (3) *The Joint Venture Income Tax Law and Regulations*

The promulgation of the JVITL in September of 1980 was followed in December 1980 by a set of Regulations that took effect retroactively to coincide with the entry into force of the JVITL.<sup>152</sup>

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<sup>146</sup> See generally, Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at pp. 26-28. Appeals are it would seem rare.

<sup>147</sup> Simon, *loc. cit.*, footnote 135, at p. 528; Pomp, Gelatt, Surrey, *ibid.*, at p. 39; Castelman, *ibid.*, at p. 783.

<sup>148</sup> ICITA, art. 1. The Act is set out in Reynolds, *loc. cit.*, footnote 135, at pp. 67-72.

<sup>149</sup> Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at p. 39, n 160; Simon, *ibid.*, at p. 548.

<sup>150</sup> Simon, *ibid.*, at p. 528, n 90.

<sup>151</sup> On this paragraph see ICITA, *supra*, footnote 148, arts. 2, 21, 25-27; Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at pp. 25-27, 32. On exemptions see, Simon, *ibid.*, at p. 529. Recent reports indicate that state enterprises will no longer be exempted. They will have to pay higher taxes, but will have greater control over profits: Enterprises Liberated from Big Pot (1983), 26 Bej. R. 3.

<sup>152</sup> JVITR, *supra*, footnote 57, art. 35.

(a) *Tax Base and Calculation*

Joint venture income tax is levied on income derived from "production business and other sources" by joint venture branches within or outside of China. The world-wide income of the joint venture is thus subject to taxation. Branch income tax is to be paid by the head office in the PRC.<sup>153</sup>

Income derived from "production and business" includes income from production and business operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry, farming, commerce, tourism, food and drink, service and other trades. Income from "other sources" includes "dividends, bonuses, interest and income from lease or transfer of property, patent rights, ownership of trademarks, proprietary technology, copyright and other sources". There is no capital gains concept; income from the sale of fixed assets enters the year's loss and gain account.<sup>154</sup> Taxable income is net income after the deduction of costs, expenses and losses, but there is provision for a five year loss carry forward period.<sup>155</sup>

Specific accounting formulae are set out in the JVITLR to determine taxable income for industry, commerce, service trades or "other lines of operation".<sup>156</sup> There are detailed provisions following accepted accounting practices for the depreciation of fixed assets and inventory valuation.<sup>157</sup> Intangible assets, including technological know-how, patents, trademarks, copyright and the use of a site, are to be valued in the joint venture contract and amortized, but not in excess of ten per cent per annum. Expenses that arose during the preparation of the joint venture or organizational expenditures may also be amortized, but subject to a twenty per cent per annum limit.<sup>158</sup>

<sup>153</sup> JVITL, *supra*, footnote 136, art. 1

<sup>154</sup> JVITR, *supra*, footnote 57, arts. 2,15. In the ICITA, there is no capital gains concept; Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at p. 8.

<sup>155</sup> JVITL, *supra*, footnote 136, arts. 2,7.

<sup>156</sup> JVITR, *supra*, footnote 57, art. 8. The taxable income of an industrial joint venture is equal to "profits from the sale of the product" and other operations plus non-operating incomes minus non-operating expenditures; Simon, *loc. cit.*, footnote 135, at p. 539; Pomp, Gelatt, Surrey, *ibid.*, at pp. 56-57. For commerce, "sale profit" plus other operating income plus non-operating income, minus non-operating expenditures constitutes taxable income; for service trades, taxable income is "net business income plus non-operating income, minus non-operating expenditures; for other lines of operation the formulae above are to be adjusted to suit the operation; Pomp, Gelatt, Surrey, *ibid.*

<sup>157</sup> JVITR, *supra*, footnote 57, arts. 10,12,13,18. Fixed assets include houses and buildings, and trains, ships, machines, and equipment used in production with a useful life exceeding one year. Fixed assets are generally depreciated using the straight line method. Accelerated depreciation may be requested. Minimum useful life is prescribed for three classes of fixed assets. Methods permitted for inventory valuation are first in first out (FIFO), and shifting and weighted averages.

<sup>158</sup> *Ibid.*, art. 16,17.

A list of permitted expenses such as is customarily found in western tax legislation is not provided in either the JVITL or the JVITLR. There is an enumeration of what are not permitted costs, losses or expenses. These include: expenditure on the purchase or construction of machinery, equipment, building facilities, and other fixed assets; expenditure on the purchases of intangible assets; interest on capital; income tax payment and local surtax payment; penalties for illegal operations and losses in the form of confiscated property; overdue tax payments and tax penalties; losses from windstorms, floods and fire covered by insurance indemnity; donations and contributions, other than those for public welfare and relief purposes; and certain entertainment expenses.<sup>159</sup> The most controversial of these has been the disallowal of "interest on capital". The meaning of this phrase is unclear. Three interpretations are plausible: it may deny any interest deduction, or deduction of foreign interest paid on loans from shareholders (i.e. as equity investment), or interest on loans to purchase fixed assets. Pursuant to the latter, interest would be capitalized as part of the cost of the asset and depreciated accordingly.<sup>160</sup> Which interpretation is the correct one is an important issue that has yet to be resolved. The JVITLR further preclude the deduction of "expenditures arising from the increase of the value of fixed assets in use" as a result of technical reform.<sup>161</sup> This implies that such expenses should be capitalized. This would be consistent with the third interpretation of "interest on capital". A deduction issue that neither the JVITL nor the JVITLR resolve is whether deductions made pursuant to the articles of association for reserve funds or for bonus, welfare and expansion funds are permitted tax deductions. The difficulty stems from the JVL stipulation that net profits may be distributed only after the payment of joint venture income tax on gross profits and the payment of the above deductions.<sup>162</sup> The wording of the JVL and JVL Regulations suggests that these are not permitted deductions within the tax context.

### (b) Tax Rates

The basic tax rate is thirty per cent of taxable income; this is subject to a further ten per cent local surtax which is levied on actual tax paid. Hence the effective rate of taxation is thirty-three per cent. Joint ventures may be exempted from the local surcharge on account of "special circumstances". What constitutes a special circumstance is not defined. Where a foreign joint venture partner remits part or all of its share of profits, a ten per cent tax must be paid on the amount remitted. Joint

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<sup>159</sup> *Ibid.*, art. 9.

<sup>160</sup> On the controversy see, Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at p. 56.

<sup>161</sup> JVITR, *supra*, footnote 57, art. 14.

<sup>162</sup> JVL, *supra*, footnote 3, art. 7.

ventures exploiting petroleum, natural gas and other resources are subject to a separate income tax regime.<sup>163</sup>

Joint ventures in existence before the enactment of the JVITL and JVITLR are subject to a special tax regime for the initial operating period of the joint venture. If the tax package negotiated before the enactment of the JVITL is more favourable to the joint venture, then it will prevail; however, if it results in a higher tax rate than that provided for under the law and regulations, then the latter will apply from January 1, 1981.<sup>164</sup>

### (c) Tax Reduction

The JVITL provides several avenues for tax reduction; all seek to make investment more attractive. The JVITL provides that a newly established joint venture scheduled to operate for at least ten years may apply for an exemption from income tax for the "first profit making year" and for a fifty per cent reduction in the second and third years. This has recently been changed to a full exemption for the first two "profit making years" and a fifty per cent reduction for the third year.<sup>165</sup> Under the JVL, joint ventures equipped with "up-to-date technology by world standards" are to receive tax exemptions and reductions for the first two to three profit making years.<sup>166</sup> The failure of the JVITL and the JVITLR to elaborate on this exemption leaves it open to question whether this provision still applies or whether it has been superseded by the provisions above. This should be discussed in the initial contract negotiations with the Chinese authorities to ensure adequate compensation is paid. Low profit operations such as "farming or forestry, or [those] located in remote, economically underdeveloped outlying areas" may qualify for a fifteen to thirty per cent reduction for a period of ten years over and above the initial three year exemptions noted above.<sup>167</sup> To encourage reinvestment in the PRC tax incentives are granted under the JVITL. Where a foreign participant reinvests part or all of its share of the profits in China for a

<sup>163</sup> JVITR, *supra*, footnote 57, art. 3,4; JVITL, *supra*, footnote 136, arts. 3,4. The provisions on petroleum, natural gas and other resources have yet to be enacted; the Regulations of the People's Republic of China of Offshore Petroleum Resources in Cooperation with Foreign Enterprises, reproduced (1982), 21 I.L.M. 136, art. 9 refers only to payment of tax in accordance with PRC law.

<sup>164</sup> Pomp, Gelatt, Surrey, *loc. cit.*, footnote 135, at pp. 52-53; Pattison, *loc. cit.*, footnote 52, at p. 145.

<sup>165</sup> JVITR, *supra*, footnote 57, art. 5. As to the recent reductions see, *supra*, footnote 141. The "first profit making year" is defined as the year in which profits exceed losses after operations in accordance with art. 7 of the JVL (payment of tax, bonus, reserve and welfare funds). This means that initial operating losses will not diminish the joint venture's opportunity for tax exemptions.

<sup>166</sup> *Supra*, footnote 3, art. 1.

<sup>167</sup> JVITL, *supra*, footnote 136, art. 5.

period of at least five years, then it may receive a forty per cent refund on income tax paid on the reinvested amount.<sup>168</sup>

Income tax paid by the joint venture or its branch offices outside of the PRC may be credited against income tax assessed at its head office, as a foreign tax credit. The amount of the tax credit is not to exceed tax payable on income overseas, calculated pursuant to Chinese tax laws. Double taxation agreements will take precedence over the JVITL provisions in this regard. By limiting its tax jurisdiction, the PRC has reduced the amount of tax that it is likely to collect from joint ventures.<sup>169</sup> Negotiations are currently underway between the Canadian and Chinese governments to conclude a taxation treaty.

#### (d) *Administration and Enforcement*

The JIVTLR provide detailed administrative guidelines for the application of the JVITL and JVITLR. Matters covered include not only accounting procedures, but also record keeping, approval of form invoices and business receipts, and procedures on how, when, and where to submit income tax forms and payment. The JVITLR give tax authorities power to investigate the financial affairs, accounting books and the "tax situation" of joint ventures. Penalties are imposed for failure to comply with the procedures as outlined in the JVITR.<sup>170</sup>

Tax is payable in quarterly installments, tax returns must be filed irrespective of gain or loss, and the calendar year is the tax year. Taxes are paid in renminbi. Late payment of tax is subject to a daily fine of one half of one per cent from the first day of arrears. In cases of tax evasion or refusal to pay taxes, authorities may impose a penalty of up to five times the unpaid amount; gross violations are to be handled by the local courts. Although notice must be given by the authorities before the imposition of penalties, taxes and penalties must be paid before application may be made to higher tax authorities for reconsideration of the assessment. Authorities must make a decision within three months of such an application; if the decision is not acceptable, then recourse may be had to the People's Courts. It should be noted that the right of interpretation of the

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<sup>168</sup> *Ibid.*, art. 6. If funds are withdrawn before the expiration of the five year period, investors are liable for the tax refunded. Local tax authorities grant the first three year exemption, but the ten year exemption must be approved by the Minister of Finance. With regard to recent initiatives to make the tax climate more favourable in the SEZs and the fourteen newly opened coastal cities, see Tax Cuts to Speed Growth (1985), 23 China Tr. Rep. (January) 12.

<sup>169</sup> *Ibid.*, art. 16; JVITR, *supra*, footnote 57, art. 32; P. Fields, Taxation: The PRC's Income Tax Laws (1982), 22 Harv. J. Int'l. L. 234, at p. 240. A credit will be granted when the foreign state taxes income over which the PRC could similarly exercise jurisdiction. This results in a loss of tax revenue for the PRC.

<sup>170</sup> On this paragraph see, JVITR, *supra*, footnote 57, arts. 20,21,23-29.

JVITL and JVITLR has been reserved to the Ministry of Finance, and not to the courts.<sup>171</sup>

#### (4) Tax Issues for Joint Venture Investors

Despite the relative detail of the JVITL and the JVITLR, there are a number of matters that are far from clear. Investors would be well advised to try to clarify these at the negotiating stage. What follows is a brief discussion of some of the more troublesome areas.

It is unfortunate that the PRC has not clarified the interrelationship between the CICT, ICITA, JVITL, and JVITLR. Concerns have been expressed that the new Foreign Enterprise Income Tax Law may apply to joint ventures as well.<sup>173</sup> The extent to which joint ventures established within one of the SEZ will be subject to the JVITL is not clear. It is possible that while tax rates may be reduced consistent with the SEZ policy, that other tax computation and administrative provisions found in the JVITR will still apply. As reflected by the recently announced tax reductions, the Chinese are cognizant of these concerns and appear to be prepared to establish a tax structure that is as attractive as that of its competitors. It is equally apparent that the system is still evolving and subject to change.

The JVITL and JVITLR leave some concepts ill-defined; these include "costs", "expenses", "losses", "operating expenses", and "cost of sales". The JVITLR focus only on what are not permitted deductions. It is highly unlikely that the PRC intended investors to have a free hand in deciding what should be deductible. Issues such as training expenses, lodging and transportation expenses and insurance have been left open. The Chinese have indicated that a standard of necessity relevant to production or operation will prevail so long as the deduction has not been prohibited.<sup>174</sup>

Some of the items in the list of prohibited costs, expenses and losses should be of concern to investors. The Regulations disallow payment of interest on capital.<sup>175</sup> Although within the context of borrowing money for the purchase of capital equipment or even intangibles, this dilemma

<sup>171</sup> On this paragraph see, JVITL, *supra*, footnote 136, arts. 8,9,10,13,14,15; JVITR, *supra*, footnote 57, arts. 30,31,34.

<sup>172</sup> It has been suggested that *ad hoc* negotiations are in fact what the Chinese authorities envisaged for the initial years; Simon, *supra*, footnote 135, at p. 550. This however does undermine investor confidence.

<sup>173</sup> Simon, *ibid.*, at pp. 550-555; *contra*, Pomp, Gelatt, Surrey, *ibid.*, at p. 55. The Foreign Enterprise Income Tax Law and Regulations are reproduced at (1982), 21 I.L.M. 802 and 804 respectively.

<sup>174</sup> Pomp, Gelatt, Surrey, *ibid.*, at p. 8. But, for example, are transportation costs of foreign employees travelling to China, or the cost of "political risk" insurance deductible?

<sup>175</sup> See *supra*, text at footnote 150.

may be resolved through capitalizing the interest and depreciating it accordingly, there appears to be no possibility of deducting interest on loans that finance short term capital shortages. The Joint Venture Loan Regulations speak of loans for accounts receivable financing and of loans to meet joint venture processing and marketing requirements.<sup>176</sup> How these are to be reconciled with the JVITL and JVITLR will have to be discussed between the parties and the Chinese authorities.

The treatment of welfare funds, reserve funds, expansion funds and bonuses under the JVL and JVITL requires clarification. A net profit may be distributed after these payments and income tax payments on gross profits are made. Nowhere is the distinction between net and gross profits defined; it presumably lies in the deduction of the above payments from gross profits after tax. Contributions to these funds do not appear to be deductible, except for contributions made for "public and welfare relief purposes".<sup>177</sup> What constitutes such relief is not defined. The quantum of money involved in such fund and bonus payments should not be underestimated; one expert has stated that such contributions on average amount to 130 per cent of the labour cost.<sup>178</sup> Whether payment out of these funds may be deducted from the joint venture's gross income has also yet to be resolved.<sup>179</sup>

Income tax payments and tax payments are not deductible.<sup>180</sup> It would thus appear that not only are joint ventures subject to the CICT turnover tax, but they will also be taxed on the amount that they have paid out in this regard; this further increases the tax burden. The fact that losses from windstorms, floods and fire risks already covered by insurance are not deductible is not controversial. It, however, raises a broader concern, namely whether losses from other sources (e.g. theft, political upheaval) not covered by insurance are deductible. It may be a drafting oversight and have been included to prevent double compensation; joint ventures should seek to clarify this with the authorities and amend the joint venture contract accordingly.

The tax benefits flowing from the provision of "up-to-date technology" need to be better defined. The Chinese authorities have made it clear that such technology is of paramount importance, but the JVITL and JVITLR are virtually silent on this point. Both the tax benefits available, and the method of assessing whether technology qualifies must be addressed. It will be recalled that the JVL imposes a penalty for providing outdated technology.<sup>181</sup>

<sup>176</sup> JV Loan Regs., *supra*, footnote 112, art. 3.

<sup>177</sup> JVITR, *supra*, footnote 57, art. 9

<sup>178</sup> Cohen, *loc. cit.*, footnote 9.

<sup>179</sup> Pomp. Gelatt, Surrey, *supra*, footnote 135, at p. 58.

<sup>180</sup> JVITR, *supra*, footnote 57, art. 9.

<sup>181</sup> JVL, *supra*, footnote 3, art. 5.



The discretion that is vested in local authorities warrants attention. Tax incentive provisions, such as re-investment, low profit operations and the ten year reduced tax rates<sup>182</sup>, and penalties are applied at the discretion of local tax authorities or the Minister of Finance.<sup>183</sup> What limits are placed on their authority and what guidelines they will use to apply such provisions is unknown.<sup>184</sup> The fact that the right of interpretation of the tax law and regulations is specifically reserved to the Ministry of Finance further reinforces this bureaucratic discretion.<sup>185</sup>

An issue that must also be addressed is the tax consequences that flow from the termination of the joint venture operation. In its present form the JVITL permits remittances of profits subject to a ten per cent surtax. This may be a sizeable penalty for winding up the joint venture. The ECR and Rules are silent on the point. It is essential that joint venture operators negotiate a tax system and means of valuing assets from the outset. Otherwise, if the real value is not reflected, the joint venture operator may wind up paying tax on capital that formed part of the initial joint venture investment.

#### K. *Structural Changes to the Joint Venture: Extension, Transfer, and Termination*

The life of the joint venture is a matter for negotiation between the parties; it must be stipulated in the joint venture agreement, contract and articles of association. Subject to a reasonableness standard, this is left to the discretion of the parties. It may be recalled that the joint venture contract and articles of association are subject to MOFERT approval before a joint venture licence can be issued. Its approval is also required for an extension of joint venture operations.<sup>186</sup> The early joint ventures concluded provided for eight or ten year operation periods; recent practice points to operation agreements for ten to twenty-five years.<sup>187</sup>

The JVL permits a transfer of one party's interest to a third party during the course of the joint venture operation. Such a transfer may only take place with the consent of the other joint venture parties.<sup>188</sup>

Provision is made for the early termination of joint ventures. Permitted causes for termination include heavy losses, the failure of a joint venture partner to abide by its contractual obligations or articles of associ-

<sup>182</sup> JVITL, *supra*, footnote 136, arts. 5,6.

<sup>183</sup> *Ibid.*, arts. 9,11,12,14; JVITR, *supra*, footnote 57, arts. 28,29.

<sup>184</sup> Simon, *loc. cit.*, footnote 135, at p. 549.

<sup>185</sup> JVITR, *supra*, footnote 57, art. 34.

<sup>186</sup> JVL, *supra*, footnote 3, art. 12; JVL Regs., *supra*, footnote 28, arts. 100,101.

<sup>187</sup> See, *supra*, footnote 8. Article 100 of the more recent JVL Regulations provide for projects of up to thirty years; and these may be extended even further.

<sup>188</sup> JVL, *supra*, footnote 3, art. 4.

ation, "force majeure", inability to obtain desired objectives and to maintain future development, occurrence of reasons for dissolution stipulated in the joint venture contract and/or articles of association. Such termination is subject to FICC approval. Where losses have been incurred through a breach of contract by a joint venture partner, the partner will be held financially responsible for the losses.<sup>189</sup> Investors should enumerate in the joint contract or articles of association situations that will permit early termination or renegotiation of the agreement. It is possible, for example, that changes in the rapidly evolving PRC legal framework will impinge on the economic viability of the joint venture entity to such an extent that it will no longer be profitable for one or both partners concerned.<sup>190</sup> Furthermore, terms such as "force majeure" and "heavy losses" should be clearly defined. The inclusion of "force majeure" as a basis for termination is an anomaly and evidently a concession to foreign investors. The Chinese do not recognize "acts of God" as falling within "force majeure"; the term "acts of nature" will achieve the same objective. While it is probable that a strike by a third party supplier will be recognized as a "force majeure", a strike within the joint venture plant does not fall under this rubric in the PRC; this should thus be provided for in the joint venture contract.<sup>191</sup>

The JVL provide that upon dissolution of the joint venture, the board of directors shall work out procedures and principles for liquidation, and shall nominate candidates for the liquidation committee.<sup>192</sup> Although the latter can best be left out of the initial agreement, investors would be well advised to make provision for the former in the articles of association or joint venture contract. This will ensure that the investor will be adequately compensated and be permitted to repatriate his capital investment. There are a number of issues that must be addressed in this regard. Firstly, the method and formulae of assessment of the joint venture value should be delineated.<sup>193</sup> Whether the PRC will recognize the "going concern" value of the joint venture or the "goodwill" is of paramount importance to investors where the joint venture has become a profitable enterprise; it will be even more important where the joint venture has been successful in marketing its goods overseas. If such matters do not enter into the final accounting, then investors should reassess their yield

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<sup>189</sup> See, generally, JVL, *ibid.*, art. 13; JVL Regs. *supra*, footnote 28, art. 102. The board of directors must make a separate application for dissolution.

<sup>190</sup> Cohen, *loc. cit.*, footnote 9, at p. 28.

<sup>191</sup> On "force majeure" see S.S. Surrey, Trade and Economic Relations with the PRC: Recent Developments (1980), 14 Int. Lawy. 15, at p. 20.

<sup>192</sup> JVL Regs., *supra*, footnote 28, art. 103.

<sup>193</sup> Cohen, *loc. cit.*, footnote 9, at p. 28. *E.g.* whether auditors or specialists should be involved in this assessment.

expectations during the lifetime of the joint venture.<sup>194</sup> Secondly, repatriation of profits should be dealt with. The JVL permits capital funds realized on dissolution to be repatriated; this, however, must be done through the Bank of China, and is subject to compliance with the ECR. Although the ECR impose a fifty per cent ceiling on the remittance of earnings of foreign employees of joint venture enterprises, no limit is imposed on the amount that may be remitted by joint ventures on winding up their operations. The Regulations only specify that winding up must be in accord with legal procedures, that taxes and liabilities must be paid, and that the winding up is subject to the joint supervision of the relevant government authorities and the SAEC.<sup>195</sup> These are presumably preconditions that must be complied with before capital realized on winding up may be remitted. The supervisory authority entrusted to the Chinese local authorities may slow down the repatriation process. Consideration should thus be given to the inclusion of a maximum time period or "reasonable-ness" clause in the joint venture contract to limit such delays. Further, whether the joint venture capital remitted on dissolution is subject to the ten per cent remittance tax imposed under the JVITL is not clear.<sup>196</sup> The JVITL imposes the remittance tax on the foreign joint venture partner's "share of the profit". The JVL clarify that the value added to the joint venture's net assets or property that exceeds required capital will be regarded as profit and taxes will be levied accordingly.<sup>197</sup>

#### L. Dispute Resolution

Disputes may arise either between the parties to the joint venture, or between the joint venture and third parties, for example, enterprises, labour, suppliers and the Chinese government. The process for dispute settlement in China is a topic worthy of treatment in a separate article; all that can be done here is to alert investors to some of the difficulties and the nature of dispute settlement in the PRC.<sup>198</sup> It should however be remembered that the Chinese perceive dispute settlement through the courts as a last resort when all other avenues have been exhausted.<sup>199</sup>

<sup>194</sup> Note that while the Regulations provide that valuation must occur, they do not address the going concern issue.

<sup>195</sup> JVL, *supra*, footnote 3, art. 10; ECR, *supra*, footnote 112, arts. 25, 26.

<sup>196</sup> JVITL, *supra*, footnote 136, art. 4.

<sup>197</sup> JVL Regs., *supra*, footnote 28, art. 106.

<sup>198</sup> For a more extensive treatment see: T.J. Klitgaard, PRC Joint Venture Dispute Resolution Proceedings (1982), 1 UCLA Pac. Bas. L.J. 1; L. Petit, Dispute Resolution in the PRC (1984), 39 Arb. J. 3; S.L. Ellis, L. Shea, Foreign Commercial Dispute Settlement in the PRC (1980), 6 Int. Tr. L. J. 115; J.K. Lockett, *loc. cit.*, footnote 40; Note, Foreign Investment in the PRC: Compensation Trade, Joint Ventures, Industrial Property Protection, and Dispute Settlement (1980), 10 G. J. Int'l. & Comp. L. 233, at pp. 259-270.

<sup>199</sup> The Chinese find resort to the courts and formal proceedings distasteful; Bosco, *loc. cit.*, footnote 4, at p. 236.

Even in the People's Court system, applicants must first try to resolve their disagreements amongst themselves before applying to the courts for redress. The Chinese custom is to avoid the western adversarial approach and favours negotiation, conciliation and arbitration.

### (1) *Disputes Between Joint Venture Parties*

Many Chinese considered the express recognition in the JVL that disputes might not be resolved internally through the consensus mechanism a revolutionary step. The legislation provides that where disputes arise between joint venture parties that can not be resolved through consultation, then resort may be had to one of the established Chinese arbitral bodies or to an arbitral body agreed upon by the parties in the joint venture contract or articles of association.<sup>200</sup> This liberal approach permitting arbitration within or outside of China has been welcomed by foreign investors; and increasingly, joint ventures are designating a foreign arbitral body.<sup>201</sup> Parties must first try to resolve their dispute through friendly discussion, conciliation or negotiation before proceeding to arbitration. Conciliation may be carried out by the Foreign Economic Trade Arbitration Commission (FETAC) in China, or under the UNCITRAL, or International Chamber of Commerce Rules.<sup>202</sup> If conciliation fails then parties can proceed to arbitration.

The substantive law governing arbitration insofar as disputes between joint venture parties are concerned, appears to be Chinese law.<sup>203</sup> It may be possible for joint venture parties to stipulate that another system of law apply; it is however, unlikely that the Chinese will agree to this *vis à vis* third parties in China. Resort to an international tribunal for joint venture disputes may be less offensive.

The two arbitral tribunals in the PRC are (FETAC) and the Maritime Arbitration Commission (MAC). Both are organized under the auspices of the China Council for the Promotion of International Trade (CCPIT). The choice of arbitral tribunal and rules will substantially affect the procedural rights of the parties and may significantly affect the outcome of the dispute. For example, decisions of FETAC, China's main arbitral body, are final; there is no possibility of appeal.<sup>204</sup> Most of China's

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<sup>200</sup> JVL, *supra*, footnote 3, art. 14; JVL Regs., *supra*, footnote 28, art. 109.

<sup>201</sup> Pattison, *loc. cit.*, footnote 52, at p. 137.

<sup>202</sup> Klitgaard, *loc. cit.*, footnote 198.

<sup>203</sup> Klitgaard, *ibid.* Article 2 of the JVL, *supra*, footnote 3, provides that all activities of the joint venture shall be governed by the "laws, decrees, and pertinent rules of the PRC". Whether this applies to disputes between joint ventures and third parties is unclear.

<sup>204</sup> F. de Bauw, D. Dewit, *Gaps in Arbitration Rules* (1983), 21 *China Tr. Rep.* (July) at pp. 6-7. The Chinese Code of Civil Procedure, article 192, provides that disputes arising from foreign economic trade, transportation and maritime affairs are not to be prosecuted in the People's Courts if they are to be arbitrated by a PRC foreign affairs

arbitration officials are civil servants who have ties to Chinese foreign trade corporations and MOFERT. It has been suggested that possible bias on the part of FETAC officials makes it a less attractive tribunal to resort to than other foreign tribunals.<sup>205</sup> This sentiment has been reinforced by the requirement that Chinese counsel must be retained by foreign parties,<sup>206</sup> and that the arbitration will be held in Chinese and in accordance with Chinese procedures. An award made by FETAC has the force of law in China. Failure to comply with the award permits the aggrieved party to petition the court to enforce the award in accordance with Chinese law, though the exact remedy is unclear.<sup>207</sup>

Major international arbitral systems and rules include the UNCITRAL rules, the Stockholm Chamber of Commerce, the Court of Arbitration of the International Chamber of Commerce, the American Arbitration Association, and the London Court of Arbitration. Any one of these would provide a suitable forum for arbitration outside of China. The Chinese have on numerous occasions agreed to submit to these systems.<sup>208</sup> The PRC has not signed the United Nations Convention for the Recognition and Enforcement of Arbitral Awards. Thus enforcement of foreign arbitral awards hinges on treaties or agreements with other nations to enforce such awards. The PRC has entered into such agreements with, *inter alios*, Japan, Sweden and the United States.

## (2) *Disputes Between Joint Ventures and Third Parties*

The JVL and its attendant legislation does not deal with disputes that arise between the joint venture and third parties. In 1979 the PRC established an extensive system of special Economic Tribunals in the People's Courts. Foreign enterprises may appear in the Economic Courts either as plaintiffs or defendants. These courts are intended to address issues such as insurance claims, delivery delays and product defects; illegal acts of foreign companies or employees may be subject to the jurisdiction.<sup>209</sup> The

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arbitration organ pursuant to a written agreement between the parties concerned. Those without a written agreement may proceed to the People's Courts. It has been suggested that the right to appeal may not be as important or useful to foreigners as might be supposed in the first instance. As opposed to being fora for determining guilt, according to some commentators, the courts are primarily fora for imposing punishment; Allen, Palay, *loc. cit.*, footnote 22, at p. 48. Moreover in light of the Chinese predilection for arbitration settlements, foreign litigants may well not be positively received, and are likely to be seen as overstepping the bounds of Chinese tolerance.

<sup>205</sup> F. de Bauw, D. Dewitt, *ibid.*

<sup>206</sup> See, *supra*, text accompanying footnotes 16-22.

<sup>207</sup> Klitgaard, *loc. cit.*, footnote 198, at p. 31.

<sup>208</sup> *Ibid.* For a discussion of the arbitration systems referred to see: *ibid.*, at pp. 14-31; Lockett, *loc. cit.*, footnote 40, at pp. 246-254; F.C. Ingriselli, International Dispute Resolution and the People's Republic of China (1984), 12 Int. Bus. Lawy. 376.

<sup>209</sup> Allen, Palay, *loc. cit.*, footnote 22, at p. 44.

JVLLMR specifically refer labour disputes to the People's Courts after mediation, consultation and arbitration have failed.<sup>210</sup>

Problems with suppliers are likely to be resolved through the courts. Domestic economic contracts are governed by the New Economic Law (ECL) while contractual relations between the Chinese and foreign parties will be governed by the recently enacted Foreign Economic Contract Law (FECL).<sup>211</sup> The enactment of the FECL is one of the most significant legislative developments in China since the enactment of the JVL itself. Given the lack of an underlying legal system, the FECL provides joint venture parties with the framework to govern their contract formation, contract performance, and contract interpretation. Contracts are to be made in writing; and under article 10, contracts concluded by means of deception or coercion are invalid. The FECL embodies the concept of "equality and mutual benefit". This is apparent from the dispute settlement provisions and the statement that "when both parties violate a contract, they should both share the responsibility". The FECL does not make Chinese arbitration mandatory. It encourages conciliation, and where that has been unsuccessful or has proved to be unpractical then resort may be had to arbitration. The FECL provides that the case should be submitted to a Chinese or other arbitration body in accordance with provision made in the contract; it is also envisaged that where the contract fails to provide for arbitration that the parties will agree at the time of the dispute to an arbitration procedure. This may prove to be difficult if there is a fundamental disagreement between the parties. Where the parties cannot agree then resort may be had to the People's Courts. Article 20 provides for liquidated damages for non-performance. Where no choice of law clause is inserted in the contract, the law of the country most closely related to the contract will apply. At the same time, parties contracting within the boundaries of the PRC are subject to its laws. The FECL does not apply to international transport contracts.

It is not unforeseeable that disputes will arise between the government and a joint venture. Traditionally, such disputes are resolved through

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<sup>210</sup> JVLLMR, *supra*, footnote 81, art. 14.

<sup>211</sup> Arts. 2,48,49,50. The ECL went into effect on July 1, 1982. It is reproduced (1983), 22 I.L.M. 330. The FECL, effective July 1, 1985 is reproduced (1985), 24 I.L.M. 799.

<sup>212</sup> It is possible to interpret article 55, which provides that regulations governing foreign economic and trade contracts will be formulated separately with reference to the Economic Law and international law, as excluding the application of the ECL to dealings with foreign enterprises including joint ventures. Klitgaard, *loc. cit.*, footnote 198, at p. 36, suggests that the ECL applies to any dealings between foreign enterprises or joint ventures and domestic enterprises; but *contra*, A. Dicks, Legal Opinion (1982), 20 China Tr. Rep. (March) 13.

<sup>213</sup> ECL, *supra*, footnote 210, art. 56.

<sup>214</sup> *Ibid.*, arts. 9 *et seq.*

negotiation. Presently it is not possible to bring an action against the government in the courts; further, it is highly unlikely that the government will submit to arbitration.<sup>215</sup>

Parties are thus well advised to make express provision for dispute resolution for all circumstances, bearing in mind that in all instances the long standing Chinese preference to avoid litigation prevails, and parties must first have resort to the other dispute resolution mechanisms before they may initiate court proceedings.<sup>216</sup> It may be advantageous to negotiate different adjudication procedures for varying circumstances. It may be wise to compromise and to make some disputes subject to Chinese law or arbitration procedures, and others subject to an independent arbitral tribunal outside of the PRC. The latter may be particularly appropriate where disputes arise regarding such matters as the division of assets on termination of the joint venture, transfer of technology, or expansion, while domestic disputes may be best kept within the PRC.

#### M. Protection of the Joint Venture

The level of protection that will be afforded to the business venture is, of course, key to the decision whether or not to proceed with a joint venture. Concerns about protection range from the right to repatriate profits to the safeguards afforded by the legal framework to fears of political upheaval. Whether or not the JVL and its attendant legislation provides adequate reliability, security and predictability is questionable. Certainly the rudimentary protections afforded by the JVL are insufficient to banish the fears of apprehensive investors. There is a great deal left to negotiation against a legal framework that is in many instances unfinished and lacking in precision.

The JVL itself provides that the resources invested by a foreign investor, the "profits due to him pursuant to agreements, contracts and articles of association" authorized by the Chinese government, and "his other lawful rights and interests" are all protected by the Chinese government; and it further states that the joint venture is governed by the "laws, decrees, and pertinent rules of the PRC".<sup>217</sup> Similarly, the JVRR provide that once a licence has been granted to the joint venture, its "legitimate production and business" is protected by the law of the PRC.<sup>218</sup> What a joint venture's "lawful rights and interests" are, and what "legitimate production and business" are, have not been defined.<sup>219</sup>

<sup>215</sup> Klitgaard, *loc. cit.*, footnote 198, at pp. 38-39.

<sup>216</sup> *Ibid.*; ECL, *supra*, footnote 210, art. 50.

<sup>217</sup> JVL, *supra*, footnote 3, art. 2.

<sup>218</sup> JVRR, *supra*, footnote 36, art. 5.

<sup>219</sup> For a discussion of the legal status of the joint venture, see, T. Hoasen Wan, A Comparative Study of Foreign Investment in Taiwan and China (1981), 11 Cal. W. Int. L.J. 236, at pp. 262-264.

Concerns have been raised with respect to possible conflict between the joint venture contract and articles of association, and the laws and regulations of the PCR. It would appear from the legislation that in the event of such a conflict Chinese laws will prevail. However, often the law is ambiguous, or marked by large lacunae. It is possible to resolve these gaps and interpretation problems through clarification in the joint venture contract or articles of association. Even though this is a plausible solution, it must be tempered with the realization that the relevant Chinese ministry or department responsible for the promulgation of the legislation usually reserves to itself the right of interpretation. And thus despite careful drafting of the joint venture articles or contract, such assurances may not be watertight. It is advantageous for joint venture parties to stipulate that in the event of such a conflict the joint venture contract prevail or compensation be awarded. If such a provision obtains the approval of the FICC, it may at least afford some degree of protection. The provision of a transitional tax period for joint ventures already operating when the tax laws and regulations were enacted can be taken as a positive indication that the PRC is unlikely to initiate unilateral changes without taking into consideration the situation of already existing joint venture operations. Moreover, the sudden and arbitrary imposition of new laws and regulations appears unlikely in view of the PRC's current practice to consult with western states in many instances prior to the enactment of new legislation.<sup>220</sup>

A caveat must be raised with regard to the PRC's pre-existing laws and the secrecy that shrouds much of its legal framework. It is one thing to require that a joint venture abide by the laws when such laws and Regulations are public knowledge, but where the laws and their application are not made public, then the task of abiding by the law becomes a formidable one. Fears have been put forward that the inaccessibility of laws, decrees and regulations may provide the potential for abuse. In particular, it has been suggested that in negotiations and operations this may permit the Chinese joint venture party to assert without just cause that a proposed course of action contravenes the law and thus should not be pursued.<sup>221</sup> Moreover, as has been noted with respect to the application of pre-existing tax laws, the interrelationship and priority between laws in China is still an enigma.

A positive sign for investors has been the recognition in the 1982 Constitution of foreign investment in the economic structure; this has been buttressed most recently by China's new economic policy statements.<sup>222</sup>

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<sup>220</sup> Prior to the enactment of the JVL China's officials attended a special seminar at Harvard University. Consultations were also held with Japanese investors.

<sup>221</sup> Torbett, Thomson, *loc. cit.*, footnote 41, at p. 849. These authors cite cases where this has indeed occurred.

<sup>222</sup> See *supra*, footnotes 8,7 and 12.



Although the general principles elaborated do not grant foreign enterprises specific rights, they constitute a reaffirmation of the PRC's stated policy to integrate private foreign commercial enterprises into the economy. No constitution since the 1949 Common Program has gone so far as to endow "foreign trade (let alone investment) with the respectability of being an integral part of the national economy".<sup>223</sup>

A further concern that has been raised repeatedly is that of political upheaval. In view of the many internal political upheavals in China since the inception of the People's Republic of China in 1949 such reservations are raised with just cause. Expropriation and nationalization are concerns that may be allayed by taking out political risk insurance. The availability of such insurance in China through the PICC has been seen by some commentators as a sign from the Chinese to reassure foreign investors. Similarly JVL provisions requiring a party causing a unilateral termination of the joint venture to bear the costs thereof have been interpreted as meaning that the Chinese would by law be required to bear the financial burden in such instances.<sup>224</sup> This is questionable since it is unlikely that a joint venture contract will guarantee against expropriation by the state. Further there is no requirement that the joint venture be concluded only with state authorities; and with the on-going decentralization and promotion of Chinese style "free-enterprise", this is even less likely. The Chinese have not denied that expropriation is possible; they have insisted that compensation will be paid.

All of the above concerns must be counterbalanced by the stated and evident desire of the PRC to modernize with western technology and capital. The Chinese leadership is well aware that it must provide a stable investment environment to attract the large capital inflows that it seeks. It is also cognizant that the external business community is meticulously watching its every move. Ultimately the PRC's knowledge that a failure to honour its promises and commitments will strongly deter, if not stop, other investors, may be the best guarantee that the business community can have that China is likely to keep its promises.

#### N. China's Bureaucracy

In terminating this overview of the JVL and its associated legislation and regulations it is appropriate to make a few comments on the inherently bureaucratic nature of China's foreign trade framework.<sup>225</sup> Foreign

<sup>223</sup> Dicks, Legal Opinion (1982), 20 China Tr. Rep. (June) 11. Dicks notes: "... for a country based on Marxist principles, the legal definition of the economic structure is a theoretical statement of the highest importance".

<sup>224</sup> Note, *loc. cit.*, footnote 198, at p. 246.

<sup>225</sup> For a discussion of China's bureaucracy see Alford, Birenbaum, *loc. cit.*, footnote 14, at pp. 82-84; Oksenberg, *loc. cit.*, footnote 9; M. Weil, Technology Transfer (1981), 9 China Bus. Rev. (March-April) 24.

investors will continually be faced with and frustrated by the seemingly impenetrable barrier presented by the plethora of branches and offices of an endless number of government departments, divisions and levels. There is a noticeable lack of coordination between various government departments and authorities. Joint venture contracts on the verge of being completed have been halted at the last minute because basic requirements such as power or water are not available.<sup>226</sup> In light of the ongoing decentralization of China's bureaucracy, and the ensuing devolution of new responsibilities on officials unaccustomed to, and in many instances uncomfortable with new authority, this problem is likely to get worse before it gets better.<sup>227</sup> At the same time investors should not be overly discouraged by this phenomena. Bureaucracy is a fact, if not a way, of life in China, and investors must make adjustments accordingly if they wish to be successful in their business operations in the PRC. Expectations of overnight success or of questions answered immediately should be abandoned. Such attitudes will only serve to reinforce the initial Chinese distrust of the West and will lead to difficult negotiations with marginal results.

To facilitate negotiations and business relations, investors should become familiar with the PRC's trade structure<sup>228</sup> and objectives before embarking on comprehensive negotiations. Investors should be aware of what is sought from them, and what they can reasonably expect from their Chinese counterparts. They must also be prepared for long and intense negotiations. The Chinese recognize that they require foreign investment for their ambitious modernization plan and in most instances will be willing to bend or circumvent the rules if they can be given good reasons to do so and if such reasons are consistent with the principles of "equality and mutual benefit".

A legitimate area of concern is the large number of matters that are subject to approval by local government authorities and the discretionary decision making power entrusted to such officials. These include the FICC approval in the first instance, registration approval, labour regulations, amendments and significant changes to joint venture operations, foreign exchange and banking approvals. As well, the discretionary decision making power found within the tax framework regarding costs, expenses and losses, and penalties to be imposed for violations, should concern investors.

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<sup>226</sup> Lew, *loc. cit.*, footnote 12, at pp. 1709, 1711.

<sup>227</sup> Oksenberg, *loc. cit.*, footnote 9; Ludlow, *loc. cit.*, footnote 34. For a candid acknowledgment of this dilemma see, Yuangchun, *loc. cit.*, footnote 62.

<sup>228</sup> See Wan, *loc. cit.*, footnote 219, at pp. 265-266 for a brief outline of the trade structure.

<sup>229</sup> *Supra*, footnote 116.

It appears however, that almost everything in the PRC is negotiable, and in many instances problems and interpretation difficulties can be avoided by including clear and detailed provisions in the joint venture contract. Joint venture investors will have to take a pragmatic approach and bring a large dose of patience to the bargaining table to conclude a successful joint venture agreement.

### *Conclusion*

Advising on any potential investment in China is a formidable task. By way of conclusion some of the most obvious matters that must be borne in mind may be summarized.

Firstly, the investor must understand the legal regime established by the JVL and its attendant laws and regulations. The Chinese leadership has since enactment of the JVL in 1979, diligently promulgated further legislation to expand and supplement the joint venture law. Unfortunately these laws and regulations raise as many questions as they answer. Difficulties stem from a failure on the part of the PRC to clearly delineate criteria for decision making, and from ambiguities in the legislation. Problems include a failure to specify criteria for the initial approval of the joint venture, the lack of definition of the term "up-to-date" technology, the broad reach of the "equality and mutual benefit" principle, the incomplete knowledge about the legal framework that supports JVL, the ambiguities in the income tax deductions, the interaction between the various tax laws, and the difficulties surrounding permitted remittances, especially within the context of termination. It is to be hoped that with time, practice and patience many of these obstacles will be resolved, or further legislation will be enacted. In large measure, indeed, the PRC has, in comparative terms, been promulgating this legislation in a legal vacuum. The underlying legal infrastructure that is taken for granted and relied on in other countries is noticeably lacking. It is inevitable therefore that new laws and regulations will continue to emerge and may substantially affect joint venture operations. In view of the PRC leadership's stated and evident desire to modernize with external investment and technology, it is likely that such changes will not be highly disruptive for joint ventures, and will serve to improve and clarify investment terms and conditions. Welcome additions in this regard will be transfer of technology legislation, a copyright law, a corporations law and bankruptcy legislation.

Another challenge facing investors is understanding the PRC's bureaucratic decision making processes and the foreign trade structure. The legislation enacted gives a great deal of discretion to government authorities. The PRC has repeatedly affirmed that it is decentralizing in order to place greater decision making authority at lower levels and to accelerate the decision making process. This may initially cause near chaos in a system unaccustomed to such a delegation of authority, but will ulti-

mately serve the interests of the investor by providing a more efficient system. With such decentralization it is to be hoped that joint venture investment will be facilitated and that some of the administrative hurdles that presently exist will disappear.

Despite decentralization, the fact that China is a socialist state and has a centrally planned economy should not be ignored. The essential nature of the PRC's economy is not likely to change in the immediate future and thus bureaucratic or government intervention is still likely to be inevitable. A foreign investor may to some extent be buffered from supply disruptions or unilateral pricing policy changes by the anticipated economic contract law and through careful negotiation of its joint venture contract; the risk, however, still remains. Similarly the possibility of political upheaval or a policy reversal rejecting foreign investment outright is conceivable. In the existing political climate it appears unlikely, but it is a risk that must be acknowledged by every investor and be considered when tallying the advantages and disadvantages of investing in the PRC.

The comments above reflect the western approach to business and law where everything is to be spelled out in "black and white". It also reflects the investors desire for reliability, security and predictability. The Chinese have obviously presented the investor with a compromise by providing that much of the legislation is subject to Chinese discretion and interpretation, while at the same time making it evident that they are willing to negotiate, and that matters can be resolved through the joint venture contract or articles of association. Through this approach the Chinese have ensured that the greater part of the decision making authority rests with them. The PRC has moreover made it evident that joint venture investment is not a "right" that can be asserted in and of itself. The joint venture legislation reaffirms the Chinese philosophy of self-reliance, which, although relegated to a secondary position in the Chinese drive to modernize, is still considered very important. The PRC does not intend to find itself at the mercy of foreign investors and clearly seeks to retain the upper hand in its development program.

As with every challenge there is a reward for those who persevere. Within the Chinese context the reward will consist not only of a profitable and viable joint venture operation and proximity to South East Asia markets but also of access to the expanding Chinese domestic market. Were it not for the latter incentive, joint venture investment in China could be compared to similar investment in other developing countries, and might even be considered inferior in light of the embryonic development of its joint venture investment program and its attendant legal framework. Recent government initiatives and changes in economic policy seem to indicate that the Chinese market is becoming a reality. And thus careful and considered negotiation today will indeed bring profits tomorrow.