

LAW FOR FOREIGN BUSINESS AND INVESTMENT IN CHINA

Vai lo Lo and Xiaowen Tian

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Preface

With China's accelerated economic reforms and accession to the World Trade Organization (WTO), foreign investors are finding it increasingly necessary to understand the regulatory environment of this potentially huge market. To provide a handy reference, we wrote *Law and Investment in China: The Legal and Business Environments after WTO Accession* in 2004. Although *Law and Investment in China* has been well received, legislative changes impacting on foreign direct investment in China in the past three years make it judicious to publish a revised and expanded version. By incorporating the most relevant legislative amendments and enactments since the end of 2004, adding new court decisions to elucidate complicated legal concepts, and explaining China's latest foreign trade and investment policies, this book is designed to provide an overview of the most up-to-date legal framework of doing business in China. The intended readers are law students, business students, students majoring in Chinese studies, lawyers practicing international transactions, expatriates from foreign countries, and management consultants.

This book is organized from the general to the specific. It commences with an overview of China's current legal system. Chapters 2 and 3 examine the legal framework of business entities in China, including both domestic and foreign investment enterprises. Chapters 4 to 9 cover substantive areas of law on business operations, including contracts, intellectual property, labor and employment, consumer protection, taxation, banking, securities, and dispute resolution. The closing chapter, Chapter 10, discusses China's latest foreign trade and investment policies. In its entirety, this book provides readers with a basic understanding of the pertinent issues on foreign direct investment in China. However, the material on each topic can also stand on its own, and the basic knowledge of a specific area of law may be obtained by focusing on the relevant chapter. For readers who are interested in having a convenient list of Chinese terms used in the book, a glossary of Chinese terms is inserted at the end.

Since China has carried out legal reforms for only three decades, its regulatory environment is relatively dynamic because new laws and regulations are frequently enacted while existing ones are often amended or repealed. Moreover, China is a large country with diverse physical, economic, and social circumstances. Accordingly, the Chinese central government enacts laws, regulations, and rules that are applicable nationwide, whereas local authorities implement them by

enacting local regulations, or when there are no national laws or regulations dealing with certain issues, enact local regulations to address important concerns. Taking page limit and manageability into consideration, this book discusses mainly laws, administrative regulations, and government rules that have general applicability. When foreign investors make business decisions, they must also consult local regulations and industry-specific laws, regulations, or rules.

In preparing the case materials for this book, we have employed both translation and editing. Therefore, the court decisions discussed in this book are not verbatim opinions actually written by Chinese judges. Almost all of the original opinions of these cases in Chinese can be accessed on the respective Web sites of the courts, www.bjgychinacourt.org, or www.chinacourt.org. To facilitate reading, we report each case by following this format: “Heading,” “Facts,” “Reasoning,” and “Judgment” or “Ruling.” The “Heading” section contains the names of the parties, the docket number of the case, the name of the court that delivered the judgment, and the date when the opinion was issued. The “Facts” section provides the pertinent factual background and discusses the lower court’s decision rendered in the case. The “Reasoning” section explains the basis on which the court has reached the judgment or ruling. The “Judgment” or “Ruling” section provides a summary of the court’s judgment or ruling, namely, what the court decision is.

Given China’s complicated regulatory framework of foreign direct investment, our objective here is to present the most relevant information in a concise and accessible manner. Readers who are interested in studying more in-depth legal analyses or wish to know how legal theories have been put into practice may consult the books or articles cited in the Further Reading section of each chapter. We hope that readers will find this book useful as well as informative.

Furthermore, we would like to express our gratitude to Gabriel Law for his dedicated assistance with the translation of the court decisions and to Routledge editorial staff for their meticulous efforts in turning our manuscript into a book.

Dr Vai Io Lo
Dr Xiowen Tian
January 2008

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1 An overview of the Chinese legal system

In December 2001, China acceded to the World Trade Organization (WTO). This event is significant not only for the Chinese, but also for foreign investors who want to establish a presence in China. It is expected that China's entry into the WTO will result in trade liberalization, and, thus, increased investment opportunities for foreign investors. To enter the Chinese market, foreign investors must understand the legal and business environments in which they will operate. Accordingly, this book aims to introduce the legal framework of conducting business in China, with emphasis on business entities, investment vehicles, contracts, intellectual property, labor and employment, consumer protection, tax considerations, securities, banking, and dispute resolution. Before delving into specific issues, however, it is imperative to have an overview of the Chinese legal system.

The Chinese legal system from 1949–78

To understand the present, one must know the past. Having defeated the Kuomintang (国民党), who subsequently fled to Taiwan, the Chinese Communist Party (共产党) (the Party) established the People's Republic of China in 1949. At the outset, the new regime abolished Kuomintang's legal system, which was considered to have supported "semi-feudal" or "semi-colonial" rule. Thereafter, it removed most of the judges who had been appointed by the Kuomintang government. In addition, the Party initiated several mass campaigns, such as the Land Reform Movement and the Movement against "Three Evils,"¹ to prepare the masses for a new political order. During those campaigns, "mass trials" were conducted to try the "enemies"² before assembled crowds. In terms of formal legal norms, only a handful of laws were enacted during this period, such as the Marriage Law, the Trade Union Law, and the Land Reform Law. Meanwhile, the government under the leadership of the Party carried out nationalization and collectivization measures. Consequently, large private industrial and commercial establishments were converted into state-owned enterprises, while medium-sized and small industrial and commercial concerns were grouped together to become collectives.

As China followed the Soviet Union in adopting a command economy, efforts were also undertaken to develop a legal system based on the Soviet model. From 1953, the government launched several legislative projects with the help of Soviet

2 *An overview of the Chinese legal system*

jurists. As a result, the first Constitution was promulgated in 1954, followed by laws relating to the state structure. The drafting of a criminal code, civil code, and criminal procedure code was also begun. Moreover, legal institutions were strengthened. For example, the concept of judicial independence was introduced, and law schools were set up to train judges and lawyers. Nevertheless, the efforts in constructing a socialist legal system did not last long. From the mid-1950s, a series of political events in China and the Maoist ideology in great measure immobilized the construction of a legal system.

In 1956, the Party launched the Hundred Flowers Movement, encouraging people to express views and criticisms. In response, many people spoke out and criticized the Party. Thereafter, the Party launched the Anti-Rightist Campaign to purge its critics. Hundreds of people, especially lawyers and judges who had been quite outspoken, were sentenced to “re-education through labor” (劳改) without any formal court proceedings. These two mass campaigns triggered the weakening of legal institutions. For instance, lawyers stopped practicing law, and law schools were switched to teach politics.

Furthermore, according to Mao Zedong (Mao), there were two basic types of social contradictions – “contradictions among the people” and “contradictions against the people.” Simply stated, “contradictions among the people” were day-to-day conflicts among ordinary people, whereas “contradictions against the people” were conflicts between the people and the enemies. To resolve conflicts among ordinary citizens, education and persuasion through mediation was the preferred means. To resolve conflicts between the people and the enemies, legal institutions, such as formal trial proceedings, were employed. Since the majority of conflicts were among the people, the construction of a legal system was not an exigency. Although the drafting of the Criminal and Criminal Procedure Codes was resumed in the early 1960s, laws and legal institutions were relegated to oblivion during the subsequent Cultural Revolution.

The notorious Cultural Revolution began in 1966, when Mao launched a mass campaign to purge counter-revolutionaries, revisionists, and “people on the capitalist road” with the assistance of the Red Guards, who consisted mainly of students and young people. Numerous people were persecuted, factories were closed down, and political meetings were the order of the day. Many contemporary scholars and commentators view the Cultural Revolution as a power struggle between the pragmatists and the radicals in the Party. Whatever the real cause, law was denounced as a legacy of capitalism and a restraint on the revolutionary masses. As a result, law schools were closed down, lawyers were persecuted, and courts were combined with public-security bureaus under military control. With the abolition of legal institutions, “politics was in command.” After Mao died in September 1976, the Gang of Four (the leading radicals in the Party) was arrested and put on trial. The downfall of the Gang of Four led to the demise of the Cultural Revolution. As the Cultural Revolution ended, the country faced the urgent tasks of enacting legal norms and restoring legal institutions.

Economic and legal reforms in the late 1970s and early 1980s

During the Cultural Revolution, political struggles put the country's economic and legal developments completely on hold. In the late 1970s, the new leadership headed by Deng Xiaoping decided to modernize the country's industry, agriculture, national defense, and science and technology. Toward this end, China implemented economic reforms and opened its door to the outside world.

Economic reforms commenced with the decollectivization of agricultural production. Prior to 1979, agricultural production in China was collective. The agricultural hierarchy consisted of communes, brigades, production teams, and individual households. Farming households were to complete production orders from their production teams. In return, the team leader would give farming households grains and other coupons. Farming households could also keep a small portion of their produce for consumption. At the end of the 1970s, the household responsibility system was implemented. This system allowed farming households to contract with their production teams. Once they had fulfilled the agreed-upon quotas of production, they could keep whatever was left. In addition, they were allowed to engage in sideline production or planting cash crops. Consequently, farming households became much more productive, and their income substantially increased.

Owing to the success of the household responsibility system, the leadership decided to implement economic reforms in industrial production. As mentioned above, China had adopted a command economy. In this kind of economy, the central government promulgated five-year plans and made annual economic decisions, on the basis of which regional authorities formulated their respective economic programs. Moreover, production from state-owned enterprises was under the supervision of their respective departments-in-charge, and their economic performance was evaluated in terms of output rather than profit. Since the state routinely meted out subsidies to loss-making enterprises, many state-owned enterprises suffered from inefficiency and low productivity. Hence, in the early 1980s, the central government decentralized economic decision-making. Local governments and enterprises were given more autonomy to make economic and production decisions. In addition, enterprise directors became accountable for profits and losses.

To attract foreign capital, technology, and management expertise, China passed its first foreign investment law, the Law on Sino-Foreign Equity Joint Ventures, in 1979. Moreover, the government established four Special Economic Zones (SEZs) – Shenzhen, Zhuhai, Shantou, and Xiamen – where investment incentives, such as preferential tax treatment, were offered to foreign investors. Subsequently, the government designated 14 Open Coastal Cities, such as Dalian, Fuzhou, Guangzhou, Shanghai, Ningbo, Qingdao, and Tianjin, to increase the inflow of foreign capital and technology. This open-door policy encouraged many foreign investors and overseas Chinese from Hong Kong, Macau, and Taiwan to invest in China, and thus, contributed to the country's rapid economic growth. Calculated at the 1978 constant price, China experienced an average annual GDP growth rate of 9.3 percent in the period of 1978–98.³

4 *An overview of the Chinese legal system*

The preceding economic reforms led to the increased complexity of commercial transactions. In particular, the successful absorption of foreign investment depended on an effective legal system in which the rights and interests of foreign investors would be protected. Most importantly, the leaders at that time, many of whom had suffered persecution during the Cultural Revolution, believed that a sound legal system was indispensable to protecting citizens' basic rights and contributing to the country's political and social stability. Hence, efforts were undertaken to rebuild a legal system. For example, the Ministry of Justice was restored in 1979, legal education was revived, and courts were reopened.

This chapter and the remainder of this book introduce the reader to the contemporary Chinese legal system, namely, what has been accomplished in a span of 30 years. In implementing economic and legal reforms, China has taken an incremental approach. That is, without years of accumulated experiences, China has often adopted economic measures and enacted legislation on a trial basis before any full-fledged implementation. For years, scholars and commentators from countries having relatively developed legal systems have criticized the Chinese legal system for various deficiencies, such as ambiguous legal provisions and weak enforcement. Having joined the WTO, China will have to accelerate its efforts in reforming and refining its legal system. Like the study of many other legal systems, our study of Chinese law also commences with the Constitution.

Constitution and state structure

China's Constitution is the fundamental law of the state and has supreme legal authority. Since its establishment in 1949, China has promulgated four Constitutions – 1954, 1975, 1978, and 1982 Constitutions. As of October 2007, the 1982 Constitution, the latest Constitution, had been revised four times.⁴ The Constitution outlines the basic structure of the state by delineating the rights and responsibilities of major government organs. Consequently, the following discussion will first highlight the important provisions of the 1982 Constitution and then introduce the various constituents of the state.

The 1982 Constitution

According to the Preamble of the 1982 Constitution, the basic task of the nation is to concentrate its efforts on “socialist modernization construction” (社会主义现代化建设) along the road of Chinese-style socialism. The Chinese people are to work diligently and self-reliantly; to achieve step-by-step the modernization of the country's industry, agriculture, national defense, and science and technology; and to promote the coordinated development of material civilization, political civilization, and spiritual civilization. Moreover, the five principles of foreign policy consist of:

- 1 mutual respect for sovereignty and territorial integrity;
- 2 mutual non-aggression;

- 3 mutual noninterference with internal affairs;
- 4 equality and mutual benefit; and
- 5 peaceful coexistence in developing diplomatic relations and economic and cultural exchanges with other countries.

Hence, the Preamble outlines the directions the country is to take and the bases on which China will handle foreign affairs.

Chapter One of the Constitution contains general principles. Apparently, the Constitution avows the rule of law because the state upholds the uniformity and dignity of the socialist legal system; all state organs, armed forces, political parties, social organizations, enterprises, and institutions must abide by the Constitution and the law; and no organization or individual is privileged to be above the Constitution or the law. In addition, China is a socialist country because the means of production is owned by the whole people or collectively owned by the working people and land in the city is owned by the state, while land in the rural and suburban areas is owned by collectives. No organization or individual may appropriate, buy, sell, or unlawfully transfer land, but the right to the use of the land, which is referred to as land use right (土地使用权), may be transferred in accordance with the law.

On the economic side, China is to adopt a socialist market economy. Public ownership is the principal component, but diverse forms of ownership may coexist. In fact, the non-public sectors of the economy, such as the individual sector (个体经济) and the private sector (私营经济), are important components of the socialist market economy. Citizens have the inviolable right to lawful private property, and compensation must be made for any expropriation or requisition. Moreover, China permits foreign investment, and the rights and interests of foreign enterprises, foreign economic organizations, and Sino-foreign equity joint ventures are protected under Chinese law.

Chapter Two of the Constitution enunciates the fundamental rights and duties of Chinese citizens. Chinese citizens are equal before the law, and the state respects and protects human rights. The Chinese version of the Bill of Rights includes freedom of speech, of the press, of assembly, of association, of procession, and of demonstration (article 35); freedom of religious belief (article 36); freedom of person (article 37); personal dignity (article 38); no unlawful search of residence (article 39); and freedom and privacy of correspondence (article 40). Nonetheless, these rights are not absolute because the exercise of such rights may not infringe upon the interests of the state, society, and the collective, and upon the lawful freedoms and rights of other citizens (article 51). Chapter Three of the Constitution outlines the structure of the state, which will be discussed in the subsequent sections of this chapter.

In comparing the Chinese Constitution with those of the USA and the Soviet Union, Professor Jones makes the following observations.⁵ First of all, the structures of the US Constitution and the Chinese Constitution are similar. That is, in both Constitutions, the powers of the most important government organs are depicted in general terms, and the government organs (the legislative, the executive, and