

## COMMENT

### EQUITY JOINT VENTURES IN THE PEOPLE'S REPUBLIC OF CHINA: THE PROMISED LAND IS NOT YET IN SIGHT FOR FOREIGN INVESTORS

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#### 1. INTRODUCTION

Prior to 1979, the legal system of the People's Republic of China (PRC or China) did not provide any mechanism for foreign investment in China. In fact, the 1978 Constitution seemed expressly to preclude such foreign investment insofar as it described the PRC as "a socialist state of the dictatorship of the proletariat"<sup>1</sup> in which the means of production were under "[s]ocialist ownership by the whole people and socialist collective ownership by the working people."<sup>2</sup> This situation changed July 1, 1979, when the Fifth National People's Congress adopted the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment<sup>3</sup> (JV Law). The JV Law, com-

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<sup>1</sup> The Constitution of the People's Republic of China art. 1, *adopted by* The First Session of the Fifth National People's Congress of the People's Republic of China, March 5, 1978, *reprinted and translated in* 1 LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 2 (Kingsway International Publications Ltd. 1982) [hereinafter P.R.C. Const.]. *See also* O.D. Nee, Jr., *The Forms of Foreign Investment in China*, in 1 COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA Bk. 3, at 1, 2 (1987) [hereinafter Nee 1].

<sup>2</sup> P.R.C. Const., *supra* note 1, art. 5. *See also* Nee 1, *supra* note 1, at 2.

<sup>3</sup> The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, *adopted by* The Second Session of the Fifth National People's Congress, July 1, 1979 *promulgated* July 8, 1979, [hereinafter JV Law], *reprinted and translated in* CHINA LAWS FOR FOREIGN BUSINESS 7,801 (CCH Australia Ltd. 1987) [hereinafter CHINA L. FOR. BUS.].

Additionally, in 1982 the Chinese government amended the Chinese Constitution in order to provide explicit constitutional protection to foreign direct investment in general, and equity joint venture investment in particular. *See* The Constitution of the People's Republic of China, art. 18, *adopted by* The Fifth Session of the Fifth National People's Congress, Dec. 4, 1982, *reprinted and translated in* CHINA L. FOR. BUS. 5,301. The amendment states as follows:

The People's Republic of China permits foreign enterprises, other foreign

monly viewed as no more than enabling legislation,<sup>4</sup> briefly set out in fifteen articles the rules governing the existence of equity joint ventures in the PRC.

The JV Law was enthusiastically greeted by foreign investors worldwide, because it was initially perceived as being the key to gaining access to China's vast natural and human resources, as well as to its immense consumer market.<sup>5</sup> When the anticipated flood of foreign investment failed to materialize,<sup>6</sup> however, it soon became apparent that

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economic organizations and individual foreigners to invest in China and to enter into various forms of economic co-operation with Chinese enterprises and other economic organizations in accordance with the law of the People's Republic of China. All foreign enterprises and other foreign economic organizations in China, as well as joint ventures with Chinese and foreign investment located in China, shall abide by the law of the People's Republic of China. Their lawful rights and interests are protected by the law of the People's Republic of China.

This amendment was intended to allay the fears of foreign investors who believed that without such constitutional protection, the JV Law and the joint ventures established under it could be declared unconstitutional under the 1978 Constitution. See Cohen & Valentine, *Foreign Direct Investment in the People's Republic of China: Progress, Problems, and Proposals*, 1 J. CHINESE L. 161, 168 (1987).

A joint venture possesses three distinctive characteristics, namely, pooled assets, shared profits and losses, and joint management. See Jaslow, *Practical Considerations in Drafting a Joint Venture Agreement with China*, 31 AM. J. COMP. L. 209, 209 n.3 (1983); Klingenberg & Pattison, *Joint Ventures in the People's Republic of China: The New Legal Environment*, 19 VA. J. INT'L L. 807, 813 (1979); Rich, *Joint Ventures in China: The Legal Challenge*, 15 INT'L LAW. 183, 194 (1981). Moreover, a joint venture will generally differ from other forms of business associations insofar as it has equity interests by all the joint venture participants, shared control through a common board of directors, shared utilization of the resources of the joint venture participants, a specific and stated purpose, executive officers who are directly employed by the joint venture entity, and a legal relationship among the joint venturers created and governed by the host country's company or joint venture law. See Swindler, *The New Legal Framework for Joint Ventures in China: Guidelines for Investors*, 16 L. & POL'Y INT'L BUS. 1005, 1017 (1984).

<sup>4</sup> See Cohen, Huang & Nee, *China's New Joint Venture Law*, in A NEW LOOK AT LEGAL ASPECTS OF DOING BUSINESS WITH CHINA 195, 197 (H. Holtzmann & W. Surrey eds. 1979); Brunsvold & Battle, *The Prospects of Joint Ventures in China*, 79 PAT. & TRADEMARK REV. 3, 6 (1981); Hsia & Haun, *China's Joint Venture Law: Part I*, 1 CHINA L. REP. 5, 10 (1980). The JV Law merely provided the statutory foundation upon which the establishment of joint ventures within the PRC could be based. The task of refining and developing a comprehensive body of law to govern the existence of joint ventures in the PRC was left to subsequent legislative efforts. See Alford & Birenbaum, *Ventures in the China Trade: An Analysis of China's Emerging Framework for the Regulation of Foreign Investment*, 3 NW. J. INT'L L. & BUS. 56, 71-72 (1981).

<sup>5</sup> See Fenwick, *Equity Joint Ventures in the People's Republic of China: An Assessment of the First Five Years*, 40 BUS. LAW. 839, 839 (1985). Following the promulgation of the JV Law, thousands of foreign firms flocked to China to investigate the feasibility of joint venture participation. See Moser, *Foreign Investment in China: The Legal Framework*, in FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 106, 115 (M. Moser ed. 1984).

<sup>6</sup> According to Western authorities, between 1979 and 1983 China completed only

the JV Law, although necessary, was not itself sufficient to bring a significant quantity of foreign investment to the PRC. Chief among the numerous complaints voiced by potential investors concerning their reluctance to engage in joint ventures in the PRC was the vagueness of the JV Law<sup>7</sup> and the lack of any other clearly defined legal framework to govern such investment.<sup>8</sup> In an effort to recapture some of the foreign investment community's initial enthusiasm for the equity joint venture in the PRC, the Chinese government embarked on an aggressive legislation program designed to close the numerous gaps left by the JV Law. During the period 1979-1982, the Chinese government promulgated over twenty laws directly relating to foreign investment in the PRC, and over sixty laws and regulations indirectly dealing with foreign investment in the PRC were implemented.<sup>9</sup>

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89 joint venture contracts. See Brady & Stepanek, *Eggs for Steel*, CHINA BUS. REV., Sept.-Oct., 1983, at 34; Brehm, *Flex Trade*, CHINA BUS. REV., Sept.-Oct., 1983, at 25; Chiang, *What Works and What Doesn't*, CHINA BUS. REV., Sept.-Oct., 1983, at 28; Swindler, *supra* note 3, at 1007 n.10. Chinese authorities, however, were slightly more positive on this subject, asserting that 112 joint ventures involving foreign investment of U.S.\$260 million were established in the PRC as of September, 1983. See Moser, *supra* note 5, at 115.

Such statistical discrepancies concerning joint ventures are common. Much of those discrepancies, however, may be attributable to the inconsistent use of terminology. See Swindler, *supra* note 3, at 1007 n.10.

<sup>7</sup> See, e.g., Jaslow, *supra* note 3, at 209; Swindler, *supra* note 3, at 1023; Note, *China's New Joint Venture Law: Analysis and Economic Overview*, 4 B.C. INT'L & COMP. L. REV. 115, 116 (1981); Birenbaum & Alford, *China's Law on Joint Ventures - The First Year in Review*, Nat'l L. J., July 21, 1980, at 26; Birenbaum, *Doing Business With China*, Wall St. J., Aug. 31, 1979, at 6, col. 4. For several reasons, however, the vagueness of the JV Law may have been intentional. First, the Chinese government may have thought it preferable to provide refined rules and regulations in subsequent legislation rather than burden the JV Law with such details. See Hsia & Haun, *supra* note 4, at 6; Swindler, *supra* note 3, at 1025; INT'L TRADE ADMIN., U.S. DEP'T OF COMMERCE, JOINT VENTURE AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA, 12 (1982) [hereinafter JV REPORT]. Second, the Chinese may have intended that such detailed terms "be spelled out by the parties in their contract association." *Id.* See also Swindler, *supra* note 3, at 1025 n.128. Third, such vagueness may have been intended to be used as a tool with which the Chinese could maintain firm control over joint venture activities. See Golden, *People's Republic of China - 1983 Joint Venture Implementing Regulations - The Supplement of Detail, in an Attempt to Attract Foreign Investment*, 15 GA. J. INT'L & COMP. L. 389, 390 n.4 (1985). Finally, commentators have most often suggested that this type of legislation was so foreign to the Chinese drafters that they simply did not know what to include and exclude from the JV Law, and thus had no alternative but to formulate a vague and flexible statute. *Id.* See also Fenwick, *supra* note 5, at 844; Hsia & Haun, *supra* note 4, at 6; Swindler, *supra* note 3, at 1025.

<sup>8</sup> See O.D. Nee, Jr., *The Forms of Foreign Investment in China*, in 1 COMMERCIAL BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA Bk. 3, at 1, 4 (1985) [hereinafter Nee 2]. China's lack of a comprehensive legal framework within which a joint venture could operate only served to compound foreign investors' misgivings concerning the JV Law's ambiguities. See also Hsia & Haun, *supra* note 4, at 6. See also Moser, *supra* note 5, at 106. Additionally, the Standing Committee of the

The most significant regulations governing joint venture investment did not come into effect until 1983. The Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (JV Regulations), promulgated by the State Council on September 20, 1983,<sup>10</sup> provided detailed rules governing the organization, registration, capitalization, management, taxation, labor relations, and liquidation of equity joint ventures in the PRC. Because the JV Regulations removed many of the uncertainties which surrounded the JV Law, and thereby allayed the fears of many foreign investors, it provided a significant impetus for joint venture investment in the PRC.<sup>11</sup> Nothing illustrates this point better than the fact that in 1984, almost seven hundred equity joint ventures were completed in the PRC,<sup>12</sup> a veritable flood relative to the eighty-nine joint ventures completed in the 1979-1983 period.

By 1986, however, foreign investment in the PRC had dropped precipitously.<sup>13</sup> This sharp decrease in foreign investment is attributable to the widespread recognition that significant difficulties still abound for the foreign joint venture investor in China.<sup>14</sup> Despite efforts by the Chinese government to address these difficulties through new legislation, most notably through the State Council Regulations concerning Encouragement of Foreign Investment (EFI Regulations)<sup>15</sup> and

National People's Congress validated on November 29, 1979 over 1,500 laws, regulations, and directives issued prior to 1957, many of which are relevant to joint ventures. See Alford & Birenbaum, *supra* note 4, at 74; Beijing Rev., Nov. 9, 1981, at 6, col. 3.

<sup>10</sup> Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, promulgated by The State Council, Sept. 20, 1983, reprinted and translated in CHINA L. FOR. BUS. 7,911 [hereinafter JV Regulations].

<sup>11</sup> See U.S. Dep't of Commerce, Incoming Telegram 1 (Sept. 8, 1983), cited in Golden, *supra* note 7, at 406 n.73 [hereinafter Incoming Telegram 1] (stating that the JV Regulations should constitute a significant force in encouraging foreign participation in joint ventures because the purpose of the JV Regulations was to "flesh out" the JV Law and to address many of the more serious difficulties confronting joint ventures under the JV Law). See also Beijing Rev., Nov. 9, 1981, at 6, col. 3.

<sup>12</sup> See Nee 2, *supra* note 8, at 4.

<sup>13</sup> See Cohen & Valentine, *supra* note 3, at 183 (foreign investment contracted for in 1986 was half the 1985 level); Kraar, *The China Bubble Bursts*, FORTUNE, July 6, 1987, at 86 (new commitments fell 48% in 1986); Yuqing, *Like Bamboo Shoots After a Rain: Exploiting the Chinese Law and New Regulations on Sino-foreign Joint Ventures*, 8 NW. J. INT'L L. & BUS. 59, 99 (1987) (citing Sullivan, *The Investment Climate*, CHINA BUS. REV., Jan.-Feb., 1987, at 8) (foreign investment in China fell 42% during the first nine months of 1986); *Foreign Investment in China: Blowing Cold*, ECON., Apr. 18, 1987, at 69 (foreign investment declined 40% during 1986);

<sup>14</sup> See Kraar, *supra* note 13, at 86; Yuqing, *supra* note 13, at 99; Schiffman, *Chinese Regulations Seek to Mollify Foreign Investors*, Wall St. J., Dec. 24, 1986, at 12, col. 1.

<sup>15</sup> State Council Regulations concerning Encouragement of Foreign Investment, promulgated by The State Council, Oct. 11, 1986, reprinted and translated in CHINA L. FOR. BUS. 7,911 [hereinafter EFI Regulations].

related laws,<sup>16</sup> the difficulties persist and have prevented the joint ven-

L. FOR. BUS. 16,701 [hereinafter EFI Regulations].

The EFI Regulations are intended to benefit all foreign investment enterprises (defined in art. 2 as "Sino-foreign joint equity enterprises, Sino-foreign co-operative enterprises and enterprises with sole foreign investment"), but most of the EFI Regulations' advantages accrue to "exporting enterprises" and "technologically advanced enterprises." According to article 2, exporting enterprises are "manufacturing enterprises whose products are primarily exported and which have a foreign exchange surplus after deducting from their total annual foreign exchange income their annual operational foreign exchange expenditure and the foreign exchange required to remit dividends earned by foreign investors." Article 2 defines technologically advanced enterprises as "manufacturing enterprises in which a foreign investor provides advanced technology to develop new products or upgrade products, increasing exports and generation of foreign exchange or replacing imports." Whether a foreign investment enterprise qualifies as an exporting enterprise or a technologically advanced enterprise is, according to article 18, to be "determined and certified by the foreign economic relations and trade authorities (MOFERT) and relevant departments of the locality in which the enterprise is situated on the basis of the enterprise contract." For an explanation of MOFERT, see *infra* note 31.

<sup>16</sup> Numerous implementing regulations for the EFI Regulations have been promulgated by both the national and local authorities. For national legislation, see Regulations on the Right of Autonomy of Foreign Investment Enterprises in the Hiring of Personnel and on Employees' Wages, Insurance and Welfare Expenses, issued by The Ministry of Labor and Personnel, Nov. 10, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 15,527 [hereinafter Autonomy Regulations]; Ministry of Foreign Economic Relations and Trade Measures for Foreign Investment Enterprises Purchasing Domestic Products for Export to Achieve a Balance of Foreign Exchange Income and Expenditure, issued by MOFERT, Jan. 20, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 16,911 [hereinafter PDP Measures]; Implementing Measures of the Ministry of Foreign Economic Relations and Trade on the Confirmation and Examination of Export-oriented Enterprises and Technologically Advanced Enterprises with Foreign Investment, promulgated by MOFERT, Jan. 27, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 16,955; Measures of the Ministry of Finance for the Implementation of the Preferential Tax Treatment Provisions of the State Council Regulations concerning Encouragement of Foreign Investment, issued by The Ministry of Finance, Jan. 31, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 40,701; Provisional Measures of the People's Bank of China on Foreign Exchange Secured Renminbi Loans for Foreign Investment Enterprises, promulgated by The People's Bank of China, Nov. 26, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 10,719; Measures of the Customs of the People's Republic of China for the Control of the Import of Materials and Parts Required by Foreign Investment Enterprises for the Fulfillment of Export Contracts, promulgated by The General Administration of Customs, Nov. 24, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 63, 175; Implementing Measures of the Ministry of Foreign Economic Relations and Trade concerning Application for Import and Export Licenses by Foreign Investment Enterprises, promulgated by MOFERT, Jan. 24, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 64,327; Measures on Import Substitution concerning Sino-foreign Joint Equity Enterprises and Sino-foreign Co-operative Enterprises, approved by The State Council and promulgated by The State Planning Commission, Oct. 19, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 63,307 [hereinafter IS Measures]; Measures for the Control of Mechanical and Electrical Import Substitution Products of Sino-foreign Joint Equity and Sino-foreign Co-operative Enterprises, approved by The State Council and promulgated by The State Economic Commission, Oct. 31, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 63,341 [hereinafter MEIS measures].

ture from becoming the significant investment force hoped for by both foreign investors and the Chinese government. Problems are complex and derived from many sources: legal, political, social, and economic. This Comment examines the most serious of these problems, focusing primarily on the legal aspects of joint ventures in the PRC. Section 2 describes the legal status of the joint venture under current Chinese law. Section 3 analyzes the procedures necessary for establishment of a joint venture in China, paying particular attention to the difficulties in the approval process and capitalization of the joint venture. Section 4 discusses the management and operational problems confronting joint ventures in China. Section 5 analyzes the most prevalent problem plaguing joint venture operations in China, the foreign exchange crisis.

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Beijing Municipal People's Government on the Implementation of the State Council Regulations concerning Encouragement of Foreign Investment, *issued by* The Beijing Municipal People's Government, Oct. 11, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 16,741; Regulations of Liaoning Provincial People's Government for the Encouragement of Foreign Investment, *promulgated by* The Liaoning Provincial People's Government, Oct. 17, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 16,757; Regulations of Anshan Municipal People's Government, Nov. 7, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 16,787; Regulations of the Shenyang Municipal People's Government for the Encouragement of Foreign Investment, *promulgated by* The Shenyang Municipal People's Government, Feb. 7, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 16,773; Implementing Measures of The Qingdao Municipal People's Government for the Implementation of the State Council Regulations concerning Encouragement of Foreign Investment, *promulgated by* The Qingdao Municipal People's Government, Oct. 16, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 97,503; Preferential Measures of the Nantong Municipal People's Government for Encouragement of Foreign Investment in the Economic and Technological Development Zone, *promulgated by* The Nantong Municipal People's Government, Nov. 6, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 98,503; Regulations of Shanghai Municipality for the Encouragement of Foreign Investment, *issued by* The Shanghai Municipal People's Government, Oct. 23, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 95,991; Implementing Measures of the Guangzhou Economic and Technological Development Zone for the Encouragement of Foreign Investment, *promulgated by* The Guangzhou Municipal People's Government, Dec. 15, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 92,201; Regulations of Zhuhai Municipality for the Provision of Further Preferential Terms for Foreign Investors, *promulgated by* The Zhuhai Municipal People's Government, Oct. 29, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 87,301; Supplementary Regulations of the Shantou Special Economic Zone for the Encouragement of Foreign Investment, *promulgated by* The Shantou Municipal People's Government, Dec. 4, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 88,201; Measures of the Shenzhen Municipal People's Government to Implement the Preferential Tax Treatment Policies of the State Council Regulations Concerning Encouragement of Foreign Investment, *promulgated by* The Shenzhen Municipal People's Government, May 5, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 86,217; Implementing Measures of Guangdong Province for the Encouragement of Foreign Investment, *promulgated by* The Guangdong Provincial People's Government, Apr. 26, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 82,321; Several Regulations of the Jiangsu Provincial People's Government for the Encouragement of Foreign Investment, *issued by* The Jiangsu Provincial People's Government, Nov. 11, 1986, *reprinted and translated in* CHINA L. FOR. BUS. 16,821.

Section 6 describes the tax environment for Sino-foreign joint ventures. Due to the severity and the pervasiveness of these problems, this Comment ultimately concludes in Section 7 that foreign investment in the PRC through equity joint ventures, though possessing tremendous potential, is presently feasible in only exceptional and narrowly-defined situations, and that investors would reap greater rewards by engaging in joint ventures in countries other than the PRC, or by engaging in other forms of investment<sup>17</sup> in the PRC.

## 2. LEGAL STATUS OF THE JOINT VENTURE

According to both the JV Law and the JV Regulations, equity joint ventures incorporated and registered in the PRC shall take the form of a "limited liability company."<sup>18</sup> The definition of a limited liability company is, however, a source of considerable confusion. Investors must rely solely on legislation existing in the JV Law and the JV Regulations in order to determine the scope of the limited liability concept, as the PRC has not yet established a Company Law.<sup>19</sup> On the issue of limited liability, the JV Law states only that the joint venturers shall share the profits, risks, and losses "in proportion to their contributions to the registered capital,"<sup>20</sup> and the JV Regulations state simply that "[e]ach party to the joint venture is liable to the joint venture within the limit of the capital subscribed by it."<sup>21</sup> These apparently

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<sup>17</sup> Other forms of foreign investment permitted in the PRC include the contractual joint venture, joint development, and compensation trade. See generally Nee 2, *supra* note 8, at 21-27; Moser, *supra* note 5, at 109-15. In contractual joint ventures, the most common form of co-operative investment arrangement, both parties contribute capital during the investment phase of the contract. In joint development projects, however, the exploitative phase is funded at the sole risk of the foreign investor. Compensation trade is a loan transaction where both the initial advance and the subsequent loan repayments are made in kind. See Moser, *supra* note 5, at 109-15; Nee 2, *supra* note 8, at 21-27.

In addition, with the advent in 1986 of the Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment, 100% foreign-owned enterprises are now permitted in the PRC. See the Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment, adopted by The Fourth Session of the Sixth National People's Congress, April 11, 1986, reprinted and translated in CHINA L. FOR. BUS. 16,651 [hereinafter SFI Law]. See generally Torbert, *Wholly Foreign Owned Enterprises Come of Age*, CHINA BUS. REV., July-Aug. 1986, at 50.

<sup>18</sup> JV Law, *supra* note 3, art. 4; JV Regulations, *supra* note 10, art. 19.

<sup>19</sup> Cohen & Valentine, *supra* note 3, at 203.

<sup>20</sup> JV Law, *supra* note 3, art. 4.

<sup>21</sup> JV Regulations, *supra* note 10, art. 19. Two Chinese commentators, Wang Jiafu and Su Qing, have stated that in their opinion, "[t]he responsibility which the limited liability company assumes for the debts of the joint enterprise is limited to its registered capital. The Chinese and foreign joint ventures do not use their other capital to bear the risks of the joint venture enterprise." See Jiafu and Qing, *A Preliminary Discussion of the Legal Settlements Between Chinese and Foreign Investment*, 3

unproblematic statements create difficulties whenever the joint venture must borrow money in excess of the capital subscribed by each party. In these situations, the Bank of China requires that all loans to joint ventures be guaranteed by the parent companies or be secured by some collateral interest.<sup>22</sup> Since the PRC has no mortgage law (outside the Special Economic Zones) or other laws permitting the creation of security interests, the parent shareholders are effectively forced to guarantee any loans made to the joint venture company.<sup>23</sup> Therefore, the limited liability of the joint venture's parents may be, in practice, illusory, or at least very far from that which is typical of traditional Western corporate forms.

An additional problem concerning the concept of limited liability is that the limitation is restricted to third parties that deal with the joint venture. Any liability between the joint venture participants that may arise from contractual obligations to one another, however, is not limited.<sup>24</sup> Therefore, because the foreign investor typically assumes a wide range of obligations within the joint venture contract,<sup>25</sup> the foreign investor may incur liability to the Chinese party far in excess of its capital contribution if it is adjudged to have failed to satisfy its contractual duties.

The JV Regulations determine the legal status of equity joint ventures in the PRC insofar as they state that such joint ventures are "Chinese legal persons."<sup>26</sup> The JV Regulations provide further that, as "Chinese legal persons," equity joint ventures are "subject to the jurisdiction and protection of Chinese law."<sup>27</sup> The dominion of Chinese law over the joint venture is also reinforced by the Foreign Economic Contract Law (FECL), which eliminates any contractual choice of law flexibility insofar as it provides that "contracts for Chinese-foreign equity joint ventures . . . to be performed within the territory of the People's Republic of China are subject to the law of the People's Republic

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FAXUE YANJIU [STUDIES IN LAW] 23 (1979)(*cited in* Hsia & Haun, *infra* note 40, at 69 n.60).

<sup>22</sup> See Nee 2, *supra* note 8, at 8.

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

<sup>24</sup> See Foreign Economic Contract Law of the People's Republic of China, arts. 16-25, *adopted by* The Tenth Session of the Standing Committee of the Sixth National People's Congress, March 21, 1985, *reprinted and translated in* CHINA L. FOR. BUS. 6,651 (Performance of Contracts and Liabilities for Breach of Contract) [hereinafter FECL]. See also Nee 1, *supra* note 1, at 7.

<sup>25</sup> These obligations are broad and are applicable to the foreign investor in areas such as transfer of technology, training of management personnel, and arranging financing for the venture or exporting its products. See Nee 1, *supra* note 1, at 8.

<sup>26</sup> JV Regulations, *supra* note 10, art. 2.

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



of China."<sup>28</sup> Article 5 of FECL complements article 15 of the JV Regulations, which makes Chinese law applicable to "the formation of a joint venture contract, its validity, interpretation, execution and the settlement of disputes under it . . . ."<sup>29</sup>

Although these provisions on their face are unobjectionable, and the subjection of any joint venture incorporated and registered in the PRC to the jurisdiction of Chinese law is reasonable, the fact that Chinese law is undergoing such rapid development and is still relatively rudimentary creates many problems for foreign investors. Specifically, the foreign investor is concerned about how future developments in Chinese law, which are certain to occur given the tremendous need for such development and the Chinese government's desire to satisfy that need, will impact on their present contractual rights and duties.<sup>30</sup> Although the Ministry of Foreign Economic Relations and Trade (MOFERT)<sup>31</sup> has stated that "some provisions in the contract may continue even though these provisions run counter to the newly promulgated laws or regulations,"<sup>32</sup> it is still uncertain which provisions would be deemed valid or invalid. Moreover, although FECL states that joint venture contracts which are executed in the PRC and approved by the relevant state authorities "may still be performed according to the stipulations of those contracts" in spite of new legal provisions,<sup>33</sup> it is uncertain how this provision will be applied in practice.<sup>34</sup>

<sup>28</sup> See FECL, *supra* note 24, art. 5; Conroy, *China's New Foreign Economic Contract Law*, INT'L FIN. L. REV., May, 1985, at 26; Gelatt, *Legal and Extra-legal Issues in Joint Venture Negotiations*, 1 J. CHINESE L. 217, 227 (1987); Stoltenberg & McClure, *The Joint Venture and Related Contract Laws of Mainland China and Taiwan: A Comparative Analysis*, 17 GA. J. INT'L & COMP. L. 45, 85 (1987).

<sup>29</sup> See JV Regulations, *supra* note 10, art. 15; Stoltenberg & McClure, *supra* note 28, at 85.

<sup>30</sup> See Cohen & Valentine, *supra* note 3, at 203; Moser, *supra* note 5, at 118. For thorough discussions of this issue, see Cohen, *Some Problems of Investing in China*, in LEGAL ASPECTS OF DOING BUSINESS IN CHINA 1983 67; Gelatt, *supra* note 28, at 227.

<sup>31</sup> MOFERT was established in March 1982 as part of a comprehensive central-level bureaucratic reorganization in which the Foreign Investment Commission (FIC) and the Import-Export Commission (IEC) were amalgamated. See Brehm, *supra* note 6, at 20; Ludlow, *China's New Foreign Trade Structure*, CHINA BUS. REV., May-June, 1982, at 30-33; *The State of the Shuffle: Who's Heading What*, BUS. CHINA, Mar. 10, 1982, at 34. Before their combination, the FIC and the IEC were actually the same organization, namely, the State Council's advisory office for foreign economic affairs. See Fenwick, *supra* note 5, at 845 n.23. According to article 3 of the JV Law, the FIC was responsible for approval of joint venture proposals. This responsibility was given solely to MOFERT in article 8 of the JV Regulations. For an overview of the organizational structure of the FIC and the IEC, see *The PRC's Investment Control and Import-Export Commissions*, CHINA BUS. REV., Mar.-Apr. 1980, at 12-13.

<sup>32</sup> *Questions and Answers Concerning Foreign Investment in China*, CHINA ECON. NEWS, May 12, 1983, at 5.

<sup>33</sup> FECL Law Provisions on Shipping, 1990

<sup>34</sup> O.D. Nee, Jr., *The Foreign Economic Contract Law: Practice Commentary*, in 1 COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA Bk. 4,

It appears at the present time that the only way a foreign investor can reduce the risk of subsequent adverse legislation is through the inclusion of "renegotiation clauses" in the joint venture contract. These protective contractual provisions essentially provide for the renegotiation of all or part of the joint venture contract should the foreign party's investment be harmed by future Chinese legislation. Renegotiation clauses of this type have been successfully negotiated in a few cases,<sup>35</sup> although in general it is still the foreign investor who must assume the substantial risk of future harmful legislation. The Foreign party bears the risk because the Chinese party typically resists the inclusion of such clauses in the joint venture contract, or, if such a clause is included, the Chinese party enjoys increased bargaining power during renegotiation.

### 3. ESTABLISHMENT OF THE JOINT VENTURE

#### 3.1. *The Approval Process*

The foreign investor's first step toward the establishment of a joint venture in the PRC is finding the right Chinese partner.<sup>36</sup> Because private attempts to find the right Chinese partner usually fail<sup>37</sup> and make the ultimate success of the joint venture unlikely from the outset,<sup>38</sup> several Chinese organizations exist to facilitate the matching of prospective joint venture participants. On the national level, in addition to MOFERT which approves and closely monitors joint venture operations, the foreign investor can contact the China International Trust and Investment Corporation (CITIC), specialized corporations, or specialized law offices.<sup>39</sup> Of these organizations, CITIC is probably the most important. CITIC is defined as "a state-owned socialist enterprise operating under the direct leadership of the State Council"<sup>40</sup> whose

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at 1. This provision has been called a "most liberal clause" despite its apparent conditionality. *Id.* at 3, 4.

<sup>35</sup> See Moser, *supra* note 5, at 118.

<sup>36</sup> See Yuqing, *supra* note 13, at 67.

<sup>37</sup> *Id.*

<sup>38</sup> See Hendryx, *The China Trade: Making the Deal Work*, HARV. BUS. REV., July-Aug., 1986, at 75; Pye, *The China Trade: Making the Deal*, HARV. BUS. REV., July-Aug., 1986, at 74.

<sup>39</sup> Yuqing, *supra* note 13, at 67-68. See also Lussenburg, *Joint Venture Investment in the People's Republic of China: A Continuing Challenge*, 63 CAN. BAR REV. 545, 551 (1985).

<sup>40</sup> *China International Trust and Investment Corporation Founded*, Wen hui bao (Shanghai), Oct. 5, 1979, at 2, quoted in Hsia & Haun, *China's Joint Venture Law: Part II*, 1 CHINA L. REP. 61, 61 (1980).

purpose is to "introduce, absorb and apply foreign investment, advanced technology, and to import advanced equipment and to bring in advanced technology for the purposes of China's national construction and promotion of socialist modernization,"<sup>41</sup> and also to "coordinate initial contacts between foreigners and their Chinese partners."<sup>42</sup>

Even at this preliminary organizational level, however, the foreign investor is confronted with potentially crippling difficulties since, in working with CITIC, the foreign investor engages with a state-owned enterprise in a country where such enterprises are notorious for their bureaucratic inefficiency.<sup>43</sup> Surprisingly, even Wu Zhichao, Vice President of CITIC, admitted in February 1981 that he and his organization were often baffled by China's Kafkaesque bureaucracy.<sup>44</sup> Finally, the value of contacts with CITIC is questionable because to date its role appears to be more peripheral than central within the Chinese framework of governmental joint venture regulation.<sup>45</sup>

More significantly, perhaps, the foreign investor should be aware of the institutionalization of conflicts of interest within these organiza-

<sup>41</sup> Charter of the China International Trust and Investment Corporation, art. 2, quoted in Hsia & Haun, *supra* note 40, at 61. An English translation of the CITIC Charter can be found in Vol. 1, No. 1 of the CHINA L. REP.

<sup>42</sup> See Rich, *supra* note 3, at 191. See also Lussenburg, *supra* note 39, at 552. In addition, if necessary, CITIC will aid in contract negotiations and the securing of foreign loans, and will act as an intermediary between Chinese and foreign parties. *Id.* In the words of Rong Yirin, the chairman of the board of directors and president of CITIC:

We will work with foreign investors in finding business opportunities for them in China, putting them in touch with potential Chinese partners, assisting them in negotiating the terms of a joint venture, and maintaining a friendly interest in their success. If a foreigner wants to invest in China but has no specific idea, we will advise him of opportunities. On the other hand, we will also find suitable foreign partners on the request of our national enterprises.

See *An Exclusive Interview with Rong Yirin*, Ta Kung Pao Weekly Supplement, No. 699, Nov. 15-21, 1979, at 4, quoted in Hsia & Haun, *supra* note 40, at 62. For another description of CITIC, see *International Trust, Investment Corporation to be Formed*, Xinhua (Beijing), July 9, 1979, reported in FOREIGN BROADCAST INFORMATION SERVICE, July 10, 1979, at L8-L9. For a thorough, yet somewhat biased, discussion of CITIC, see Yirin, *China's Open Policy and CITIC's Role*, 39 J. INT'L AFF. 57 (1986).

<sup>43</sup> For general discussions of the difficulties experienced by foreigners in interaction with the Chinese bureaucracy, see Alford & Birenbaum, *supra* note 4, at 82; Hsia & Haun, *supra* note 40, at 79-83. For a discussion of strategies to cope with the Chinese bureaucracy, see Lieberthal & Oksenberg, *Understanding China's Bureaucracy*, CHINA BUS. REV., Nov.-Dec., 1986, at 24.

<sup>44</sup> In the words of Vice-President Wu, "In some cases, even we [CITIC] do not know to whom (sic) in China we must contact in order to get investment information or opinions." See *Beijing Will Not Expand Foreign Ventures in '81*, Bus. Standard (Hong Kong), Feb. 12, 1981.

<sup>45</sup> See Alford & Birenbaum, *supra* note 4, at 83.

tions. For example, the Great Wall Law Office, which is often retained by foreign investors to prepare joint venture documentation, is staffed by lawyers from MOFERT, which is responsible for joint venture authorization.<sup>46</sup>

After the foreign investor finds a Chinese partner for the potential joint venture, the JV Regulations require the parties to prepare a "project proposal" and a "preliminary feasibility study," both of which must be submitted to the "department in charge" by the Chinese party.<sup>47</sup> Two problems may arise at this point. First, the determination of which authority is the proper "department in charge" can be a confusing process with inconsistent results, since there is no clearly defined rule that applies to all cases.<sup>48</sup> Second, although the project proposal is not legally binding, its terms are not easily changed once Chinese authorities have approved them, despite the absence of formal negotiation over them.<sup>49</sup> Therefore, the unsuspecting foreign investor can find itself trapped by potentially unfavorable and practically nonnegotiable terms even at the preliminary "letter of intent" stage.

If initial approval is received from the "department in charge," and if the foreign and Chinese parties wish to further pursue the joint venture, the next step is the application process.<sup>50</sup> At this stage, the Chinese partner is responsible for gaining approval not only from MOFERT but also from the local authorities.<sup>51</sup> The documents which

<sup>46</sup> Kraar, *supra* note 13, at 88; Yuqing, *supra* note 13, at 68.

<sup>47</sup> JV Regulations, *supra* note 10, ch. 2, art. 9(1). For a discussion of the details of this provision, see Stoltenberg & McClure, *supra* note 28, at 71.

<sup>48</sup> See Nee 1, *supra* note 1, at 35. Judging from past approval practices, a general rule can be inferred that "the Provinces of Guangdong and Fujian may approve investments up to any level without higher approval, that independent municipalities directly under the State Council such as Beijing and Tianjin may approve investments up to U.S.\$10,000,000 without higher approval and Shanghai may approve investments up to U.S.\$30,000,000; and that Ministries and certain coastal provinces have authority to approve investments between U.S.\$3 and 5 million without higher approval; all other investments must go to MOFERT for prior approval." *Id.* See also Moser, *supra* note 5, at 108.

Additionally, the JV Regulations are silent concerning who is to bear the cost of preparing the feasibility study. It should therefore be considered an appropriate subject of negotiation between the parties. See Lussenburg, *supra* note 39, at 552 n.31; Stoltenberg & McClure, *supra* note 28, at 72 n.80; Swindler, *supra* note 3, at 1027 n.135.

<sup>49</sup> See Gelatt, *supra* note 28, at 223; Nee 1, *supra* note 1, at 35. The terms of the preliminary project proposal become solidified subsequent to their approval by the government because Chinese negotiators know, in a typically bureaucratic fashion, that they should accede only to those terms which have been authorized by their superiors, and they are thus very reluctant to transcend the originally proposed and approved terms. Nee 1, *supra* note 1, at 35-36.

<sup>50</sup> Nee 1, *supra* note 1, at 36. See also Lussenburg, *supra* note 39, at 552; Moser, *supra* note 5, at 119, 123.

<sup>51</sup> JV Regulations, *supra* note 10, arts. 8-10. See also Lussenburg, *supra* note 39, <https://scholarship.law.upenn.edu/jil/vol10/iss2/5>

must be submitted after negotiation include an application for creation of the joint venture,<sup>52</sup> a secondary feasibility study,<sup>53</sup> the joint venture agreement, contract and articles of association,<sup>54</sup> a list of candidates for the board of directors,<sup>55</sup> and the opinion of the local authorities concerning the establishment of the joint venture.<sup>56</sup> The JV Regulations require approval or rejection of the application within three months.<sup>57</sup> Within one month after approval, the joint venture must be registered with the local bureau of the General Administration for Industry and Commerce (GAIC) pursuant to the JV Regulations<sup>58</sup> and the Regulations of the People's Republic of China on the Registration of Joint Ventures Using Chinese and Foreign Investment.<sup>59</sup>

It is during this stage of the establishment process—after preliminary approval of the joint venture by the “department in charge” and before the joint venture legally comes into being through its registration with GAIC—that many difficulties arise for the foreign investor. First, as a preliminary matter, it is absolutely imperative that the joint venture's contract agreement and articles of association be thoroughly negotiated and meticulously drafted, given China's undeveloped body of commercial law.<sup>60</sup> These documents should attempt to provide for all foreseeable details of the joint venture's existence, and yet retain a measure of flexibility to accommodate subsequent changes of circumstance.<sup>61</sup> Such forecasting is inherently difficult, but it will naturally be more difficult for the foreign investor than the Chinese party due to the Chinese party's superior knowledge of and familiarity with the legal, political, economic and cultural forces in China which will impact on

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at 553.

<sup>52</sup> JV Regulations, *supra* note 10, art. 9(2)(a).

<sup>53</sup> *Id.* art. 9(2)(b).

<sup>54</sup> *Id.* art. 9(2)(c).

<sup>55</sup> *Id.* art. 9(2)(d).

<sup>56</sup> *Id.* art. 9(2)(e).

<sup>57</sup> *Id.* art. 10.

<sup>58</sup> *Id.* art. 11. For a general discussion of the nature and structure of GAIC (also referred to as GACIC - the General Administration for the Control of Industry and Commerce), see Lutz, *The General Administration for the Control of Industry and Commerce*, CHINA BUS. REV., Mar.-Apr. 1983, at 25.

<sup>59</sup> See The Regulations of the People's Republic of China on the Registration of Joint Ventures Using Chinese and Foreign Investment, art. 2, *promulgated by* The State Council, July 26, 1980, *reprinted and translated in* CHINA L. FOR. BUS., 7,841.

<sup>60</sup> See P. VERZARIU & D. STEIN, JOINT VENTURE AGREEMENTS IN THE PEOPLE'S REPUBLIC OF CHINA 20 (U.S. Dep't of Commerce, Int'l Trade Admin., Nov., 1982).

<sup>61</sup> *Id.* It is common for Chinese negotiators to resist the inclusion of such detail and specificity in the joint venture contract when foreign interests are concerned. When, however, Chinese interests are at stake, Chinese negotiators are eager to use detailed

the joint venture's operations. In this respect, the foreign investor will certainly be at a negotiating disadvantage relative to the Chinese party.

Second, in order to obtain a favorable contract with a Chinese party, the foreign investor must be prepared to invest large quantities of both time and money in the negotiation process.<sup>62</sup> Although it is sometimes possible to negotiate a joint venture contract in as little as six months, one commentator suggests that it is reasonable to plan on a three year negotiation period.<sup>63</sup> This will necessarily be feasible for only wealthy and determined investors.<sup>64</sup>

Many factors combine to create the notoriously slow pace of Chinese negotiations. First, as previously mentioned, the Chinese party tends to become intransigent over terms already approved by higher authorities at the preliminary letter of intent stage, even though it is precisely these terms that the foreign party intended to reserve for negotiation during the formal negotiation period.<sup>65</sup> Second, due to the PRC's self-imposed international isolation, which ended only in 1978 through the reforms of Deng Xiaoping, Chinese negotiators are generally unfamiliar with international customs and practices, and thus bar-

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<sup>62</sup> Cohen & Valentine, *supra* note 3, at 198-99. See also Moser, *supra* note 5, at 116 ("Negotiations have often proved to be lengthy and complicated, burdened by the bureaucratic style of Chinese decision-making").

<sup>63</sup> See Lussenburg, *supra* note 39, at 554. For example, contract negotiation proceeded for several years in both the Great Wall Hotel and the Schindler Elevator joint ventures. See Birenbaum & Alford, *supra* note 7, at 26. The ITT joint venture contract required over six years to negotiate. See Brown, *Sino-Foreign Joint Ventures: Contemporary Developments and Historical Perspective*, 1 J. NORTHEAST ASIAN STUD. 25, 41 (1982).

Due to such sizeable initial expenditures of both time and money, the foreign investor's decision to participate in a joint venture must be viewed as a long term commitment. Lussenburg, *supra* note 39, at 554. This is, in fact, the way in which existing or potential foreign joint venture participants see their investment. See Burns, *Why Investors Are Sour on China*, N.Y. Times, June 8, 1986, at F7, col. 1 ("In every case, U.S. partners are paying a very high price to be in China now because their parent corporations have made a strategic decision to enter the China market for the long term. They have taken a great commercial and potential political risk, and, for most, the potential payoff is still years away.")

<sup>64</sup> See Bloomfield, *Legal Aspects of Joint Ventures in China*, INT'L BUS. LAW., Oct., 1986, at 335. Chinese authorities and commentators have acknowledged this fact, and therefore urge that joint ventures be reserved for industrial projects involving large capital expenditures and sophisticated technology. See Brehm, *supra* note 6, at 16.

<sup>65</sup> See *supra* note 49 and accompanying text. Chinese negotiators are not autonomous risk takers and entrepreneurs who may bargain freely, but are constrained by strict governmental supervision. See P. VERZARIU & D. STEIN, *supra* note 60, at 11. A related problem stems from the fact that Chinese negotiators cling tenaciously to the form joint venture contract and articles of association developed by MOFERT, despite MOFERT's intention to make the model simply a starting point for negotiations. Because the model is in many ways heavily weighted in favor of the Chinese party, foreign parties must make vigorous efforts to depart from the MOFERT model. Typically, a lengthy "battle of the forms" ensues. See Gelatt, *supra* note 28, at 224.

gain for terms and conditions which are unknown in the rest of the world.<sup>66</sup> Third, foreign investors have suggested that in increasingly frequent instances, negotiations languish until bribes or kickbacks are given to Chinese negotiators to "grease the deal."<sup>67</sup> Finally, the slow Chinese negotiating process can be explained by the desire to reach the most favorable contract, which causes the Chinese to use protracted negotiations and plan-revisions as techniques to increase their leverage at the bargaining table.<sup>68</sup>

A third problem that frequently arises during the negotiation period is delay, not from the Chinese negotiators, but from the Chinese governmental entities at either the national or local level. The typical joint venture must obtain approval not simply from MOFERT, but from a host of governmental bodies.<sup>69</sup> These authorities jealously protect their jurisdiction and autonomy, and consequently shun interdependence and coordination.<sup>70</sup> It is common for routine matters to become lost in China's bureaucratic maze, sometimes for several years.<sup>71</sup> Although the EFI Regulations seek to reduce such delays through greater

<sup>66</sup> Further, China's lack of experience in establishing and operating joint ventures necessitates the resolution of fundamental and relatively simple issues on a case-by-case basis. See Moser, *supra* note 5, at 116. China's self-imposed international isolation and its promotion of self-reliance was largely a consequence of a strong mistrust of foreigners and foreign influences. This mistrust developed as a result of a history of foreign practices within China, committed primarily by Western countries, that the Chinese viewed as exploitative. See Swindler, *supra* note 3, at 1010 n.19. This suspicion of foreign influences is still present, as evidenced by the cautious attitude with which China permits foreign investment within its borders. See Hsia & Haun, *supra* note 4, at 6; P. VERZARIU & D. STEIN, *supra* note 60, at 10.

<sup>67</sup> The Chinese term for such practices is *hao cho*, which literally means "nice benefit from a business deal." Kraar, *supra* note 13, at 86, 88. See also Cohen & Valentine, *supra* note 3, at 195; Yuqing, *supra* note 13, at 68.

<sup>68</sup> See P. VERZARIU & D. STEIN, *supra* note 60, at 11. Another Chinese negotiation technique that is frequently a source of irritation to foreign investors is reference to "internal regulations" that, according to the Chinese, determine the resolution of a particular issue, but which are unavailable for the foreign party's inspection. Such secret laws do, in fact, often exist, but sometimes foreign investors sense that Chinese appeals to internal regulations are merely ploys to increase bargaining power. See Gelatt, *supra* note 28, at 229-30.

<sup>69</sup> For example, such governmental bodies include the General Taxation Bureau of the Ministry of Finance, the Customs Administration, the General Administration for Exchange Control, and the Bank of China. See Baigen, *China: New Provisions to Encourage Foreign Investment*, INT'L BUS. LAW., May, 1987, at 204, 205. Additional governmental bodies include the China International Trust and Investment Corporation, the Foreign Investment Bureau, and the General Administration for Industry and Commerce. See Stoltenberg & McClure, *supra* note 28, at 70.

<sup>70</sup> See generally, Lieberthal and Oksenberg, *supra* note 43, at 24. To make matters worse, there can be inconsistent and conflicting opinions even within the same governmental authority. Cohen & Valentine, *supra* note 3, at 200.

interdepartmental cooperation,<sup>72</sup> Chinese bureaucrats will likely be unwilling or unable to apply the new provisions in practice.<sup>73</sup>

A fourth and final problem that can arise during this negotiation period stems from the vagueness of the approval authority's criteria for obtaining approval of joint ventures. Aside from the minimum conditions expressed in articles 8(1) and 8(2) of the JV Regulations, the Chinese authorities have never explained their basis for approval of joint ventures.<sup>74</sup> Consequently, after investing significant time and money in an effort to negotiate a favorable joint venture contract, the foreign investor may discover that the contract is unacceptable to the approval authority for some previously undisclosed reason.<sup>75</sup> In sum, the entire joint venture approval process sometimes resembles a shot in the dark.

### 3.2. Capitalization of the Joint Venture

The JV Law requires, as regards the capital structure of the joint venture, that the foreign party must hold at least twenty-five percent of the registered capital.<sup>76</sup> There is no specified maximum percentage of

<sup>72</sup> The EFI Regulations provide that the "various levels of the People's Government and relevant departments in charge should strengthen and improve their coordination and efficiency and promptly examine and approve applications by foreign investment enterprises on matters requiring reply or resolution." EFI Regulations, *supra* note 15, art. 17.

<sup>73</sup> See Yuqing, *supra* note 13, at 117. The force of article 17 is undermined by its inclusion of a three month time limit for the approval or non-approval of joint venture documents. Because article 10 of the JV Regulations contain an identical three month time limit, governmental approval authorities will probably interpret article 17 of the EFI Regulations as simply sanctioning "business as usual." See Cohen & Chang, *New Foreign Investment Provisions*, CHINA BUS. REV., Jan.-Feb., 1987, at 11, 13.

<sup>74</sup> See Lussenburg, *supra* note 39, at 553 n.35. Commentators have suggested, however, that the Yugoslav law on joint ventures be used by analogy. See Klingenberg & Pattison, *supra* note 3, at 820-21. The Yugoslav joint venture law specifies the criteria for approval as being 1) compliance with applicable laws and regulations, 2) economic benefit, 3) sufficiency of participants' financial resources to implement the proposals, 4) fairness of provisions according to customary international standards, 5) equitable valuation of foreigner's capital contribution, and 6) the furtherance of current national trade and economic policies. See Rich, *supra* note 3, at 193.

<sup>75</sup> Obtaining approval from the various government authorities is a frustrating experience largely because the authorities often require the foreign party to make concessions, in addition to those already made at the bargaining table, before approval is granted. See Cohen & Valentine, *supra* note 3, at 200 ("[F]oreign investors have become frustrated by the frequency with which PRC examination and approval authorities demand changes in crucial terms which the parties can agree on between themselves under Chinese law . . . . The result . . . is that the foreign party often feels that it has been placed in an unfair bargaining position, especially when, as frequently happens, it is informed of the conditions for approval shortly before the date scheduled for the festivities announcing the contract."). See also Gelatt, *supra* note 28, at 226.

<sup>76</sup> JV Law, *supra* note 3, art. 4. This investment floor is an attempt by the Chinese government to ensure that the foreign investor's participation is sufficiently great



registered capital that the foreign investor may hold, thus making it possible for a joint venture to be ninety-nine percent foreign owned.<sup>77</sup> Nevertheless, as articles 21 through 24 of the JV Regulations make clear, there are significant restrictions governing the registered capital of a joint venture, which in some cases can be particularly burdensome for the foreign investor.<sup>78</sup>

Joint venture capital contributions may take many forms. A joint venture participant may contribute cash, in-kind contributions such as machinery, materials and equipment, or intangible property such as patents, trademarks and other intellectual property.<sup>79</sup> In addition, the Chinese participant is permitted to contribute land-use rights.<sup>80</sup>

The valuation of capital contributions in forms other than cash in order to determine the capital structure of the joint venture has proved to be an intractable and pervasive problem. First, concerning capital contributions by Chinese participants which typically take the forms of buildings and land-use rights,<sup>81</sup> the valuation of land-use rights has been arbitrary and subject to abuse. Unlike the valuation of other capital contributions, which can be ascertained through consultation between the parties with reference to international market prices<sup>82</sup> or, in the absence of an international market price, through appraisal by a third party appointed by the joint venture participants,<sup>83</sup> the valuation

to motivate it to make a commitment to the success of the joint venture. Hsia & Haun, *supra* note 4, at 14.

<sup>77</sup> See Moser, *supra* note 5, at 120. In practice, the distribution of the registered capital of joint ventures is generally 50:50 or 49:51, the majority position in the latter case usually being held by the Chinese participant. *Id.* Although there has been speculation concerning the possibility of 100% foreign ownership of joint ventures, see Rich, *supra* note 3, at 196, neither experience nor the underlying principles of the joint venture legislation support such a conclusion. Lussenburg, *supra* note 39, at 554. Such 100% foreign ownership would not constitute a joint venture, and thus the joint venture legislation would be inapplicable. Hsia & Haun, *supra* note 4, at 14. See also *An Exclusive Interview with Rong Yirin*, *supra* note 42, at 6. Instead, a 100% foreign-owned enterprise would be governed by the SFI Law and related legislation.

<sup>78</sup> See Moser, *supra* note 5, at 121.

<sup>79</sup> JV Regulations, *supra* note 10, art. 25.

<sup>80</sup> *Id.* arts. 25, 48.

<sup>81</sup> See Bloomfield, *supra* note 64, at 329. In general, the investment composition preferred by Chinese negotiators results in the Chinese participant contributing land-use rights, buildings and premises, and the foreign participant contributing industrial property, know-how, and advanced technology. *Id.* For an example of such an arrangement, see Agreement on the Establishment of a Joint Venture Elevator Company in the People's Republic of China among China Construction Machinery and Schindler Holdings AG and Jardine Schindler (Far East) Holdings SA, *reprinted in* F. DE BANN & B. DEWIT, CHINA TRADE LAW 59 (1982).

<sup>82</sup> JV Regulations, *supra* note 10, art. 25. See VERZARIU & STEIN, *supra* note 60, at 25. See also Bloomfield, *supra* note 64, at 329; Lussenburg, *supra* note 39, at 555.

<sup>83</sup> JV Regulations, *supra* note 10, art. 25. See Lussenburg, *supra* note 39, at 555.

of land-use rights is reserved by the JV Regulations exclusively for the Chinese government.<sup>84</sup> Such unilateral determination of land-use values by the Chinese government is necessarily arbitrary since there is no free market mechanism by which the fair market value of real property can be measured.<sup>85</sup> Moreover, the local government which is responsible for appraisal of land-use rights is permitted to collect and retain the land-use fee, and therefore has an incentive to inflate the appraised value of such rights.<sup>86</sup> Although the EFI Regulations<sup>87</sup> and several local regulations<sup>88</sup> establish ceilings for site use fees, the ceilings are still high and do not apply to many joint ventures.<sup>89</sup> Therefore, in order to avoid becoming the victim of arbitrary and excessive land-use fees, the foreign investor must take great pains carefully to investigate, negotiate, and include the site value in the joint venture contract or articles.<sup>90</sup>

Second, concerning capital contributions by foreign investors which typically consist of technologically advanced equipment and industrial property,<sup>91</sup> the JV Regulations impose numerous restrictions on both in-kind contributions and industrial property rights. To be acceptable as a capital contribution, any machinery, equipment or materials from the foreign party must be "indispensable" to the operations of the joint venture,<sup>92</sup> must be unable to be produced in China (or is produced in China at "too high" a price<sup>93</sup>), and its price to the joint venture must not be higher than the international market price for the same or simi-

<sup>84</sup> JV Regulations, *supra* note 10, art. 49. See Lussenburg, *supra* note 39, at 556. See also Bloomfield, *supra* note 64, at 329.

<sup>85</sup> See Lussenburg, *supra* note 39, at 556 ("the lack of an open market to determine site values makes such designations arbitrary."); Nee 1, *supra* note 1, at 10-11; Swindler, *supra* note 3, at 1030.

<sup>86</sup> See Swindler, *supra* note 3, at 1030. See also Cohen & Valentine, *supra* note 3, at 197.

<sup>87</sup> EFI Regulations, *supra* note 15, art. 4.

<sup>88</sup> See, e.g., The Shanghai Municipality Trial Measures for the Administration of Site Use Rights of Chinese-foreign Equity Joint Ventures and the Site Use Fees to be Charged, *reprinted and translated in* E. ELIASOPH, LAW AND BUSINESS PRACTICE IN SHANGHAI 79 (1987).

<sup>89</sup> See Nee 1, *supra* note 1, at 13. For example, the land-use fee ceiling contained in the EFI Regulations only applies to export enterprises and technologically advanced enterprises. Moreover, the exception in article 4 of the EFI Regulations that makes the land-use fee ceiling inapplicable to joint ventures located in "busy urban areas of large cities" may swallow the rule if interpreted broadly. Such a broad interpretation would be detrimental to many joint ventures that must, for various reasons, be located in or near metropolitan areas. Cohen & Valentine, *supra* note 3, at 197.

<sup>90</sup> See Lussenburg, *supra* note 39, at 556; Bloomfield, *supra* note 64, at 329. See generally Gelatt, *supra* note 28, at 233-34.

<sup>91</sup> JV Regulations, *supra* note 10, art. 28(1).

<sup>92</sup> *Id.* art. 27(1).

<sup>93</sup> *Id.* art. 27(2).

lar items.<sup>94</sup> In addition, any industrial property contributed to the joint venture by the foreign party must be capable of manufacturing products “urgently” needed in China or products suitable for export,<sup>95</sup> must be capable of improving “markedly” the performance and quality of existing products,<sup>96</sup> or must be capable of “notable” savings in raw materials, fuel, or power.<sup>97</sup> The EFI Regulations appear to have lowered the Chinese criteria for advanced technology, so that technology the Chinese do not presently possess is acceptable as a foreign investor’s capital contribution.<sup>98</sup> If, however, the foreign investor is deemed to have failed to meet these criteria, or, as article 5 of the JV Law states, failed to supply technology or equipment “truly advanced and appropriate to China’s needs,” the foreign party will be held liable for damages.<sup>99</sup> Because these criteria are not free from ambiguity, the capital contribution of the foreign investor will depend on their good faith application by the approval authority.<sup>100</sup>

Additionally, the foreign investor who contributes technology to the joint venture must be cautious about the timing of the transfer. If the foreign party transfers technology to the Chinese party before the contract is approved and signed, the foreign party will be at a loss should the contract fail to be implemented for some reason.<sup>101</sup> This problem can obviously be avoided by waiting until the contract is implemented before the technology is transferred to the Chinese party. If, however, the technology must be delivered before the contract is approved and signed, then the foreign investor should provide in a sepa-

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<sup>94</sup> *Id.* art. 27(3).

<sup>95</sup> *Id.* art. 28(1).

<sup>96</sup> *Id.* art. 28(2).

<sup>97</sup> *Id.* art. 28(3).

<sup>98</sup> EFI Regulations, *supra* note 15, art. 2(2). See Nee 1, *supra* note 1, at 14; Yuqing, *supra* note 13, at 107.

<sup>99</sup> JV Law, *supra* note 3, art. 5. See Lussenburg, *supra* note 39, at 556 n.56. See also Goodrich, *Joint Ventures in the PRC: A Legal Analysis in the Context of Current Chinese Economic and Political Considerations*, 15 VAND. J. TRANSNAT’L L. 521, 531 (1982).

<sup>100</sup> In addition to the vagueness of the aforementioned terminology, there may be a contradiction of terms. In particular, there may be a conflict between technology that is “truly advanced” and technology that is “appropriate to China’s needs.” This poses a dilemma for both the foreign investor and MOFERT, which is responsible for determining what is appropriate for “China’s needs,” insofar as China is probably not yet in a stage of development in which it can effectively utilize “truly advanced” technology. See Hsia & Haun, *supra* note 40, at 75; Lussenburg, *supra* note 39, at 556. This predicament may have been partially solved with the enactment of the Regulations on Administration of Technology Import Contracts of the People’s Republic of China, promulgated by The State Council, May 24, 1985, reprinted and translated in CHINA L. FOR. BUS. 6,683. The Regulations help to provide foreign investors with rough guidelines concerning what technology is acceptable to the Chinese.

<sup>101</sup> See Bloomfield, *supra* note 64, at 329.

rate agreement for payment by the Chinese party should the joint venture contract fail through no fault of the foreign investor.<sup>102</sup>

#### 4. MANAGEMENT OF THE JOINT VENTURE

##### 4.1. *Control and Administration of the Joint Venture*

###### 4.1.1. *The Board of Directors*

According to the JV Law and the JV Regulations, the "highest authority" within each joint venture is the board of directors.<sup>103</sup> The directors are to be appointed by the parties to the joint venture, the number of directors appointed by each party being determined by "consultation" among the parties with reference to their equity shares.<sup>104</sup> The chairman of the board must be appointed by the Chinese party, the vice-chairman by the foreign party.<sup>105</sup>

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

<sup>103</sup> JV Law, *supra* note 3, art. 6; JV Regulations, *supra* note 10, art. 33. See Jaslow, *supra* note 3, at 218.

<sup>104</sup> JV Law, *supra* note 3, art. 6; JV Regulations, *supra* note 10, art. 34. See Gelatt, *supra* note 28, at 236. By permitting board composition to be determined through negotiation rather than strict adherence to equity participation, the JV Law and the JV Regulations distinguish between ownership and control of the joint venture. See Bloomfield, *supra* note 64, at 329; Lussenburg, *supra* note 39, at 557. *But see* P. VERZARIU & D. STEIN, *supra* note 60, at 33. For example, in the now defunct Sanyo refrigeration joint venture, only six out of ten board members were Japanese appointees despite 75% foreign equity participation. See Pattison, *China's Developing Legal Framework for Foreign Investment: Experience and Expectations*, 13 L. & POL'Y INT'L BUS. 89, 114 (1981). In the Sino-French Joint Venture Winery Ltd. between Tianjin Vineyard and Remy Martin, the French partner holds only a 38% equity share yet has 50% of the seats on the board. See Bloomfield, *supra* note 64, at 329.

A majority of the board seats, however, does not equate with effective control of the joint venture. In fact, Rong Yirin has stated that a majority position on the board is unimportant because "[g]enerally speaking, the board of directors should reach unanimous decisions through consultation." See *An Exclusive Interview with Rong Yirin*, *supra* note 42, at 6. See also Gelatt, *supra* note 28, at 236-37. Therefore, because article 6 of the JV Law mandates that board decisions be reached through "consultation . . . on the principle of equality and mutual benefit," minority interests are accommodated and any gap between equity participation in, and control of the joint venture may be effectively bridged. See Bloomfield, *supra* note 64, at 329-30; Lussenburg, *supra* note 39, at 558.

<sup>105</sup> JV Law, *supra* note 3, art. 6; JV Regulations, *supra* note 10, art. 34. The Chinese government has insisted that the Chinese party retain the right to appoint the chairman. Initially, this meant that the chairman had to be a Chinese national. See Lussenburg, *supra* note 39, at 558; Nee 1, *supra* note 1, at 14. The Chinese text of the JV Law supports this conclusion, since the characters in the Chinese text that have been translated as "appointed" are "dan ren," which in practice means "assumed by." See Hsia & Haun, *supra* note 4, at 15 n. 17. Moreover, Rong Yiren indicated that a Chinese national must assume the chairman's position when he said that "foreign partners can be vice-presidents on boards of directors" but did not include the chairman as a possible position for foreign participants. *Id.* at 15-16. According to the Chinese, "a Chinese chairman will enjoy the advantage of an easy approach to the Chinese people

Decision making at the board level has generally been a source of irritation for foreign joint venture participants. The principal complaint seems to be the same one voiced by foreign investors during the contract negotiation phase—the extremely slow pace of Chinese decision making.<sup>106</sup> Board meetings can continue for several days even when the agenda and issues are simple and clear.<sup>107</sup>

The persistent sluggishness in board deliberations can be explained first by the fact that the Chinese directors are always reluctant to transcend the basic premises of the authorized joint venture contract because they know that within the state bureaucracy no action should be taken without first obtaining approval from a superior.<sup>108</sup> In addition, in accordance with both Chinese tradition and the JV Law, Chinese directors strive to reach decisions “through consultation by the participants on the principle of equity and mutual benefit,”<sup>109</sup> rather than through a confrontational voting mechanism characteristic of Western board decision making. Although such consultation may be beneficial to the foreign interests which often constitute a minority of the board, it does not easily lend itself to deliberational efficiency because it engenders protracted negotiation.<sup>110</sup> Finally, although Chinese law requires unanimity of the board in only four situations,<sup>111</sup> in practice unanimity is required for most, if not all, board decisions. This is because, at the Chinese participant’s behest, the board usually consists of an equal number of Chinese appointed and foreign appointed directors, who normally vote in blocks.<sup>112</sup> Therefore, unless the two groups agree, director deadlock will result for even the most ordinary decisions.<sup>113</sup> Government interference is an additional obstacle to effective

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either vertically or horizontally.” See Note, *supra* note 7, at 138 n.184. Nevertheless, through time, practice has proved that the Chinese are flexible on this point and sometimes are willing to appoint a foreign chairman. See Bloomfield, *supra* note 64, at 329; Lussenburg, *supra* note 39, at 558.

<sup>106</sup> See Huan, *China’s Open Door Policy, 1978 - 1984*, 39 J. INT’L AFF. 1, 13 (1986). See also Bloomfield, *supra* note 64, at 330; Nee 1, *supra* note 1, at 16.

<sup>107</sup> See Nee 1, *supra* note 1, at 16.

<sup>108</sup> *Id.*

<sup>109</sup> JV Law, *supra* note 3, art. 6. See also Jaslow, *supra* note 3, at 225.

<sup>110</sup> See Bloomfield, *supra* note 64, at 330.

<sup>111</sup> JV Regulations, *supra* note 10, art. 36. The four situations requiring a unanimous board are: (1) Amendment of the articles of association of the joint venture; (2) Termination and dissolution of the joint venture; (3) Increase or assignment of the registered capital of the joint venture; (4) Merger of the joint venture with other economic organizations. *Id.*

<sup>112</sup> See Moser, *supra* note 5, at 125.

<sup>113</sup> One commentator suggests that the possibility of director deadlock can be minimized by the inclusion of four provisions in the joint venture articles of association. First, issues other than those listed in article 38 of the JV Regulations as requiring a unanimous vote should be decided by a simple majority vote. Second, if a matter cannot

decision making at the board level.<sup>114</sup> Chinese governmental entities frequently countermand board decisions without any consultation or explanation.<sup>115</sup> Moreover, some issues which foreign investors perceive as fundamental to joint venture operations are not even given to the board to decide, but are reserved for the Chinese government.<sup>116</sup> Such government interference disrupts joint venture operations, infringes upon joint venture autonomy, and reduces any joint venture's chances of success.<sup>117</sup>

The EFI Regulations attempt to address this problem in article 15. Article 15 is perhaps the most significant legal concession given by the Chinese government in the EFI Regulations insofar as it grants joint ventures autonomy and decision making authority over a number of fundamental issues.<sup>118</sup> For example, article 15 provides that joint ventures may "within the scope of business approved in their contracts, . . . set their own production and operation plans, . . . raise and utilize funds, . . . purchase production materials, . . . market their products and . . . set their own level of wages, method of salary payment and systems of bonuses and allowances" and may "in accordance with their production and operational requirements, determine their own structure and personnel system, employ or dismiss senior operational and management personnel and add or dismiss workers."<sup>119</sup> This is clearly a laudable change, although it remains to be seen how article 15 will be interpreted<sup>120</sup> with respect to prior joint venture legislation,<sup>121</sup> and how it will be applied in practice by the Chinese authorities.<sup>122</sup>

be decided by a vote, then a deadline must be established for the "consultation" period. Third, if the board is unable to resolve the issue through consultation, then the question may be referred to arbitration. Finally, if the problem proves to be insurmountable, the foreign partner is entitled to withdraw from the joint venture. See Bloomfield, *supra* note 64, at 330.

<sup>114</sup> It is also an obstacle at the managerial level. See *infra* note 134.

<sup>115</sup> Baigen, *supra* note 69, at 204, 205; Hendryx, *supra* note 38, at 75, 83; Kraar, *supra* note 13, at 86, 87.

<sup>116</sup> For example, the Chinese government makes final decisions on product pricing and raw materials and energy resources allocation to permit conformity with the national economic plan. See Baigen, *supra* note 111, at 205; Bloomfield, *supra* note 64, at 330; Nee 1, *supra* note 1, at 17-18.

<sup>117</sup> See, e.g., Baigen, *supra* note 69, at 205 ("[I]n June, 1986, both the General Manager and the Deputy General Manager of the Sino-US Parker Sealing Parts Company were dismissed by the Machinery Industry Department of the Hubei Provincial Government without consultation with the company's board of directors. Although this government agency's decision was put right after five months, the company's operations had already been disrupted.")

<sup>118</sup> Yuqing, *supra* note 13, at 115-17.

<sup>119</sup> See EFI Regulations, *supra* note 15, art. 15.

<sup>120</sup> MOFERT has the authority to interpret these provisions. *Id.* art. 21.

<sup>121</sup> See *supra* notes 3-11 and accompanying text.

<sup>122</sup> While there are currently examples of joint ventures enjoying considerable au-

#### 4.1.2. Management

In the joint venture hierarchy, beneath the board of directors is the management of the joint venture operations.<sup>123</sup> The management of each joint venture is to be appointed by its board of directors,<sup>124</sup> may be comprised of either Chinese or foreign citizens,<sup>125</sup> and is responsible for organizing and conducting the daily operations of the joint venture.<sup>126</sup>

The decision making process at the managerial level, like that at the Board of Directors level, is cumbersome. The deputy system has developed independently of the JV Law or the JV Regulations. Under the deputy system, the typical joint venture contract provides that the foreign party is to appoint the top-level management positions, such as the President, while the Chinese party is to appoint the deputy counterpart, such as the Vice President.<sup>127</sup> The first drawback of such a system is that, because it effectively doubles the size of the management staff, management of the joint venture will tend to be excessively and inefficiently large. The second problem is that in practice, all decisions must be made jointly by both the manager and the deputy manager.<sup>128</sup> This shared managerial decision making, although furthering the important principle of equality that is traditionally vital in dealing with the Chinese, impedes the managerial deliberation process, and can potentially bring the decision making process to a halt should the two disagree as to the proper course of action. A final difficulty of the deputy system is that the Chinese workforce will naturally tend to follow the directions of the Chinese deputy manager more closely than the directions of the foreign manager, if indeed the foreign manager's directions are followed at all, thus again limiting the effectiveness of the manager's decision making power.<sup>129</sup>

A second problem occurring frequently in the management of a joint venture concerns the operations of management committees. These management committees, which typically consist of an equal number of Chinese and foreign appointed managers, are responsible for a substantial portion of the joint venture's management decisions. The manage-

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tonomy, Gargan, *Riding China's Capitalist Road*, N.Y. Times, May 10, 1987, § 3, at 4, col. 3, others have experienced considerable government interference. See *supra* note 117.

<sup>123</sup> See Moser, *supra* note 5, at 124-25; Nee 1, *supra* note 1, at 15.

<sup>124</sup> JV Law, *supra* note 3, art. 6; JV Regulations, *supra* note 10, art. 40.

<sup>125</sup> JV Regulations, *supra* note 10, art. 40.

<sup>126</sup> *Id.* arts. 38, 39. See Lussenburg, *supra* note 39, at 559 (discussing appointment procedure and role for each management position).

<sup>127</sup> See Moser, *supra* note 5, at 125.

<sup>128</sup> See Nee 1, *supra* note 1, at 15.

<sup>129</sup> *Id.*

ment committee, however, often experiences the same problems commonly encountered at the director level, namely, extremely slow decision making due to the requisite consultation, and deadlock due to equalized block voting.<sup>130</sup> Because many of the decisions delegated to management committees cannot effectively be made in such an atmosphere, they are in practice forced back up the chain of command to be made at the director level.<sup>131</sup> The directors are then required to grapple with routine decisions in a setting certainly no more, and probably less conducive to decision making than that at the managerial level.

Departmental independence is a third management problem. Foreign managers soon discover that they are unable to implement established plans because departments within the joint venture refuse to cooperate with one another.<sup>132</sup> This lack of coordination is because Chinese corporate departments, like most entities within Chinese society, cherish their independence and self sufficiency.<sup>133</sup> Moreover, the ties which joint venture departments do have are vertical, to government supervisors, rather than horizontal, to other departments.<sup>134</sup> The

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<sup>130</sup> Many of the problems experienced in the management of a joint venture can be traced to the fact that Chinese management skills are often rudimentary or radically different than those of foreign managers. See Pattison, *supra* note 104, at 172. See also Stepanek, *Joint Ventures: Why U.S. Firms are Cautious*, 10 CHINA BUS. REV., July-Aug., 1980, at 32-33; Hayden, *Foreign Partners' Problems in Joint Ventures in China*, Asian Wall St. J., July 1, 1981, at 6, cols. 5-6. Moreover, attempts by foreign managers to teach the Chinese new management skills often prove to be extremely difficult. In the words of one U.S. manager working in China:

They accept new ways of management in principle, but they have difficulty putting them into practice. The biggest problem is that they don't know how to define what a problem is. The reasons for a failure have never been accepted or explored. It's the old "face" thing. Management doesn't want to hear about uncertainties or failures, only accomplished facts . . . . They don't work together as a good team. Part of the problem we've had is getting them to work together; we've had to force them to hold meetings where everybody who should be present is present . . . . They don't like to get into a meeting where they have to talk about problems. No one will commit to anything until the problem's been solved. That's been the toughest thing to try to change.

U.S. Dept. of Commerce, Incoming Telegram, Subject: After the Contract is Signed: The Experience of U.S. Companies in Shanghai, International Trade Administration: China Office 4 (Aug. 1984) *cited in* Golden, *supra* note 7, at 407 n.81 [hereinafter After the Contract].

<sup>131</sup> See Nee 1, *supra* note 1, at 16.

<sup>132</sup> Hendryx, *supra* note 38, at 81 ("From the very beginning of any Chinese joint venture, foreign managers find they can't execute agreed-to plans because department heads won't coordinate their activities with one another.").

<sup>133</sup> "Fiefdoms" occur when various functions develop a sense of autonomy. "Shanto juyi, or 'mountain peakism,' is a Chinese term: 'This mountain peak is my territory; the others are not my concern.'" *Id.* at 82.

<sup>134</sup> "One reason [interdepartmental] coordination is difficult is that the different departments in a Chinese company have more allegiance to—and ties with—their



result is that large projects that require interdepartmental cooperation fail, and small projects that can be accomplished within a single department are duplicated within many.<sup>135</sup>

A final managerial problem experienced by foreign joint venture investors arises from uncertainty concerning who is truly the decision making authority. In some instances, managers receive little or no direction from the board due to the aforementioned deliberational problems at the board level.<sup>136</sup> Even if management does receive direction from the board, however, plans are often stymied due to lack of departmental cooperation or government interference.<sup>137</sup> In such an environment, the foreign manager is typically able to achieve little.

#### 4.2. *Operational Matters: Supply, Pricing, and Marketing*

The JV Law and the JV Regulations state that a joint venture must, all other things being equal, preferentially utilize Chinese-supplied components and raw materials.<sup>138</sup> The three difficulties commonly mentioned by foreign investors concerning Chinese sourcing are the frequent supply shortages of such materials, the inferior quality of the materials when their supply is adequate, and the high international

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counterparts in the planning and government bureaucracy than they have to other departments in their own organization . . . . It's just as if the treasurer of IBM reported through state channels to the secretary of the treasury in Washington." *Id.* at 81.

<sup>135</sup> Hendryx provides an example of two departments' needless duplication of work:

In one case, for example, to better control inventory and lay the foundation for an MRP-type production planning system, two computer operator trainees and a dozen stockroom clerks checked and input 15,000 inventory items into the computerized system, including about 7,000 purchased components. At the same time, the finance department took steps to implement a badly needed cost-accounting system by creating a master list of purchased parts with updated standard costs. They used the same Chinese data base software as the computer operators to create the standard cost files. Despite repeated requests from the foreign manager that the two groups coordinate their efforts, neither did so. The finance departments man entered the inventory items but used different part numbers and different names and descriptions along with the standard cost for the 7,000 purchased items. Chaos ensued. For more than three months, people worked side by side and never talked about what they were doing—they were from different departments.

*Id.*

<sup>136</sup> See *supra* § 4.1.1. See also Hendryx, *supra* note 38, at 83. ("When foreign managers complain that they can't get anything done, what they really mean is that they can't figure out who's in charge—who's supposed to make the decisions.").

<sup>137</sup> See *supra* notes 132-36 and accompanying text (lack of departmental cooperation) and notes 113-17 and accompanying text (governmental interference).

<sup>138</sup> JV Law, *supra* note 3, art. 9; JV Regulations, *supra* note 10, art. 57. See also

market price that they must pay for the materials.<sup>139</sup>

Regarding the problem of Chinese supply shortages, many joint ventures have been forced to halt production, sometimes for several months, when contractually guaranteed sources fail to deliver necessary components or raw materials.<sup>140</sup> This is clearly the most serious and potentially ruinous problem with Chinese sourcing. Article 5 of the EFI Regulations seeks to alleviate this problem by giving priority to export enterprises and technologically advanced enterprises in obtaining "water, power and transportation and communications facilities."<sup>141</sup> This provision, however, falls short of assuring the foreign investor that these essential services will be available, and excludes many other materials that the joint venture would prefer to obtain domestically.

Even if the supply of necessary components and raw materials is adequate, however, the quality of such inputs is frequently inferior to international standards, thus making it difficult or impossible to export the finished product. This problem has been voiced repeatedly by Japanese investors, who are renowned for their meticulous quality control standards.<sup>142</sup>

Finally, the pricing of Chinese-supplied inputs may present various problems, depending upon the particular component or raw material the joint venture is required to purchase. If, for instance, the joint venture purchases any of the six raw materials designated in article

<sup>139</sup> See Fenwick, *supra* note 5, at 863-64; Lussenburg, *supra* note 39, at 560. See also U.S. Dept. of Commerce, Incoming Telegram, Subject: Japanese Investment in China 3 (Aug. 1984) quoted in Golden, *supra* note 7, at 401 n.48 [hereinafter Japanese Investment in China] (stating that "parts are often of inferior quality; despite this fact, the joint venture will be charged the internationally prevailing price. This means the foreign investor can be squeezed on one side by Chinese determination of production costs (both fixed and variable) and on the other by Chinese setting the selling price."); Burns, *A.M.C.'s Troubles in China*, N.Y. Times, Apr. 11, 1986, at D1, col. 1, D4, col. 1 (Director of engineering at Jeep Automobile joint venture stating that "[t]he Chinese tell us they can provide virtually everything, but it doesn't work that way. When you find a supplier, it almost always turns out that he can't guarantee the quantity or quality, or the prices are out of line, or they want to sell you 10,000 items when all you need is a few hundred.").

<sup>140</sup> See Cohen & Valentine, *supra* note 3, at 198 ("Availability of quality inputs at any price is often a problem."). See also Fenwick, *supra* note 5, at 863; Lussenburg, *supra* note 39, at 562; Swindler, *supra* note 3, at 1033; *Beijing Plant for Japanese TV Giant*, Money: South China Morning Post, Dec. 7, 1986, at 3 (Hitachi's color television joint venture was forced to halt operations for several months in 1986 due to lack of components).

<sup>141</sup> EFI Regulations, *supra* note 15, art. 5.

<sup>142</sup> See Japanese Investment in China, *supra* note 139, at 3 (Japanese investors noting that the inferior quality of Chinese components undermines Japanese quality control standards and provides another factor which discourages the export of finished products in a competitive market). See also Burns, *supra* note 63 (A.M.C. was able to export none of the 800 Jeeps produced in China in 1986).

65(1) of the JV Regulations— gold, silver, platinum, petroleum, coal, and timber—and uses them directly in production for export, the joint venture must pay the international market price, and may pay in either renminbi or foreign exchange.<sup>143</sup> If, however, the joint venture requires import or export materials handled by Chinese foreign trade companies, the joint venture must pay a price negotiated with reference to the prevailing international market price, and must pay in foreign exchange.<sup>144</sup> This latter requirement can be particularly burdensome for the joint venture insofar as foreign exchange accounts are frequently difficult to balance.<sup>145</sup> Finally, all other materials required by the joint venture may be purchased at the price charged state-owned enterprises, and may be paid for in renminbi.<sup>146</sup>

Regardless of the particular Chinese input the joint venture wants to purchase, however, it is probable that its price will be inflated, a fact to which the rash of price gouging incidents attests.<sup>147</sup> The EFI Regulations, in article 16, attempt to remedy this problem by stating that the "Notice of the State Council on Halting the Practice of Indiscriminate Charging of Enterprises" will be enforced.<sup>148</sup> It also provides that joint ventures may refuse to pay unreasonable charges and may appeal the charges to the local or national economic commissions.<sup>149</sup> Once again, however, the foreign investor must wait to see how this provision will be applied in practice.<sup>150</sup>

<sup>143</sup> JV Regulations, *supra* note 10, art. 65(1). The international market prices are provided by the State General Administration of Foreign Exchange Control or foreign trade departments. *See also* Lussenburg, *supra* note 39, at 561.

<sup>144</sup> JV Regulations, *supra* note 10, art. 65(2). *See also* Lussenburg, *supra* note 39, at 561.

<sup>145</sup> *See* Nee 1, *supra* note 1, at 18.

<sup>146</sup> JV Regulations, *supra* note 10, art. 65(3). *See also* Lussenburg, *supra* note 39, at 561.

<sup>147</sup> *See* Kraar, *supra* note 13, at 86 ("Unrealistic pricing of raw materials also sabotages projects. Beatrice wanted to make orange juice concentrate in Canton but gave up after China offered the most expensive oranges in the world."). *See also* Cohen & Valentine, *supra* note 3, at 194 ("Prices and charges often bear no relation to the quality of the goods or services provided, or to the prices and charges paid by PRC enterprises or nationals."). In addition to fraudulent pricing practices, the inflated prices of processed and semi-processed goods can also be explained by inefficiency and low productivity. *Id.* at 198.

<sup>148</sup> EFI Regulations, *supra* note 15, art. 16.

<sup>149</sup> *Id.*

<sup>150</sup> One author identifies a problem in the unrealized potential of the law due to inconsistency between the law and policy decided at the national level. The example he provides is a law which allows the possibility of creating an enterprise solely for domestic sales and gives the local government the responsibility for imbalances in foreign exchange. In practice this type of deal has proven all but impossible to negotiate because it is "a matter of policy decided at the national level . . . . It is the most common example of the law going further than present policy allows." Bangsberg, *Progress to*

Despite the fact that the JV Regulations and the EFI Regulations permit, albeit discourage, a joint venture to acquire its inputs from abroad, which would apparently eliminate the aforementioned Chinese sourcing difficulties, this legislative concession is rendered largely illusory by the fact that joint ventures typically lack sufficient foreign exchange with which to make such purchases.<sup>151</sup> Article 14 of the EFI Regulations, as well as the Regulations of the State Council concerning the Balance of Foreign Income and Expenditure of Sino-foreign Joint Equity Exchange Ventures (FEB Regulations),<sup>152</sup> are intended to alleviate the foreign exchange crisis for many joint ventures. These provisions are seriously flawed in several respects, however, and thus their effectiveness is doubtful.<sup>153</sup> Because it is unlikely that foreign sourcing will become significantly easier for joint ventures in the near future, foreign investors will likely have no alternative but to continue to rely on the generally high priced, inferior quality, and sporadically supplied Chinese inputs.

Access to the vast Chinese domestic market has always been a lure to potential foreign investors. In contrast, the Chinese government has always sought to increase exports in an effort to earn foreign exchange and become integrated in the international marketplace.<sup>154</sup> The initial resolution of these conflicting interests, the JV Law, completely accommodated Chinese goals, and it failed to mention, much less make accessible to joint ventures, the Chinese consumer market.<sup>155</sup> In the JV Reg-

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lawyer involved in negotiations of joint ventures in China).

<sup>151</sup> See Lussenburg, *supra* note 39, at 560; Nee 1, *supra* note 1, at 18. See also Bloomfield, *supra* note 64, at 330. For example, when A.M.C.'s foreign exchange account became depleted and the Chinese government refused to replenish it with converted renminbi, A.M.C. was unable to continue importing the Jeep kits necessary for production, and thus production stopped. See Burns, *supra* note 139.

In addition, any imported equipment or materials which are not investment capital are subject to industrial and commercial taxes and import duties, unless China cannot guarantee their domestic production and supply. JV Regulations, *supra* note 10, art. 71(3). For example, the Jeep kits which A.M.C. imports are subject to an import duty of between 50 and 70 percent. See Burns, *supra* note 139, at D4, col. 3. This further escalates the costs of imported materials, and makes export of the finished product even more difficult. *Id.*

<sup>152</sup> Regulations of the State Council concerning the Balance of Foreign Exchange Income and Expenditure by Sino-Foreign Joint Equity Ventures, *promulgated by the State Council*, Jan. 15, 1986, *reprinted and translated in CHINA L. FOR. BUS.* 8,031 [hereinafter FEB Regulations].

<sup>153</sup> See *infra* notes 211-40 and accompanying text.

<sup>154</sup> As one Chinese commentator stated, "Foreigners want domestic sales; the Chinese side wants international sales. This creates a contradiction." See C. BAOTAI, *ZHONGWAI HEZIJINGYING QIYEFU JI QI SHISHI JINGYAN QIANTAN* 107 (1983), *cited in* Fenwick, *supra* note 5, at 855 n.60. See also Cohen & Valentine, *supra* note 3, at 166; Schiffman, *supra* note 14, at 12, col. 1.

<sup>155</sup> See Golden, *supra* note 7, at 408.

ulations foreign investors gained legislative concessions, however, and now joint ventures can sell their products domestically if the product is presently imported or "urgently" needed by the PRC.<sup>156</sup> Nevertheless, joint ventures are still encouraged to sell their products on the international market.<sup>157</sup>

Although the JV Regulations have legally opened the Chinese domestic market to foreign joint venture investors, many problems remain. First, on a practical level, the standard of living of the average Chinese consumer is relatively low, and thus China's buying power is limited.<sup>158</sup> Second, it remains unclear how the urgency of a product needed in the PRC is determined, thus leaving MOFERT to make a determination that is arbitrary and potentially detrimental to foreign interests. Moreover, it is not clear what happens if a product which was once determined to be urgently needed loses this status.<sup>159</sup> Third, the joint venture which hopes to sell its products on the domestic market must contend with China's relatively undeveloped transportation system. The producer can never be confident that the goods will arrive at the market at a specified time, or even that they will arrive at all.<sup>160</sup> Fourth, any goods sold by the joint venture on the domestic market must be integrated in the state-planned economy.<sup>161</sup> The joint venture is thereby subjected to the infamous bureaucratic inefficiencies of the Chinese distributional system.<sup>162</sup> Fifth, any joint venture-produced good to be sold on the domestic market will have its selling price determined by the Chinese government, with few exceptions.<sup>163</sup> This problem is particularly troubling to foreign investors since the permitted profit margin on a particular product is established according to the perceived quality of the product. If, for some reason, the product is deemed "inferior" by the Chinese authorities, its selling price can be set below its cost.<sup>164</sup> Finally, sales on the domestic market typically yield only

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<sup>156</sup> JV Regulations, *supra* note 10, art. 61. See Lussenburg, *supra* note 39, at 561; Moser, *supra* note 5, at 130; Swindler, *supra* note 3, at 1031.

<sup>157</sup> JV Regulations, *supra* note 10, art. 60. See Moser, *supra* note 5, at 130.

<sup>158</sup> Kraar, *supra* note 13, at 86.

<sup>159</sup> See Golden, *supra* note 7, at 410.

<sup>160</sup> See Japanese Investment in China, *supra* note 139, at 3. See also Swindler, *supra* note 3, at 1042.

<sup>161</sup> JV Regulations, *supra* note 10, art. 64. See also Lussenburg, *supra* note 39, at 561; Moser, *supra* note 5, at 130-31; Nee 1, *supra* note 1, at 18.

<sup>162</sup> See After the Contract, *supra* note 130, at 4; Alford & Birenbaum, *supra* note 4, at 82-83.

<sup>163</sup> JV Regulations, *supra* note 10, art. 66. See also Lussenburg, *supra* note 39, at 561; Moser, *supra* note 5, at 131.

<sup>164</sup> See Japanese Investment in China, *supra* note 139, at 3. An item may be priced at the international market rate with government approval. In that case, the joint venture may sell the goods to the appropriate departments. JV Regulations, *supra* note 10, art. 61.

renminbi earnings.<sup>165</sup> Despite the FEB Regulations and the EFI Regulations, which are intended to facilitate the conversion of renminbi into foreign exchange, such conversion remains exceedingly difficult. These problems, either singly or in combination, diminish the attractiveness of the domestic Chinese market.

### 4.3. *Labor Management*

#### 4.3.1. *Employment and Termination*

The JV Law provided little guidance concerning labor management.<sup>166</sup> Matters such as the employment and discharge of workers were left completely subject to joint venture negotiations.<sup>167</sup> Subsequently, the JV Regulations, the Regulations of the People's Republic of China on Labor Management in Joint Ventures Using Chinese and Foreign Investment (LM Regulations) adopted in July of 1980,<sup>168</sup> and the Provisions for the Implementation of the Regulations on Labor Management in Joint Ventures Using Chinese and Foreign Investment adopted in January of 1984,<sup>169</sup> provided substantive guidelines for joint venture labor management.

The LM Regulations provide that worker employment, dismissal and resignation, working hours, employment tasks, wages, insurance, vacations, and discipline must be covered in the labor contract negotiated between the joint venture and the labor union.<sup>170</sup> The LM Regulations further provide that a joint venture may employ workers recruited by the local authorities or, with the approval of the authorities, may recruit its own workers.<sup>171</sup> In either case, the qualifications of the

*supra* note 10, art. 66.

<sup>165</sup> JV Regulations, *supra* note 10, art. 66. See Kraar, *supra* note 13, at 88; Lussenburg, *supra* note 39, at 561.

<sup>166</sup> See Lussenburg, *supra* note 39, at 562.

<sup>167</sup> See Golden, *supra* note 7, at 405; Nee 1, *supra* note 1, at 19.

<sup>168</sup> Regulations of the People's Republic of China on Labor Management of Joint Ventures Using Chinese and Foreign Investment, *promulgated by* The State Council, July 26, 1980, *reprinted and translated in* CHINA L. FOR. BUS. 7,861 [hereinafter LM Regulations].

<sup>169</sup> Provisions for the Implementation of the Regulations on Labor Management of Joint Ventures Using Chinese and Foreign Investment, *promulgated by* The Labor and Personnel Department of the People's Republic of China, Jan. 19, 1984, *reprinted and translated in* CHINA L. FOR. BUS. 7,867.

<sup>170</sup> LM Regulations, *supra* note 168, art. 2. See Lussenburg, *supra* note 39, at 562-63; Moser, *supra* note 5, at 126. Small joint ventures, however, may contract with staff and workers on an individual basis. LM Regulations, *supra* note 168, art. 2. See Moser, *supra* note 5, at 126.

<sup>171</sup> LM Regulations, *supra* note 168, art. 3. See Lussenburg, *supra* note 39, at

workers may be verified by the use of examinations.<sup>172</sup> Nevertheless, in practice most joint ventures have been forced to accept workers nominated by the Chinese partner without any formal examination process.<sup>173</sup> Therefore, the foreign investor may find that the LM Regulations provide little support with which to influence the hiring of workers.

Regarding the termination of workers, the foreign investor is equally encumbered. Although the LM Regulations state that "surplus workers and staff members as a result of changes in production and technical conditions of the joint venture . . . who fail to meet the requirements after training and are not suitable for other work can be discharged,"<sup>174</sup> these provisions are virtually worthless because of the numerous protections afforded Chinese workers in other provisions.<sup>175</sup> In general, if the Chinese partner does not agree to the termination, the foreign investor may find the dismissal of a joint venture employee, for all intents and purposes, to be impossible.<sup>176</sup>

Regarding management employees, the JV Regulations provide that joint venture officers may be dismissed for "graft or serious dereliction of duty."<sup>177</sup> It may be inferred that any act or omission which falls short of this high standard, such as a negligent or incompetent act or omission, is not of sufficient gravity to justify dismissal.

Article 15 of the EFI Regulations purports to give complete autonomy to joint ventures regarding the employment and termination of workers and management personnel.<sup>178</sup> The joint venture need only file "[d]etails of recruitment, discharge and dismissal of employees" with

<sup>172</sup> LM Regulations, *supra* note 168, art. 3. See Moser, *supra* note 5, at 563.

<sup>173</sup> Moser, *supra* note 5, at 126. In addition to discovering that it has little influence over the quality of the workers hired, the foreign investor will also likely find that the quantity of workers hired is beyond its control. See Gelatt, *supra* note 28, at 239.

<sup>174</sup> LM Regulations, *supra* note 168, art. 4. See Lussenburg, *supra* note 39, at 563; Moser, *supra* note 5, at 126-27.

<sup>175</sup> LM Regulations, *supra* note 168, arts. 5, 6, 14. For example, any dismissal must be reported to the local labor bureau for approval, after which the joint venture's labor union can file an objection to the dismissal with the board of directors. If the dispute cannot be resolved through consultation, the dismissed employees may request arbitration before the labor bureau. If either party disagrees with the arbitration ruling, a suit may be brought in Chinese court. See Lussenburg, *supra* note 39, at 563-64; Moser, *supra* note 5, at 127.

<sup>176</sup> See Moser, *supra* note 5, at 127; See also Incoming Telegram 1, *supra* note 11, at 2; Bennett, *Peking Announces Detailed Regulations Concerning Foreign-Chinese Joint Ventures*, Wall St. J., Sept. 27, 1983, at 41, col. 2 ("[A]lthough joint ventures nominally have the right to hire and fire, many said that in practice the ventures have no authority. 'You can't hire and fire on your own no matter what they say . . .'").

<sup>177</sup> JV Regulations, *supra* note 10, art. 41. See Swindler, *supra* note 3, at 1035

n.197.

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<sup>178</sup> EFI Regulations, *supra* note 15, art. 15. See Yuqing, *supra* note 13, at 115.

the local labor and personnel authorities.<sup>179</sup> In a country where Mao's "iron rice bowl" remains a fundamental principle,<sup>180</sup> however, policies designed to approximate free market labor practices will likely prove impossible.<sup>181</sup>

#### 4.3.2. *Employee Remuneration*

The legislative and cultural barriers to the termination of employees is a serious problem for the foreign joint venture investor, particularly given the generally recognized inferior productivity of Chinese workers when judged by international standards.<sup>182</sup> Low worker productivity might be acceptable if the labor cost were sufficiently low relative to other countries. The LM Regulations, however, provide for wage levels of joint venture workers to be set at "120 to 150% of the real wages of the workers and staff members of state-owned enterprises of the same trade in the locality."<sup>183</sup> The EFI Regulations, which in

<sup>179</sup> EFI Regulations, *supra* note 15, art. 15. The EFI Regulations conflict with the older JV Regulations. Further experience is needed to see how the two sets of rules work together. See Yuqing, *supra* note 13, at 115-17.

<sup>180</sup> Mao Zedong's "iron rice bowl" was a policy whereby all citizens enjoyed a job and, unfortunately, an equally poor standard of living. Although this policy has been criticized since Mao's death, it is only in the last year that the concept of taking care of everyone from birth to death, which is deeply rooted in the Chinese tradition of the workplace, has been seriously threatened. See *Smashing the Bowl*, *ECONOMIST*, Sept. 25, 1987, at 43 [hereinafter *Smashing the Bowl*]. See also Alford & Birenbaum, *supra* note 4, at 86 n.278.

<sup>181</sup> Riots broke out during the Summer of 1986 over China's new bankruptcy law which also promised to bring job dislocation. This precedent does not bode well for the Chinese government's capacity to impose new reforms. *Smashing the Bowl*, *supra* note 180, at 44. This kind of reform-engendered political turbulence is extremely troubling to existing joint ventures and a severe deterrent to potential joint venture investors as it indicates political instability and the possible reversal of positive reforms. Cohen & Valentine, *supra* note 3, at 187-88.

<sup>182</sup> According to a U.S. engineer in China:

It's an unsafe work environment. There's junk all over, and so many people, most of them sitting down watching. All of the basic construction is pretty low level. The people are doing a pretty good job, but they had to be taught everything to our standards. And it's difficult to get them to maintain it.

After the Contract, *supra* note 130, at 4. See Burns, *supra* note 139, at D4, col. 4 (workers that are touted by the Chinese government as being among "Peking's best" require an average of 88 man-hours for each completed Jeep, compared with 32 man-hours in A.M.C.'s Toledo factory) (the article includes a photograph of a Chinese assembly line worker taking a nap while Jeeps roll past him); Burns, *supra* note 63, at F7, cols. 5-6 (productivity rates are so low that it is more expensive to produce goods in China than in the United States or Western Europe).

<sup>183</sup> LM Regulations, *supra* note 168, art. 8. See Bloomfield, *supra* note 64, at 331 (the basis from which the 120-150% increase is calculated is often settled by contract); Hsia & Haun, *supra* note 40, at 70; Lussenburg, *supra* note 39, at 564; Moser, *supra*



article 15 purport to grant autonomy to joint ventures in the determination of wages, offer no relief because their implementing provisions, the Autonomy Regulations, establish a joint venture wage floor at 120 percent of the average wage of workers in state-owned enterprises in the same locality.<sup>184</sup> In addition, joint ventures are required to provide benefits such as labor insurance, medical expenses, and other subsidies that are given to workers in state-owned enterprises.<sup>185</sup> Although the EFI Regulations exempt export enterprises and technologically advanced enterprises from payment of state subsidies to staff,<sup>186</sup> all joint ventures must continue to pay labor insurance, welfare benefits, and housing subsidies for Chinese workers.<sup>187</sup> It has been estimated that because of these subsidies, a joint venture worker's total remuneration is two to three times the amount of the worker's basic wage.<sup>188</sup> This being the case, China may have priced itself out of the market relative to other developing Asian country labor rates.<sup>189</sup>

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<sup>184</sup> Autonomy Regulations, *supra* note 16, art. 2(i). Furthermore, to the extent that the Autonomy Regulations remove the wage ceiling provided by prior legislation, set at 150% of state-owned enterprise wages, they create the possibility of higher labor costs. Cohen & Valentine, *supra* note 3, at 197.

<sup>185</sup> LM Regulations, *supra* note 168, art. 11. See Hsia & Haun, *supra* note 40, at 70; Lussenburg, *supra* note 39, at 564; Moser, *supra* note 5, at 127.

<sup>186</sup> EFI Regulations, *supra* note 15, art. 3. State subsidies include subsidies for heat, cooking coal, grain allowance, and other staples. See Yuqing, *supra* note 13, at 109 n.192.

<sup>187</sup> EFI Regulations, *supra* note 15, art. 3. See Yuqing, *supra* note 13, at 117.

<sup>188</sup> See Moser, *supra* note 5, at 127. See also Cohen & Valentine, *supra* note 3, at 196 n.126 ("[t]ypically, an unskilled employer of a [joint venture] will receive a take-home pay of approximately \$40 per month . . . , while the direct cost to the [joint venture] (including subsidies) will be approximately \$140."). Foreign investors often find it difficult to obtain a detailed accounting of the composition and use of these employee subsidies. See Gelatt, *supra* note 28, at 240.

<sup>189</sup> For example, it is estimated that the wages paid joint venture workers in China's Special Economic Zones are approximately 30% lower than wages paid in Hong Kong. The productivity rate of workers in China, however, is estimated to be 50% lower than that of workers in Hong Kong. Therefore, the overall labor costs will be higher in China than in Hong Kong. See Huan, *supra* note 106, at 16. Another author makes a similar observation:

[T]he Chinese government has not made its labor supply significantly more attractive to foreign investors than the labor forces of other developing countries competing for the same industrial investment. China is only one of the nations offering inexpensive labor as an incentive for investment. When compared with some South American, African, and other Asian nations, the Chinese labor pool suffers from a serious language barrier, cultural unfamiliarity, differing professional standards, and a vast lack of contact with the Western world.

Golden, *supra* note 7, at 406-07. See also Cohen & Valentine, *supra* note 3, at 196 ("Labor productivity in the PRC lags behind that of places such as Hong Kong, Taiwan, Singapore and South Korea because ventures are often pressed to hire more staff than they need, they are burdened by excessive charges and subsidies, and workers lack incentives to perform efficiently.")

A final issue relevant to labor matters concerns the equality of pay principle between Chinese and foreign employees. Chinese negotiators have consistently insisted, based on the principle of equality, that Chinese employees receive the same compensation as their foreign counterparts.<sup>190</sup> In contrast, foreign investors assert that, for several reasons, equality of compensation, although an acceptable principle in theory, is wholly inappropriate in the context of a Sino-foreign joint venture. First, equality of pay ignores the radically different economic and societal contexts of the foreign and Chinese managers. Foreign managers are paid by the company according to prevailing labor market conditions, and paid a premium to work in a distant, developing country such as China, but Chinese managers are paid according to non-market, government-established wage guidelines, and are not required to leave their homeland.<sup>191</sup> Second, Chinese managers typically lack the skill and experience of their foreign counterparts, and thus will be incapable of truly performing equal work.<sup>192</sup> This fact is implicitly acknowledged by China's open door policy, whose purpose is to import managerial knowledge and expertise.<sup>193</sup> Third, the Chinese manager does not personally benefit from equal pay, because the overwhelming majority of the salary must be given to the Chinese partner or the Chinese government.<sup>194</sup> Finally, the principle of equal pay is nowhere mandated in current legislation, and in fact runs counter to the spirit of the law.<sup>195</sup> Some compromises have been negotiated concerning this issue, but usually they are not considered satisfactory from the foreign investor's perspective.<sup>196</sup>

## 5. FOREIGN EXCHANGE RESTRICTIONS

### 5.1. *Balancing of Foreign Exchange Accounts*

The JV Law delegated foreign exchange issues in general, and the repatriation of joint venture profits in particular, to foreign exchange

<sup>190</sup> This principle is known as *tonggong tongchou*, or "equal pay for equal work." See Gelatt, *supra* note 28, at 240. See also Bloomfield, *supra* note 64, at 331; Lussemburg, *supra* note 39, at 565; Nee 1, *supra* note 1, at 19.

<sup>191</sup> See Cohen & Harris, *Equal Pay for Equal Work*, CHINA BUS. REV., Jan.-Feb., 1986, at 10.

<sup>192</sup> *Id.* at 10-11. See also Cohen & Valentine, *supra* note 3, at 196.

<sup>193</sup> Cohen & Harris, *supra* note 191, at 10-11.

<sup>194</sup> *Id.* at 11. See also Cohen, *Equity Joint Ventures*, CHINA BUS. REV., Nov.-Dec., 1982, at 24; Cohen & Valentine, *supra* note 3, at 196.

<sup>195</sup> Cohen & Harris, *supra* note 191, at 11. Instead of being a legal principle, the equality of pay principle "reflects the political undesirability of a foreign manager earning an amount far in excess of his Chinese counterpart's salary." See Gelatt, *supra* note 28, at 241.

<sup>196</sup> See Lussemburg, *supra* note 39, at 565 n.93.

regulations which, in 1979, were yet to be created.<sup>197</sup> When on December 18, 1980, the State Council promulgated the Provisional Regulations for Foreign Exchange Control of the People's Republic of China (FEC Regulations),<sup>198</sup> any hopes in the foreign investment community for a favorable foreign exchange law were dashed. Most devastating from the foreign joint venture investor's perspective was the FEC Regulations' requirement that joint ventures deposit all foreign exchange receipts with the Bank of China, or a bank approved by the Bank of China, and then make all foreign exchange disbursements from their foreign exchange deposit accounts.<sup>199</sup> Because Chinese renminbi is not convertible into foreign exchange, these provisions effectively limit a joint venture's foreign exchange disbursements to its foreign exchange earnings from exports. Such a stringent limitation was disastrous for newly established joint ventures which typically try to import almost all production inputs and materials due to Chinese sourcing inadequacies,<sup>200</sup> and which find it difficult, if not impossible, to export finished products due to their inferior quality.<sup>201</sup> For these joint ventures, chronic foreign exchange imbalances, and all of their undesirable consequences, were the inevitable result.<sup>202</sup> Any joint venture that was fortunate enough to be able to manufacture exportable products was compelled to do so, and abandon the domestic market sales that often was a motivating factor behind the foreign investment.<sup>203</sup>

Several of these difficulties were apparently solved with the advent of the Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital and Sino-Foreign Joint Equity Ventures (FEC Rules).<sup>204</sup> For instance, article 12 of the FEC Rules provides that foreign exchange can be used as the currency of settlement between joint ventures and Chinese domestic enterprises in four cases, namely (1)

<sup>197</sup> JV Law, *supra* note 3, arts. 8, 10.

<sup>198</sup> Provisional Regulations for Foreign Exchange Control of the People's Republic of China, *adopted* by The Regular Session of the State Council, Dec. 5, 1980, *promulgated* by the State Council, Dec. 18, 1980, *reprinted and translated* in CHINA L. FOR. BUS., 10,353 [hereinafter FEC Regulations].

<sup>199</sup> *Id.* art. 22. *See also* Lussenburg, *supra* note 39, at 572-74; Moser, *supra* note 5, at 131; Nee 1, *supra* note 1, at 21-22.

<sup>200</sup> Yuqing, *supra* note 13, at 100.

<sup>201</sup> Cohen & Valentine, *supra* note 3, at 188.

<sup>202</sup> Cohen & Valentine, *supra* note 3, at 188; Yuqing, *supra* note 13, at 100.

<sup>203</sup> Moser, *supra* note 5, at 131-32.

<sup>204</sup> Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital and Sino-foreign Joint Equity Ventures, *approved* by The State Council, July 19, 1983, *promulgated* by The State Administration of Exchange Control, (SAEC) Aug. 1, 1983, *reprinted and translated* in CHINA L. FOR. BUS. 10,483 [hereinafter FEC Rules].

where the products manufactured by the joint venture are import substitutes and the purchaser is a Chinese unit actively involved with foreign trade, (2) where products are purchased for the production of goods that would otherwise be exported or imported by a Chinese unit actively involved with foreign trade, (3) where a Chinese entity has completed construction work for the joint venture, and (4) where approval has been given by SAEC.<sup>205</sup> These provisions make it possible, at least in theory, for a joint venture to both sell its products on the domestic Chinese market and to earn foreign exchange through those sales.

This policy of permitting joint ventures which sell their products on the domestic market to earn foreign exchange is similarly promoted by the JV Regulations. Article 75 of the JV Regulations provides that if a joint venture which sells domestically experiences a foreign exchange imbalance, the deficit would be righted by the PRC itself, either at the local or the national level.<sup>206</sup> This provision has been interpreted to mean that joint ventures selling their products principally within China can have their renminbi earnings converted into foreign exchange at the favorable internal conversion rate if this was approved by the authorities at the feasibility study and contract negotiation stages.<sup>207</sup>

In practice, however, article 12 of the FEC Rules and article 75 of the JV Regulations have been a disappointment to foreign investors. For instance, if a joint venture desires to take advantage of either article 12 or article 75 provisions, approval must be received from the Chinese authorities, either at the local or the national level.<sup>208</sup> Before 1985, approval was extremely difficult to obtain, and only joint ventures which undertook high priority projects or produced goods that the Chinese urgently needed or imported received article 12 or article 75 approval.<sup>209</sup> After 1985, approval was virtually impossible to obtain, as China's foreign exchange reserves had dwindled and pressure was put

<sup>205</sup> *Id.* art. 12. See also Lussenburg, *supra* note 39, at 573-74; Moser, *supra* note 5, at 132. Notwithstanding these provisions, experience has shown that "most joint ventures have yet to show a profit in anything other than the inconvertible Chinese currency, the renminbi . . . For many, the best that can be expected is an accumulating surplus of renminbi, whose value is questionable." Burns, *supra* note 63, at F7, cols. 1-3.

<sup>206</sup> JV Regulations, *supra* note 10, art. 75. See also Fenwick, *supra* note 5, at 859; Lussenburg, *supra* note 39, at 574 n.127; Moser, *supra* note 5, at 132.

<sup>207</sup> See Randt, *New Joint Venture Implementing Regulations - A Step Forward*, 5 E. ASIAN EXEC. REP., Nov., 1983, at 9. When the Chinese government's foreign exchange reserves are depleted, however, as they are presently, it is unlikely that the government will permit joint ventures to take advantage of these provisions which will only further deplete their reserves. See generally Burns, *supra* note 63, at F7, col. 1.

<sup>208</sup> FEC Rules, *supra* note 204, art. 12; JV Regulations, *supra* note 10, art. 75.

<sup>209</sup> See Bloomfield, *supra* note 54, at 330.

upon joint ventures to become self-sufficient in their foreign exchange requirements.<sup>210</sup> Therefore, foreign investors cannot depend on article 12 or article 75 to remedy their foreign exchange dilemma.

In 1986, the Chinese government promulgated the FEB Regulations in an effort to solve the foreign exchange crisis.<sup>211</sup> As is the case with much of China's joint venture legislation, however, it too is flawed and will probably not significantly encourage foreign investors. First, article 3 of the FEB Regulations provides that a joint venture which experiences a foreign exchange deficit can have that deficit "adjusted" by the voluntarily converted surplus foreign exchange of other joint ventures.<sup>212</sup> Such adjustment is to be made through a fund administered by either the central or the local authorities.<sup>213</sup> This provision is problematic inasmuch as it can function only when there are many joint ventures in China that are willing to convert their excess foreign exchange to renminbi.<sup>214</sup> Currently, there are very few joint ventures that have a foreign exchange surplus, and even fewer that are willing to convert it to renminbi.<sup>215</sup> It is therefore improbable that the authorities will have anything in the fund with which to make the adjustment.<sup>216</sup>

<sup>210</sup> See Cohen & Valentine, *supra* note 3, at 189; Gelatt, *The Foreign Exchange Quandary*, 13 CHINA BUS. REV., May-June, 1986, at 20; Gelatt, *supra* note 28, at 242.

<sup>211</sup> See *supra* note 152.

<sup>212</sup> FEB Regulations, *supra* note 152, art. 3. See also Gelatt, *supra* note 210, at 29; Yuqing, *supra* note 13, at 100-01.

<sup>213</sup> FEB Regulations, *supra* note 152, art. 3 (the "local People's Government or relevant department shall be responsible for adjustment [of] the foreign exchange . . ."). However, the responsibility of the government is subject to the limitation found in article 7. When the enterprise creates the imbalance by not fulfilling the "stipulated contractual obligations for exports and generation of foreign exchange," the government is absolved of its responsibility of "resolving the situation through adjustment." *Id.* art. 7. See also Gelatt, *supra* note 210, at 29; Yuqing, *supra* note 13, at 101.

<sup>214</sup> See Yuqing, *supra* note 13, at 101 ("A shortcoming in the provision is that it can be used only when many foreign investment enterprises in China are rich in foreign exchange and are willing to swap this surplus for Chinese currency.").

<sup>215</sup> See Gelatt, *supra* note 210, at 29 (Gelatt views the adjustment process critically, noting that "[t]his rule seems to imply that MOFERT or other [governmental] authorities have the right to rob Peter to pay Paul - to requisition foreign exchange from one joint venture to make up for the deficit of another.").

<sup>216</sup> Rather than forcing joint ventures to relinquish their foreign exchange, officials explain that "foreign exchange voluntarily converted by exchange-rich joint ventures needing renminbi for local costs will be held in reserve and used to meet the needs of deficit-ridden ventures that sell domestically." Gelatt, *supra* note 210, at 29. In his article Gelatt questions the sufficiency of these reserves because, with the exception of hotels, relatively few joint ventures "enjoy the luxury of a foreign exchange surplus that might be converted . . . into local currency." *Id.*

Article 3 of the FEB Regulations is similar to article 14 of the EFI Regulations insofar as they both permit joint ventures to "adjust" their foreign exchange. Article 14 appears to be less cumbersome than article 3 to the extent that article 3 requires government administration of the adjustment fund, whereas article 14 permits joint ven-

Because there is no indication of the Chinese government's willingness to supplement the fund with foreign exchange of its own, article 3 of the FEB Regulations is more restrictive than article 75 of the JV Regulations.<sup>217</sup>

Second, article 4 of the FEB Regulations states that "special consideration" with respect to sales on the domestic market will be given to joint ventures that satisfy certain narrowly-defined conditions.<sup>218</sup> These conditions require the joint venture to manufacture products with "advanced or key technology" that are "sophisticated," "internationally competitive," and "urgently needed" in China.<sup>219</sup> An unspecified governmental entity must inspect the products to ensure that they satisfy these criteria.<sup>220</sup> If the joint venture is found to have satisfied these conditions, it can have its foreign exchange imbalance corrected by the local or national government.<sup>221</sup> Article 4, like article 3, reverses the progress made in the JV Regulations. It makes the criteria for accessing the Chinese market, originally established in article 61 of the JV Regulations, much more stringent. Specifically, article 61 states only that joint venture products must be "urgently needed" in order to be sold "primarily" on the Chinese market. Article 4, on the other hand, states that to obtain "special consideration" for domestic sales, the products must not only be urgently needed, but must also possess certain other characteristics mentioned above.<sup>222</sup> While it is clear that the decision regarding special consideration and foreign exchange correction is to be made by the authorities at the initial joint venture approval stage, it is not clear whether that decision can be changed to the detriment of a joint venture if, at a subsequent time, the joint venture's products are deemed to no longer satisfy article 4's stringent criteria for

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tures to, under government supervision, directly "engage in mutual adjustment of their foreign exchange surpluses and shortfalls." Nevertheless, article 14 of the EFI Regulations, like article 3 of the FEB Regulations, is flawed because of the dearth of joint ventures that actually have too much foreign exchange and too little renminbi. *Id.*

<sup>217</sup> "If, as the [FEB Regulations] imply, excess foreign currency turned over by joint ventures will be the only source of direct foreign exchange subsidies for deficit-ridden ventures, then the outlook seems decidedly more bleak than it did under article 75 of the 1983 [JV Regulations]." *Id.*

<sup>218</sup> FEB Regulations, *supra* note 152, art. 4. *See also* Gelatt, *supra* note 210, at 28; Yuqing, *supra* note 13, at 101.

<sup>219</sup> *See supra* note 215.

<sup>220</sup> *See supra* note 215.

<sup>221</sup> FEB Regulations, *supra* note 152, art. 4. *See also* Yuqing, *supra* note 13, at 102.

<sup>222</sup> JV Regulations, *supra* note 10, art. 61; FEB Regulations, *supra* note 152, art. 4. *See supra* text accompanying note 219. *See also* Gelatt, *supra* note 210, at 28-29 (noting that the 1983 JV Regulations have been narrowed by the FEB Regulations to include "high technology" and "high quality, internationally competitive products.").

product quality.<sup>223</sup> Finally, because the value of article 4 is dependent upon the adequacy of the Chinese government's foreign exchange reserves, it will become worthless if those reserves are depleted.<sup>224</sup>

Article 5 of the FEB Regulations states that joint ventures may sell their products, for foreign exchange, as import substitutes to Chinese "end-users."<sup>225</sup> The products must be ones which "China needs to import on a long-term or urgent basis," and must, "depending on requirements as to quality and specifications and the import situation," be approved by the relevant authorities.<sup>226</sup> Despite the fact that article 5 provides that governmental authorities shall "actively support domestic end-users" in making these purchases from joint ventures at "international prices," this provision is faulty in two respects. First, there remains the problem that foreign exchange in China is scarce, and Chinese customers simply may not possess the requisite amount of foreign exchange to make the purchase.<sup>227</sup> Second, Chinese customers exhibit a strong preference for imported goods due to their perceived superiority, and thus the joint venture may be unable to find Chinese customers willing to purchase domestically produced goods for foreign ex-

<sup>223</sup> Gelatt recognizes this problem by stating that:

[s]ince decisions on special foreign exchange dispensation must be made at the feasibility study stage - before the joint venture has been established - the [FEB Regulations] imply that the foreign investor's products will be the ones appraised. What is not clear is whether an additional appraisal of the joint venture's products will follow once the venture begins production. If so, could a joint venture whose own products fail the test that the foreign investor's products passed have its benefits revoked?

Gelatt, *supra* note 210, at 29.

<sup>224</sup> "Article 4 is likely to be confined by China's limited foreign exchange reserves. Thus, during the next few years, China may not be in a position to offer this treatment to a large number of joint ventures." Yuqing, *supra* note 13, at 102.

<sup>225</sup> FEB Regulations, *supra* note 152, art. 5. See also Gelatt, *supra* note 210, at 29 (Gelatt points out that "instead of explicitly stating that joint ventures producing import substitutes may sell them for foreign exchange to Chinese customers, the [FEB Regulations] merely state that economic relations and trade departments should 'actively support' Chinese units wishing to buy import substitution products 'according to international prices.'"); Yuqing, *supra* note 13, at 102.

<sup>226</sup> To a certain extent, article 5 reiterates article 64 of the JV Regulations, which allows joint ventures to sell items needed for import to Chinese foreign trade companies for foreign currency. JV Regulations, *supra* note 10, art. 64(4). The major difference is that article 5 allows sales to any "Chinese end-users" not just "Chinese trade corporations." See Yuqing, *supra* note 13, at 102.

Article 8 of the FEB Regulations enables joint ventures not engaged in import substitution to sell their products to Chinese enterprises for foreign currency with the approval of the state foreign exchange administration. Article 8 only applies to enterprises selling products outside of the special economic zones and technological development zones of the 14 open coastal cities, implying that permission is not needed for sales within such zones. MOFERT has not published any regulations interpreting this provision however. See Gelatt, *supra* note 210, at 29.

change.<sup>228</sup> Article 6 of the FEB Regulations provides an opportunity for countertrade. According to article 6, joint ventures that have a foreign exchange imbalance would be permitted, with government approval, to purchase export-quality Chinese goods for renminbi, and then sell those goods for foreign exchange on the international market.<sup>229</sup> This provision is, however, also unworkable in practice because any Chinese entity that is capable of earning foreign exchange through exports is usually unwilling to sell its products domestically for renminbi.<sup>230</sup> In addition, permission from the government to export Chinese-produced goods is extremely difficult to obtain because the Chinese foreign trade corporations, which seek to monopolize the export market, possess great political power.<sup>231</sup>

Article 9 of the FEB Regulations permits a foreign investor with two or more joint ventures in China to pool their foreign exchange so that the foreign exchange deficit of one joint venture may be offset by the foreign exchange surplus of another.<sup>232</sup> This adjustment may only be made, however, with the approval of the government and all the joint venture parties.<sup>233</sup> Because it is improbable that a Chinese party to a joint venture with a foreign exchange surplus would consent to such an exchange with an unrelated joint venture, the value of article 9 is questionable.<sup>234</sup> Also, because so few joint ventures presently are fortunate enough to have a foreign exchange surplus, the provision will rarely be applicable.<sup>235</sup>

<sup>228</sup> Gelatt, *supra* note 210, at 29; Kraar, *supra* note 13, at 89; Yuqing, *supra* note 13, at 102. The IS Measures, *supra* note 16, and the MEIS Measures, *supra* note 16, clarify the opportunities for import substitution, but fail to expand the opportunities granted by article 12 of the FEC Rules, article 75 of the JV Regulations, and article 5 of the FEB Regulations. The basic flaw of the new measures is, once again, their failure to provide sufficient incentive to Chinese consumers to buy domestically-produced joint venture products for foreign exchange. Cohen & Valentine, *supra* note 3, at 192-93.

<sup>229</sup> FEB Regulations, *supra* note 152, art. 6; Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 103.

<sup>230</sup> Cohen & Valentine, *supra* note 3, at 190; Gelatt, *supra* note 210, at 30. Although the PDP Measures, *supra* note 16, clarify the opportunities for countertrade available to joint ventures, they do little to remedy the basic problem of firms' refusal to sell exportable products to joint ventures for renminbi. Cohen & Valentine, *supra* note 3, at 191-92.

<sup>231</sup> Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 105.

<sup>232</sup> FEB Regulations, *supra* note 152, art. 9; Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 105.

<sup>233</sup> FEB Regulations, *supra* note 152, art. 9; Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 105-06.

<sup>234</sup> Cohen & Valentine, *supra* note 3, at 190; Gelatt, *supra* note 210, at 30.

<sup>235</sup> See Gelatt, *supra* note 210, at 29. Article 14 of the EFI Regulations increases the possibility for joint ventures to pool their foreign exchange earnings insofar as it eliminates the requirement found in article 9 of the FEB Regulations that the joint



Finally, article 10 of the FEB Regulations permits joint ventures to reinvest, with government approval, their renminbi earnings in other domestic enterprises capable of earning foreign exchange.<sup>236</sup> Such reinvestment would also qualify for a 40% income tax refund,<sup>237</sup> or a full refund if the reinvestment is made in an export enterprise or a technologically advanced enterprise.<sup>238</sup> This provision is problematic, however, because domestic enterprises are less interested in renminbi investments than in investment in the form of foreign exchange or foreign technology. It is therefore unlikely that the joint venture in need of foreign exchange will find another enterprise willing to part with its foreign exchange earnings for a renminbi investment.<sup>239</sup>

The FEB Regulations provide a legal basis for joint ventures with foreign exchange imbalances to obtain relief. Because, however, the relief is to come from government entities, Chinese trade corporations, or other Sino-foreign joint ventures, which are themselves typically in need of foreign exchange, the practical application of these provisions is suspect. It is probable that any attempt to get these other entities within China to share their scarce foreign exchange with a joint venture through the FEB Regulations will amount to little more than an attempt to get blood from the proverbial stone.<sup>240</sup>

## 5.2. *Repatriation of Profits and Wages*

As the previous section makes clear, joint ventures in China are faced with a foreign exchange crisis that is not mitigated by existing legislation. This foreign exchange crisis makes it difficult, if not impossible, for many joint ventures to pay their foreign personnel, and remit their profits, in foreign exchange. Even when a joint venture is fortunate enough to have a positive foreign exchange balance, however, current legislation limits the repatriation of foreign exchange in the form of profits and wages.

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ventures be related. Cohen & Valentine, *supra* note 3, at 190-91. Article 14 of the EFI Regulations will, however, likely be of limited effectiveness given the fact that there are presently very few joint ventures with too much foreign exchange and too little renminbi. *Id.* at 191.

<sup>236</sup> FEB Regulations, *supra* note 152, art. 10; Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 106.

<sup>237</sup> FEB Regulations, *supra* note 152, art. 10; Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 106. See also JVIT Law, *infra* note 250, art. 6.

<sup>238</sup> EFI Regulations, *supra* note 15, art. 10. If the project does not continue for five years, however, the income tax refund must be repaid. *Id.*

<sup>239</sup> Gelatt, *supra* note 210, at 30; Yuqing, *supra* note 13, at 106.

<sup>240</sup> As one commentator has said, "[f]oreign investors should accept the fact that, unless their project is of extraordinary national importance, no form of assurance of foreign exchange availability is likely to be forthcoming." Gelatt, *supra* note 28, at 243.

The legislation governing the repatriation of wages in foreign exchange is confused and conflicting. Article 25 of the FEC Regulations expressly stipulated that only 50% of a foreign employee's after-tax wages could be remitted abroad.<sup>241</sup> This limitation created many difficulties for the joint venture attempting to attract high caliber foreign personnel, and made meticulous salary planning a necessity.<sup>242</sup> One solution to this problem was to pay part of the foreign employee's salary outside of China. This proved to be an unsatisfactory solution, however, because in practice it was the foreign investor who was forced to bear the total cost of such payments.<sup>243</sup>

Subsequent to the FEC Regulations, both the JV Regulations and the FEC Rules seem to liberalize the former 50% repatriation ceiling. According to the JV Regulations, foreign employees may apply to the Bank of China for permission to remit abroad 100% of their after-tax earnings.<sup>244</sup> The FEC Rules state that a foreign employee must receive permission from SAEC before amounts exceeding 50% of after-tax earnings may be repatriated.<sup>245</sup> Given these two rules, it remains unclear whether foreign personnel must apply to both the Bank of China and SAEC for approval. In addition, the criteria for approval of such applications remains unknown, and thus the prospect of arbitrary rejection arises, despite the statement of Chinese authorities that "all reasonable applications" will be granted.<sup>246</sup> Such a harmful prospect would obviously increase as China's foreign exchange reserves declined.

The foreign joint venture investor may remit abroad its proportionate share of the enterprise's after-tax profit by debiting the joint venture's foreign exchange deposit account. Such debits can only be made, however, pursuant to an application to SAEC, and approval by the Bank of China.<sup>247</sup> Because the legislative language governing joint venture profit repatriation is permissive, it is uncertain whether approval of repatriation would be withheld during periods of severe foreign exchange shortage within the PRC.<sup>248</sup>

Finally, the advent of the Detailed Implementation Regulations Governing Violation of Exchange Control of the People's Republic of

<sup>241</sup> FEC Regulations, *supra* note 197, art. 25; Yuqing, *supra* note 13, at 94.

<sup>242</sup> See Cohen, *supra* note 194, at 24; Lussenburg, *supra* note 39, at 573.

<sup>243</sup> See Cohen, *supra* note 194, at 24.

<sup>244</sup> JV Regulations, *supra* note 10, art. 79. See Fenwick, *supra* note 5, at 859; Swindler, *supra* note 3, at 1036; Yuqing, *supra* note 13, at 94.

<sup>245</sup> FEC Rules, *supra* note 204, art. 15. See Lussenburg, *supra* note 39, at 573; Yuqing, *supra* note 13, at 94.

<sup>246</sup> See Cohen, *supra* note 194, at 24; Yuqing, *supra* note 13, at 94.

<sup>247</sup> See FEC Regulations, *supra* note 198, art. 24; FEC Rules, *supra* note 204, art. 13; Lussenburg *supra* note 39, at 573; Yuqing, *supra* note 13, at 95.

<sup>248</sup> See Lussenburg, *supra* note 39, at 573.

China, promulgated March 25, 1985, makes it imperative that the foreign investor follow the FEC Regulations, because they establish substantial penalties for evasion of the FEC Regulations.<sup>249</sup>

## 6. JOINT VENTURE TAXATION

### 6.1. *Taxation of the Joint Venture Enterprise*

The primary statute that governs the taxation of joint ventures in the PRC is the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment (JVIT Law).<sup>250</sup> The JVIT Law defines the taxable income of a joint venture as the annual net income of the enterprise derived from production, business, and other sources.<sup>251</sup> The JVIT Law establishes an income tax rate of 33% on the joint venture's net income, comprised of a 30% national tax and a 10% local surtax of the assessed income tax.<sup>252</sup> In addition, there is a 10% income tax levied on any profits

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<sup>249</sup> Detailed Implementation Regulations Governing Violation of Exchange Control of the People's Republic of China, *approved by* The State Council, March 25, 1985, *promulgated by* SAEC, April 5, 1985, *reprinted and translated in* CHINA L. FOR. BUS. 10,521. These regulations create three classes of offenses, as well as penalties corresponding to each class. For example, article 2 lists six cases that are regarded as "unlawful acquisition of foreign exchange (arbitrage)," to which the penalties described in article 3 apply. Article 4 contains four cases of "evasion of exchange control," to which the penalties of article 5 apply. Article 6 enumerates four cases considered as "disrupting financial stability," to which the penalties of article 7 apply. In addition, the offenses listed in articles 2, 4, and 6 are not exclusive, as article 8 permits penalties to be imposed for offenses not contained in articles 2, 4, or 6. Finally, article 9 is the "carrot and the stick" provision: "[T]hose guilty of minor offen[s]es or offenders who voluntarily confess to their unlawful activities to the SAEC, show sincere repentance and demonstrate meritorious conduct by informing against other offenders, shall be dealt with leniently or be exempt from punishment." However, "[o]ffenders who refuse to confess, who try to cover up their offenses or refuse to mend their ways despite repeated admonitions, shall be punished severely" according to articles 3, 5, and 7. *Id.*

<sup>250</sup> The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, *adopted and promulgated by* The Third Session of the Fifth National People's Congress, Sept. 10, 1980, *reprinted and translated in* CHINA L. FOR. BUS. 41,551 [hereinafter JVIT Law].

The JVIT Law is refined by 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, *approved by* The State Council, Dec. 10, 1980, *promulgated by* The Ministry of Finance, Dec. 14, 1980, *reprinted and translated in* CHINA L. FOR. BUS. 41,603 [hereinafter JVIT Regulations].

<sup>251</sup> See JVIT Law, *supra* note 250, art. 1; Yuqing, *supra* note 13, at 89 n.105. "Production and business" income is derived from "the production and business operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, tourism, catering, service and other trades." Income from "other sources" is derived from "dividends, bonuses, interest and income from lease or transfer of property, patents, technical know-how, trademark interests, copyright and other items." JVIT Regulations, *supra* note 250, art. 2.

<sup>252</sup> JVIT Law, *supra* note 250, art. 3. See Conroy, *Joint Ventures in China and*

remitted abroad by the foreign investor.<sup>253</sup> Numerous provisions exist, however, in the JVIT Law and the EFI Regulations to give preferential treatment to joint ventures. First, article 5 of the JVIT Law permits a joint venture, with the approval of the tax authorities, to be exempt from the income tax during its first two profitable years, and allows a 50% reduction of the income tax payable during the next three years.<sup>254</sup> Second, article 6 of the JVIT Law permits a joint venture which reinvests its profit in China for five years to obtain a 40% rebate of the income tax paid on the reinvested amount, subject again to the approval of the tax authorities.<sup>255</sup> Finally, the JVIT Law provides, in article 7, that any losses incurred by a joint venture in a tax year may be carried over to the following tax year, and may be made up with a matching amount taken from that year's income.<sup>256</sup>

The EFI Regulations give additional preferential tax treatment to export enterprises and technologically advanced enterprises. First, article 7 of the EFI Regulations exempts from the 10% income tax any profits from such enterprises repatriated by the foreign investor.<sup>257</sup> Second, article 8 grants an additional 50% reduction of the income tax payable after the expiration of the usual tax exemption and reduction period if the export enterprise exports 70% or more of the value of its products.<sup>258</sup> Technologically advanced enterprises will, according to article 9, be granted a 50% reduction in the income tax rate for three years, after the expiration of the usual income tax exemption and reduction period.<sup>259</sup> Finally, joint ventures which reinvest their profits in China for five years in an export enterprise or technologically advanced enterprise may, upon the approval of the tax authorities, obtain a full rebate of the income tax paid on the reinvested amount, under article

*Their Tax Treatment*, INT'L FIN. L. REV., Jan., 1985, at 26; Yuqing, *supra* note 13, at 89.

<sup>253</sup> JVIT Law, *supra* note 250, art. 4. See Conroy, *supra* note 252, at 27; Stoltenberg & McClure, *supra* note 28, at 82; Yuqing, *supra* note 13, at 89.

<sup>254</sup> JVIT Law, *supra* note 250, art. 5. See Conroy, *supra* note 252, at 26; Yuqing, *supra* note 13, at 90. A joint venture's first profitable year "refers to the year in which a joint venture has begun making profit after the losses, if any, in the initial stage of its operation have been made up in accordance with the provisions of article 7 of the [JVIT Law]." JVIT Regulations, *supra* note 250, art. 5.

<sup>255</sup> JVIT Law, *supra* note 250, art. 6. See Conroy, *supra* note 252, at 27; Yuqing, *supra* note 13, at 90.

<sup>256</sup> JVIT Law, *supra* note 250, art. 7. See Yuqing, *supra* note 13, at 90.

<sup>257</sup> EFI Regulations, *supra* note 15, art. 7. See Stoltenberg & McClure, *supra* note 28, at 83 n.112; Yuqing, *supra* note 13, at 110.

<sup>258</sup> EFI Regulations, *supra* note 15, art. 8. See Stoltenberg & McClure, *supra* note 28, at 83 n.112; Yuqing, *supra* note 13, at 110.

<sup>259</sup> EFI Regulations, *supra* note 15, art. 9. See Stoltenberg & McClure, *supra* note 28, at 83 n.112; Yuqing, *supra* note 13, at 110.

10 of the EFI Regulations.<sup>260</sup>

Despite the generally favorable tax legislation for joint ventures, problems remain in practice. The definition of taxable income is not as clear and unambiguous as the JVIT Law seems to suggest. Many of the particular items to be included or excluded from taxable income are subject to negotiation. It is therefore imperative that a precise, detailed definition of taxable income be established during the joint venture negotiation period.<sup>261</sup>

Another tax problem commonly encountered by joint ventures concerns indirect taxes. These indirect taxes often take the form of contributions that must be made by the joint venture to various funds such as welfare, bonus, reserve, labor union, recreational, or expansion funds. The precise amount that the joint venture must contribute to such funds is open to negotiation, so the foreign investor must be assertive in order to avoid excessive charges.<sup>262</sup>

A final tax problem is that many of the tax benefits can be realized only with government approval. In practice, satisfactory government approval may be difficult to obtain because many approvals are extremely vague, or amount to little more than recommendations.<sup>263</sup>

## 6.2. Taxation of Foreign Joint Venture Employees

The taxation of foreign joint venture employees is, according to article 70 of the JV Regulations, governed by the Individual Income Tax Law of the People's Republic of China (IIT Law).<sup>264</sup> The IIT Law makes an individual's residence determinative of the income that is subject to Chinese taxation.<sup>265</sup> Article 1 of the IIT Law states that

<sup>260</sup> EFI Regulations, *supra* note 15, art. 10. See Stoltenberg & McClure, *supra* note 28, at 83 n.112.

<sup>261</sup> Conroy, *supra* note 252, at 29. See also Cohen & Valentine, *supra* note 3, at 205; Gelatt, *supra* note 28, at 244-45.

<sup>262</sup> See Cohen & Valentine, *supra* note 3, at 205; Conroy, *supra* note 252, at 29.

<sup>263</sup> See Cohen & Valentine, *supra* note 3, at 205; Conroy, *supra* note 252, at 29; Gelatt, *supra* note 28, at 245-46.

<sup>264</sup> Individual Income Tax Law of the People's Republic of China, *adopted and promulgated* by The Third Session of the Fifth National People's Congress, Sept. 10, 1980, *reprinted and translated in* CHINA L. FOR. BUS. 37,751 [hereinafter IIT Law].

The IIT Law is complemented by the Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China, *approved* by The State Council, Dec. 10, 1980, *promulgated* by The Ministry of Finance, Dec. 14, 1980, *reprinted and translated in* CHINA L. FOR. BUS. 37,853 [hereinafter IIT Regulations]. In addition, the IIT Law is modified by the Provisional Regulations of the State Council Concerning the Reduction of Individual Income Tax on Wages and Salaries of Foreign Nationals Working in China, *promulgated* by The State Council, Aug. 8, 1987, *reprinted and translated in* CHINA L. FOR. BUS. 37,913 [hereinafter IIT Reduction Regulations].

individuals not residing in China, or residing in China for less than one year, are taxed only on Chinese-source income.<sup>266</sup> If an individual resides in China for more than one year, but less than five years, that individual will be taxed on Chinese-source income and foreign-source income that is remitted to China.<sup>267</sup> Finally, if an individual resides in China for more than five years, that individual must be taxed on income from all sources, regardless of whether it is remitted to China.<sup>268</sup>

The IIT Law specifies six categories that are considered income for tax purposes: 1)wages and salaries, 2)compensation for personal services, 3)royalties, 4)interest, dividends, and bonuses, 5)income from the lease of property, and 6)other items determined to be taxable by the ministry of finance.<sup>269</sup> Wage and salary income which exceeds a specified deduction is taxed progressively at rates from 5% to 45%.<sup>270</sup> All other categories of income are taxed at a flat rate of 20%.<sup>271</sup> According to the IIT Reduction Regulations, however, any income tax payable by foreign joint venture employees under the IIT Law shall be reduced by one half.<sup>272</sup>

## 7. CONCLUSION

China has progressed very far, very fast. In less than eight years, the Chinese government has enacted an impressive body of law governing the operations of Chinese and foreign owned joint ventures in the PRC, and has concluded a substantial number of joint venture contracts with foreign investors. Hopefully, such positive trends will continue. Nevertheless, this Comment has endeavored to expose and analyze the tremendous problems which joint ventures in China presently face and will continue to face in the foreseeable future, in an effort to show that, despite China's progress since 1979, the balance is tipped decidedly against joint venture participation for the majority of

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*ple's Republic of China*, 7 NW. J. INT'L L. & BUS. 666, 684 (1986). It should be noted that under the current laws there is some ambiguity as to what constitutes "residence." *Id.*

<sup>266</sup> IIT Law, *supra* note 264, art. 1. See Easson & Jinyan, *supra* note 265, at 685; Yuqing, *supra* note 13, at 91.

<sup>267</sup> IIT Regulations, *supra* note 264, art. 3. See Easson & Jinyan, *supra* note 265, at 685; Yuqing, *supra* note 13, at 91.

<sup>268</sup> IIT Regulations, *supra* note 264, art. 3. See Easson & Jinyan, *supra* note 265, at 685; Yuqing, *supra* note 13, at 91.

<sup>269</sup> IIT Law, *supra* note 264, art. 2. See Easson & Jinyan, *supra* note 265, at 687; Yuqing, *supra* note 13, at 91.

<sup>270</sup> IIT Law, *supra* note 264, art. 3(1). See Easson & Jinyan, *supra* note 265, at 688; Yuqing, *supra* note 13, at 91.

<sup>271</sup> IIT Law, *supra* note 264, art. 3(2). See Easson & Jinyan, *supra* note 265, at 689-91; Yuqing, *supra* note 13, at 91.

<sup>272</sup> IIT Reduction Regulations, *supra* note 264, art. 2(i).

investors.

There certainly are, and will continue to be, cases in which the foreign investor weighs the prospective advantages and disadvantages of joint venture investment in China and concludes not only that the advantages outweigh the disadvantages, but also that the net advantage in China is greater than that offered by other countries in which one could invest. This, however, remains the exceptional case. As a rule, after examining the myriad problems that continue to surround the joint venture in China, the foreign investor will usually be better served by alternative investment vehicles within China, or by a joint venture investment in another country.