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Mr. Li felt boxed in when he thought about his meeting earlier that morning.[1] He had spent three hours with representatives of a Sino-French joint venture and the conversation had been difficult and inconclusive.

The French manager was incensed that the product he was manufacturing in Tianjin—factory-grade electrical switches—had been reverse-engineered by two enterprises in central China. The copied switches resembled the French switches in every way, even down to the French patent code numbers on the side of the housing box. Now the copied switches were being sold across China and competing with the French firm's products. More distressing, the quality of the copied switches was not good because of mistakes in the manufacturing process. One small Chinese factory that used the pirated switches had burned to the ground because of an electrical overload. At another location, a hospital generator had exploded after one of the switches had been installed, blowing out a wall in a second floor operating room. Potential purchasers were beginning to avoid the switches altogether—regardless of whether they had been manufactured by the Sino-French joint venture or the pirate enterprises in central China.

Mr. Li heads the Tianjin municipal ministry that had jurisdiction over many of the commercial operations in the Tianjin Economic Development Administration (TEDA)—a new economic zone for Sino-foreign

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[1] I have changed many of the names mentioned in this article at the request of the interviewees. The situations presented are all based upon actual facts and occurrences.

joint ventures some 20 kilometers outside the main part of the city. The zone sits on the edge of Tonggu harbor and is one of north China's most rapidly growing industrial centers. As more foreign firms move in, Mr. Li's ministry group is gaining in prominence and his staff is becoming one of the most professional and respected in the city. Li's superiors consider the zone a commercial success story and a real boon for Tianjin's economy.

The French manager had been blunt and outspoken at the meeting. He held up one of his own switches and placed it side-by-side with one of the pirated switches. Then he dared anyone in the room to tell which was the real one. He showed advertisements run by one of the pirate firms and complained that even the ads were copies of his. For dramatic emphasis, he showed large photographs of the burned factory and the damaged operating room.

The copied switches were only the tip of an even more troublesome iceberg, the Chinese co-manager of the joint venture said. The French firm had contracts with other Tianjin-area suppliers for some of the basic materials used by the joint venture. The most important of these Tianjin-supplied materials—plastic resins—had also been diverted to the southern Chinese pirate firms. The Chinese suppliers had used the French formulae, manufactured the new plastics, and then sold most of their output directly to the Chinese pirate firms.

"We have well-negotiated agreements," said the Chinese co-manager, "and we thought that we had good working relationships with our suppliers. Probably the relationships cannot be restored after these problems. But they must give us back our formulae and they must not use it to supply materials to our competitors. We cannot survive if we have to compete against ourselves."

The French manager's final words were the most difficult for Mr. Li. "We have a contract signed by you, the Tianjin municipal government, and the ministry in Beijing. We want you to enforce this contract. Bring suit against the pirate factories and stop their production."

Mr. Li understood the problems of the two managers and he wanted to find a way to resolve their complaints. The success of the joint venture was important to both the future of the development zone and to his own career.

How to find a way through the thicket of problems? The French manager was right—the joint venture had a contract, it had been negotiated with all of the right offices, and it was based on the last two sets of

regulations promulgated by the State Council.[2] The Tianjin municipal code governing the operation of joint ventures in the TEDA zone was even more explicit. There was little question in Mr. Li's mind that the French manager was correct in arguing that a contract violation had occurred.

But using the legal system, as the French manager was insisting, did not seem comfortable. Mr. Li later described his situation (using his old Marxist lexicon) as a tension between theory and practice. The foreigner believed in his contract and in the rule of law; he was familiar with court systems in Europe and he knew how to be an effective advocate. But Chinese practice was based on a different set of working assumptions. To rely on written law to enforce behavior, said the *Analects*, was never as important as proper behavior itself; falling back on legal code was evidence that people and their government had failed.[3] Although Mr. Li did not think of himself as a Confucian scholar, he still harbored a strong feeling that attempting to resolve a contract problem through the court system could only result in more trouble for everyone.[4]

It is not my intention to explicate China's Foreign Economic Contract Law (FECL), the Joint Venture Law (JVL), or the Foreign Enterprise Income Tax Law (FEITL). The analysis of these codes has been done in great detail by others.[5] Instead, I will examine the actual behav-

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[2] In previous studies I have described and analyzed the procedures used in China to acquire, assimilate, and utilize foreign goods and technologies. I have argued that this process is shaped by (1) a multi-tiered process that includes a number of distinct and separate stages, and (2) a group of key players whose activities shape the workings of the different stages. *See* Roy F. Grow, *In Search of Excellence in China's Industrial Sector: The Chinese Enterprise and Foreign Technology, in* CHINA'S ECONOMIC DILEMMAS IN THE 1990'S: THE PROBLEMS OF REFORMS, MODERNIZATION, AND INTERDEPENDENCE (Joint Economic Committee, U. S. Government Printing Office 1991). *See also* the case studies in OTTO SCHNEPP ET AL., UNITED STATES-CHINA TECHNOLOGY TRANSFER (1990).

[3] *See* Steven K. Hazen, *Good Business Sense: Changing Practice in the People's Republic of China*, 10 HASTINGS INT'L & COMP. L. REV. 583 (1987); David A. Hayden, *The Role of Contract Law in Developing the Chinese Legal Culture*, 10 HASTINGS INT'L & COMP. L. REV. 571 (1987).

[4] For Chinese views, *see* Hugh T. Scogin, *Between Heaven and Man: Contract and the State in Han Dynasty China*, 63 S. CAL. L. REV. 1325 (1990); Gao Xi-Ching, *Today's Legal Thinking and Its Impact in China*, 52 LAW & CONTEMP. PROBS. 89 (1989).

[5] There are a series of accounts that have outlined the general framework of the Chinese Foreign Economic Contract Law (FECL). Among the most insightful analysts is Preston M. Torbert. *See, e.g.*, Preston M. Torbert, *New Implementing Rules on Technology Import Contracts*, 10 E. ASIAN EXECUTIVE REP. 20 (1988). *See also* RICHARD J. GOOSEN, BUSINESS LAW AND PRACTICE IN THE PRC (1987); Wil Armstrong, *The Development of Commercial Law for Foreign Investment in China*, 12 HOUS. J. INT'L L. 55 (1989); Gary Watson, *Business Law in the People's Republic of China, 1978-1989*, 27 AM. BUS. L. J. 315 (1989); Zhao Yan, *A Comparative Study of the Uniform Commercial Code and the Foreign Economic Contract Law of the People's Republic of China*, 93 COM. L. J. 63 (1988); Henry Zheng, *A Comparative Analysis of the Foreign Economic Contract Law of the People's Republic of China*, 3 CHINA L. REP. 227 (1986).

ior of the most important actors governed by this set of laws—the Chinese and foreign enterprises that work with one another and which must find ways to resolve their competing claims.[6] In this study, I will examine the tension between Chinese and foreign firms by focusing on several specific and limited questions having to do with actual practice: How do Chinese enterprises form contractual relationships with one another? How useful is China's relatively young and underdeveloped body of commercial law and precedent in resolving disputes between Chinese enterprises? How much can this body of law and regulation be relied upon by foreign firms who interact with Chinese enterprises?[7]

I will approach these questions by examining the behavior of the most important actors in this arena—the Chinese and foreign enterprises which have formed contract relationships. The data used in the body of this paper are drawn from a long-term research project that began in the early 1980's. In the course of more than a dozen years of work investigating more than 65 Japanese and 45 American firms involved in China, I have worked with or interviewed several hundred corporate and government officials who have been closely involved in these projects. Most of these interviews took place over an extended period of time, and in a number of cases I worked as a consultant for the companies or became involved in the corporate planning process. I have been able to follow most of these projects for a number of years and in some cases the record extends back over a decade. Altogether, my study includes almost 250 different projects with as many Chinese enterprises.[8]

I have used a small subset of my larger data base for the analysis in this paper. From my larger group of case studies, I have chosen 32 different Chinese enterprises that were involved in some sort of commercial dispute—either with their foreign partner or with another Chinese firm. Sometimes these conflicts were small and limited, involving, say, nothing more than a disagreement over the timing of a payment. Other conflicts were more visceral and threatened the basic relationship between the enterprises themselves. All had one thing in common: both foreign and

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6 I have written elsewhere in detail about the ways that foreign and Chinese enterprises interact with one another during the earlier stages of their commercial relationship. *See, e.g.,* Roy F. Grow, *Acquiring Foreign Technology: What Makes The Transfer Process Work?, in* SCIENCE AND TECHNOLOGY IN POST-MAO CHINA (Merle Goldman & Denis Simon eds., 1989).

7 For a recent statement on the kinds of frustration that builds up between foreign and Chinese managers *see Party of the First Part: China Tries to Improve Contract Law,* 156 FAR E. ECON. REV. 42 (1993); Clement Shum, *Companies With Foreign Equity Participation in China,* 10 J. BUS. L. 185 (1991).

8 Roy F. Grow, *Comparing American and Japanese Technology Transfers in China: Assessing the 'Fit' Between Foreign Firms and Chinese Enterprises, in* TECHNOLOGY TRANSFER IN INTERNATIONAL BUSINESS (1991).

Chinese managers had difficulty finding an appropriate arena for resolving their conflicts.

What Mr. Li faced as he looked for a way of helping the joint venture under his jurisdiction is a problem that is at the heart of China's utilization of contract law and commercial regulation today. While China's reform policies have created an increasingly elaborate and complex body of law, many of the key players in the Chinese economy—both individuals and enterprises—are ill-equipped to use these new methods.[9] In the following pages, I will outline some of the reasons why this is the case.

I. THE ENTERPRISE IN CHINA'S NEW COMMERCIAL SYSTEM

China has literally re-invented itself during the last decade and a half. The central allocation mechanism is gone: the old State Planning Commission that in the past exercised authority over the flow of virtually all of China's inputs and outputs now oversees only two dozen prices—primarily in areas of energy, precious metals, and transportation. The big Beijing ministries are now little more than loose bureaucratic shells and real decision-making authority has shifted to provincial, county, municipal, and township level agencies. Even the authority to levy and collect taxes has moved to local levels and China today has no real equivalent of the American national Internal Revenue Service.

No communist society's economy has grown more rapidly than China's. Beginning with the 1978-79 reforms, the Chinese economy has emerged—in the space of fifteen years—as the fastest growing in the world. Many economists now believe that past estimates of the economy's size and its rate of growth severely underestimated what has occurred. Instead of the $400 per capita output used in our old estimates, many analysts now argue that a more accurate per capita figure is somewhere between $2,000 and $4,000.[10] Total output, other analysts argue, is now more in the range of $1.5 trillion, pushing China past Hong Kong, Taiwan, Korea, and Singapore (and perhaps even Japan) as the center of gravity for East Asian commercial development.

A. THE NEW CHINESE ENTERPRISE

Immense growing pains have accompanied this rapid growth. The Chinese reform movement's emphasis on economic decentralization, en-

[9] *See* Clement Shum, *Contractual Joint Ventures in the People's Republic of China*, 11 BUS. L. REV. 272 (1990).

[10] See the description of the recent reevaluation of Chinese output data in *When China Wakes*, THE ECONOMIST (Supp.), November 28, 1992, at 1-16.

terprise autonomy, and entrepreneurial authority has been accompanied by a fitful movement toward a new system of commercial relationships.

The real centers of gravity in the new Chinese economy are the enterprises and their managers. It is inside the enterprise that the most important economic and commercial decisions are now made and it is the managers of these enterprises who are the most important links in the web that is responsible for China's rapid economic growth.[11] Many of these enterprises, however, have been cast adrift in a sea of new commercial relationships; they have been left almost on their own to forge new strategies in what seems—at least to many Chinese managers—a trial and error world.

Consider *Guangming Appliance Factory #1.* The Shanghai factory makes a range of small appliances including a sleek aluminum cased toaster oven that has become one of the smash commercial hits in China's booming consumer economy. In both the large cities and the cash-rich countryside of central China, people use *Guangming's* toaster ovens for a variety of tasks that range from heating simple traditional foods to preparing prepackaged off-the-shelf meals.

Manager Wang has been *Guangming's* director since the mid-1980's. His job has changed almost entirely during this period. In the past, the manager of the appliance factory lived in a world governed by central allocation: targets were set by higher authorities, resources were distributed by a series of interlocking local and national agencies and output was spoken for years in advance—almost regardless of quality or price. The most valuable commodity a manager could bring to an enterprise was "contacts with the heavens": an ability to get along with higher-ups who could provide all of the things that meant success or failure for an enterprise—more personnel, lower targets, increased pay for workers, and new equipment.

Now Manager Wang's world is completely different. At almost every level of Chinese commercial activity—from the provincial-level state factories to the independent and energetic township enterprises—the real center of administrative and decision-making authority has shifted away from the ministries and to the enterprise itself. Today Manager Wang's daily activities more closely resemble those of an American executive than they do those of a 1980's Chinese manager. Most of his day is spent overseeing the "three great needs": finding inputs for his

[11] For a study on how this new managerial center of gravity came about, *see* Roy F. Grow, *Japanese and American Firms in China: Lessons of a New Market*, 21 COLUM. J. WORLD BUS. 49 (1986).

production, monitoring the factory operations, and keeping on schedule the output that goes to his customers.

Finding his own inputs is a new task for Manager Wang and he spends a considerable amount of time figuring out who can supply them and how much they will cost. Increasingly, the ministries and agencies leave these tasks to Wang himself. Now his aluminum casings come from one supplier, his copper wiring from another, a small chip that regulates temperature and timing from a third, a set of plastic knobs from a fourth, and printed packaging material from a fifth.

Monitoring all of the things needed to keep his factory going—over and above the inputs needed to produce the toaster ovens—is equally complex. Most difficult to arrange are what Wang calls "social-use permits": state and local tax forms, environmental use statements, and building permits. Each comes from a different agency and each must be approved using a different procedure. Then there is water, electricity, truck transportation, and machine maintenance products. Again, each comes from a separate source and each is negotiated through a separate set of procedures.

The customer/end-user side is equally complex. Gone are the days when a manager could assume that all of the enterprise's output would be claimed by one or two end-users who worked through a state plan. Now, Manager Wang himself manages the sales and distribution of his product. His representatives fan out across the province and they have strong commercial relationships with almost a dozen different distribution agencies and department stores. The enterprise arranges its own transportation, prints its own brochures, and collects its own sales receipts. The factory is even organizing an after-market repair facility for the area's increasingly savvy consumers.

Wang thus lives in a complex world of inputs, production processes, and outputs that he and his staff manage and worry about. The success or failure of an enterprise increasingly falls on the shoulders of the manager and his staff, rather than on some "higher Chinese authority" as had been so common in the past.

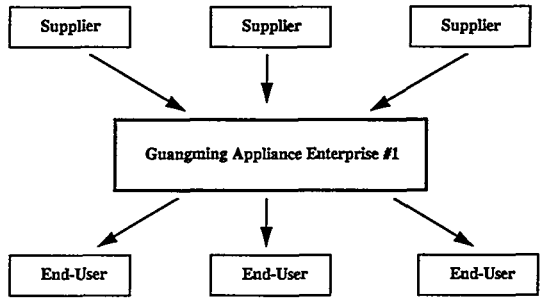
B. Negotiating a Contract

Each of *Guangming's* inputs and outputs is negotiated, not commanded, and each is governed by a complex set of personal relationships and formal rules.[12]

[12] Xu Guojian, *Contract in Chinese Private International Law*, 38 Int'l & Comp. L. Q. 648 (1989).

Chart 1

The Central Role of the Enterprise



Consider Manager Wang's struggle to find an input as simple as the plastic knobs and handles for the toaster ovens. The search began when the enterprise's chief engineers agreed on the final design for the new toaster oven model. The marketing staff had argued that the knobs and handles—along with the aluminum casing and the glass front—would be the oven's primary selling point.

After setting the design, the staff turned to the question of sourcing. Some argued that the knobs should be made in-house—the work could be given to some of the underemployed women in the work unit. Others argued for the simplicity of a purchase agreement. Hire the job out, one staff member argued, and you won't have to worry about finding all of the raw materials, maintaining the quality of the molds, and using the right finishing compounds.

The production staff shopped their design to three different enterprises in the area and then narrowed the decision down to a single firm. Manager Wang sent a representative to the supplier and they talked about prices, quantities, and delivery schedules. The general outline of a satisfactory agreement was completed in an afternoon's conversation.

The actual contract with this supplying enterprise was worked out under the direction of a province-level negotiating team. The team facilitated several discussions between representatives of the two factories, wrote a brief letter of understanding that was signed by representatives from both sides, and then sketched out a draft contract. This draft contract began with a standard boiler plate cover that outlined a series of general propositions governing commercial relationships in the province. Then the contract went on to stipulate—in a few short paragraphs for

each category—design, quantity, quality, delivery dates, and method of payment.

The draft document went to each of the Chinese enterprises and a few changes were made by each side. Then the revised draft was sent to a province-level board for review and it was amended again. Finally, after nine weeks of discussions and negotiation, the contract was signed by both factory managers.

Manager Wang followed this procedure for each of his toaster oven's inputs and outputs. There were times when Wang had time to reflect on how different his job had become in a decade; in the 1980's he and his enterprise would have been more of a passive instrument—receiving inputs negotiated by outside agencies and using prices set by others to balance his books. Now it is Wang who sits at the very center of the process and his "supervising agencies" have been turned into centers of review and approval, rather than the instigators of action.

C. Cross-Jurisdictional Problems

The enterprise manager's world is complicated by the changing role of the old agencies and ministries of the state economy. Although the days of direct management, allocation, and supervision are long gone, the ministries still claim a sort of general jurisdictional oversight responsibility, and there remain a series of loose administrative boundaries and loyalties that cut across almost every Chinese commercial transaction.

The State Council and the State Planning Commission, for example, still engage in a planning exercise that sets general guidelines and priorities for a five-year period. Most analysts argue that the charting of this plan is more a political exercise than an effort at rational and long-term planning. Almost always—as in the case of the document worked out in 1990—the guidelines lay out a series of national priorities, and these priorities become one of the means used by the Beijing and provincial ministries to debate national policies and influence the nature and pace of economic development.

The national planning exercise has important local consequences for managers such as Wang, since it sets out a series of general guidelines for the central ministries and then encourages the ministries to push for implementation. In the most recent plan, for example, there was general agreement that the Chinese economy needed infrastructure development, that certain categories of production (such as alloy steel) continue to need "guidance," that energy was a major priority, and that the next important step in the reform process was the development of a nationwide social security safety net.

These general priorities work their way through the commercial system in a variety of ways. The most important consequence involves the ways that China's enterprises bid on scarce resources and the ways that conflicts between enterprises competing for these resources are resolved. For example, many small enterprises are able to make a good case to a local office of one of the nationally chartered banks for loans if their commercial plans and expansion projects fit one of the general priorities in the five-year plan. The local rail transport agency, for example, can make a strong claim on the People's Bank for hard currency to buy switching equipment from Germany, and argue that their needs outweigh those of, for instance a small consumer-goods enterprise that wants to buy new equipment from Japan.[13]

The bank's decision on loans for rail equipment will have ripple effects in other areas. Requests for space on China's over-burdened rail system might be ranked by a local transportation enterprise official according to the general priorities of the Plan; should a request to ship toaster ovens, say, rank above a similar request to ship telephone line equipment. Similarly, a request for an exemption from China's increasingly complex environmental regulations might be weighed in terms of these general needs, or permission to set up a sales office in another province might become enmeshed in decisions about relative importance of using aluminum for toaster ovens as opposed to airplanes.

Many observers argue that the big Beijing ministries have, in effect, transformed themselves from agencies of direct administration and control into organizations of guidance, influence, and coordination. While the big ministries no longer exert direct control over the flow of resources and commodities, they continue to wield administrative influence and often use this influence to support the enterprises, projects and managers they consider to be within their nominal jurisdiction.

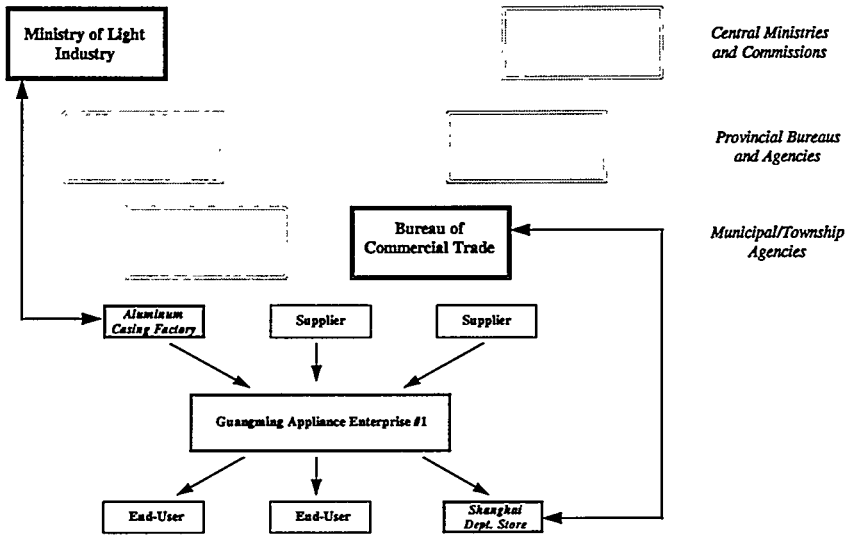
The fact that Mr. Wang deals with suppliers and end-users that cut across these vague jurisdictional boundaries makes his role more difficult. For example, during the past year Mr. Wang found himself caught squarely in the middle of a dispute between one of his suppliers and one of his best customers that cut across such a jurisdictional line.

The dispute involved the aluminum casings Mr. Wang uses for his toaster ovens. He buys these casings from a factory that is nominally under the general jurisdiction of the national Ministry of Light Industry. The aluminum casing factory has the authority to sign its own contracts, hire its own labor, and make changes in its production technologies. But

13 See the ripple effects of such cases described in David A. Sneider, *The Baoshan Debacle: A Study in Sino-Japanese Contract Dispute Settlement*, 18 N.Y.U. J. INT'L L. & POL. 541 (1986).

Chart 2

Competing Jurisdictions of Enterprise Partners



the aluminum casing factory asked for help from the central ministry when it needed additional funds to complete an expansion project in 1991. The national ministry, in effect, co-signed the local enterprise's loan application and used its deposits in the Bank of China as a sort of collateral. In return, the casing factory signed on to a separate project sponsored by the ministry; it agreed to supply pressings for another factory that was making a product that would be exported to the Philippines. The Philippine-bound product would, in turn, earn foreign currency for the Beijing ministry which could be used for yet another set of projects.

On the other hand, one of Manager Wang's best customers is a Shanghai department store that is that city's major outlet for consumer appliances. The department store, however, is under the jurisdiction of the Shanghai Municipal Commercial Authority which charters its sales operations, issues its commercial permits, and receives its tax payments.

Manager Wang's problem came from a series of complaints brought to him by the department store's sales representative. The casings on one of the toaster-oven models were "popping"—bulging out and cracking when used for a long time at a high temperature. There had been some serious damage from several of the popping episodes and the department

store's customers wanted compensation—both for the toaster ovens and for the damages caused by the appliances.

Mr. Wang looked to the casing factory to stand behind its products and compensate the department store customers. But the factory manager denied that his factory was responsible. He argued that his "supervising agency"—the Ministry of Light Industry—had set up guidelines that regulated the extent of his liability. He noted that Wang had known about these regulations since a ministry representative had been present during the contract negotiations and had noted these provisions in the final version of the contract. He argued that since the casings were made to Wang's specifications, since no complaint had been received from Wang's factory after delivery, and since the casings worked nicely in other models, he was not responsible—as his ministry's guidelines noted—for the department store customer's damages. He showed Wang the series of regulations from his ministry and argued that he had no further responsibility in the affair.

The manager of the department store argued in a similar fashion. The manager showed Wang a set of guidelines from his municipal ministry that made the sellers of a product—both the direct seller of the finished product and the manufacturer of the subassembly parts—responsible for the quality of the items they manufactured and liable for damages these products caused. The Shanghai municipal code that governed this type of complaint, he argued, made the original producer liable for damages; the aluminum casing factory clearly had the responsibility to reply to his customer's complaints and offer appropriate compensation.

II. Resolving Contract Disputes

Manager Wang thus found himself caught between two ministries with different jurisdictional responsibilities, two enterprises that based their operation on different sets of regulations, and two managers who were not about to give in to each other. Wang confronted a problem increasingly familiar to almost every entrepreneurial Chinese enterprise manager as the old state relationships broke down: his old recourse—asking a supervising ministry for resolution—was now almost completely gone.[14]

Wang surveyed the different courses of action that were available to him. His first option was to try to handle the affair himself. He could call

[14] For an overview of some of this earlier practice, *see* Wang Guiguo, *A Survey of China's Economic Contract Law*, 3 China L. Rep. 259 (1986); Henry Zheng, *A Comparative Analysis of the Foreign Economic Contract Law of the People's Republic of China*, 3 China L. Rep. 227 (1986).

the manager of the aluminum casing factory, perhaps meet with him over a meal, and try to work out some sort of a compromise that would be acceptable to both of them. This seemed an option without teeth; all of the phone calls and meetings to this point had not changed the other manager's actions. Further, if the meetings did not work, not only would the department store's customers remain unsatisfied, but Wang's relationship with one of his most important suppliers would be jeopardized.[15]

Another option was to rely on the People's Court system—a series of local and provincial commercial courts that handled "economic problems" for Chinese enterprises. Once before, Wang had worked his way through this process and it seemed excruciatingly slow and complex. First came trips to the local procurate office to detail the nature of the grievance. Wang had been interviewed by two young men who cross-examined his statements and demanded supporting documents for all of the claims. A long two month waiting period followed, when nothing at all seemed to be going on. Finally the local officials published their decision—unfavorable in Wang's case—and added a requirement that Manager Wang pay the costs of the court hearings as well as the penalties levied in the case.[16]

Wang's final option was "administrative persuasion" that used informal discussions through a series of intermediaries to settle disputes.[17] In Wang's province, such intermediaries are usually named beforehand during the contract negotiation stage. They can be representatives from one of the agencies that oversees the enterprise, a "neutral" representative from a local government organ, or a senior ministry official from Beijing or the provincial capital.[18] In the best of circumstances, these outside representatives play a sort of mediating role; they bring the parties together, get some factual information on the table, and push the parties toward an agreement. If the process fails, however, the decision of the mediators is final and, at least in some parts of China, there is no appeal.

Manager Wang had used this method once before in a dispute with the supplier of his packaging materials. Wang had ordered a supply of

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15 *See* Peter V. Smilde & Viveca Y. Tung, *Conciliation of Commercial Disputes in the People's Republic of China*, 4 CAN.-AM. L. J. 43 (1988).

16 For another description *see* Phyllis L. Chang, *Deciding Disputes: Factors That Guide Chinese Courts in the Adjudication of Rural Responsibility Contract Disputes*, 52 LAW & CONTEMP. PROBS. 101 (1989).

17 Gao Yongfu, *Economic Contract Laws in China*, 21 U.S.F. L. REV. 317 (1987).

18 Tim N. Logan, *The People's Republic of China and the United Nations Convention on Contracts for the International Sale of Goods*, 5 CHINA L. REP. 53 (1988).

Table 1

Where Commercial Disputes are Settled

	Through Informal Channels	Through Administrative Channels	Through the Court System	Total Number of Cases
Disagreement w/ Suppliers				
Delivery problems	8	6	1	15
Schedule problems	9	3	1	13
Quantity problems	5	3	0	8
Payment problems	15	6	5	26
Disagreement w/ End-Users				
Delivery problems	13	3	2	18
Schedule problems	10	1	1	12
Quantity problems	5	1	6	
Payment problems	14	3	4	21
Disputes about Support/ Infrastructure	4	2	2	8
Dispute about Intellectual Property	3	1	3	7
	92	30	19	141

boxes and put down a large down payment to guarantee the order. However, the box factory had not shipped his supplies and Wang had been forced to deliver his toaster ovens by wrapping them in blankets and transporting them in the back seat of the company car. After a series of meetings with a mediating team, the two factories had worked out a new schedule that brought boxes to Manager Wang in two weeks.

Wang decided to use the mediation method in his dispute with the aluminum casing factory and he sent in the papers that constituted a formal application for outside involvement. The first meetings had been devoted to gathering information about the case. The mediators met with each factory manager separately, read the contracts, and examined the production and delivery schedules. The sessions with the manager of the casing factory had not gone well, however; after the first meeting, the casing factory manager stopped coming and sent only a low-level staff member.

The mediators agreed with Wang that the casing factory was responsible, in part, for the "popping" of the oven casings. They concluded that the casings sent to Manager Wang's factory were actually copied from a design used by a different model of oven, rather than from Wang's specifications. They agreed that the casing factory, not the department store, should answer the complaints of the department store's customers.

Then they worked out a strategy to pressure the casing supplier—who continued to boycott the meetings—into action. First, the mediators placed a sort of attachment on the casing factory's bank account. "If the manager doesn't come around," one of the mediators said, "we will simply transfer some of his assets to your account. But he is most likely to come in and see what the problem is. When he does, we will hold another meeting and see if we can work through the issue again. You should have a resolution in two weeks."

Wang would later talk about the process with a chuckle. "It worked for me this time," Wang said, "because I knew one of the mediators. We had gone through training school together. If he had not been a friend, I don't know how the case would have turned out."

Wang's story about the search for a way to resolve contract disputes is not an unusual one. China in the mid-1990's still lacks a well-established and workable system of dispute resolution. The old ministry relationships have been torn down and conflicts are no longer handled through the old bureaucratic command system. A new commercial code is slowly coming into being and some areas—like Tianjin, Shanghai, and Shenzhen—are far ahead of other parts of the nation.

Most Chinese managers prefer not to use the more formal legal system.[19] They tend to rely instead on the older, highly personalistic processes that are more deeply rooted in Chinese organizational culture. As most of the participants in this process readily admit, the advantage (and the final decision) quite often goes to the manager who has a personal relationship with one of the members of the mediating team.

Table 1 outlines the findings of a simple survey about the resolution of contract disputes among Chinese enterprises. The thirty-two Chinese enterprises in this survey were involved in a series of disputes which had reached a point of standoff; communication had broken down and the participants were faced with the choice of either giving up the matter altogether or finding an outside method of conflict resolution.

By Western standards, most of these cases would have found their way into some formal part of the legal system. In China's new commercial world, however, the overwhelming tendency is to use the more informal and personalistic process. As with Manager Wang, the managers of most Chinese enterprises tend to avoid the more formal and impersonal economic court system.

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19 John A. Spanogle, Jr. & Tibor M. Baranski, Jr., *Chinese Commercial Dispute Resolution Methods: The State Commercial and Industrial Administration Bureau*, 35 AM. J. COMP. L. 761 (1987).

III. Disputes Between Foreign Firms and Chinese Enterprises

Nominally, foreign firms in China are governed by a set of commercial rules and regulations that outline their status and legal responsibilities, trade relations, intellectual property rights, and contract procedures. In theory, these laws and regulations appear to grant foreign firms a unique position in the Chinese economy and they offer an important set of contractual and operational safeguards for these firms.[20] Foreign managers often enter the China market assuming that their joint venture or direct sales operation has a special and privileged position in China's commercial world.

In practice, the foreign enterprise must fit into the larger Chinese commercial system's set of inputs, production functions, and outputs. Foreign firms in China thus become a part of the same complex system of personalistic relationships, competing lines of jurisdictional authority, and changing roles that govern other Chinese enterprises.[21]

Mr. Li's problems with the French joint venture illustrate this point. Although the formal legal status of the French joint venture is different than that of its local Chinese counterparts, in practice every dispute between a foreign firm and a Chinese enterprise has to work its way through the system of parallel jurisdictional arenas, cross-cutting bailiwicks, and competing local and provincial legal codes.

For the French manager of the joint venture, the situation seemed fairly straight forward. Why not determine what jurisdiction the pirate factories fell under, bring charges, and let the process work its way through the Chinese court system? The French manager argued that this was the process spelled out in his joint venture contract.[22] "I have three choices," he said, pointing to the contract. "I can use a mediation and conciliation, go to arbitration, or use the court system. I think that the court system will work best, since China does not want the publicity of a court case that will hit the international media."

To Mr. Li, however, the case was more complex. He was not worried so much about whether the French manager was right or wrong, or whether the joint venture had a contract that had been approved by the

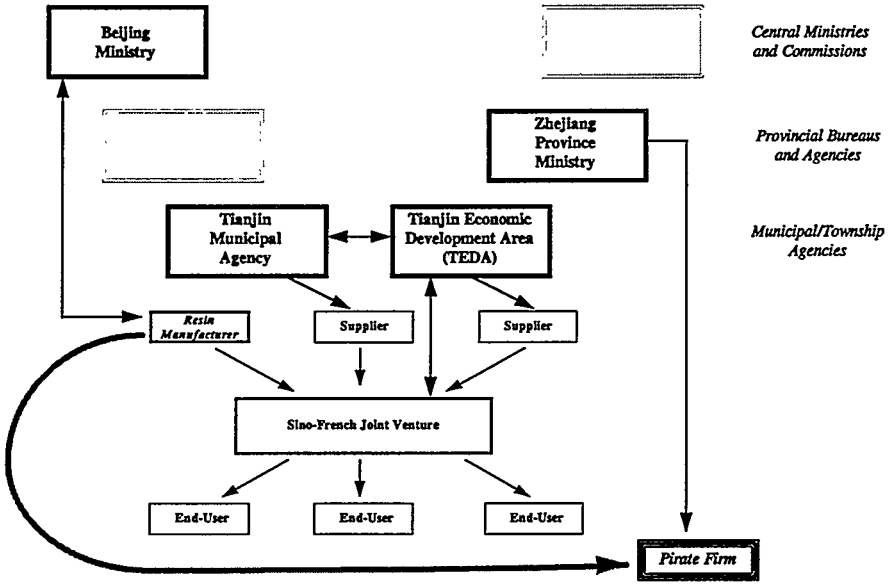
20 Note the discussion in Stanley B. Lubman, *Investment and Export Contracts in the People's Republic of China: Perspectives on Evolving Patterns*, 3 B.Y.U. L. Rev. 543 (1988).

21 Eldon H. Reiley & Hu Run Fu, *Doing Business in China after Tiananmen Square: The Impact of Chinese Contract Law and the U.N. Convention of Sale of Goods on Sino-American Business Transactions*, 24 U.S.F. L. Rev. 25 (1989).

22 Note the procedures described in Tim N. Logan, *The People's Republic of China and the United Nations Convention on Contracts for the International Sale of Goods: Formation Questions*, 5 China L. Rep. 53 (1988).

Chart 3

The Complex World of a Joint Venture



proper authorities. Technically, Mr. Li believed, the French manager was correct in all of the statements and charges he had made.

Mr. Li was more concerned about whether or not the impasse could be resolved at all, given the relationship between the different Chinese enterprises, the boundaries between their administrative jurisdictions, and the absence of some mechanism of enforcement that crossed these boundaries.[23]

The problem, Mr. Li said later, was that there was no clear line of responsibility between his office—which was part of TEDA and the Tianjin municipal authority—and the French manager's supplier of plastic resins. The resin supplier was directly subordinate to a Beijing ministry while the pirate firm that bought the resins was linked to a provincial-level organization. Too many administrative lines had been broached, he thought, and there was no political entity or law-enforcement mechanism that could cross the lines to resolve the dispute.

A. Problem Sources

Foreign managers of joint ventures in China often lay on Chinese commercial law the responsibility for resolving contractual disputes be-

23 Stanley R. Arnold, *With a Client in China*, 87 COM. L. J. 170 (1982).

tween their organizations and Chinese enterprises. Most Chinese observers, however, believe that the source of such problems is more often located in the first steps taken by the foreign firm in establishing its China operation. Mr. Li had once asked the French manager why the foreign firm had picked that particular Chinese enterprise to make the resin material. The French manager replied that there had been a combination of factors responsible for the decision and that the most important were an introduction by a Hong Kong consulting firm, the looks of the Chinese factory itself and, most importantly, the low price that the Chinese manager offered.

Mr. Li hesitated before he asked what he considered the most important questions: "Did you know the lines of administrative authority for all of the enterprises you were dealing with? Did you look for any sort of relationship between the different firms?"[24]

The French manager looked a little angry. "Why should I be worried about relationships? Doesn't Chinese law apply equally to all of the parties involved in my contract?"

It was the answer Mr. Li feared most. He had been involved in so many cases of this sort; foreigners read China's joint venture law and see the outlines of a process for conflict resolution that includes a series of mediators, arbiters, and procurates. It all seems clear and straight forward.[25] Yet the process outlined in these commercial regulations did not come close to the reality that Mr. Li had to administer, and he had seen many joint ventures looking for a formal means of conflict resolution where none really existed.

Many Chinese managers and officials note that Japanese businessmen tend to carry out their negotiations in a much different manner. Japanese businessmen take longer to work out the contract itself and often insist on greater precision than their American and European counterparts. However, the logic of the Japanese negotiating strategy—what many Japanese business teams really try to accomplish in their negotiation sessions—is much different. Japanese negotiating teams focus almost exclusively on building a series of inter-personal relationships with their Chinese counterparts: they spend more time than their American and European competitors trying to understand their partner's problems and attempting to work their way through the network of formal and infor-

24 Note the account in Denny F. Wong & Christopher G. Oechsli, *Getting a Binding Contract: Legal Status and Authority of Chinese Enterprises and Their Representatives; How Foreigners Can Determine Who They Are Dealing With*, 11 E. ASIAN EXECUTIVE REP. 9 (1989).

25 An Chen, *Why Some Sino-Foreign Economic Contracts are Void and How to Prevent Voidness*, 23 WILLAMETTE L. REV. 679 (1987).

mal relationships that enmesh every Chinese enterprise.[26] Even after their carefully negotiated contract is completed, the Japanese partners in a joint venture operation almost never pursue litigation in the Chinese court system.

Mr. Li had watched many times as a Japanese joint venture rejected one potential supplier after another, and he had admired the ability of Japanese negotiators to penetrate the relationship issues. He believed that Europeans and Americans, on the other hand, tended to focus more on technical details such as the kinds of equipment that were needed and the methods of payment. He had once heard an American engineer comment on the old aphorism that all Chinese looked alike. Mr. Li supposed that the same held true for Chinese enterprises—they all looked alike to foreigners and the quality that distinguished one from the other, in foreign eyes, had to do with production functions and cost.

The French manager, for example, stated that he had located the joint venture in the TEDA zone for several reasons. The most important factors, he said, had to do with the area's infrastructure. The zone had its own source of electricity and this freed the enterprises in the zone from the periodic blackouts that hit other parts of the Tianjin area. In addition, the zone was near Tonggu harbor—one of China's best deep-water ports. The supplies and machinery needed for the factory could be moved in quickly and export production could be shipped out easily, avoiding China's overcrowded rail system. Most important, said the French manager, was the fact that TEDA had been given special economic zone status. In the manager's mind, his firm was thus also granted a special status; it would be subject to a different set of regulations and taxes would be assessed at a rate different than for firms outside the zone.

A second set of factors had to do with "cost." Mr. Li had participated in a number of joint venture negotiations and foreigners (Americans in particular) seemed totally engrossed in issues having to do with relative price. These foreign firms spend most of their negotiating sessions working through the costs of their Chinese inputs and their constant struggle was to find the lowest cost supplier. The underlying assumption seemed to be that once a contractual agreement about price had been agreed upon, the most important part of the negotiation had been completed.

Absent in almost all of the American and European negotiations was any attempt to sort out the relationships between the various Chinese enterprises or to understand the different administrative and juris-

26 Grow, *supra* note 11, at 54-56.

dictional boundaries that shaped their actions. Looking back at the negotiation sessions he had witnessed, Mr. Li observed that a major part of the problem faced by foreign managers lay not with Chinese law, but in the way they saw their position in the Chinese commercial world. They believed, correctly, that Chinese foreign contract law and the joint venture regulations gave foreign firms a kind of special status in China. But one of the most common failings of foreign managers was to extend this view of their own special status to their relationships with Chinese suppliers and customers. Their working assumption most often was that the suppliers and customers operated according to the same rules and based their activities on the same logic as did the foreign firms that enjoyed special joint venture status.

In fact, most Chinese enterprises—even those that have contractual relationships with foreign joint venture partners—continue to operate in the vague world of incomplete contract law and murky cross-cutting administrative lines of authority. Once a foreign manager steps outside the protected bubble of his special status and forms a commercial relationship with a Chinese enterprise, he makes himself subject to all of the pressures faced by domestic Chinese enterprises.

B. Problem Solutions: Rules for Successful Foreign Managers

The world of foreign commercial activity in China is filled with success stories and American firms are among the strongest; Otis Elevator, Proctor and Gamble, Campbell Soup, Cargill, Nike, and Foxboro are only a few of the most prominent examples. These American successes are matched by an equal number of Japanese firms; Suntory, Toyota, Matshushita, Mitsibishi, and Ajinomoto have all established an important presence in the new China market.

The Japanese and American success stories are more similar than they are different and managers in all of these firms tell long and involved tales about their China operations. When pressed about the factors that separate them from their less successful competitors, they usually offer a very short list of reasons for their success that have to do with the ways they settle potential or actual disputes with Chinese enterprises and agencies. Of all of the factors that managers and analysts have mentioned, the following "rules" are most often mentioned by successful foreign managers in the China market.

Rule 1: Contract law continues to play a supporting and peripheral role in Chinese commercial conflict resolution

Successful foreign managers almost always express surprise at just

how far Chinese commercial law has developed during the past decade. "When I came here in the early 1980's," one foreign manager stated, "there was almost no commercial code, no court system I could use, and no one to talk to about my problems outside the ministries. Now there is good commercial law in almost every part of China."

Nonetheless, say these same managers, foreign firms that rely on this new contract law as their primary means of conflict resolution are almost certain to fail. "Chinese contract law is fine if you have certain kinds of problems—such as the expatriation of profits. But it is of little use in resolving a conflict with your Chinese suppliers and customers."

Rule 2: Central government ministries are not centers of conflict resolution

Successful foreign managers in the China market argue that the last place they look for help in conflict resolution is in the big Beijing ministries and the agencies of the State Council. Newcomers are often fooled by these government organs, successful foreign managers argue. The newcomer sees a big building, watches the bureaucrats promulgate regulations, and makes the (incorrect) assumption that in those ministries lies the power to make the system work.

"The best advice I could give a newcomer to China," said one American manager, "is to avoid the Beijing ministries altogether. The real action is where your factory and its suppliers are located. If you can't make it work at the local level, you can't make it work at all. If your contracts are not well-negotiated on the local level, and if you have not sorted out your local relationships, no Beijing bureaucrat can make it work for you."

Rule 3: Contract negotiation is primarily a relationship-building process

Chinese observers are constantly surprised at the importance foreigners attach to the most straightforward and mechanical parts of a contract negotiation. Foreigners—Americans in particular—spend the greatest amount of their time negotiating "hardware" issues (machinery, parts) and price.

For both Chinese managers and the most successful foreign negotiators, the signing of a contract represents a plateau in the development of a relationship, not the completion of a discrete phase of the project.

The most successful foreign managers note that the contract negotiation is a process that allows the two sides to know one another, understand one another's genealogy, and begin the building of a longer term relationship. As one Chinese manager argued, "Negotiating a contract is

like putting tea on the table. It facilitates the social interaction but it does not substitute for the actions themselves. It is the same with a contract negotiation: once the contract is negotiated, it has lost its use. It is simply a means to something more important."

Rule 4: Conflict resolution is almost always accomplished through non-formal channels

As the Chinese system changes and evolves, most successful foreign managers argue, contract law and the court system will become more useful to outsiders. But that day has not yet arrived and most foreign managers of successful foreign operations argue that attempting to "force" the system simply does not work.

"Most of my Chinese suppliers rely on informal, personal relationships to settle their disputes," one foreign manager stated. "For Chinese managers, the system is built on a series of informal relationships. I am most successful when I use the same style. Conversation and the constant exchange of information are exponentially more successful than litigation. If I have to resort to the Chinese court system, I know that I have already lost my case."

Rule 5: Negotiating "price" is not the same as determining "cost"

One of the most difficult points in negotiating a contract between foreign and Chinese enterprises comes in moving away from a simple emphasis on "price" and toward the more complex understanding of long-term "cost." "Many Chinese firms," says one foreign manager, "can supply my inputs at a cheap price. But if the relationship bogs down or if it gets entangled in the Chinese legal system, the long-term costs to a project can multiply quickly."

"One of my most troublesome moments in negotiating a contract," says an American manager, "was facing the home office back in the States. In the home office, all they were interested in was my bottom-line hard figures. We went through nine versions of the final contract and each version was more specific about delivery dates and price figures. How could I explain that not all Chinese factories are alike, that not all were related to my operation in the same way, and that the lowest price might actually cost more in the long run?"

IV. Mr. Li's Solution

Mr. Li had a great deal of sympathy for the French manager and his problems with the private enterprises. But he doubted that he could settle the case in a way that would be satisfactory to the foreigner. The

problems were overwhelming; the Chinese enterprises fell under different jurisdictions and were located within different provinces and municipalities. The French manager had an agreement that had been negotiated in Tianjin, but this agreement was not very useful in Beijing and even less so in Shanghai or Nanjing.

So Mr. Li used a more time-honored method. He called an old schoolmate who now worked in the Shanghai development zone. A week later he flew to Shanghai and explained the problem faced by the French manager. Together, the two men worked out a way of bringing the illegal production to a halt. The resin supplier in Tianjin would not be granted the necessary transit permits to ship his product south. In turn, the pirate firm would be cited for violation of environmental regulations, including using potentially corrosive chemicals without the proper clearances.

In six weeks the problem was solved; the shipments of resins had stopped and the pirate firms were no longer making the switches. Later, when Mr. Li explained the solution to the French manager, he was not at all surprised to see a cloud pass across the manager's face. "What about the law? What about my contract? Are they worth anything?"

Mr. Li was not certain that he could offer an answer that would satisfy the French manager. But he knew that sooner or later the French manager would have to take into account the reality of China's emerging system of commercial relationships and the vigorous but still underdeveloped system of contract law that is only now just beginning to take shape.