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I. INTRODUCTION

This chapter presents a general introduction to aspects of the Chinese legal system of particular interest to investors in securities of Chinese enterprises or companies organized to invest in China. Our principal focus is on the creation of legally binding obligations under Chinese law, and the enforcement of those obligations. We do not address the legal and practical issues involved in structuring and negotiating a deal in China. Rather, we will try to help answer a question that has come increasingly to the forefront in the business and investment community: once you have a deal in China, what have you got?

To approach this question, a flat recitation of Chinese law will not do. Legal development in China is being driven—or, in many cases, pulled at some distance behind—by the extraordinarily fundamental and comprehensive reform process begun in China in 1979 and the ferocious commercial energy that process has unleashed. Practice is well ahead of law in some areas and well behind it in others, and both law and practice are constantly evolving. The best way to understand Chinese law is to examine it within the framework of a few basic themes relating to the historical and cultural context in which the law operates and to the current reform process in particular. These themes, far from being abstract and

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academic, are often an essential means of making sense of what goes on day to day in the commercial and financial arena. We will begin by introducing these basic themes, and then proceed to an overview of contract law; the law relating to property rights; securities law; certain features of the company law and joint venture law; and the enforcement of legal obligations and laws protecting creditors (such as bankruptcy law and the law relating to mortgages and security interests). Finally, we will briefly discuss the legal system of Hong Kong and how it may change after the transition to Chinese control in 1997.

II. CENTRAL THEMES

A. The Development of the Legal System

The state has historically played—and continues to play—a pervasive role in economic activity in China. In the Communist era, the state has been the dominant economic actor. As a consequence, the development of law as a system of norms governing economic activity involving private parties was stunted for many years.

The Chinese legal system today is a classic example of a glass that is half empty or half full, depending upon how you look at it. Law has been a crucial underpinning for the PRC's stunning economic progress of the past 18 years. Indeed, China is undoubtedly the contemporary world's leading example of a national elite's conscious application of law as a stimulus to development. When Deng Xiaoping assumed the leadership in 1978 and put an end to the policy of "class struggle" that had led to the Cultural Revolution of 1966-76, he and his colleagues in the Party Politburo and Central Committee made it clear that the construction of a legal system would be an indispensable element of the newly-proclaimed modernization policy. At that time, the PRC displayed virtually none of the indicia of a formal legal system. It had almost nothing in the way of useful economic legislation. Its Soviet-style legal institutions from the 1950s were a shambles. Its judges, prosecutors, lawyers, legislative draftsmen and ministry legal experts had been on the shelf for at least 20 years, and legal education and scholarship were barely starting to revive.

Eighteen years later, we are able to look back on a remarkable burst of legislative activity. There are now in place at the national level—to name only some of the basic building blocks—a mini-code entitled General Principles of Civil Law, detailed domestic and foreign-related contract laws, edicts pertaining to the licensing of technology, a fairly comprehensive collection of laws and regulations for authorizing and attracting the various forms of foreign direct investment, a number of

regulations relating to loans, guaranties, foreign exchange controls and other financial matters, a company law, central and commercial banking legislation, detailed regulations for the securities industry, a negotiable instruments law, a law on security interests, a trial bankruptcy law, a series of laws concerning income taxation of enterprises and individuals as well as other taxes, several laws on labor protection and trade unions, elaborate laws for the protection of intellectual property rights and for the prohibition of unfair competition, a real estate law, a considerable body of environmental and consumer protection legislation, a civil procedure code, an administrative litigation law and rules for the conciliation and arbitration of domestic and international business disputes. Much more national economic legislation, including more sophisticated laws regulating securities and partnerships, is scheduled to be adopted in the near future, a good deal of it based upon impressive local regulations already in place in the country's leading commercial centers.

International legislation has also been a major part of this effort. The PRC now adheres to most of the principal multilateral treaties for economic cooperation, such as the Vienna Convention on Contracts for the International Sale of Goods, the Paris Convention for the Protection of Industrial Property Rights, various copyright and patent conventions, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the Hague Convention on service abroad of documents in civil and commercial matters. China has, in addition, erected an impressive network of bilateral agreements to promote trade and investment with many countries, including numerous tax treaties, mutual protection of investment agreements and judicial assistance agreements.

And yet Western investors in China complain incessantly about the lack of transparency, clarity and consistency in Chinese law; about rigid bureaucratization and the lack of clear criteria or accountability for bureaucratic actions; and about the lack of a competent and independent judiciary to enforce the law. These complaints are often fair, and evidence very serious problems for foreign businessmen and investors. Indeed, they are frequently shared by Chinese parties as well. Clearly, the Chinese legal system has a long way to go before it provides anything close to a functional equivalent of the mature legal systems found in the major Western nations.

The reform process begun in 1978 is still a very recent phenomenon in historical terms, and the Chinese legal system is very much a work in progress. Observers viewing it from the outside, or encountering it directly (often to their great frustration), do well to maintain that historical perspective. It is relatively easy to adopt legislative frameworks and regulatory regimes—often imported from abroad—to govern broad fields

of activity. It is much more difficult and time consuming to put those laws into practice, to adapt them to local conditions, to fill in the gaps and to develop a body of interpretation and precedent that can make the rules meaningful in specific cases. Most difficult and time consuming of all—as evidenced by the continued weakness of the Chinese judiciary—is the task of building institutions that can effectively, consistently and fairly enforce those laws across a country as vast as China. The system of modern commercial law in China cannot be understood without appreciating how young it is; 18 years is a very short period of time to develop the web of rules, customs, practices, institutions, habits and attitudes that make up a legal system.

B. The Role of the State

The ubiquitous presence of the state and the multiplicity of roles that it plays—regulator, business operator, business owner, business partner, sovereign borrower—is a frequent source of confusion for Westerners. The reform process is not necessarily reducing the role of the state; indeed, reform and openness have increased the frequency and diversity of encounters between foreign businessmen and the Chinese state in its various guises. Reform is, however, changing the role of the state in important ways, with the essential thrust being toward greater devolution of economic responsibility, greater autonomy for enterprises and greater differentiation between the role of the state as sovereign and its role as an economic actor. Fewer and fewer enterprises are entirely state-owned, and an increasing number of those that are entirely state-owned are being transformed into stock companies with limited liability and, in many cases, share ownership distributed among a number of governmental entities and state-owned enterprises. Consistent with the basic principles of the reform program, the Chinese government is less likely than in the past to stand behind the debts of a Chinese business enterprise simply because that enterprise is owned, directly or indirectly, by the state. There is a certain irony to the fact that China, in becoming more like capitalist states, is becoming a more confusing place for Western businessmen.

C. The Dynamic of Reform

Reform in China is not proceeding in accordance with a detailed master plan. There is a great deal of experimentation involved. In any given field there are frequent cycles of *laissez faire*—creating a sort of policy laboratory in which the government can study the effects of unbridled activity—followed by a tightening of regulation. Likewise,

experimentation is frequently tolerated (or encouraged) at a local or regional level, followed by a tightening of regulation at the central level. There are frequent sharp turns and reversals as the government encounters unexpected effects of new policies. The inevitable result of the way the reform process works is a great deal of uncertainty. Therein lies a great dilemma for foreign investors. Change means uncertainty, and uncertainty can be an investor's enemy; but it would be a great lost opportunity if China were to alter its commitment to rapid and radical change.

D. The Center vs. the Provinces

The reform process in China is taking place against the backdrop of a vigorous struggle for authority among central, provincial and local levels of government. The current struggle is simply the latest variation on one of the most ancient and enduring themes of Chinese history, epitomized by the familiar saying that "heaven is high and the emperor is far away." The struggle has intensified as the reform process has advanced, stimulating greater economic activity—which in China as elsewhere resists regulation—throughout the country. The result of this for foreign investors is further uncertainty and confusion concerning governmental policies, applicable laws and regulations and required approvals. Often investors are caught in the middle, between the more investor-friendly local authorities and the more macro-oriented central authorities, each offering their own—often sharply divergent—visions of the applicable regulatory framework and the proper way to proceed. In addition, the vastness of China and the existence of entrenched local power bases often makes it difficult for the central government to enforce laws that it adopts for the benefit of investors. This is in fact one of the principal points made by the central government itself in the recent dispute with the U.S. over the enforcement of intellectual property rights. The conflict between central and local authorities will continue to handicap the development of the Chinese legal system, and to heighten the risks for foreign investors, at least until China evolves and enforces a reasonably clear and rational allocation of authority between the central and provincial governments.

E. Corruption

The problem of corruption in China has received a great deal of attention. An analysis of the sources and the extent of this problem is beyond the scope of this chapter, but the effect of corruption on the development of the legal system should be noted. Corruption of course undermines the fair and impartial administration of law and erodes respect

(or inhibits the development of respect) for the rule of law. The importance in Chinese culture of *guanxi*—relationships—is itself a mild form of corruption to the extent that it affects relations between the government and private entities, in that it inevitably compromises the principle of equal treatment under the law. The point where relationships and "favors" turn into bribery and graft is not always clear, although responsible investors certainly can—and the vast majority of investors do—successfully conclude transactions without any need to skate close to the line. But even where corruption is not in fact present, the widespread suspicion of it is corrosive of legal relationships. One may hope that a relaxation of state control over the economy will over time reduce the opportunities and incentives for corruption, but clearly this problem will continue to cloud business relationships and the development of the legal system for a long time to come.

III. THE LEGISLATIVE AND JUDICIAL FRAMEWORK

In structure and theory, China's legal system is a "civil law" system based on written statutes. Unlike in the "common law" system of the U.S. and the U.K., decided cases do not constitute binding precedents, but they are sometimes referred to as guidance.

In form, under the Constitution of 1982, the highest governmental authority in China is the legislature, the National People's Congress ("NPC"), which is composed of 3,000 deputies and only meets in plenary session for one three-week sitting a year. Through its Standing Committee, however, the NPC has become increasingly active in the legislative drafting process and no longer plays a "rubber stamp" role for legislation proposed by the Communist Party or the State Council.

The State Council is the executive arm of the government and has the power to enact and administer rules and regulations. In theory, since China has a unified, hierarchical government rather than one based on a separation of powers, the State Council is subordinate to the NPC. It currently has 31 ministries, nine commissions (including the State Planning Commission, the State Economic and Trade Commission and the State Commission on Restructuring the Economic System) and many administrative agencies under its jurisdiction. The Premier has overall responsibility for the State Council and the performance of the executive functions of the government.

China is divided for administrative purposes into 22 provinces, five autonomous regions and three municipalities (Beijing, Shanghai and Tianjin) under the direct control of the central government. China does not have a federal system, in that there are no spheres of authority

constitutionally reserved for the provincial governments; they are, at least in theory, merely administrative arms of the central government. Provincial and local governments may adopt rules and regulations, so long as they are not inconsistent with central government laws, rules and regulations. As indicated above, however, the practice is often not as simple as the theory.

The court system in the PRC has four levels: the Elementary People's Court, the Intermediate People's Court, the High People's Court and the Supreme People's Court. The courts contain specialized divisions for different types of cases, usually including civil, economic, administrative and foreign-related business divisions. An increasing number of courts are establishing intellectual property divisions and there are also several specialized courts. The Supreme People's Court, the highest court in China, is responsible to the NPC and supervises the adjudicative work of all other courts, but has no power over their personnel or budgets. Decisions in these matters are in the hands of local government, a system that contributes greatly to what the Chinese have labeled "local judicial protectionism." Although the judicial system has made important progress in the past decade, it still suffers from great inefficiency and a severe shortage of capable judges trained and experienced in commercial law. More fundamentally, despite constitutional and legislative language that confers the power to decide cases independently, the courts, like all other governmental institutions, are subject to tight political control, which is primarily manifested in criminal cases involving alleged "counterrevolutionary" offenses as well as in cases involving local economic interests in which the local government has a stake.

The Communist Party of China has been the governing political party of China since the establishment of the People's Republic of China in 1949. The Communist Party plays a leading role (recognized in the Constitution) at all levels of government, although its specific legislative, executive and judicial functions are rarely spelled out in publicly available official documents. Party policy in legal affairs is usually formulated and coordinated by the Political-Legal Committee of the Party Central Committee, whose leading members include the President of the Supreme Court, the Procurator General, the Minister of Justice, the Minister of Public Security and the Minister of State Security.

IV. THE CREATION OF BINDING OBLIGATIONS

A. Contract Law Basics

Although the General Principles of Civil Law (the "Civil Code") contains a number of basic contract principles, China actually has a bifurcated system of contract law, with the Economic Contract Law of 1993 applying to contracts between entities with Chinese nationality and the Foreign Economic Contract Law of 1985 (the "FECL") applying to most contracts between foreign entities and Chinese economic entities. The following discussion concentrates on the FECL, although it should be noted that the contracts between Chinese entities and foreign-invested enterprises ("FIEs") established in China are (because such FIEs have Chinese nationality) governed by the Economic Contract Law.

Most of the principles of contract law reflected in the FECL are quite similar to those embodied in the contract laws of Western jurisdictions. Indeed, the concepts of offer and acceptance, intent, consideration and other matters dealing with formation of contracts are not materially different from North American models. The FECL and an "Explanation of Several Questions Concerning Application of the Foreign Economic Contract Law" issued by the Supreme People's Court in 1987 stipulate a number of grounds which may render a contract void, including various circumstances relating to capacity, authority and legality (discussed further below) and fraud or duress. In addition, contracts may be voidable upon application of a party in the event of fundamental mistake or "manifest unfairness," although the principle of severability reflected in the FECL may permit the offending clause alone to be voided.

The principles of contract performance and liability for breach included in the FECL are likewise similar to those prevalent in Western legal systems. The FECL permits parties to agree on liquidated damages for breach. There is provision for excusing performance on grounds of *force majeure*, which has raised the issue of whether acts of the Chinese government, such as changes in the state economic plan, can constitute *force majeure* excusing performance by a Chinese enterprise. However, contracting parties are permitted to (and frequently do) define and limit in the contract the events that will be deemed to constitute *force majeure*.

Under the FECL, the parties are permitted to choose the law that will govern the resolution of disputes arising under the contract, except that joint venture contracts and contracts for exploration or development of natural resources must be governed by Chinese law. If no governing law is stipulated, the law of the country with the greatest contact with the transaction (usually China) will apply. On matters for which Chinese law

has made no provision, the FECL specifically permits the application of international practice.

Consistent with the Chinese preference for the settlement of disputes through friendly means, the FECL states that "when contractual disputes arise, the parties should do everything possible to resolve them through consultation or third party mediation". However, the parties may agree in the contract to submit disputes to a Chinese or foreign arbitral body. If there is no arbitration agreement, either party may bring suit in the Chinese courts. Although the FECL does not authorize reference of disputes to foreign courts, international financial contracts with Chinese entities often provide for the non-exclusive jurisdiction of foreign courts. In practice, most contracts between Chinese and foreign entities provide for arbitration, and Chinese entities are frequently prepared to agree to arbitration outside of China (see section 8 below).

The FECL includes a vague but helpful "grandfather" provision purporting to insulate certain types of contracts from adverse changes in Chinese law. Article 40 of the FECL states that, in the event of a change in law, joint venture contracts and natural resource contracts that have previously been approved by the state may continue to be implemented in accordance with their original terms.

As the foregoing discussion suggests, there is much in the FECL—despite the fact that its provisions are very general and leave many gaps—that should give comfort to foreign investors and businessmen. As a practical matter, the greatest challenge facing foreign parties in assuring themselves that they have concluded legally valid contracts with Chinese enterprises flows from the strict limits that are placed on the permitted activities of Chinese entities; frequent uncertainty regarding what governmental approvals are required in connection with a given transaction; and the resulting inability of the foreign party in many cases to be sure that its contract is with a competent party, fully authorized and with all of the official approvals required to make it valid and binding.

B. Capacity, Authority and Approvals

According to the FECL and the Explanation by the Supreme People's Court, a contract will be void and unenforceable if, among other things,

- a party to the contract does not possess capacity to contract;
- the Chinese party has not received authority to engage in international trade;

- the conclusion of the contract by the Chinese party exceeds its permitted business scope;

- the contract is concluded by an agent in the name of a principal and the agent does not have authority to act as agent, or has acted in excess of its authority, and the principal does not subsequently ratify the agent's act;

- the contract violates the law or public interest of the PRC;

- approval of the contract by governmental authorities is required and has not been obtained; or

- the contract harms the interest of the state, the public or third parties or is concluded with the duplicity of the parties or by using illegitimate forms to conceal illegal objectives.

In dealings with Chinese enterprises, issues of legal capacity, authority and governmental approvals take on a prominence they ordinarily do not have, and present pitfalls they ordinarily do not present, in transactions among Western enterprises. The reasons for this relate to some of the factors identified above as central themes of China's legal development. Economic activity has historically been under tight state control, involving strict limits on the types of enterprises permitted to engage in a given type of activity and the governmental approvals required for any given transaction. The reform process has liberated an enormous amount of pent-up economic energy, encouraging enterprises with an entrepreneurial attitude to push the envelope of permitted activity. For better or worse, they are often one step ahead of the law. This may be an inevitable result of the way the reform process works; experimentation is tolerated (often without any official sanction) while new regulatory regimes are formulated. This advances the ball on reform but frequently leaves investors in a very frustrating position. They are offered opportunities for transactions that they know are not strictly authorized by law, but they know that "everybody's doing it"; they see governmental authorities with full knowledge of such transactions doing nothing to stop them (or even encouraging and participating in them) and believe, probably quite rightly, that the law will continue to be ignored until it is ultimately changed to catch up with practice; but they cannot be certain, they cannot get the type of comfort from lawyers that they are accustomed to getting in other jurisdictions, and they are left with a lingering fear that they might end up as a target of the government's next campaign against foreign investment

abuses. The guerrilla war between central and local authorities, and often among different governmental agencies at the same level, adds a further dimension to the problem, treating investors to the spectacle of two or more sets of governmental officials offering entirely different interpretations of what the law requires. Problems like these are at the root of a pervasive sense of ambiguity and vague anxiety that often afflicts investors in China.

This syndrome may be to some extent the unavoidable condition of the China investor. But these risks can be identified, isolated and contained, at a level that many investors over the years have found to be tolerable, through a thorough understanding of the legal principles involved and prudence and discipline in executing transactions. The following brief summary of the law relating to legal capacity, authority and approvals gives some indication of the areas in which risks can be managed, and the areas in which the Chinese government must do more to create an acceptable investment climate.

C. Legal Capacity

Chinese civil law provides for the existence of "legal persons", *i.e.*, organizations that possess legal capacity for civil acts and that enjoy civil rights and bear civil obligations independently in accordance with law. There are different types of legal persons, although the most important is the "enterprise legal person", a status designed for entities with an economic focus. An enterprise legal person must be registered with the State Administration of Industry and Commerce. State and collectively owned enterprises, and most foreign-invested enterprises, are enterprise legal persons. In certain circumstances government agencies may possess the status of legal persons and enter into business contracts. Individuals are *not* legal persons under Chinese law, although they may enter into contracts governed by the Civil Code. Only legal persons and (pursuant to the Civil Code) individuals may enter into binding contracts under Chinese law.

As the discussion above indicates, the issue of legal personality under Chinese law is somewhat complex but extremely important in determining whether a Chinese party may enter into a binding contract and, if so, what legal regime it will be governed by. Accordingly, a foreign party entering into business transactions in China must obtain appropriate evidence of the legal person status of the Chinese party.

1. Authority

The issue of authority can be broken down into two sub-issues: (i) is the contract within the authorized scope of business of the Chinese enterprise, and (ii) is the person executing the contract on behalf of the Chinese party authorized to do so? Unlike most business enterprises in Western jurisdictions, Chinese enterprises are subject to tight restrictions on the scope of business activities in which they are authorized to engage. These restrictions are one of the means employed by the state to regulate economic activity. The permitted business scope of an enterprise is set forth in its business license. The FECL requires not only that the contract in question be within the authorized scope of the enterprise's business, but also that a contracting enterprise be specifically authorized to enter into contracts with foreign parties. These matters can usually be verified to the reasonable satisfaction of a prudent foreign party, although sometimes (particularly with certain types of governmental organizations) the situation is not entirely clear.

Although each legal person has a single authorized "legal representative," contracts executed by other responsible employees pursuant to their duties in the ordinary course of business are normally valid and binding upon the Chinese party. However, there is not a well-developed concept in Chinese law analogous to the common law doctrine of "apparent authority" (pursuant to which an entity may be bound by acts of a person whom it permits or suffers to hold himself out as an authorized representative of that entity), although the FECL does provide that, if a principal is aware of a contract entered into by an agent and fails promptly to issue a disclaimer, the contract will be considered valid. At this early stage in the development of PRC law, in order to minimize the likelihood that the contract may be claimed or rendered void for lack of authorization of the signer, it is desirable to require any signer, including the legal representative, to produce a power of attorney evidencing his authorization. In addition, in the case of an enterprise converted into a stock company governed by the recently enacted Company Law, approval of the board of directors of the enterprise may be required.

2. Approvals

The task of obtaining all necessary governmental approvals is usually the greatest challenge in concluding any transaction in China. The number and variety of governmental approvals required for any given transaction can be quite astonishing to business people accustomed to the less regulated business environment of the West. As noted above, the failure

to obtain a necessary governmental approval may render a contract void and unenforceable. Unfortunately, it is sometimes difficult even to determine what approvals are required. The situation with respect to approvals is rendered particularly chaotic by struggles for power among governmental authorities, particularly the struggle between central and local authorities referred to above. Widespread confusion and brazen flouting of central government regulations by local authorities often put investors in an extremely awkward position. There is without a doubt a pressing need for China to introduce greater transparency and certainty with respect to approvals that are required for business transactions and the criteria that will be applied in granting them.

D. Who is Responsible?

Under Chinese law, the legal person entering into a contract is responsible for the obligations under that contract. With few exceptions, entities that are not parties to the contract have no liabilities under it. This means that, in the case of a contract entered into by a subsidiary company, the liability does not extend to the parent company in the absence of an explicit written guarantee. Likewise, in the case of a contract entered into by a state-owned enterprise, the liability does not extend to the enterprise's "department in charge" or any other governmental entity. Foreigners making contracts with any Chinese entity must assume—just as is the case in the U.S. and other Western jurisdictions—that only the specific legal entity executing a contract will be liable under that contract, unless a written guarantee (which must be enforceable as a contract in its own right) is provided by some other party. The reform process, in progressively liberating Chinese enterprises from the control—and weaning them from the support—of governmental organs, has probably increased the likelihood of unremedied defaults in contracts between Chinese and foreign enterprises.

With respect to foreign borrowings, the practice that evolved in China during the 1980s and early 1990s was to limit broad authority to borrow to ten overseas borrowing "windows", including the Bank of China, the Bank of Communications, the China International Trust and Investment Company ("CITIC"), the China Investment Bank, and the "ITICs" of Guangdong, Fujian, Hainan, Shanghai, Tianjin and Dalian. Borrowings in foreign currency by any other Chinese entity were typically guaranteed by one of the "windows", most commonly the Bank of China. There was an implicit assumption among lenders—never tested—that the Chinese government would stand behind the debt and guarantees issued by the "window" entities. In the past few years, the availability of guarantees

from the Bank of China and the other "windows" has declined dramatically. This is a prelude to introduction of a new debt management system designed to favor borrowings by entities with a capacity to pay without government support. In addition, the Chinese government has made clear that only debt issued directly by the central government—such as the $1 billion bond issue through the Ministry of Finance completed in February 1994—constitutes a legal obligation of the Chinese government and that, consistent with the principles of reform, even debt of such prominent "windows" as the Bank of China and CITIC should not be considered as being backed by the full credit of the Chinese government. As stated in the prospectus for the 1994 Ministry of Finance bond issue:

> While the Central Government is responsible for the debt it issues, with the exception of certain internal debt incurred by certain Central Government-owned institutions, it has not guaranteed the payment of any other debt. It has, in the past, taken steps to ensure that such other debt is repaid. In many cases, however, the Central Government is under no legal obligation to ensure repayment. For example, before the reform of the banking system that began in July 1993, the Central Government indirectly supported debt incurred by certain of the specialized and commercial banks and its international trust and investment corporations through such mechanisms as committing to extend loans to repay debt incurred by those institutions. As the financial system reforms are implemented, however, the relationship of these institutions to the Central Government is expected to change . . . .

While internal Chinese regulations provide for various forms of support by central government organs for debt issued by the "window" entities, and none of the "windows" has ever defaulted on a foreign borrowing, those internal regulations do not constitute an official guarantee to lenders or bondholders.

The degree of responsibility of parent entities for borrowings and other contractual obligations of their subsidiaries is frequently an issue in dealing with Chinese enterprises. Like Western companies, Chinese enterprises frequently conduct business transactions through subsidiaries. Mainland Chinese parents may enter into transactions through Hong Kong or other non-PRC subsidiaries, often to avoid approval requirements applicable to the Mainland company. The parent may offer a letter of support or some other non-binding comfort to the foreign party—again, frequently because the parent may not be willing to ask for, or may not be able to get, the necessary governmental approvals (such as SAEC approval for the

guarantee of a foreign exchange borrowing) to enter into a binding commitment. While the Chinese parent might voluntarily honor such a "moral obligation" for business reasons, it is not a contract and would not be enforceable under Chinese law.

In maintaining the distinction between parent and subsidiary, Chinese law is not substantially different from U.S. law, except that there is as yet no well-developed doctrine under Chinese law similar to the doctrine under U.S. law permitting creditors to "pierce the corporate veil" in certain circumstances where corporate formalities have not been observed and the distinction between parent and subsidiary has not been observed by the parent itself.

E. Some Observations on Contracts in China

Relative to Westerners, Chinese tend to view contracts somewhat more in the context of the overall relationship between the parties and somewhat less as discrete compacts complete within their four corners. The net effect of this relationship orientation on respect for contractual obligations is debatable; one might argue that it leads to an approach to the interpretation and application of contracts that may be somewhat less faithful to the letter of the contract, but perhaps more faithful to the spirit.

One thing that may certainly be said about the Chinese emphasis on relationships, however, is that it often leads to a dangerous fallacy among Westerners: the notion that the Chinese don't do business with long, detailed contracts, but rather insist upon relying principally on the bond of trust. Foreigners frequently submit too easily to platitudes about the Chinese (or Asian) way of doing business, when in fact the need for a detailed contract covering all material contingencies is usually even greater when doing business in China than it would be elsewhere. The reason for this is that, given the state of development of Chinese law, the contract must not only set forth the business deal between the parties, but also provide a broader legal framework for the deal, filling some of the gaps in the legal system itself. In addition, sufficiently detailed contracts can allow foreign parties to avoid some of the difficulties of enforcing contracts in China. It is often possible, if the Chinese party has breached a contract and friendly negotiations are unsuccessful in resolving the dispute, to appeal for assistance from the Chinese enterprise's department in charge, the municipal government or other higher authorities—and such appeals are often successful, if the contract is clear and covers whatever contingency has arisen. Chinese enterprises, contrary to the stereotype, are usually willing to work with detailed contracts, and indeed in negotiations study

the wording at least as carefully, and take it at least as seriously, as their Western counterparts.

The foregoing discussion does not purport to answer a bottom-line question of considerable interest to investors: are Chinese enterprises more likely to renege on contracts than are their Western counterparts? This essentially empirical question is at this point unanswerable in any scientific fashion. Ad hoc impressions cannot substitute for data. One thing is clear, however—the answer is unlikely to be simple and unequivocal. Moreover, pre-occupation with the general issue can distract attention from practical problems resulting from economic developments that adversely influence Chinese contractual performance. One example is "triangular debt" and its effect on the ability of essentially sound and well-intentioned enterprises to honor their obligations. The experience of the past 18 years suggests that, if a Chinese enterprise does not pay its debts, the reason is far less likely to be some cultural predilection for, and legal indulgence toward, reneging on obligations than the simple fact that the enterprise does not have the money.

Before leaving this subject, some mention should be made of the recent Lehman Brothers lawsuits that have received much media attention. Lehman filed suits in U.S. federal court seeking to collect a total of more than $124 million from four Chinese state-owned enterprises in connection with various foreign exchange spot and futures contracts, foreign exchange options and interest rate swaps. The Chinese enterprises claimed that the individuals entering into the relevant contracts were not authorized to do so (and in fact were inexperienced employees taken advantage of by Lehman); that the transactions were outside of the permitted scope of business of the enterprises; that the transactions required certain governmental approvals that were not obtained; that Lehman knew or should have known of these deficiencies; and that, in any event, Lehman failed adequately to disclose the risks involved in the transactions. All of the facts of these cases may not become clear for some time to come, especially since Lehman has now settled three of its four suits on a confidential basis, in each case on terms reportedly favorable to Lehman. Whatever the details, a strong argument can be made that these cases are best looked at not as archetypal examples of Chinese enterprises not paying their debts, but rather as fairly typical examples of the type of litigation arising in various parts of the world over the enormous losses sustained in derivatives transactions in early 1994. In fact, the similarities between the defenses espoused by the defendants in the Lehman Brothers suits and the claims made by Orange County in its recent suit against Merrill Lynch—a suit seeking avoidance of various derivatives transactions on the grounds

that the transactions were not authorized activities of the municipality and that Merrill Lynch did not adequately explain the risks—are quite striking.

Despite the amount of press they have gotten in the West, neither the Lehman Brothers experience nor the McDonald's case (discussed briefly below) is particularly representative of the real issues facing investors in evaluating the worth of contractual rights in China. But there are real issues, and they arise principally from the fact that the process of economic and legal reform has proceeded faster in some fields than in others. State-owned enterprises have been permitted to expand and multiply their commercial relationships with foreigners—thereby greatly increasing the probability of occasional defaults. When the defaults come, foreigners naturally take the view that the Chinese government should stand behind the obligations of these enterprises. The government takes the position that these are commercial debts and not the government's responsibility—that (as a top official of CITIC was quoted in the *International Herald Tribune* as saying) "these foreign lenders have their own lawyers" and should know better than to seek recourse from the government. On the face of it, the government has the better end of the argument, and foreign parties must get used to performing more sophisticated credit analysis of Chinese enterprises. But the Chinese government cannot entirely absolve itself of responsibility for the performance of state-owned enterprises unless and until it has established a legal framework providing fully effective enforcement mechanisms through which those enterprises can be held accountable. As discussed further below, China is still a good distance from that point. In the long run, it will be in the best interests of everyone concerned for foreign investors and governments to focus on the issue of improving creditors' ability to enforce valid claims against debtor enterprises, rather than seeking continued government bail-outs that simply help to perpetuate the immaturity of the Chinese legal and economic systems.

V. PROPERTY RIGHTS

The law relating to private property rights is not very well developed—which is understandable, given that China remains a Communist state. All land in China is owned by either the state or collectives, and it was only in 1988 that a constitutional amendment was adopted clarifying the right of private entities to hold long-term land use rights. This action cleared the way for the adoption, in 1990, of regulations providing a reasonably comprehensive system for the granting of long-term land use rights in exchange for the payment of a grant fee to the state. Under this system, until a grant fee is paid and a land grant

contract is entered into with the relevant land bureau, land is held in the PRC only pursuant to "allocated" land use rights, which may be revoked with minimal compensation. The current law generally requires state-owned enterprises with allocated land use rights to convert them into "granted" land use rights before contributing them to a joint venture with a foreign enterprise or leasing them, although Chinese joint venture partners frequently resist regularizing their land use rights in this manner (quite simply because it would require them to make a substantial payment to the government that they otherwise would not have to make). Granted land use rights may be terminated prior to expiration only "under special circumstances . . . in accordance with legal procedure if such early termination is required in the public interest." Compensation must be paid to the holder of the land use rights in an amount taking into account the remaining term of the rights and the extent of the land development and utilization. Although it is hard to predict how this will work out in practice in any given case, the concepts are not substantially different from those governing the practice of "eminent domain" condemnation in the U.S. and other Western nations.

In addition to the real property law described above, China has extensive laws governing the protection of intellectual property rights, including rights under patents, trademarks and copyrights. The complaints of foreign companies and governments in this area have been about enforcement, not about the legal regime itself. Although the press frequently reports glaring examples of PRC failure to enforce copyright protections in the media and computer software fields, there are also many cases (which have received far less attention) in which Chinese officials have effectively cooperated in protecting patent and trademark rights of foreign companies.

There are a number of other Chinese laws that provide protection for private property, including provisions of the Chinese Constitution, the General Principles of Civil Law, the State Compensation Law, the Administrative Litigation Law, the Inheritance Law and the legislation relating to FIEs. In addition, China is party to a number of treaties for the mutual encouragement and protection of investment that provide for some type of market value-based compensation in the event of an expropriation of private property, although there is as yet no such treaty with the U.S.

VI. SECURITIES LAW

As the 1990s began, the first officially sanctioned public stock markets in China since the Communist revolution were established in Shanghai and Shenzhen. In 1992, these markets were opened to foreign investors with

the first issuance of "B Shares", which are traded in U.S. dollars (in Shanghai) or Hong Kong dollars (in Shenzhen).

The Chinese government has worked for the past several years to formulate a comprehensive regulatory framework for the country's nascent stock markets. In early 1993, the Securities Commission of the State Council and its executive arm, the China Securities Regulatory Commission ("CSRC"), were established by the State Council and charged with regulatory authority over China's securities markets. In April 1993, the State Council issued the Provisional Regulations on the Administration of Share Issuance and Trading (the "Provisional Regulations"), which were followed by the Detailed Implementing Rules for the Disclosure of Information by Companies Limited by Shares Issuing Shares to the Public (the "Disclosure Rules") and the Provisional Procedures on the Prohibition of Securities Fraud (the "Fraud Procedures") later in 1993. In 1995 the State Council issued the Provisions on the Listing of Foreign Investment Shares [*i.e.*, B Shares] Inside China by Companies Limited by Shares (the "B Shares Provisions"), which were followed in 1996 by implementing rules. A proposed national Securities Law has proceeded through numerous drafts over the past three years and is eagerly awaited by the investment community, but—in part because of the intense interest (and, it appears, bureaucratic maneuvering) that the legislation has attracted within the Chinese government—it has not yet been promulgated. In the meantime, the NPC has promulgated a Company Law governing the organization of joint stock companies, and the CSRC has issued implementing rules under the Company Law relating to the issuance of shares by Chinese enterprises in foreign markets (the "Overseas Listing Rules") and a set of mandatory provisions for the articles of association of such enterprises (the "Mandatory Provisions"). Various agencies have issued regulations on such matters as state-owned assets, asset valuation, accounting and auditing and labor matters, all of which have contributed to the development of a regulatory framework for joint stock companies and the stock markets.

The Provisional Regulations, which remain the principal source of securities law in China pending completion of the national Securities Law, reflect an effort to draw upon North American and European models to create a modern system of securities regulation. Among other provisions, the Provisional Regulations set forth approval requirements, general disclosure requirements and procedures for listings of securities; require periodic disclosure of information by issuers as well as prompt disclosure of a number of specified "major events" relating to an issuer; require disclosure of any holdings exceeding 5% of the outstanding shares; require anyone acquiring at least 30% of the outstanding shares of an issuer to

make an offer to acquire the remaining shares at a price equal to the greater of the market price and the greatest price paid by the acquiror for any shares within the past 12 months; and prohibit trading on inside information (which is also dealt with extensively in the Fraud Procedures).

The Provisional Regulations relate to publicly traded stock in China, including both B Shares and A Shares (shares traded in Renminbi and permitted to be held by Chinese investors only). Offerings and trading of securities of Chinese issuers on overseas markets (such as "H Shares" traded on the Stock Exchange of Hong Kong and "N Shares" traded on the New York Stock Exchange) are also governed by the securities laws and listing rules applicable to the relevant trading market. The Overseas Listing Rules and the Mandatory Provisions contain certain provisions intended to facilitate compliance by Chinese issuers with foreign securities laws and listing rules and to make Chinese issuers more attractive in foreign markets.

The domestic market for bonds issued by Chinese enterprises is at an earlier stage of development than the stock market. The bond market is regulated principally by the People's Bank of China ("PBOC") rather than the CSRC. Enterprise Bond Regulations were issued in 1993, but these relate only to renminbi-denominated bonds issued in China by Chinese enterprises. There is at present no public market in China for bonds denominated in foreign currency.

Compared with the U.S. model, the Chinese securities regulatory system as it now stands relies relatively more on administrative action and relatively less on private action and market forces. With respect to the issuance of securities, both domestically and abroad, it is a "merit-based" system rather a "disclosure-based" system: an enterprise may issue stock publicly only if it meets certain standards and receives the approval of the CSRC. Enforcement of disclosure standards and other legal requirements is principally through administrative action. Private rights of action under the Provisional Regulations are unclear and are only beginning to be tested. This is in sharp contrast to the U.S. system of "private enforcement," which provides a powerful mechanism for policing the securities markets by facilitating direct recourse for investors against issuers in the courts. Given the limited resources available to the CSRC and the length of time required to build a strong securities regulatory institution with a critical mass of competent and well-trained staff, the reliance on administrative enforcement is likely to be a drag on the development of the Chinese securities markets for some time to come.

Another essential foundation of successful securities markets that will take some time to develop in China is what might be called a "culture of disclosure." The transition to public securities ownership, necessitating

disclosure of previously confidential business information, is often extremely jolting and traumatic for business people even in countries with well-developed securities markets. The development of a habit of disclosure—a reflexive response to business developments and decisions in terms of their public disclosure implications—takes a long time in any company. The impediments to this transition are all the more difficult in China, where much business information is still classified as "state secrets"—penalties for unauthorized disclosure being sometimes quite severe—and where public securities ownership and the concept of accountability to stockholders are very new phenomena. Disclosure in China's securities markets is not yet up to international standards, and compliance by Chinese issuers with disclosure rules applicable in foreign markets requires a great deal of education, and especially careful due diligence, by lawyers and bankers.

VII. COMPANY LAW AND JOINT VENTURE LAW—RIGHTS OF SHAREHOLDERS AND INVESTORS

When an investor purchases stock in a Chinese joint stock company, he becomes a shareholder of that company, entitled to the rights of a shareholder under the Company Law and the company's articles of association. Likewise, when a foreign company invests in a joint venture, it is entitled to certain rights under the applicable joint venture law and the joint venture contract.

Under the Company Law, shareholders of a joint stock company have certain enumerated rights and obligations. The shareholders' general meeting is the primary means through which shareholders exercise their powers under the Company Law. At the annual general meeting, shareholders have the right to decide on the business policy and investment plans of the company; to elect and replace directors and supervisors and decide on matters concerning their remuneration; to consider and approve reports of the board of directors and the supervisory board; to consider and approve the company's proposed annual budgets, final accounts, profit distribution plans and plans for making up losses; to pass resolutions concerning the increase or reduction of the company's registered capital and on the issue of company bonds; to pass resolutions on matters such as the merger, division, dissolution or liquidation of the company; and to amend the articles of association. All resolutions must be adopted by more than half of the voting rights in attendance except for resolutions regarding the merger, division or dissolution of the company and amendments to the articles of association, which must be adopted by more than two-thirds of the voting rights in attendance.

Protection of minority shareholders of a corporation under Western company laws is based in large part on the concept of "fiduciary duties" of the directors of the corporation. In the U.S., these duties are expressed in terms of a "duty of loyalty" (requiring directors to act in the interest of all shareholders) and a "duty of care" (requiring directors to act with due care in the management of the corporation's affairs), and there is an extensive body of case law providing guidance as to what these duties require in particular circumstances. The Company Law of the PRC imposes a number of requirements on directors of companies governed by that law, including a provision that directors "shall comply with the Articles of Association of the company, perform their duties faithfully, and uphold the interests of the company and shall not use their position in the company to seek personal gain." The Overseas Listing Rules repeat this dictate and provide further that the directors "shall act honestly and in good faith and in the best interest of the company." What precisely the formulation in the Overseas Listing Rules adds to the Company Law provision, and whether they add up to a concept of fiduciary duty comparable to that applicable in Western jurisdictions, will be difficult to tell until a body of interpretation develops.

The Chinese law and regulations relating to Sino-foreign joint ventures do not contain specific provisions regarding protection of minority investors, other than provisions requiring certain major actions (including amendment of the joint venture's articles of association, termination or dissolution of the venture, change in the venture's registered capital and merger of the venture with other organizations) to be approved by unanimous vote of the directors. Parties typically include a broader list of such matters in joint venture contracts. The joint venture law does not include any provisions imposing fiduciary duties upon directors of joint venture companies, and it is implied in law and commonly assumed in practice that the principal role of a director in a joint venture company is to represent the interests of the investor appointing that director.

VIII. ENFORCEMENT OF OBLIGATIONS AND PROTECTION OF CREDITORS

A. Enforcement

As noted above, contracting parties are permitted under the FECL to choose arbitration as the means for dispute settlement under the contract, and contracts between Chinese and foreign enterprises typically provide for arbitration. Foreigners tend to avoid the possibility of reference to the People's Courts because of the risk of local bias and because of the other

weaknesses of the Chinese judiciary discussed previously, and Chinese parties also tend to prefer arbitration as the agreed means of dispute resolution. Chinese law specifically prohibits reference of disputes relating to joint venture and natural resources contracts to foreign courts, and only arbitration and reference to the People's Courts are expressly authorized by the FECL. In any event, China has not yet succeeded in concluding judicial assistance agreements with most major Western nations for the mutual recognition and enforcement of court judgments (France is a distinguished exception), whereas it is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Accordingly, foreign parties tend to prefer submission to arbitration over running the substantial risk that a foreign court judgment would not be recognized by the Chinese courts. In cases (including many loan agreements and derivatives transactions) when the contract is governed by foreign law and the borrower has assets, or has granted sufficient security, overseas, the foreign party may be comfortable that it will not need to enforce a judgment in China and may therefore insist that the Chinese party submit to the jurisdiction of a foreign court for the resolution of disputes.

Since the usual preference is for arbitration, the issue in negotiating contractual dispute resolution provisions tends to be between Chinese arbitration and arbitration outside China, with Chinese parties naturally preferring the former and foreign parties the latter. The China International Economic and Trade Arbitration Commission ("CIETAC") has exclusive jurisdiction in China over foreign-related arbitration, except in maritime cases. CIETAC's panel of arbitrators includes a number of foreign legal experts, and CIETAC is developing a reputation as a reasonably fair and efficient arbitral body. However, the operation of the CIETAC arbitration rules makes it likely that the three-member arbitration tribunal in a given case will consist of at least two Chinese arbitrators, raising concerns about local bias. In addition, the CIETAC rules emphasize the role of mediation in dispute resolution and encourage tribunals to act as both mediators and arbitrators, which may make parties seeking the equivalent of a strict judicial determination of their legal rights uncomfortable. Although it is frequently a subject of intense negotiation, Chinese enterprises often agree to arbitration outside China, with arbitration in Sweden under the auspices of the Stockholm Chamber of Commerce being the most popular choice.

If an award is rendered by an arbitral tribunal in favor of a foreign party and the Chinese party fails to honor it, or if the Chinese party challenges the validity of the arbitration agreement itself, the foreign party will have to seek enforcement of the agreement and/or the award in the Chinese courts. Consistent with international practice and the New York

Convention, the grounds on which an arbitration agreement or arbitral award may be challenged in the Chinese courts are quite limited. A potentially troublesome issue in this area is the possibility that a contract (including the arbitration clause) might be challenged in court on the ground that the Chinese party lacked legal person status or was acting outside its authorized scope of business. Despite the principle of "severability" of the arbitration clause reflected in Chinese arbitration law, the law may be interpreted as requiring these issues to be determined by the courts. In at least one case, Chinese courts have also refused to enforce an arbitration clause on the ground that the dispute involved fraud claims as well as contract claims and was therefore a matter for the courts. Assuming that the arbitration agreement is valid, an arbitral award rendered under it may only be challenged on the limited grounds set forth in the New York Convention. In foreign-related cases (unlike in domestic arbitrations) the courts are not permitted to review arbitral awards for errors of law. At least in the case of a CIETAC arbitration, any challenges to the validity of an arbitral award must be made in the Intermediate People's Court in Beijing rather than in the Chinese party's local court (presumably to minimize local bias in favor of the PRC party).

Chinese law includes provisions for execution and judicial levy against the assets of an enterprise that fails to comply with a court judgment or arbitral award, but as a practical matter any such action must usually be taken in the courts of the locality where the Chinese party is based and where it will have the maximum benefit of local connections and favoritism. This has caused some problems for foreign parties in enforcing arbitral awards in China, as Chinese courts have sometimes frustrated foreign efforts to enforce both PRC and foreign arbitration awards. In an effort to correct these problems, the Supreme People's Court in 1995 issued a notice to lower courts requiring them to obtain the approval of High People's Courts before invalidating an arbitration clause or declining to enforce an arbitration award in cases involving foreign interests. In general, there is still insufficient practical experience with the enforcement of arbitral awards to permit a broad assessment of practice in this area to be made with any confidence.

The discussion above summarizes the current state of law and practice in typical situations where there is a direct contract between the foreign party and the Chinese party. The situation with respect to securities issues is somewhat different. In this area, distinctions should be drawn between equity and debt securities; between securities offered on foreign markets and securities offered on domestic markets; and between sovereign and non-sovereign issuers.

Purchasers of debt securities of Chinese issuers may have claims under the terms of the securities themselves or under applicable securities laws. "Window" entities issuing bonds abroad typically agree that foreign law (for example, New York law in the case of dollar-denominated bonds targeted principally at the U.S. market) will apply to claims in connection with the bonds; will submit to the jurisdiction of a foreign court and appoint an agent for service of process in the relevant jurisdiction; and will waive any claim of sovereign immunity in connection with any action (including a proceeding to execute on assets to enforce a judgment) in connection with the bonds. Prospectuses for such bond issues include a disclaimer to the effect that the issuer has been advised by its Chinese counsel that "there is doubt" as to the enforceability in Chinese courts of claims relating to the bonds, whether in original actions or actions to enforce judgments and whether arising under the terms of the bonds themselves or under any foreign securities law. However, the "window" enterprises typically have substantial assets abroad that creditors can look to in evaluating their practical ability to enforce judgments. As the universe of Chinese enterprises issuing debt securities abroad begins to expand, the task of evaluating the credit quality of issuers in terms of available security and other assets subject to levy abroad will become increasingly complex.

The Chinese government, in issuing sovereign debt, takes a narrower approach to submission to jurisdiction and waiver of sovereign immunity than do the "window" entities. For example, in the 1994 U.S. dollar bond issue, the government refused to submit to U.S. jurisdiction, or waive sovereign immunity, in connection with any action under the U.S. securities laws and refused to waive sovereign immunity in connection with any action against its assets abroad to enforce a judgment relating to the bonds. Clearly, the greater comfort of "full faith and credit" comes at a price in terms of the availability of effective remedies in the event of a default.

A purchaser of equity securities issued abroad by a Chinese enterprise may have claims under applicable securities laws or claims under the Company Law and/or the issuer's articles of association. A Chinese issuer offering stock in a foreign market will submit to the jurisdiction of the courts of the foreign country for claims under the applicable securities laws, but will offer the usual disclaimers regarding the ability to enforce foreign securities law liabilities in China. Pursuant to an agreement between PRC and Hong Kong regulatory authorities, the Mandatory Provisions require, in the case of H Share issuers, that claims under the Company Law or the issuer's articles of association be submitted to arbitration (with the claimant having the choice of either CIETAC

arbitration or arbitration conducted by the Hong Kong International Arbitration Center). Similar provisions have not to date been included in the articles of association of N Share issuers; accordingly, holders of N Shares would have to pursue such claims in the Chinese courts. China lacks developed procedures analogous to two devices that are very important under U.S. law in facilitating shareholder claims: the shareholder derivative suit (pursuant to which shareholders may maintain actions in the name of the corporation against corporate officers, directors or controlling shareholders) and the class action suit (pursuant to which a small number of shareholders may maintain an action on behalf of themselves and all other shareholders similarly situated). Although some suits similar to class actions are being experimented with, until such devices are more than novelties, good claims may be legally or financially infeasible for shareholders to pursue, thereby increasing reliance on administrative authorities to enforce shareholder rights.

Purchasers of B Shares on the Chinese domestic market will generally be relegated to the Chinese courts to pursue claims under the Chinese securities laws, the Company Law or the issuer's articles of association. Claimants will thus have to contend with the general weaknesses of the Chinese court system discussed above as well as the barriers to bringing shareholder derivative suits and class actions.

B. Mortgages and Security Interests

In 1995 China promulgated the long-awaited Security Law covering security interests in real and personal property. The Security Law covers five types of security: guaranties, mortgages (covering both movable and immovable property), pledges (in which the possession of the security is transferred), lien (in which the creditor under a service contract may retain possession of the debtor's property as security for payment) and deposit. Buildings, land use rights and movable property such as machinery may be mortgaged. The mortgage provisions of the Security Law in particular provide on a national scale what was previously available in many local regulations: the mortgaging of land use rights and registration and foreclosure provisions not substantially different from those common in Western legal systems. Recent regulations have further elucidated the means of properly registering a security interest in land use rights in particular. Neither national nor local regulations, however, generally contain provisions for the registration and enforcement of security interests in personal property (*i.e.*, tangible and intangible property other than real property, such as equipment and intellectual property rights). While Chinese law recognizes the grant of such a security interest as a contractual

obligation, the lack of registration and foreclosure procedures means that there is no effective protection against the claims of subsequent purchasers without notice of the security interest, and no efficient means of executing against the collateral in the event of a default on the underlying obligation.

There is very little practical experience in foreclosure on mortgaged property in China. Any such foreclosure would require application to the courts in the locality where the mortgaged property is situated, raising the concerns discussed above regarding local favoritism. Even after the promulgation of the Security Law, the state of law and practice relating to mortgages and security interests in China has generally been viewed by international financial institutions as an unacceptable basis for lending on the strength of asset values. This is one reason why many institutions refuse to lend to Chinese enterprises in the absence of a guarantee from the Bank of China or other "window" entity. The sharp decline in the availability of such guarantees, and the increasing need to develop viable project finance structures for the development of China's infrastructure, should provide a powerful stimulus for further development of the law in this area. In the meantime, transactions must be structured creatively to provide to the greatest extent possible for security located outside China.

C. Bankruptcy Law

There are several different pieces of legislation that deal with bankruptcy in China. On the national level, there is the Law of the People's Republic of China on Enterprise Bankruptcy (for Trial Implementation) ("Trial Bankruptcy Law"), the Company Law (which includes some bankruptcy-related provisions applicable to limited liability companies and joint stock companies) and the Code of Civil Procedure (which includes some bankruptcy-related provisions applicable to legal persons, including joint ventures and other foreign-invested enterprises). In addition, there are several local regulations relating to bankruptcy and/or liquidation.

The Trial Bankruptcy Law was promulgated in 1986 and applies only to state-owned enterprises, although it has been applied in practice by courts to some collectively-owned enterprises. For practical and policy reasons, bankruptcies have been allowed only on an experimental basis and in relatively limited numbers since the law was adopted. All of the national and local laws relating to bankruptcy require that a People's Court declare an enterprise to be bankrupt for a bankruptcy to be effective, regardless of whether the proceedings are voluntary or involuntary. The Trial Bankruptcy Law also requires the consent of the department in charge of the enterprise before the enterprise can even apply for bankruptcy.

Creditors do receive some protections under the various bankruptcy-related laws, including the ability to petition for the insolvency of a state-owned enterprise; the creation of a liquidation committee by the People's Court; the holding of creditors meetings at which all unsecured creditors have the right to vote; a public announcement procedure for creditors to register their claims; and the invalidation of certain actions taken by an enterprise declared bankrupt before such declaration. In general, secured creditors enjoy priority as to payment with respect to the collateral security. The priority of payments to other claimants in the event of a liquidation is: (i) expenses of the liquidation committee, (ii) accrued and unpaid salaries and labor insurance, (iii) accrued and unpaid taxes and (iv) all other unsecured claims and insufficiently secured claims (to the extent of the unsecured amount).

The Trial Bankruptcy Law must be viewed as merely the first step in a legislative process that may ultimately lead to a workable bankruptcy law regime. As law and practice in this area now stand, it cannot be said that there is a bankruptcy law in China that can be relied upon to protect creditors from the dissipation of assets in an insolvency situation and to provide an orderly framework for the reorganization or liquidation of insolvent enterprises. The bankruptcy-related provisions of the Company Law and the Code of Civil Procedure are not intended to substitute for a comprehensive bankruptcy law regime. While the procedures applicable under the Trial Bankruptcy Law once a bankruptcy proceeding is commenced are reasonably consistent with international standards in terms of protection of creditors, the law's limited scope, together with the judicial and administrative discretion involved in the determination to commence a bankruptcy proceeding and the lack of experience in administering proceedings under the law, make it a very slender reed for the time being. It is expected that a new bankruptcy law will be promulgated in the near future. Chinese officials have promised that the new law will apply to all types of enterprises and will allow less governmental interference in the bankruptcy process.

IX. THE SPECIAL ISSUE OF HONG KONG

A. General Characteristics of Hong Kong Legal System

Hong Kong, which is a recognized international financial center, has a well-developed and respected legal system based on the English common law system. The principal sources of Hong Kong law are: (1) the rules of common law and equity of England (so far as they are applicable to local circumstances), (2) decisions of the Hong Kong courts, (3) local legislation,

(4) English Acts and Orders in Council that apply to Hong Kong and (5) Chinese law and custom.

Statutory law of Hong Kong is created by way of ordinance, and the ordinances generally follow the principles of English Acts of Parliament. Every ordinance in Hong Kong is a public ordinance. Ordinances are now enacted bilingually with the first piece of bilingual legislation enacted on April 13, 1989. The Chinese text is an authentic version of the law which the courts can look to, with the English text, in ascertaining the meaning of an ordinance.

When the English common law and the rules of equity are inapplicable to the circumstances of Hong Kong or its inhabitants, Chinese law and custom may be applied. There is even stronger reason to apply Chinese law and custom where there is no local statute or decision covering the particular circumstances. English law is not applicable when it would result in "injustice or oppression," but it is not clear what this means in practice.

The Hong Kong judiciary is generally considered to be well-qualified and independent from the executive government. Currently, the highest court in Hong Kong is the Court of Appeal. Below the Court of Appeal is the High Court of Justice, which may be a trial court or an appeal court. The High Court of Justice and the Court of Appeal together constitute the Supreme Court of Judicature. Below the High Court of Justice are the District Courts and the Magistracies, which are inferior courts. Appeal from the Court of Appeal lies to the Judicial Committee of the Privy Council in England if certain conditions are met.

B. Key Provisions of Basic Law

In 1984, pursuant to a Joint Declaration with the PRC, the United Kingdom agreed to surrender sovereignty over Hong Kong to the PRC in 1997. On July 1, 1997, Hong Kong will become a special administrative region ("SAR") directly under the authority of the central government of China. The political slogan accompanying the 1984 treaty was "one country, two systems": for 50 years after 1997, the Hong Kong SAR is to have a high degree of autonomy; it will be largely self-governing, and, in particular, the legal system and the laws will remain basically unchanged. Hong Kong's new constitution will be the Basic Law (promulgated by the PRC in 1990), which will take effect on the British departure in 1997. The Basic Law will bind executive, legislative and judicial branches of the SAR government and provide a framework in which the present legal system can continue. The key provisions of the Basic Law as it relates to the Hong Kong legal system and commercial law are as follows:

- The Hong Kong SAR government will be composed of local inhabitants. The Chief Executive, who will nominate principal officials, will be appointed by Beijing after election or consultations held locally.

- The legislature, to which the executive authorities will be accountable, will be constituted by elections.

- Judicial power, which is to be exercised independently, will be vested in the SAR courts, and these courts will possess the power of final adjudication. Under the PRC's constitutional system, however, the Standing Committee of the NPC has the power to interpret the Constitution and the Basic Law and thereby to determine questions that arise concerning the allocation of competence between the SAR and the Central Government.

- A prosecuting authority will control criminal prosecutions free from any interference.

- The laws previously in force, other than those made in the United Kingdom, but including common law and equity, will be maintained unless they contravene the Basic Law, subject to their amendment by the SAR legislature.

- The rights and freedoms of inhabitants are to be protected. Every person will have the right to judicial remedies, confidential legal advice, access to the courts, and representation in the courts by lawyers of his or her choice. Every person will have the right to challenge the actions of the executive branch of government in the courts.

- The social and economic systems in Hong Kong and the lifestyle of inhabitants will remain unchanged.

The Basic Law also specifically stipulates that the Hong Kong SAR government will provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial center. The degree to which the current legal system of Hong Kong will remain relevant after the change to Chinese sovereignty, however, cannot be confidently known, as it would be reckless to assume that promises made in the Joint Declaration and the Basic Law will all be stringently observed. Much may depend upon how the NPC Standing

Committee plays the role of "balance wheel" accorded to it, rather than to the PRC Supreme Court, in what is a de facto experiment with a federal system.

A 400-member selection committee of Hong Kong people is currently being chosen for the purpose of electing the SAR's first Chief Executive. The PRC is also preparing for a provisional legislature to replace Hong Kong's present Legislative Council.

C. Issues Relating to the Judiciary Post-1997

As a practical matter, the prospects for preserving Hong Kong's legal system—including its well-developed commercial law—after 1997 will depend upon the continued strength, competence and independence of the judiciary. For that reason, issues relating to the judiciary have taken on a special significance in the run-up to 1997.

The Basic Law provides for the establishment of a Court of Final Appeal in the Hong Kong SAR. Relying solely on the Basic Law, the setting up of the court is possible only when the Basic Law comes into effect on July 1, 1997. In 1991, however, the Chinese and the British governments, through the Joint Liaison Group that is supposed to promote a smooth transition, agreed in principle to the earlier establishment of the Court of Final Appeal in order to achieve judicial continuity. Nevertheless, after four frustrating years of failure, in June 1995 the two governments, as part of a renegotiated understanding, abandoned the effort to establish the Court of Final Appeal before the Basic Law comes into effect, but did agree upon the principles for establishing the Court in 1997. This new agreement, embodied in a draft of a Hong Kong Court of Final Appeal Bill, was adopted by Hong Kong's Legislative Council after prolonged and bitter debate over its contents. One of the main controversies stirred by the legislation dates back to the provisions of the 1991 UK-PRC agreement concerning the composition of the court. Those provisions, reaffirmed in the June 1995 renegotiated understanding, stipulate that, in any sitting, the court is to consist of five judges: the Chief Justice, who by law must be a Chinese national, three permanent Hong Kong judges (who may be local or expatriate) and a non-permanent judge who may be drawn, depending on the need of each particular case, from either a list of non-permanent Hong Kong judges or a list of distinguished judges from other common law jurisdictions. The provision regarding judges from other jurisdictions originates from Article 82 of the Basic Law. The wording of that article has given rise to heated debate as to whether at any one sitting more than one overseas judge should be allowed. Many members of the legal profession are of the opinion that the formula of at least four local judges,

including the Chief Justice, and not more than one judge from overseas to make up the court is not inconsistent with the Basic Law. Others, including the Bar Association, disagree. There is also continuing uncertainty and worry over the criteria and procedures for appointing the Chief Justice and all other members of the Court of Final Appeal.

The other major controversy that has arisen concerns the court's jurisdiction. Article 19 of the Basic Law removes "acts of state, such as defense and foreign affairs" from the court's purview. Until announcement of the June 1995 UK-PRC renegotiated understanding, this provision attracted little attention, apparently because of the assumption that the concept of "act of state" would continue to be interpreted narrowly as it has traditionally been under English common law and would therefore not remove many types of cases from the Court of Final Appeal's jurisdiction. Opponents of the recent UK-PRC understanding claim that, as part of the compromise reached, the UK agreed to accept the PRC's potentially much broader definition of "act of state." The UK and the Hong Kong Government deny this and emphasize that the task of reconciling the common law and the Basic Law in this respect as in others will be left to the courts. Yet, this further highlights the role to be played by the NPC Standing Committee in interpreting the allocation of judicial power under the Basic Law.

Of course, perceptions of the SAR legal system as a whole will also reflect evaluation of the long-awaited detailed rules for appointing the Chief Executive, electing the new legislature and for regulating their relations with each other and with the Central Government, which is to maintain an office in Hong Kong. Moreover, how the Communist Party will relate to the new governmental arrangements will be a subject of increasing attention.

X. CONCLUSION

This brief introduction gives some indication of the continued weaknesses and gaps in the Chinese legal system, as well as of the major strides that have been made over the past 18 years of rapid reform. The Chinese legal system certainly remains underdeveloped in many important areas. Law has played a leading role in the reform process, but in many respects it is struggling to catch up with the enormous changes in the economy and in business practice that reform has brought.

The question for investors is whether, despite the evident flaws of Chinese law, a transaction in China can be structured in a manner that limits legal risks to a manageable level. The experience of the last 18 years suggests that with prudence, discipline and a thorough understanding

of where the pitfalls lie (and, it must be said, a healthy skepticism of short-cuts through the legal thicket offered up by eager local parties promising that their *guanxi* will save the day), foreign investors have a good chance of avoiding disaster and earning returns proportionate to the risks they are accepting.