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Philip J. Wilson

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by
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INTRODUCTION

In the flush of rapprochement between the United States and the People's Republic of China (hereinafter the PRC or China), much was said about the rosy future for United States–Chinese business cooperation. In fact, the fourteen intervening years since the historic Shanghai Communiqué have witnessed a profound transformation in United States–Chinese commercial relations. But the warming of the political climate between Washington and Beijing was not in itself sufficient to thaw commercial relations.

China was essentially a *terra incognita* for foreign investment when it began to reopen itself to Western enterprise in the 1970s. Even with the resumption of the "Four Modernizations" policy in 1977 and its concomitant recognition of the need to encourage foreign investment aggressively, the PRC still lacked the basic legal infrastructure that serves as the foundation for commercial enterprises and transactions in and among most nations of the world. China's basic legal doctrines failed to define adequately the character of corporations and other business entities, their rights and responsibilities, and the extent of their protection from government expropriation. The Chinese legal system also lacked a clear articulation of the Chinese understanding of contracts and their functioning; of the access of foreign persons, legal or natural, to Chinese judicial forums; and of the system of taxation applicable to foreigners. Moreover, China appeared to recognize no personal property rights where industrial and intellectual property was concerned.[1]

† Associate, Graham & James, San Francisco. Member of the Bar, California. The author gratefully acknowledges the advice and suggestions of Alexander D. Calhoun and Sally A. Harpole, Graham & James partners in San Francisco and Beijing, respectively.

1. *See, e.g.*, the Regulations on Rewards for Inventions in the People's Republic of China, made public by the State Council on December 28, 1978, *reprinted in* CHINA BUS. REV., Jan.–Feb. 1979, at 60, which provide for the rewarding of inventors with a combination of spiritual encouragement and material rewards "with the emphasis on spiritual encouragement." *Id.* at art. VI. Once an inventor has received an "invention certificate", a medal, and a small cash reward, the Regulations declare that "[a]ll inventions belong to the state. All units throughout

Symptomatic of the mystery enshrouding the PRC was the unknown legal status of the very governmental entities with which foreign investors were required to transact business. In many cases regulations governing these matters were declared "State secrets",[2] precluding verification or reliance by foreign businesses.[3]

Despite proclamations of Chinese receptiveness to foreign investment,[4] surprisingly little activity occurred before 1979. With the publication in 1979 of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (hereinafter the Joint Venture Law),[5] however, China began to close the gaps in its legal structure. The Joint Venture Law and the related economic laws and regulations the PRC has since promulgated represent the culmination of an intensive process of analysis and incremental development. Rather than attempting a comprehensive codification at the outset, China opted for a more patient approach. Drafting the barest minimum necessary to facilitate initial investment, China let the international marketplace guide, in large part, the contours of its ultimate legal framework. The initial joint ventures, such as the Schindler elevator venture and the Jianguo Hotel venture, provided essential indications of foreign investors' reactions to various contract provisions before the process of codification into formal regulations began.[6] By declining to set out its own standards prematurely, and repeatedly assuring that whatever the ultimate language of its laws the legal guarantees contained in then-existing contracts would be respected,[7] China let foreign investors suggest the legal definitions, guarantees, and processes which they considered to be most important. In this way,

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the country . . . may make use of inventions as needed." *Id.* at art. IX. *See also* Note, *Joint Ventures in the People's Republic of China*, 14 J. INT'L L. & ECON. 133, 146 (1979).

2. Chinese secrecy policies are frequent sources of irritation in commercial dealings. For example, many matters of central concern in equipment transfers, such as the conditions under which the equipment is to be transported or operated, may be declared State secrets and cannot be divulged to the foreign participant. The Provisional Regulations on Guarding State Secrets (promulgated on June 8, 1951) consider all the following to be State secrets: "secret information on trade plans, state financial plans and budgets, railways, construction plans and undertakings, scientific inventions and discoveries . . . and all 'other state affairs which should be kept secret.' " Theroux, *Technology Sales to China: New Laws and Old Problems*, 14 J. INT'L L. & ECON. 185, 212 (1980), *quoting* Xinhua Domestic Service (in Chinese), Apr. 10, 1980.

3. Indeed, the inability to verify the legal status of various levels of public pronouncements has been termed "one of the most frustrating legal problems of doing business with China." Gelatt, *New Constitution Improves, Clarifies Legal Position of Foreign Investors*, E. ASIAN EXEC. REP., Feb. 1983, at 9. "A foreigner may find such a regulation, which, as often as not, he is not allowed to see, to be in conflict with a publicized law or regulation, and have no way to ascertain the authority of its issuing organization." *Id.*

4. *See, e.g.*, Theroux, *supra* note 2, at 192.

5. *See infra* note 135.

6. *See, e.g., China Venture with Swiss, Jardine Suggests Terms of Deals to Come*, Asian Wall St. J., Mar. 28, 1980, at 1, col. 3.

7. *See, e.g.*, the assurances of Lieu Nyan Tse, Vice President of the All China Federation of Industry and Commerce to a Hong Kong business gathering that all joint venture agreements signed and approved by the Foreign Investment Control Commission "before the publication of such supplementary laws and regulations will be as valid as those signed afterward." *China Aide Stresses Joint Venture Safety*, Asian Wall St. J., Dec. 31, 1979, at 4, col. 1.

the PRC gained the benefit of foreign expertise in legal draftsmanship and obtained an accurate reflection of the fundamental needs of foreign businesses[8] simply by examining the shape of investment contracts actually negotiated with foreign investors and lawyers.

This Article will examine the current state of China's foreign investment-related laws and their impact on legal decision-making by foreign investors in the areas of joint venture establishment and technology transfer. It will begin with a general description of typical arrangements for the transfer of technology. It will then examine the PRC's legal framework as it relates to technology transfers in foreign trade. Finally, the Article will focus on certain problematic elements of licensing agreements in the Chinese context and the methods previously used to deal with such problems.

I
TYPICAL TRANSACTIONS INVOLVING TECHNOLOGY TRANSFERS TO THE PRC

Technology has been transferred to China via four primary mechanisms: pure technology licensing agreements, combined sales and licensing agreements, countertrade agreements, and joint ventures. As each mechanism entails different consequences, it is useful to describe their salient features.

A. Pure Technology Licensing Agreements

In its purest form a licensing agreement simply entails the limited transfer of some form of technology or know-how and the right to its use. The essence of a patent or trademark is the "right to exclude" others from using it;[9] a license takes the form of a limited waiver of that right. The consideration for this waiver may be a lump-sum payment based on the abstract value of the technology or based on the estimated value of the products in whose manufacture it will be used. Alternatively, the consideration may consist either of periodic payments of the lump sum or of a royalty to be paid for each increment of actual use. The agreement may allow the licensee unrestricted use of the licensed technology or it may limit use by geographic area, time, or level of production, for example.

This method of technology transfer is attractive because it requires virtually no capital investment by the licensor. However, this feature proved to be a great drawback to capital-poor nations such as China, which desire rapid

8. For example, prior to the promulgation of China's tax laws, representatives stated that tax rates could be specified in joint venture contracts and would remain binding after official tax rates became known. *China Nears Approval of Joint Ventures*, Asian Wall St. J., Dec. 12, 1979, at 1, col. 3.

9. A patent, for example, is "a grant to the patentee . . . of the right to exclude others from making, using, or selling the invention . . . ." 35 U.S.C. § 154 (1983). When a patent holder licenses a patent, he waives that right to exclude for the purposes defined in the license. *See* 35 U.S.C. § 261 (1983).

modernization of their industrial plants.[10] A licensor who also manufactures the finished product faces a disincentive to use this method for technology transfer, because licensing the technology effectively eliminates the licensee as a potential customer of the product.

In the past, the Chinese have disfavored pure licensing agreements.[11] This distaste has resulted in part from an ideological indisposition to pay "capitalist" royalties which furthered monopolistic exploitation of resources the Chinese felt should be the common heritage of mankind.[12] The Chinese preference for technology transfers combined with sales of major new capital facilities has added to the traditional distaste for pure licensing agreements.[13] However, as the PRC has reevaluated its modernization program to eliminate many of these large-scale plant acquisitions, it has become increasingly receptive to pure licensing agreements as one means of acquiring the foreign technology necessary to modernize operations in China's existing industrial plants.[14]

B. Combined Sales and Licensing Agreements

A more common arrangement has involved a combined sales and licensing agreement, in which the sale of machinery or a plant, for example, is combined with the transfer of a license to use the related technology. This combination has become widely used in recent years.[15] Although the commitment of capital required by this method works a particular hardship on countries like the PRC, it carries the advantage of assuring the technical training and assistance needed to maintain quality control after the initial transfer has been completed.

C. Countertrade Agreements

The term "countertrade agreement" encompasses a number of types of barter-like contractual arrangements in which capital imports are linked to future export products.[16] This method of technology transfer allows a developing nation to avoid consuming scarce foreign exchange in order to finance

10. *See* Weil, *Technology Transfers*, CHINA BUS. REV., Mar.–Apr. 1981, at 21. *See also* Ludlow, *Licensing Technology to the PRC*, 12 LES NOUVELLES, J. LICENSING EXECUTIVES SOC'Y 65 (1977).

11. Ludlow, *supra* note 10, at 65.

12. L. ECKSTROM, *Licensing Operations in the People's Republic of China*, in 3 LICENSING IN FOREIGN AND DOMESTIC OPERATIONS 27.01[1], 27.03[12] (rev. 1984); Note, *Foreign Investment in the People's Republic of China*, 10 GA. J. INT'L & COMP. L. 233, 255 (1980).

13. Ludlow, *supra* note 10.

14. *See* Weil, *supra* note 10.

15. A recent list of agreements involving technology transfers through the China Machinery Corporation for Economic and Technological Cooperation with Foreign Countries alone listed nearly forty such agreements. *Transferring Technology to the First Ministry of Machine Building*, CHINA BUS. REV., Mar.–Apr. 1981, at 26.

16. *See* Chen, *China's Different Forms of Flexible Trade*, INTERTRADE, Dec. 1983, at 72; Goldsmith, *The Uncertain Winds of Countertrade*, CHINA BUS. REV., July–Aug. 1980, at 30.

imports of expensive capital goods.[17] Countertrade is increasingly becoming one of China's preferred forms of international trade. In 1980, China International Trust and Investment Corporation (CITIC) officials took note of the shorter time frame and less complicated terms of countertrade transactions, as compared to joint ventures. The officials also noted the greater likelihood that countertrade would result in actual capital investment rather than mere assembly or processing contracts.[18] The advantages to a developing country are obvious. In the case of a jet engine, development costs can approach one billion U.S. dollars before the first unit begins to operate. Yet, by means of a countertrade contract with General Electric,[19] China could gain the benefits of that technology for an investment of only five million U.S. dollars.[20]

Countertrade agreements are frequently undertaken as acts of goodwill by a foreign company hoping to participate in more significant transactions in the future.[21] Many of those who have dealt with the PRC feel that such purchases of Chinese goods can be instrumental in demonstrating the commitment necessary to a long-term trading relationship with the PRC.[22] In the words of Avon's director of new ventures, both parties' view of their coproduction agreement was that "the cooperation [will] be expanded and eventually lead to a joint venture for the production and marketing of Avon products in China."[23]

In the most fundamental form of countertrade, compensation agreements, imports of capital equipment or technology are paid for in part with the directly resulting finished product. The Chinese think of such shipments as installment loan repayments,[24] complete with additional quantities of output to be delivered as a form of interest.[25] By the end of 1981, approximately five hundred compensation agreements were in effect in China, most involving goods worth U.S $500,000 or less.[26]

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17. *See* Cohen & Nee, *China: All About Compensation Trade, Part 1*, Asian Wall St. J., July 3, 1979, at 4, col. 3.

18. *Agency to Help Hong Kong Firms Set Up and Finance China Ventures*, Asian Wall St. J., Aug. 12, 1980, at 1, col. 3.

19. *See infra* note 23.

20. *GE's Patient Approach*, CHINA BUS. REV., July–Aug. 1980, at 26.

21. For example, Black & Decker apparently ordered ball bearings and drill bits worth $350,000 in the hopes of stimulating subsequent Chinese orders for its own products. Goldsmith, *supra* note 16, at 31.

22. *How to Succeed in Business with China? U.S. Firms Find Friendship is the Key*, Asian Wall St. J., Apr. 9, 1980, at 3, col. 1.

23. Wren, *infra* note 29. *See also GE's Patient Approach*, *supra* note 20, in which a General Electric official describes GE's agreement to have two jet engine components manufactured by the Shenyang Aero Engine Factory as a means of assuring additional later cooperative production contracts, as well as obtaining "an edge in competing for a share of China's engine market."

24. Cohen & Nee, *supra* note 17.

25. *See, e.g.*, Note, *Legal Aspects of Sino-American Oil Exploration in the South China Sea*, 14 J. INT'L L. & ECON. 443, 474 (1980) ("Basically, the Chinese consider the contractor's costs of performance as a loan which is repaid with interest, through installments in crude oil.").

26. Address by Carolyn L. Brehm, Oberlin College (Sept. 24, 1982), at 7. An example of a successful compensation agreement is that negotiated by Container Transport International, Inc. (CTI), a U.S. corporation which leases cargo containers. Under the terms of their agreement,

A second form of countertrade is the counterpurchase or indirect compensation agreement, where the foreign company providing capital goods or technology receives a portion of its compensation in export goods unrelated to the capital goods or the products of its technology. In essence, it is given credits to be spent in the "company store".[27] However, the strict vertical hierarchies and the lack of informal horizontal links among ministries and foreign trade corporations have limited the possibilities for this kind of agreement in China.[28]

Finally, various forms of cooperative production, also known as non-equity joint ventures or contractual joint ventures, are feasible. In such co-production agreements, both parties manufacture the components, appropriate to their technological capabilities, from which an end-product is then assembled. The foreign firm typically provides technology, training, and supervision to the Chinese firm and manages overall assembly or construction. In practice, however, a co-production agreement has often meant that components manufactured abroad are merely assembled or processed in China to take advantage of lower labor costs.[29]

According to one assessment, the PRC has entered into more than 16,000 processing or assembly contracts.[30] One main advantage of these co-operative production transactions is that profit need not be proportionate to respective capital contributions, as is the case with equity joint ventures,[31] but is instead determined by the parties to the contract. Another factor contributing to the popularity of such arrangements is the expedited procedure for

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signed in February 1979 with MACHIMPEX and Civet Investment Company, Ltd., a Hong Kong financing company, CTI was to construct and put into operation a marine cargo container factory outside Guangzhou. In exchange, CTI received a fixed price on the purchase of 50,000 containers over the first five years of operation, an output worth $125 million. Goldsmith, *supra* note 16, at 30.

27. Chen, *supra* note 16. An example is the agreement initiated in 1980 between Unit Rig and the Ministry of Metallurgical Industry in which Unit Rig provided off-road dump trucks for use in coal and iron mining in exchange for a "dollar volume of Chinese-made mining machinery parts." Goldsmith, *supra* note 16, at 31.

28. Goldsmith, *supra* note 16, at 31.

29. Avon Products, Inc., for example, began production under a co-production agreement with the No. 4 Daily Needs Chemical Factory in Peking and the China National Import and Export Service Corporation for Light Industry to make skin moisturizing cream. The cream, to be sold under the brand name of Love Fragrance (Ai Fang), will *not* be sold door-to-door. Wren, *Peking Factory Making Avon Cream for Chinese*, N.Y. Times, Sept. 23, 1982, at D1, col. 4. Most of the factory's output was to be marketed domestically, with approximately 7.5% going to Avon. Another example is the agreement by Sord Computer System, Inc. to ship components to a plant in Tianjin for assembly into small computers it planned to market in Japan, the United States, and Europe, as well as in the PRC. *Sord Computer System Announces Plan To Set Up Assembly Operation in China*, Asian Wall St. J., Feb. 7, 1980, at 3, col. 1.

30. Brehm, *supra* note 26, at 2. Chinese officials recently gave a considerably more conservative estimate of 2,213 as the overall number of contractual joint ventures signed between 1979 and 1984. Feng Tianshun, Bring About a New Stage of Economic Cooperation Between the Chinese and American Peoples, China Council for the Promotion of International Trade (CCPIT) Seminar, April 18, 1985, at 4–5 (on file with the office of the International Tax & Business Lawyer).

31. *See infra* note 144.

negotiating and executing the contracts involved. Co-production agreements are not subject to the same approval procedures required for joint ventures.[32]

Despite their popularity, countertrade transactions have had to surmount a number of major hurdles. Perhaps more so than in most commercial transactions, questions of valuation are paramount in countertrade agreements. The negotiator for one American firm with countertrade experience, the Thurman Scale Company, labeled valuation as the single biggest problem encountered.[33] Quality control is another, longer-term problem which confronts companies that intend to market products obtained through countertrade agreements under their own company label.[34] The Chinese formerly resisted the notion of foreign supervision or management of Chinese workers; however, they are becoming increasingly receptive to this idea.[35]

D. Joint Ventures

Perhaps the most complex alternative for licensing arrangements is the joint venture, in which technology, fixed assets, and capital may be contributed to a newly-formed limited liability Chinese corporation with the licensor continuing as an equity owner. The licensor receives a continuing return, in addition to its license, in the form of a share of the profits from the manufacture and sale of the finished products.[36] A joint venture entails a commensurate involvement in the continuing management of the new joint venture corporation, which may be one of the attractions of this arrangement to the Chinese.[37]

It was originally hoped that joint ventures would serve as the primary vehicle for foreign investment in China.[38] Numerically, they have been overtaken by other forms of investment, such as countertrade and contractual

32. Abrahams, *Partnerships in Zhongguo*, E. ASIAN EXEC. REP., Mar. 1982, at 7.

33. Goldsmith, *supra* note 16, at 31.

34. Stepanek, *Joint Ventures: Why U.S. Firms Are Cautious*, CHINA BUS. REV., July–Aug. 1980, at 32. Quality control is a problem even where the product is intended for the PRC market since it may result in Chinese dissatisfaction with the foreign partner or even in revocation of the foreigner's trademark. "The licensor needs assurances that the product produced by the licensee falls within an acceptable quality range . . . . Without such guarantees, a licensor . . . can lose the goodwill associated with his fine quality products." Brunsvold, *Negotiation Techniques for Warranty and Enforcement Clauses in International Licensing Agreements*, 14 VAND. J. TRANSNAT'L L. 281, 282 (1981).

35. *See infra* note 167 and accompanying text. Indeed, in the case of the Special Economic Zones they affirmatively advertise this fact.

36. The Joint Venture Law requires profits to be shared in proportion to the assets initially contributed. *See infra* note 144. The licensor may additionally receive a traditional royalty as described in the pure licensing agreement. *See supra* text accompanying notes 9–14.

37. *See, e.g.*, Theroux, *supra* note 2, at 210.

38. *See, e.g.*, *Agency to Help Hong Kong Firms Set Up and Finance China Ventures*, Asian Wall St. J., Aug. 12, 1980, at 1, col. 3; *Foreign Investments Increase in China After New Inducements and Assurances*, Wall St. J., Feb. 6, 1984, at 24, col. 2; Reynolds, *The Joint Venture Law of the People's Republic of China: Preliminary Observations*, 14 INT'L LAW. 31 (1980); Gelatt, *China Bares Its Joint Venture Policy*, Asian Wall St. J., Oct. 17, 1983, at 14, col. 1.

joint ventures.[39] Nonetheless, joint ventures remain key to understanding foreign investment in the PRC, since much of China's thinking about investment practices is contained in legislation focused on equity joint ventures.

E. Primary Concerns of Licensing Decisionmakers

Each of the forms of licensing agreements discussed in the previous sections poses numerous concerns to a potential licensor. Prominent among those relevant to this Article are:

(1) receiving an advantageous return on the transferred technology;

(2) avoiding technology "leakage" in the form of unauthorized transfers of the technology to third parties; and

(3) avoiding the "self-inflicted wounds" of creating a new competitor.[40]

Licensors must also consider the potential problems of governing law, *force majeure*, and arbitration, among a myriad of others, some of which will be discussed in Part V below. The three concerns listed above appear to be the factors that generally make or break a licensing deal, however,[41] and greater attention will therefore be given to their implications in the examination of the legal foreign trade structures of the PRC.

II
THE LEGAL FRAMEWORK IN THE PRC FOR JOINT VENTURES AND TECHNOLOGY TRANSFERS

At the time the Joint Venture Law was promulgated, the PRC had no other public laws in force to protect foreign investment. Today, there are several basic PRC statutes affecting foreign investors. The Chinese legal framework has developed to such a degree that the PRC has established a Legal Advisor's Office in the Legal Affairs Department of the China Council for the Promotion of International Trade (CCPIT), to advise on Chinese and foreign trade law.[42] Because the protection of intellectual property rights involved in technology transfers frequently requires judicial enforcement of license provisions, the following discussion will consider those aspects of the Civil Procedure Law of the PRC[43] and the Agreement on Trade Relations

39. *See supra* text accompanying note 30 and *infra* note 137 and accompanying text.

40. For this last concern, see Arnold, *Basic Considerations in Licensing*, in DOMESTIC AND INTERNATIONAL LICENSING OF TECHNOLOGY 11, 19 (T. Arnold & J.T. McCarthy eds. 1980); Blair, *Technology Transfer as an Issue in North/South Negotiations*, 14 VAND. J. TRANSNAT'L L. 301, 325 (1981).

41. For additional perspectives on the concerns of licensors, see Blair, *supra* note 40; L. ECKSTROM, *supra* note 12, at 27.01[1].

42. Jin Yan, *China's Import Commodities and Trade Practice*, [1980] 2 CHINA'S FOREIGN TRADE 5, 6. *See also Chinese Lawyers to Aid Foreign Investors*, Asian Wall St. J., Aug. 8, 1980, at 1, col. 4. Recently, a new entity was created by CCPIT to provide legal advice to domestic and foreign businesses on questions of Chinese law. *See China Global Law Office*, CCPIT pamphlet (on file with the office of the International Tax & Business Lawyer).

43. *See infra* note 126.

Between the PRC and the United States[44] which govern a licensor's ability to protect his stake in technology once it is transferred to a licensee in China. The discussion will also cover pertinent provisions of the Economic Contracts Law,[45] the Joint Venture Law,[46] and the Special Economic Zones Regulations.[47]

A. The 1979 Agreement on Trade Relations Between the PRC and the United States

The Agreement on Trade Relations Between the People's Republic of China and the United States of America (hereinafter the U.S.–PRC Trade Agreement)[48] represented a significant milestone in the attempts to harmonize commercial relations between the United States and the PRC. The Trade Agreement contains four principal elements. First, the Trade Agreement established most-favored-nation status[49] between the two nations in economic matters. The United States and the PRC further agreed to consider in their bilateral relations that, "at its current state of economic development, China is a developing country."[50] Second, the two nations opened the door to liberal currency provisions in trade transactions:

> Payments for transactions between the People's Republic of China and the United States of America shall either be effected in freely convertible currencies mutually accepted by firms, companies and corporations, and trading organizations of the two countries, or made otherwise in accordance with agreements signed by and between the two parties to the transaction. Neither Contracting Party may impose restrictions on such payments except in time of declared national emergency.[51]

Both nations also agreed to assist in providing access to capital and banking facilities to promote trade.[52]

Third, the two nations moved to moderate their differences in the treatment of patents, trademarks, and copyrights, an area of acute interest to potential foreign investors with technology to license or otherwise contribute to a joint venture. Perhaps in reflection of the sparse nature of PRC law on the subject, the Trade Agreement recognized the importance of individual contracts in providing protection for intellectual property. The parties agreed to "permit and facilitate enforcement of provisions concerning protection of industrial property in contracts between firms, companies and corporations, and trading organizations of their respective countries, and [to] provide

44. *See infra* note 48.
45. *See infra* note 60.
46. *See infra* note 135.
47. *See infra* note 136.
48. Agreement on Trade Relations, July 7, 1979, U.S.–PRC, 31 U.S.T. 4651, T.I.A.S. No. 9630, *reprinted in* China Econ. News, Feb. 4, 1980, at 1; 18 I.L.M. 1041 (1979).
49. *Id.* at art. II.
50. *Id.* at art. II(3).
51. *Id.* at art. V(1).
52. *Id.* at art. V(2)–(4).

means, in accordance with their respective laws, to restrict unfair competition involving unauthorized use of such rights."[53]

The wording of this provision raised as many questions as it answered. With respect to trademarks, the two nations agreed that "on the basis of reciprocity, legal or natural persons of either Party may apply for registration of trademarks and acquire exclusive rights thereto in the territory of the other Party in accordance with its laws and regulations."[54] Unfortunately, until recently the PRC possessed a trademark law only for purposes of registration and not enforcement, making uncertain the existence of any effective trademark protection for U.S. investors in the PRC.

The Trade Agreement also used ambiguous language in dealing with copyrights, stating that each nation "shall take appropriate measures, under its laws and regulations and with due regard to international practice, to ensure to legal or natural persons of the other Party protection of copyrights equivalent to the copyright protection correspondingly accorded by the other Party."[55] The two nations further agreed that "each Party shall seek under its laws and with due regard to international practice, to ensure to legal or natural persons of the other Party protection of patents and trademarks equivalent to the patent and trademark protection correspondingly accorded by the other Party."[56] One may interpret these phrases as requiring that the United States give the same protection to Chinese products in the United States as the PRC gives to U.S. products in the PRC and vice versa. It is unclear whether the United States may give *more* than the equivalent PRC protection and whether the "protection correspondingly accorded" is a reference to the treatment by one party of its own citizens or the citizens of the other party.

Fourth, the Trade Agreement discussed contract dispute resolution methods, securing mutual recourse to arbitration remedies.[57] The Trade Agreement binds each nation to "seek to ensure that arbitration awards are recognized and enforced by their competent authorities . . . in accordance with applicable laws and regulations."[58] Unfortunately, no comparable mention is made of the enforcement of judicial awards.

Although significant problems persisted, the Trade Agreement did assure U.S. investors that transactions in the PRC would begin to acquire certain familiar characteristics and could be treated similarly to those in other developing nations, subject, of course, to the substantive foreign trade and investment laws of the PRC.

53. *Id.* at art. VI(4).
54. *Id.* at art. VI(2).
55. *Id.* at art. VI(5).
56. *Id.* at art. VI(3).
57. *Id.* at art. VIII(2).
58. *Id.* at art. VIII(3).

B. The Domestic and Foreign Economic Contracts Laws

In an environment which lacked most of the statutory framework of other nations, the most foreign businessmen could hope for was to augment the Chinese legal system with protective provisions in individual contracts.[59] Yet, despite the importance of specific contracts in the PRC, surprisingly little was known about Chinese contract law. A first attempt was made to codify Chinese contract law with the adoption of the Economic Contracts Law of the People's Republic of China in 1981 (hereinafter the Economic Contracts Law).[60] Although the Economic Contracts Law made no reference to its applicability to contracts involving foreigners, it was until recently the only indication of a general Chinese law of contracts. The PRC has now taken a second step in the development of its contract law with the recent adoption of the PRC Foreign Economic Contract Law (hereinafter the Foreign Contract Law).[61] Although the new Foreign Contract Law presumably preempts the Economic Contracts Law with respect to the regulation of contracts involving foreigners, it remains important to be familiar with the principal aspects of each law because many aspects of the law of contracts discussed in the earlier Economic Contracts Law are not treated in the Foreign Contract Law.

Each statute begins by describing the overall nature of a contract under the Chinese form of socialism. At a fundamental level the Economic Contracts Law describes contracts as "agreements between *legal* persons for the purpose of realizing certain economic goals and clarifying mutual rights and obligations."[62] Nowhere does that statute entertain the possibility that economic contracts might involve natural persons. Whether or not such a limitation remains viable in China's changing economy, the new Foreign Contract Law recognizes its inappropriateness in commercial relations with non-socialist foreigners. The new law encompasses contracts between economic institutions of the PRC on the one hand and their foreign counterparts *or individuals* on the other hand.[63] The role of the State in economic planning and control of Chinese society is reflected in the Economic Contracts Law in repeated prohibitions against contracts being used to "undermine

59. In fact, they have been repeatedly advised to do just that, and given repeated assurances that such provisions would be respected as having the force of law. For example, in an address to the A.B.A. by Ren Jianxin, then-director of CCPIT's Legal Department, he requested that the parties to patent licensing agreements "negotiate the declarations in their contracts for the protection of patents . . . according to the concrete circumstances of the transaction and according to international practice" after which "the authorities in our country will protect the patents accordingly." *Trade with China*, 65 A.B.A.J. 1063, 1063–64 (1979).

60. Adopted by the Fourth Session of the Fifth National People's Congress and promulgated on December 13, 1981.

61. Adopted by the Tenth Session of the Standing Committee of the Sixth National People's Congress on March 21, 1985 *reprinted infra* at page 46. The new Foreign Contract Law entered into effect on July 1, 1985 pursuant to rules for its implementation which are to be developed by the State Council.

62. Economic Contracts Law, *supra* note 60, at art. 2 (emphasis added).

63. Foreign Contract Law, *supra* note 61, at art. 2 (emphasis added).

State plans, [or to] damage the interests of the State or the public interest."[64] Contracts continue to be expected to reflect "the principles of equality and mutual benefit, and of reaching unanimity through consultation."[65] Both statutes require that all contracts be written.[66] While documents that are contemporaneous with and amend a contract are considered to be "integral parts of the contract" under the Economic Contracts Law,[67] parol evidence is not. Article 13 of that statute states that, unless otherwise provided by law, renminbi must be used as the currency for payments, and that payments must be made by bank transfers rather than in cash.[68]

Each statute describes the conditions for the formation and performance of contracts. A domestic contract is formed simply by the parties reaching an "agreement in accordance with the law on the principal terms of an economic contract."[69] The Economic Contracts Law makes no reference to the concepts of offer and acceptance, however, and the important question of how such an agreement manifests itself is not addressed. The Foreign Contract Law now provides that a contract is formed only "when the parties reach agreement on the articles in writing, and sign their names."[70] Agreement may be manifested through a series of written or electronic communications, but in such cases the contract is formed "only when a letter of affirmation is signed, provided a party to the contract requests the signing of such a letter."[71] Finally, contracts requiring the approval of a government agency, such as joint venture contracts, are formed in a legal sense only when such

64. Economic Contracts Law, *supra* note 60, at art. 4. *See also id.* at art. 7(1). Social policy reinforcement remains a goal of the Foreign Contract Law, which provides that contracts shall not harm the PRC's social and public welfare, and that contracts which do are invalid. Foreign Contract Law, *supra* note 61, at arts. 4 & 9.

65. Foreign Contract Law, *supra* note 61, at art. 3.

66. Economic Contracts Law, *supra* note 60, at art. 3; Foreign Contract Law, *supra* note 61, at art. 7. In the literature concerning investment in the PRC, foreigners are repeatedly warned never to consider a deal with Chinese partners final until it is in writing. *See, e.g.*, Theroux, *supra* note 2, at 213, where he observes that "there is no deal until the parties have reduced their understanding to writing and have signed it." This has been questioned on occasion. *See, e.g.*, Bennett, *U.S., China Face Problems Over Legal Agreements*, Asian Wall St. J., Apr. 9, 1984, at 8, col. 1, noting that both then-U.S. Treasury Secretary Donald Regan and former National Security Advisor Zbigniew Brzezinski had recently complained of a lack of Chinese respect for the integrity of written contracts when China wished to retaliate for perceived slights in unrelated dealings in other areas of the economy.

67. Economic Contracts Law, *supra* note 60, at art. 3.

68. *Id.* at art. 13. This is one aspect of general Chinese contract law not treated by the new Foreign Contract Law. The new law does provide in an article dealing with dispute settlement that "in the absence of relevant stipulations in the laws of the PRC, international norms shall apply." Foreign Contract Law, *supra* note 61, at art. 5. International treaties to which the PRC is a party shall prevail even when in conflict with relevant provisions of Chinese law. *Id.* at art. 6. If this principle applies to other aspects of the Foreign Contract Law, then to the extent the Economic Contracts Law is a "relevant stipulation in the laws of the PRC," it would seem to similarly limit the currency for payments to renminbi.

69. Economic Contracts Law, *supra* note 60, at art. 9. The five principal terms of a contract are listed as: 1) object or subject of the contract; 2) quantity and quality; 3) price or compensation; 4) time, place, and method of performance; and 5) liability for breach. *Id.* at art. 12.

70. Foreign Contract Law, *supra* note 61, at art. 7.

71. *Id.*

approval is obtained.[72]

After describing the overall prerequisites, the Economic Contracts Law applies these principles to specific types of contracts, prescribing such characteristics as the mandatory terms, the conditions of negotiation, and the legal duties and obligations of the parties. The statute expressly addresses purchase and sale contracts,[73] construction work contracts,[74] processing contracts,[75] contracts for the transportation of goods,[76] contracts for the supply and use of electricity,[77] contracts for storage and safekeeping,[78] contracts for the lease of property,[79] loan contracts,[80] property insurance contracts,[81] and contracts for scientific and technological cooperation.[82]

The new Foreign Contract Law lists the provisions that must generally be contained in a contract as follows:

(1) titles or names, nationalities, and addresses of offices or residences of the parties involved;

(2) date and place the contract was signed;

(3) type of contract and category and scope of the contract objectives;

(4) technical terms, quality, standards, specifications, and number of contract objectives;

(5) time limit, place, and method for fulfilling the contract;

(6) price conditions, sum of payment, payment method, and various additional expenses;

(7) transferability of the contract and conditions for transfer;

(8) compensation and other responsibilities for violating the contract;

(9) ways for solving contract disputes; and

(10) the language used in the contract and its effectiveness.[83]

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72. *Id.*

73. Economic Contracts Law, *supra* note 60, at art. 17.

74. *Id.* at art. 18.

75. *Id.* at art. 19.

76. *Id.* at art. 20.

77. *Id.* at art. 21.

78. *Id.* at art. 22.

79. *Id.* at art. 23.

80. *Id.* at art. 24.

81. *Id.* at art. 25.

82. *Id.* at art. 26. Scientific and technological cooperation contracts include those involving research, experimental production, distribution of research results, transfer of technology, and technical consulting services. Unless a departmental plan in existence governs the contract's subject matter, the parties are free to negotiate its terms, which must include identifying the specific project, "the technological and economic requirements, the rate of progress, the form of cooperation, an estimated budget of the expenses and materials, the remuneration, the liability for breach of contract and similar terms." *Id.* However, contracts involving products or projects under a compulsory State plan "must be concluded in accordance with State-issued targets." *Id.* at art. 11.

83. Foreign Contract Law, *supra* note 61, at art. 12.

The Economic Contracts Law allows contracts, once formed, to be altered under certain circumstances. It establishes five situations in which modification or rescission is permissible:

(1) where both parties agree to modifications or rescission not damaging to the interest of the State or implementation of the State plan;

(2) where a State plan on which a contract was based is amended or cancelled;

(3) where there is a shutdown, termination, or production change by one party who then "truly has no means of performing the economic contract";

(4) where *force majeure* or other cause that a party cannot prevent makes performance impossible; and

(5) where a contract breach by one party makes performance unnecessary.[84]

All modifications or rescissions must be in writing.[85] If one party suffers losses due to modification or rescission, the party that is responsible is liable to pay compensation,[86] and a merger or division of one party requires its survivor or survivors to remain individually or severally liable for performance of the contract.[87] The Foreign Contract Law provides for modification in less specific terms, stating only that contract terms "may be changed after the parties concerned, through consultation, agree to the changes,"[88] without any restrictions other than that such amendments must be in writing[89] and that they not "affect the right of one party to demand compensation for loss from the other party."[90]

Contracts are void under the Economic Contracts Law when they fall into one or more of four specified categories.[91] This provision includes a notion of severability; where one or more portions of a contract are held void, "if the validity of the remainder is not affected, the remainder shall still be

84. Economic Contracts Law, *supra* note 60, at art. 27. But note that a "change in the person in charge or in the legal representative" is *not* justification for modification or rescission. *Id.* at art. 31. Presumably, this reassures foreign investors against alteration of their contractual arrangements merely as a result of personnel purges within their PRC investment partners.

85. *Id.* at art. 28.

86. *Id.* at art. 27.

87. *Id.* at art. 27.

88. Foreign Contract Law, *supra* note 61, at art. 28.

89. *Id.* at art. 32.

90. *Id.* at art. 34. The Foreign Contract Law does, however, provide that if a contract required the approval of a State organ to be signed, any amendments must be approved by the same organ. *Id.* at art. 33.

91. Economic Contracts Law, *supra* note 60, at art. 7. The four categories are: (1) violating the law or State policies and plans; (2) signed through use of fraud, duress, or "similar means"; (3) signed by an agent in excess of the scope of his power of agency; and (4) violating the interests of the State or the public. These categories are narrowed to two in the new Foreign Contract Law: (1) contradiction of the laws of the PRC or its social or public welfare, and (2) execution by means of deception or coercion. Foreign Contract Law, *supra* note 61, at arts. 9 & 10. In each provision relating to compliance with Chinese policy it will be important to see what compliance the PRC requires when a policy in effect at the time of execution is altered or reversed during the life of the contract.

valid."[92] The new Foreign Contract Law, too, provides that a contract's validity is not impaired if the offending articles "are removed or corrected through consultation by the parties."[93]

The Economic Contracts Law examines in some detail the legal obligations resulting from breach of contract. According to article 32 of the statute:

> If, due to the fault of one party, an economic contract . . . cannot be fully performed, the party at fault shall be liable for breach of the contract; if both parties are at fault, based upon the actual conditions, each party shall be commensurately liable for the breach of contract that is its responsibility.

Unfortunately this language fails to clarify whether the term "fault" involves absolute liability for mere causation, or whether it incorporates some notion of negligence. Similarly, the statute refers to liability for non-performance due to the "fault of higher-level leading authorities or authorities in charge of operations,"[94] but again fails to define the key elements of fault, liability, or "authorities".[95]

The Foreign Contract Law now takes a somewhat narrower approach to liability, stating only that a party violates a contract when the party "fails to fulfill a contract or fails to meet the conditions agreed on for fulfilling a contract."[96] Again it provides that when both parties violate a contract, "they should both share the responsibility."[97]

Article 35 of the Economic Contracts Law establishes a somewhat unique measure of damages for breach of contract. Under article 35, if the breach has caused actual damages in excess of the amount of the breach of contract damages, the breaching party must pay not only "breach of contract damages", but also "compensation and supplement the breach of contract damages by the insufficient amount."[98] In essence, the initial "breach of contract damages" establish a form of liquidated damages, to be supplemented where appropriate by the actual damages incurred.

This is taken a step further in the Foreign Contract Law, which provides that the parties to a contract "may agree in the contract on the amount of compensation one party should pay the other if the former should violate the contract; or they may agree on a method for calculating the amount of

92. Economic Contracts Law, *supra* note 60, at art. 7. Thus, as long as the remaining portions of the contract independently meet the tests of the formation of a contract in articles 9–12, *supra* text accompanying note 69, the contract will remain valid.

93. Foreign Contract Law, *supra* note 61, at art. 9.

94. Economic Contracts Law, *supra* note 60, at art. 33.

95. Presumably, "authorities" refers to higher level PRC or Communist party authorities, but the provision does not make that clear.

96. Foreign Contract Law, *supra* note 61, at art. 18.

97. *Id.* at art. 21. Although the statute leaves ambiguous whether such sharing would mean neither party could collect damages or whether notions of comparative fault would apply, the CCPIT has indicated that liability would be commensurate with the respective breaches. Remarks of China Council for the Promotion of International Trade delegation, CCPIT Seminar, April 18, 1985 (copy on file in the office of the International Tax & Business Lawyer).

98. Economic Contracts Law, *supra* note 60, at art. 35.

compensation."[99] Although the measure of damages for breach of a foreign contract is "the loss suffered by the other party," such damages may not exceed those that were reasonably foreseeable at the time the contract was signed.[100] Where a contract contains a liquidated damages clause, it will normally control the measure of damages. However, if in light of the actual damages suffered it appears that the estimated damages provided by the parties in their liquidated damages clause was either "too high or too low for the loss [actually] caused . . ., either party may appeal to an arbitration agency or a court of law for an appropriate reduction or increase in the amount."[101] In any event, the new statute requires any injured party to mitigate its damages or to forfeit the right to compensation for any damages that could have been mitigated.[102] Interestingly enough, if a duty to make a payment is breached, the new law gives the other party the right to ask for interest on such overdue payments and permits the parties to agree in advance on the rate or method of calculation of interest.[103]

The Economic Contracts Law further appears to give the non-breaching party an absolute right to demand specific performance of a contract, without regard to the nature or subject of the contract, the adequacy of monetary damages, or other criteria normally applied in Western contract law.[104] This provision could prove to be of enormous value to technology licensors seeking to enforce confidentiality provisions by means of specific performance. It remains to be seen, however, whether the Chinese courts will become a practical forum for the enforcement of such provisions. In any event, there is no mention of such a right in the Foreign Contract Law, so whatever its role in domestic contract law, it will be applicable to foreign contracts only by analogy.

As in the provisions for the formation of contracts, the Economic Contracts Law sets out specific provisions on breach of contract liability for each of various kinds of contracts, including purchase and sale contracts,[105] construction work contracts,[106] processing contracts,[107] contracts for the transportation of goods,[108] contracts for the supply and use of electricity,[109] contracts for storage and safekeeping,[110] contracts for the lease of prop-

99. Foreign Contract Law, *supra* note 61, at art. 20.
100. *Id.* at art 19.
101. *Id.* at art. 20. Whether such adjustments would still be subject to limitation to the damages that should have been reasonably foreseeable is unclear.
102. *Id.* at art. 22.
103. *Id.* at art. 23.
104. Article 35 concludes as follows: "If the other party demands continued performance of the contract, the breaching party shall continue to perform." Economic Contracts Law, *supra* note 60, at art. 35.
105. *Id.* at art. 38.
106. *Id.* at art. 39.
107. *Id.* at art. 40.
108. *Id.* at art. 41.
109. *Id.* at art. 42.
110. *Id.* at art. 43.

erty,[111] loan contracts,[112] property insurance contracts,[113] and contracts for scientific or technical cooperation.[114]

The Economic Contracts Law prohibits corporations from carrying litigation damages as costs of doing business:

> An enterprise shall pay breach of contract damages and compensatory damages out of the enterprise's reserve fund, retained profits or portion of the profits and losses that it shares with the State, and it may not record such payment as a cost . . . .[115]

However, no similar limitation is set forth in the Foreign Contract Law.

Finally, each statute discusses the resolution of contract disputes. The Economic Contracts Law establishes three means: consultation, mediation or arbitration, and litigation.[116] Election of arbitration or mediation does not bind the parties to an arbitrated award; if either or both parties disagree with a decision made after arbitration, they may file suit in people's court within fifteen days of receipt of the written arbitration decision.[117] However, a statute of limitations bars applications for mediation or arbitration not submitted "within one year from the date [the party] knows or should have known of the infringement of its rights."[118]

The new Foreign Contract Law for the first time explicitly authorizes the parties to a contract to "seek settlement to disputes, in accordance with laws of their choosing applicable to such disputes."[119] If no such designation is made, the law of the country "most closely related to the contract" shall govern.[120] In the event a dispute actually arises, the new law instructs both parties to "do everything possible to settle it through consultation, or through mediation by a third party."[121] If consultation and mediation are unsuccessful, the parties may submit their dispute to Chinese or foreign arbitral bodies pursuant to the terms of their contract or to an agreement reached after the development of the dispute.[122] If the contract contains no arbitration clause and the parties are unable to agree on one after the fact, they may submit the

111. *Id.* at art. 44.

112. *Id.* at art. 45.

113. *Id.* at art. 46.

114. *Id.* at art. 47. A breaching transferor of technology becomes liable for part or all of the commission or transfer fee received as of the date of breach and for expenses caused by delays in the rate of progress; a breaching transferee forfeits rights to recover any fees or commissions already paid and becomes liable for "all expenses paid in dealing with the consequences of the non-performance."

115. *Id.* at art. 36.

116. *Id.* at art. 48.

117. *Id.* at art. 49.

118. *Id.* at art. 50.

119. Foreign Contract Law, *supra* note 61, at art. 5.

120. *Id.* Note, however, that article 5 also provides that all contracts for "joint ventures, cooperative management, and cooperative prospecting and development of natural resources, operating within the boundaries of the PRC, are subject to the laws of the PRC."

121. *Id.* at art. 37.

122. *Id.*

dispute to a people's court.[123] Finally, the only reference in the Foreign Contract Law to a statute of limitations bars the prosecution of disputes over commodity-purchase or sales contracts not brought within four years of the time the injured party knew or should have known that its rights or interests were injured. Limitations with respect to other types of contracts "shall be prescribed by law."[124]

After an initial attempt at articulating contract law, the PRC has now issued a law applicable to contracts with foreigners which looks much more like a codification of Anglo–American common law of contracts than the earlier, more civil code-like Economic Contracts Law. In so doing, the PRC has made its legal environment much more familiar to at least one important group of foreign investors. Nonetheless, many questions remain. To the extent questions are addressed in the Economic Contracts Law, but not in the Foreign Contract Law, will the earlier statute be applied to foreign contracts, despite its apparent limitation to domestic contracts? As has so often been the case in understanding Chinese law, we must once again await the implementing regulations to see the answers to the further round of questions which this new statute has engendered.

C. The Civil Procedure Law

Despite the tremendous preference in the PRC for resolving disputes through arbitration or mediation,[125] Westerners may want to assess prospects for litigation. In 1982, as part of its ongoing endeavor to provide the necessary legal framework to reassure foreign investors, the PRC provisionally adopted a civil procedure law which answers at least some of the questions relating to judicial standing and enforcement of legal claims.[126]

The Civil Procedure Law generally provides that strictly legal persons, such as "[e]nterprise or business units, organs or groups", may be parties to judicial actions.[127] Article 81 of the statute states that in order to have standing to sue, a plaintiff must have a "direct interest in the case." Foreign

123. *Id.* at art. 38.

124. *Id.* at art. 39. Again, whether the Economic Contracts Law will govern for other types of foreign contracts will hopefully be clarified by the implementing regulations.

125. Throughout, the Civil Procedure Law stresses the importance of arbitration and mediation as preferred alternatives to adjudication. It instructs that when "hearing civil cases, the people's courts shall put their emphasis on mediation." Civil Procedure Law, *infra* note 126, at art. 6. The Civil Procedure Law then calls for further attempts at mediation at trial, *id.* at art. 97; at the close of argument, before judgment is rendered, *id.* at art. 111; and, finally, by an appellate court should either party appeal a decision, *id.* at art. 153.

126. Civil Procedure Law of the People's Republic of China (For Trial Implementation), adopted at the Twenty-second Session of the Standing Committee of the Fifth National People's Congress, March 8, 1982 [hereinafter cited as Civil Procedure Law.]

127. *Id.* at art. 44. Article 44 also provides that "persons who have the capacity to institute and continue proceedings in court shall be parties to civil actions." *But cf. id.* at art. 49, which implies that the quoted passage in article 44 means that the legal representatives or lawyers "who have the capacity to institute and continue proceedings in court" shall also be considered parties to such actions.

individuals are given the right to sue by a provision that a "foreigner or stateless person who brings an action or responds to an action in a people's court shall have the same procedural rights and obligations as a citizen of the People's Republic of China."[128]

These articles do not by themselves address the important question of whether joint ventures or foreign investors may bring suit in Chinese courts to enforce their claims. Whether or not the phrase "enterprise or business unit" is interpreted as restricted to Chinese entities, a joint venture, as a Chinese enterprise,[129] would presumably have standing. More importantly, the question of whether foreign business entities may bring suit in Chinese courts in their own right is not directly answered. Article 186 of the Civil Procedure Law provides that foreign business entities "shall enjoy and bear rights and obligations according to this [Civil Procedure] Law."[130] However, the Civil Procedure Law contains no provision specifically enumerating the "rights and obligations" of foreign businesses. Until the actual extent of these rights and obligations becomes known, the practical effect of the Civil Procedure Law will remain unclear.[131]

The Civil Procedure Law specifically authorizes China to enter into reciprocal treaties which allow Chinese courts to enforce foreign judgments,[132] provided that such judgments do not "violate any fundamental principles of the laws of the People's Republic of China or the interests of our country and society."[133] Article 203 instructs a reviewing Chinese court to "make an

128. *Id.* at art. 186. Presumably this includes rights and obligations wherever they may be incorporated into the laws of the PRC, not just those to be found in the Civil Procedure Law.

129. Article 1 of the Joint Venture Law, *infra* note 135, permits "foreign companies, enterprises, other economic entities or individuals . . . to incorporate themselves, within the territory of the [PRC], into joint ventures with Chinese companies, enterprises or other economic entities." Article 2 of the Joint Venture Implementation Regulations, *infra* note 136, states that joint ventures "are Chinese legal persons."

130. Note, however, that this language is narrower than the language applied in the case of foreign individuals, *supra* text accompanying note 128. Note also that in the "principle of reciprocity", the PRC will impose equivalent limitations on the individuals and entities of any jurisdiction that imposes limitations on the exercise of procedural rights by Chinese citizens or entities. *See* Civil Procedure Law, *supra* note 126, at art. 187. "Civil actions brought by foreigners, foreign organizations or international organizations that enjoy judicial immunity" will be governed either by Chinese law or by relevant international treaties to which the PRC is a party. *Id.* at art. 189. Where an international treaty to which the PRC is a party conflicts with "this Law, the regulation or regulations provided by that international treaty shall be applied." *Id.* This leaves unclear the conflict rule to be applied where international treaties conflict with other Chinese laws or relevant procedural rules. It also applies on its face only to actions where the foreign party is the plaintiff, leaving the riddle unsolved for foreigners who find themselves defendants in Chinese civil suits.

131. Subsequent legislation suggests that foreign investors have some rights of access to Chinese courts. *See, e.g.*, for example, the right of the holder of an infringed trademark to bring suit in people's court, *infra* text accompanying note 198, or the similar right of the holder of a patent which has been infringed, *infra* text accompanying note 220.

132. Civil Procedure Law, *supra* note 126, at arts. 202–203. However, it also limits such enforcement by requiring that matters "entrusted by a foreign court which contradict the sovereignty or security of the People's Republic of China shall be rejected." *Id.* at art. 202.

133. *Id.* at art. 203.

order recognizing the effectiveness of a final judgment or order entrusted to it for enforcement by a foreign court."[134]

The symbolic importance of the new Civil Procedure Law is that it responds to concerns of foreign investors by clarifying some of the uncertainties of Chinese civil litigation. While many serious questions remain about the judicial status of foreign investors, the new law at least begins to address the role of foreign litigants in Chinese courts.

D. The Joint Venture Law and Implementation Regulations

Since the early stages of China's current modernization efforts, major joint ventures have been expected to play a prominent role. The adoption of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (hereinafter the Joint Venture Law),[135] and the related four sets of Regulations,[136] represents a major development for foreign investment in post-revolutionary China. Although relatively few joint ventures have actually been formed since the enactment of the Joint Venture Law,[137] the law has had a profound effect on foreign investment in the PRC because of the changing official attitudes which it reflects. For the first time, foreign investors in China have been given an indication of the nature of their official status and the rules by which they are expected to play. To the extent other forms of economic activity resemble joint ventures, the joint venture legislation may foreshadow their treatment as well.

Because of the unknown legal status of most PRC semi-official agencies and corporations,[138] it is not clear that contracts with such entities

134. *Id.*

135. Adopted on July 1, 1979 at the Second Session of the Fifth National People's Congress and promulgated on July 8, 1979. The discussion that follows is necessarily a cursory one. For a detailed and thorough analysis of the terminology and implications of the Joint Venture Law, see Torbert & Thomson, *China's Joint Venture Law: A Preliminary Analysis*, 12 VAND. J. TRANSNAT'L L. 819 (1979).

136. These are: the Regulations of the People's Republic of China on the Registration of Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on July 26, 1980 [hereinafter cited as the Joint Venture Registration Regulations]; the Regulations of the People's Republic of China on Labour Management in Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on July 26, 1980 [hereinafter cited as the Labor Management Regulations]; the Regulations of the PRC on Special Economic Zones, approved on July 1, 1979 at the Second Session of the Fifth National People's Congress [hereinafter cited as the Special Economic Zones Regulations]; and the Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on September 20, 1983 [hereinafter cited as the Joint Venture Implementation Regulations].

137. Only about two hundred had been formed as of the end of 1983. *See Bank of China Eases Its Rules on Lending to Foreign Partners in Joint Ventures*, Asian Wall St. J., Jan. 30, 1984, at 2, col. 1.

138. Indeed, to date CITIC is the only one to make public its enabling statute and terms of incorporation. Interview with Li Wenjie, a director of CITIC, in Beijing (Nov. 19, 1980), *quoted in* Ellis, *infra* note 140, at 293.

automatically carry the needed authorization of the Chinese Government.[139] The Joint Venture Law provides for timely determinations of such issues by requiring the Foreign Investment Control Commission (FICC) to authorize or reject submitted contracts and agreements within three months.[140] Authorized ventures must then register with the General Administration for the Control of Industry and Commerce of the PRC (GACIC).[141] In turn, the GACIC authorizes its regional bureaus to register the joint venture in their localities.[142]

The Joint Venture Law provides that joint ventures in the PRC be formed as "limited liability companies".[143] The foreign participant is generally required to contribute a minimum of twenty-five percent of the venture's registered capital. No maximum is set, leaving the possibility of a wholly foreign-owned Chinese corporation.[144] The Joint Venture Law specifically allows foreign investors interested in ventures involving the licensing of technology or other sharing of intellectual property to count such contributions as

139. The Joint Venture Law speaks of protecting "by the legislation in force, the resources invested by a foreign participant in a joint venture and the profits due him pursuant to the agreements, contracts and articles of association *authorized* by the Chinese Government as well as his other lawful rights and interests." Joint Venture Law, *supra* note 135, at art. 2 (emphasis added).

140. Joint Venture Law, *supra* note 135, at art. 3. The criteria for approval of joint venture agreements appear to have evolved to be the following: "the capacity of the company to do the job; available infrastructure; debts involved; availability of foreign currency to complete the project; and adequate natural resources." Ellis, *Decentralization of China's Foreign Trade Structures*, 11 GA. J. INT'L & COMP. L. 283, 292 (1981). Although the FICC's approval is formally required for all joint ventures under article 3 of the Joint Venture Law, approval of whatever agreement has already been worked out between the foreign and Chinese parties is often thought of as essentially automatic. The FICC has on occasion, however, exercised its authority to insist on modifications to specific contract terms, such as profits, taxation, arbitration, labor, and the repurchase price by the Chinese party to the joint venture agreement. *See, e.g., Schindler's Ups and Downs*, FAR E. ECON. REV., July 11, 1980, at 67.

141. Joint Venture Law, *supra* note 135, at art. 3. The Joint Venture Law refers to this agency by its former name, the General Administration for Industry and Commerce (GAIC), which was recently changed to its present form. Lutz, *The General Administration for the Control of Industry and Commerce*, CHINA BUS. REV., Mar.–Apr. 1983, at 25. Although the joint venture must register with the GACIC within one month of FICC approval, Joint Venture Registration Regulations, *supra* note 136, at art. 2, no time restriction is given for processing registration applications and it is not clear from the text of this provision whether operations may begin simultaneously with the registration process, nor whether registration follows automatically from approval by the FICC.

142. Joint Venture Law, *supra* note 135, at art. 3. The documents and information that a joint venture must provide in its registration application are specified in the Joint Venture Registration Regulations, *supra* note 136, at arts. 3–4.

143. Joint Venture Law, *supra* note 135, at art. 4. Although the PRC still has no corporations law, it recently defined a "limited liability company" to mean that "each party to the joint venture is liable to the joint venture within the limit of the capital subscribed by it." Joint Venture Implementation Regulations, *supra* note 136, at art. 19.

144. Joint Venture Law, *supra* note 135, at art. 4. However, Chinese officials at the time indicated that even one hundred percent foreign equity in a joint venture would not result in foreign control of a joint venture's management since the PRC would retain a veto power through its appointment of the chairman of the board of directors. *China Said to Bar Control of Industries by Foreigners, Even with Full Ownership*, Asian Wall St. J., July 25, 1979, at 3, col. 1. Generally, the ratio of capital contributions by the participants in a joint venture must also govern the distribution of its profits, risks, and losses. Joint Venture Law, *supra* note 135, at art. 4.

part of a participant's capital investment.[145] This provision caused considerable consternation, however, with its requirement that a foreign participant's contributions of technology or equipment be "truly advanced and appropriate to China's needs."[146] For many operations in China today, these two requirements are contradictory; the ability of the industrial and social infrastructure to absorb "truly advanced" technology generally does not justify the sacrifices necessary to obtain it, and, thus is not "appropriate to China's needs". The Joint Venture Implementation Regulations appear to recognize this conflict and substitute the somewhat weaker requirement that the technology acquired by a joint venture "be appropriate and advanced and enable the venture's products to display conspicuous social economic results domestically or to be competitive on the international market."[147]

A related problem involves the Joint Venture Implementation Regulations' provisions limiting technology licensing agreements to a term of ten years and giving a technology licensee the right to continue use of the licensed technology after expiration of the license.[148] Under this provision, a foreign investor who licenses technology to a joint venture, rather than assigns it as a capital contribution, in effect, may be donating the technology, royalty free, for the remaining term of any joint venture lasting longer than ten years.[149]

The Joint Venture Law also contains several taxation provisions which may affect technology transfers. Ventures with "up-to-date technology by world standards" may receive reductions or exemptions from income tax for the first two to three profitable years.[150] Additionally, any reinvestment of profits in the PRC by the foreign participant may qualify "for the restitution

145. Joint Venture Law, *supra* note 135, at art. 5 ("Each party to a joint venture may contribute cash, capital goods, industrial property rights, etc., as its investment in the venture."). This was seen by many as a simple recognition by the Chinese of economic reality. *See, e.g.*, Cohen & Nee, *Joint Ventures: Behind the Headlines, Part I*, Asian Wall St. J., July 10, 1979, at 4, col. 3. The new Joint Venture Implementation Regulations further define the right of each party to a joint venture to contribute as its share of the registered capital of the joint venture "cash or buildings, premises, equipment or other materials, industrial property, know-how, and the right to the use of a site." Joint Venture Implementation Regulations, *supra* note 136, at art. 25. Note, however, that industrial or intellectual property contributed by foreign investors must qualify as at least one of the following:

> 1) Capable of manufacturing new products urgently needed in China or products suitable for export;
>
> 2) Capable of improving markedly the performance and quality of existing products and raising productivity; [or]
>
> 3) Capable of notable savings in raw materials, fuel or power.

Id. at art. 28.

146. Joint Venture Law, *supra* note 135, at art. 5. *See* Cohen & Nee, *Joint Ventures: Behind the Headlines, Part II*, Asian Wall St. J., July 23, 1979, at 4, col. 3.

147. Joint Venture Implementation Regulations, *supra* note 136, at art. 44.

148. *Id.*, at art. 46. *See also* Gelatt, *China Bares Its Joint Venture Policy*, Asian Wall St. J., Oct. 17, 1983, at 14, col. 1.

149. The new Joint Venture Implementation Regulations provide that joint ventures are to last for terms of ten to thirty years, except for certain types of long-range investments. Joint Venture Implementation Regulations, *supra* note 136, at art. 100.

150. Joint Venture Law, *supra* note 135, at art. 7.

of a part of the income taxes paid."[151] Moreover, the new Joint Venture Implementation Regulations exempt joint ventures from customs duties, and industrial and commercial consolidated taxes on most materials and equipment imported for use in the manufacture of goods for export from the PRC.[152]

The foreign exchange transactions of a joint venture are regulated by the Joint Venture Implementation Regulations, pursuant to the Interim Regulations on Foreign Exchange Control of the People's Republic of China[153] and the Rules for the Implementation of Foreign Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprises and Chinese-Foreign Joint Ventures.[154] Joint ventures are required to open both foreign exchange deposit accounts and renminbi deposit accounts with the Bank of China or other designated banks, at interest rates as announced by the Bank of China.[155] To open foreign exchange deposit accounts with overseas banks or banks in Hong Kong or Macao,[156] joint ventures need special permission. However, the Joint Venture Law allows a joint venture "in its business operations, [to] obtain funds from foreign banks directly,"[157] a provision of considerable consequence to venture financing.

The statute also allows a foreign participant to remit abroad its net profits, funds received upon termination of the venture, or other funds.[158] Similarly, the statute guarantees that foreign employees of a joint venture will be able to remit abroad their "wages, salaries or other legitimate income . . . after payment of the personal income tax."[159]

The Bank of China has announced recently that it eased the conditions under which foreign participants in joint ventures may obtain Bank of China loans. Foreign investors no longer must finance start-up expenses on their own, receiving Bank of China credit only for later expansion, but may receive

151. *Id.*

152. Should such goods be reallocated to the domestic market, import duties and taxes would become payable. Joint Venture Implementation Regulations, *supra* note 136, at art. 71. Again, note that the reduction in the tax burden apparently came "in response to foreigners' reluctance to invest in China because they consider taxes to be too high." *China Eases Taxes on Joint Ventures*, Asian Wall St. J., Feb. 6, 1984, at 6, col. 3.

153. Promulgated by the State Council in December 1980. *See* Horsley, *The Regulation of Foreign Exchange Used by Foreign Enterprises and Chinese-Foreign Joint Venture*, E. ASIAN EXEC. REP., Nov. 1983, at 8.

154. Approved by the State Council on July 19, 1983 and promulgated by the State Administration of Exchange Control on August 1, 1983.

155. Joint Venture Implementation Regulations, *supra* note 136, at art. 74.

156. *Id.* at art. 76.

157. Joint Venture Law, *supra* note 135, at art. 8. The new Joint Venture Implementation Regulations permit joint ventures to apply to the Bank of China for foreign or renminbi loans. In addition, joint ventures may borrow foreign exchange as capital from non-Chinese banks or banks in Hong Kong or Macao. Joint Venture Implementation Regulations, *supra* note 136, at art. 78.

158. Joint Venture Law, *supra* note 135, at art. 10. Remittance is allowed through the Bank of China in accordance with foreign exchange regulations. *Id.*

159. *Id.* at art. 11. *See also* Joint Venture Implementation Regulations, *supra* note 136, at art. 79.

loans from the Bank of China from the date of creation of the venture.[160]

In addition to the registration regulations described above, the PRC issued labor relations regulations specific to joint ventures.[161] Labor relations under the Joint Venture Law have been of great concern to foreign investors. The Cultural Revolution disrupted education, leading to a shortage of engineers and other skilled workers. This shortage has caused foreign investors to doubt China's capacity to operate and maintain facilities after the foreigners leave. Where the foreign participant gives quality or performance guarantees, its ability to retain influence over personnel selection is essential.[162] The Joint Venture Law made scant mention of personnel decisions,[163] giving additional importance to the Labor Management Regulations.[164] Article 2 of the Labor Management Regulations requires joint ventures to sign labor contracts specifying the terms of "employment, dismissal and resignation of the workers and staff members, tasks of production and other work, wage and awards and punishment, working time and vacation, labour insurance and welfare, labour protection and labour discipline." These regulations allow joint ventures to test potential workers for needed qualifications[165] and to discharge employees who cannot be retrained or otherwise utilized when an employer's needs change.[166] A joint venture may discipline workers for violations of its rules or regulations, although discharges must be approved by "the authorities in charge of the joint venture and the labour management department."[167]

The regulations require joint ventures to implement currently unspecified PRC rules and regulations regarding labor protection, and to "ensure safety in production and civilized production."[168] The Joint Venture Implementation Regulations now guarantee staff and workers of joint ventures the right to form trade unions.[169] Moreover, trade union representatives have the right to attend board of directors meetings as non-voting members. They may then report the opinions and demands of staff and workers, and boards of directors are instructed to "heed the opinions of the trade union and win its cooperation."[170] Labor disputes are subject to labor–management department arbitration at the request of either party.[171] However, if either party is

160. *Bank of China Eases Its Rules on Lending to Foreign Partners in Joint Ventures*, Asian Wall St. J., Jan. 30, 1984, at 2, col. 1.

161. Labor Management Regulations, *supra* note 136.

162. Foreign investors in the PRC have frequently complained of general low productivity. *See, e.g.*, Ottley & Lewis, *Labor Law in the SEZ's: Moving toward Western Norms*, E. ASIAN EXEC. REP., Feb. 1983, at 11, 13.

163. Joint Venture Law, *supra* note 135, at art. 6.

164. Labor Management Regulations, *supra* note 136.

165. *Id.* at art. 3.

166. *Id.* at art. 4.

167. *Id.* at art. 5.

168. *Id.* at art. 13.

169. Joint Venture Implementation Regulations, *supra* note 136, at art. 95.

170. *Id.* at art. 98.

171. Labor Management Regulations, *supra* note 136, at art. 14.

dissatisfied with the arbitration result, either party may file a suit in people's court.[172]

E. The Special Economic Zones Regulations

Chinese willingness to accommodate the concerns and preferences of foreign investors has materialized in the Special Economic Zones (SEZs).[173] In 1979, in an effort to create incentives for foreigners to invest in economically depressed regions of China, the PRC issued the Regulations of the People's Republic of China on Special Economic Zones in Guangdong Province (hereinafter the SEZ Regulations).[174] The regulations designate three of the province's cities—Shenzhen, Zhuhai, and Shantou—for special treatment of foreign investment. At the same time, an SEZ was authorized in Xiamen, Fujian Province[175] and, in 1983, an SEZ was approved in the Shanghai area.[176] Finally, the PRC recently announced that an additional fourteen coastal cities would be added in varying degrees to the ranks of the SEZs.[177] These SEZs have been extremely successful at attracting foreign technology and investment. Since their creation, they have attracted $2.8 billion, or nearly half of all foreign investment commitments in China.[178]

The SEZ Regulations allow the enterprises to be wholly foreign-owned or to be joint ventures with Chinese investment.[179] They guarantee foreign investors complete managerial independence and grant the right to import foreign employees for "technical and administrative work",[180] making

172. *Id.*

173. *See generally* Fenwick, *Evaluating China's Special Economic Zones*, 2 INT'L TAX & BUS. LAW. 376 (1984).

174. Special Economic Zones Regulations, *supra* note 136.

175. Nishitateno, *China's Special Economic Zones: Experimental Units for Economic Reform*, 32 INT'L & COMP. L.Q. 175, 177 (1983). Although the Xiamen SEZ has been created and is in operation, formal regulations to govern it have not yet been adopted. Regulations have been adopted in Guangdong. *New Regulations for Guangdong SEZs*, CHINA BUS. REV., Sept.–Oct., 1980, at 54, 56.

176. *Premier Zhao Ziyang Calls on the Shanghai Economic Zone to Lay Stress on Regional Planning and Economic Integration*, INTERTRADE, Dec. 1983, at 7, 10. *See also* Daohan, *Planning and Building the Shanghai Economic Zone*, INTERTRADE, Dec. 1983, at 11.

177. *14 Coastal Cities Expand Foreign Investment*, CHINA BUS. REV., May–June 1984, at 4. *See also* Fung, *China Opens 14 Cities to Investment*, Wall St. J., June 27, 1984, at 31, col. 1.

178. *China Forging Ahead with Its Economic Zones*, Asian Wall St. J., Jan. 30, 1984, at 2, col. 1. At that time, only $380 million had actually been invested in the SEZs.

179. Special Economic Zones Regulations, *supra* note 136, at art. 4. Other SEZs have already capitalized on this potential. Huli, a port city in Xiamen municipality, which is an SEZ in Fujian Province, advertises to foreign investors the fact that "foreign managers will have total control in factories which are 100% owned by foreign investors." Terry, *Decentralizing Foreign Trade-Fujian Province*, CHINA BUS. REV., Sept.–Oct. 1980, at 11, *cited in* Ellis, *supra* note 140, at 300.

180. Special Economic Zones Regulations, *supra* note 136, at art. 10. The Provisional Labor and Wage Regulations (Guangdong Special Economic Zones), adopted on November 17, 1981 by the Thirteenth Session of the Standing Committee of the Fifth Provincial People's Congress of Guangdong, further liberalized labor management in its SEZs. The regulations permit the probationary hiring of employees, *id.* at art. 4, and the enforcement of rules of performance by means of warnings, wage reductions, and dismissals, *id.* at art. 17, and require employees who

possible much tighter quality-control standards. Enterprises in the SEZs benefit from preferential land use and rental terms[181] as well as simplified entry and exit requirements.[182] Such enterprises are exempt from import duties on raw materials and machinery,[183] allowing the SEZs to operate as duty-free zones. Enterprises under the SEZ regulations receive preferential tax treatment vis-à-vis other joint ventures outside the SEZs.[184] After-tax profits,[185] and assets and funds from a terminated enterprise,[186] can be remitted out of the PRC. Reinvestment in a special zone for a period of five years entitles an investor to apply for "exemption of income tax on profits from such reinvestment."[187] The SEZ Regulations require, however, that the output of SEZ enterprises be exported; domestic sales are subject to custom duties and must be approved by a newly created agency.[188]

III
THE PROTECTION OF INTELLECTUAL AND INDUSTRIAL PROPERTY

In the past, foreign investors were extremely reluctant to share needed technology with Chinese business operations because of the absence of legal protection or definition of the legal rights regarding ownership of technology. China's adoption of laws for the creation and protection of patent and trademark rights indicates the importance of technology to Chinese modernization efforts. Since the new laws have been tailored to the concerns of a socialist society, foreign investors contemplating the transfer of technology to the PRC should carefully study alternatives under these laws.

A. Trademark Protection

The PRC has for some time afforded limited protection for trademarks.[189] Foreigners were able to register trademarks in China under the Regulations for the Control of Trade Marks [sic].[190] However, since the registration procedures did not guarantee any meaningful enforcement or

receive special training to remain with the enterprise for at least one year or to reimburse the enterprise for the cost of the training. *Id.* at art. 15.

181. Nishitateno, *supra* note 175, at 179.

182. Special Economic Zones Regulations, *supra* note 136, at art. 18.

183. *Id.* at art. 13.

184. Income tax is assessed at the rate of fifteen percent, rather than the thirty to fifty percent rates applying to foreign enterprises elsewhere in China or the thirty-three percent effective rate applied to joint ventures outside the SEZs. Special Economic Zones Regulations, *supra* note 136, at art. 14.

185. As determined by the Special Economic Zones Regulations, *supra* note 136, at art. 15.

186. *Id.* at art. 11.

187. *Id.* at art. 15.

188. *Id.* at art. 9.

189. *See generally* Dawid, *Trademark Protection in the PRC*, 9 DEN. J. INT'L L. & POL'Y 217 (1980).

190. Issued in 1963, *reprinted in* Hsiao, *Communist China's Foreign Trade Organization*, 20 VAND. L. REV. 303, 318 (1967).

protection of trademarks, foreigners were limited to the protections available under the Economic Contracts Law or the judicial remedies allowed under the constitution, the Civil Procedure Law, and the U.S.–PRC Trade Agreement.

A new Trademark Law took effect on March 1, 1983,[191] and for the first time enabled the holder of a registered trademark the concomitant exclusive "right of use".[192] The new law, however, is designed to protect rights of the public more than those of the registrant. The central focus of trademarks in the PRC continues to be quality control, to "urge producers to ensure product quality and maintain the reputation of the trademark so as to protect the consumers' interests."[193] Anyone using a trademark is held responsible for the quality of products on which the mark appears. For this reason trademark rights in the PRC arise only as the result of registration, regardless of priority of actual use.[194] Once a trademark is registered,[195] the holder may transfer all or a portion of his rights to it. The assignment of all of one's rights in a trademark requires an application to the trademark bureau and a guarantee by the transferee of the quality of manufacture.[196] For the first time, the new Trademark Law also permits the more limited transfer of rights by means of a license. Such a transaction requires both a written contract, reported to the trademark bureau, and the licensor's supervision of the licensee's quality.[197]

Finally, the Trademark Law provides for the meaningful enforcement of trademark rights. Article 38 of the law defines infringement as any of the following:

> (1) using, without the permission of the owner of a registered trademark, a trademark similar to or resembling the registered trademark on a similar prod-

191. The Trademark Law of the People's Republic of China, promulgated by the Standing Committee of the National People's Congress on August 23, 1982, effective March 1, 1983 [hereinafter cited as the Trademark Law]. *See* Gelatt & Chan, *China's New and Improved Trademark Law*, Asian Wall St. J., Oct. 22, 1982, at 6, col. 1; *New Trademark Law Adopted*, E. ASIAN EXEC. REP., Oct. 1982, at 7; Patch, *New Trademark Law Permits Company Registrations*, E. ASIAN EXEC. REP., Nov. 1982, at 6. The Trademark Law applies only to goods, however, and does not provide for service-mark registration.

192. Trademark Law, *supra* note 191, at art. 3.

193. *Id.* at art. 1. This focus contrasts with the function of a trademark in the United States, where it serves principally as an indication of source, embodying the identity and goodwill of the manufacturer. *See* Patch, *supra* note 191, at 6–7.

194. Patch, *supra* note 191, at 12.

195. The Trademark Law, *supra* note 191, at art. 9, requires an applicant to follow the procedures established in "the agreement signed between his own country and the PRC, an international treaty signed by both countries, or reciprocal principles." Once registered, a mark is valid for a term of ten years, with ten-year renewals possible after that. *Id.* at arts. 23–24. However, if the holder fails to use the mark for a period of three years at any time, the registration is subject to cancellation. *Id.* at art. 30. Note, however, that the Detailed Implementing Rules for the Trademark Law, promulgated and effective on March 10, 1983 [hereinafter cited as the Trademark Regulations] permit this requirement to be satisfied by advertisement or exhibition of the mark. *Id.* at art. 20.

196. Trademark Law, *supra* note 191, at art. 25.

197. *Id.* at art. 26.

> uct or on a product of the same kind; (2) arbitrarily manufacturing or selling trademark labels registered by another person; (3) causing other forms of damage to another person's patent right to a registered trademark.

The injured party may ask the industry and commerce administration to initiate an action against the infringer, or may bring its own suit in people's court.[198] If the court finds a violation of article 38, the court may order the infringer to cease infringing, to compensate the holder of the mark, and to pay a cash fine.[199] The concept of trademark protection is still new to the Chinese courts, however, and it remains to be seen how well the new system will function in practice. Nonetheless, it provides much that foreign investors seek in the way of a statutory commitment to the protection of intellectual property.

B. Patent Protection

Historically, foreigners have been unwilling to sell advanced equipment or the process for its manufacture to the PRC because of the lack of adequate protection for patent rights and the fear that technology transferred to one Chinese entity would be made available to all other sectors of the Chinese economy.[200] "While some American companies felt they could rely on confidentiality clauses in their sales or licensing agreements, others believed they were inadequate or were too laborious to negotiate and simply walked away."[201] Therefore, "[i]n order to encourage the practice of making technical transfer with compensation,"[202] the PRC recently adopted a new Patent Law.[203] The new law was five years and more than twenty drafts in the making, as China has sent officials to study the patent laws and systems of many other countries.[204] Although the new law recently took effect on April 1, 1985, it is already causing foreign investors to reassess the risks of transferring

198. *Id.* at art. 39. Note also that because of the public safety purpose of the statute, much of the enforcement emphasis, particularly in the Trademark Regulations, is directed against a trademark registrant rather than an infringer, as part of ensuring that a trademark serves its function of indicating quality. *See* Patch, *Regulations Implementing New Trademark Law*, E. ASIAN EXEC. REP., Oct. 1983, at 19, 20.

199. Trademark Law, *supra* note 191, at art. 39. In the event compensation is ordered, the Trademark Law provides that it may be based on either the amount of loss suffered by the injured party or the amount of unlawful profit gained by the infringer. *Id.* Presumably, the amount of loss suffered by the injured party could encompass not only lost profits, but also injury to reputation such as contemplated by article 38(3), *supra* text accompanying note 198.

200. *Chinese Legislators Approve Patent Law*, N.Y. Times, Mar. 13, 1984, at 44, col. 1; Theroux & Peele, *China's Coming Patent Law*, E. ASIAN EXEC. REP., Apr. 1983, at 7, 8.

201. *New Chinese Patent Law May Help Trade*, San Francisco Chron., Mar. 13, 1984, at 12, col. 3.

202. State Science and Technology Commission document, Oct. 1982, *cited in* Theroux & Peele, *supra* note 200, at 8.

203. Patent Law of China, adopted at the Fourth Session of the Standing Committee of the Sixth National People's Congress on March 12, 1984, effective April 1, 1985 [hereinafter cited as the Patent Law].

204. *See New Chinese Patent Law May Help Trade*, *supra* note 201; Gelatt & Sweetman, *China's Ambiguous New Patent Law*, Asian Wall St. J., Apr. 9, 1984, at 14, col. 1.

technology to the PRC. Like the earlier Trademark Law, the Patent Law represents a blend of Western property protection and socialist ideology.

The Patent Law will allow the new Patent Office of the PRC to issue patents for three types of "inventions-creations": inventions, utility models, and designs.[205] The patents will grant exclusive-use rights for a term of fifteen years for inventions and five years for utility models and designs. Three-year renewals are apparently available only for the latter two.[206]

Under the new law, a patent application must demonstrate three characteristics in order to be approved. First, the invention-creation must be "novel", meaning that it has not been publicly disclosed anywhere in the world or publicly used in the PRC. [207] Since patent registrations in other countries are considered public disclosures, patents already in use will not qualify for registration in the PRC.[208] Second, the invention-creation must be "inventive", meaning that it represents "notable progress" over prior technology.[209] Third, an invention-creation must have "practical applicablility", meaning that it "can be made or used and can produce effective results."[210] Patents may not be obtained for certain categories of invention-creations, including scientific discoveries, pharmaceutical products, animal and plant varieties, rules and methods for mental activities,[211] and invention-creations which are "contrary to the laws of the State or social morality or . . . detrimental to public interest."[212]

Once a patent has been approved, the holder has exclusive rights to use

205. Although the Patent Law itself provides no further definition of these three categories, the recently announced Implementing Regulations of the Patent Law of the People's Republic of China, approved by the State Council and promulgated by the Patent Office of the PRC on January 19, 1985 [hereinafter cited as the Patent Regulations], define in Rule 2 an "invention" as "any new technical solution relating to a product, a process or improvement thereof," a "utility model" as "any new technical solution relating to the shape, the structure, or their combination, of a product, which is fit for practical use," and a "design" as "any new design of the shape, pattern, color, or their combination, of a product, which creates an aesthetic feeling and is fit for industrial application."

206. Patent Law, *supra* note 203, at art. 45.

207. *Id.* at art. 22.

208. *See* Gelatt & Sweetman, *supra* note 204. However, patent applications filed within one year of filing in another country are not deemed to have lost their novelty by reason of public disclosure if China and the other country are parties to an international agreement to this effect. Patent Law, *supra* note 203, at art. 29. Essentially, the PRC is focusing on acquiring state-of-the-art technology.

209. Patent Law, *supra* note 203, at art. 22. What "notable progress" will require in practice remains to be seen.

210. *Id.* This appears to be appropriated from the only previous recognition of patent rights in the PRC, the Regulations on Rewards for Inventions in the People's Republic of China, *supra* note 1, at art. II, which also required inventions to have been "proved applicable through practice." Both statutes appear to rule out the frequent United States practice of protective registration of patents as research is completed, long before a technological innovation might be in any way practically useful.

211. Patent Law, *supra* note 203, at art. 25. It appears that the last category is intended to prohibit patent applications for computer software. Gelatt & Sweetman, *supra* note 204.

212. Patent Law, *supra* note 203, at art. 5.

the patent in the PRC.[213] The Patent Law permits patent applications as well as patent rights to be assigned,[214] and allows a patent holder to license the use of its patent to another.[215] The Patent Law places an obligation on patent holders either to use their patents or to license their use to someone else[216] so that patent holders are prevented from using the registration process as a means of "locking-up" patented technology. If a patent is not used within three years of its issuance, the Patent Office is authorized to grant a "compulsory license" for a fee to be negotiated between the licensor and licensee, or adjudicated by the Patent Office.[217]

Finally, the new law contains provisions regarding the enforcement of patent rights against infringement. Infringement occurs when one "passes off the patent of another"[218] or exploits a patent "without the authorization of the patentee."[219] As in the case of trademarks, an injured patent holder[220] may request the Patent Office to prosecute the matter or may itself bring a suit in people's court. If a patent has been infringed, the available remedies are an order to stop the infringing behavior and compensation for damage.[221]

Unquestionably, the new Patent Law will make technology transfers more attractive to foreign investors; how much more attractive depends on whether the new Patent Law gives foreign technology transferors confidence that their intellectual property rights will be protected. This confidence in turn will depend on how the new law and the implementing regulations are interpreted, and on the manner in which the new patent system is ultimately put into operation.

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213. "[N]o entity or individual may, without the authorization of the patentee, exploit the patent, that is, make, use or sell the patented product, or use the patented process for production or business purposes." *Id.* at art. 11.

214. *Id.* at art. 10.

215. "Any entity or individual exploiting the patent of another must . . . conclude with the patentee a written license contract for exploitation and pay the patentee a fee for the exploitation of the patent. The licensee has no right to authorize any entity or individual, other than that referred to in the contract for exploitation, to exploit the patent." *Id.* at art. 12.

216. *Id.* at art. 51.

217. *Id.* at arts. 51–58. Article 51 requires the patentee "to use the patented product, or to use the patented process, in China, or otherwise to authorize other persons to make the patented product, or to use the patented process, in China." In contrast to the compulsory licensing of trademarks, where the implementing regulations reduced the impact of a use requirement through a more flexible definition of "use", the Patent Regulations are silent on that important issue. The Patent Regulations merely provide that any entity requesting a compulsory license for the exploitation of a patent must submit an application to the Patent Office showing that it "has not been able to conclude with the patentee a license contract for exploitation on reasonable terms." Patent Regulations, *supra* note 205, at Rule 68.

218. Patent Law, *supra* note 203, at art. 63.

219. *Id.* at art. 60.

220. Any other "interested party" has similar standing to make this request. *Id.*

221. Unfortunately, the implementing regulations provide no further guidance on the extent of the damages subject to compensation.

IV
THE TAX FRAMEWORK IN THE PRC FOR JOINT VENTURES AND TECHNOLOGY TRANSFERS

Since 1982, the Internal Revenue Service has allowed a U.S. income tax credit for at least some taxes paid in the PRC,[222] and on April 30, 1984, President Reagan and Premier Zhao Ziyang of the PRC signed an income tax treaty to eliminate double taxation of income between the United States and the PRC.[223] As a result, tax planning considerations are becoming an increasingly important and complex aspect of structuring investment in the PRC.

Foreign corporations and individuals investing in China may find themselves subject to one or more of the several tax-related laws and sets of regulations which the PRC has promulgated or made public since 1979.[224] Depending on the entity and form of investment chosen, foreigners may be subject to income tax at the individual, joint venture, or foreign enterprise level, or some combination of these levels.[225] Each of these taxes will be discussed in turn.

A. The Joint Venture Income Tax Law and Implementing Regulations

In 1980 the PRC adopted the first two elements of its tax structure relating to foreign trade by issuing an Income Tax Law of the People's Republic

222. An I.R.S. private letter ruling allowed credits under I.R.C. § 901 (1984) and Temp. Treas. Reg. § 4.901–2(a)(1) for the foreign enterprise income tax. *See* Murphy, *U.S. Allows Chinese Income Taxes to be Credited Against U.S. Income Taxes*, E. ASIAN EXEC. REP., Aug. 1982, at 23.

223. Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion on Income, April 30, 1984, United States–PRC, 1984 I.L.M. 677 [hereinafter cited as the U.S.–PRC Tax Treaty]. *See generally* Schreyer, *A Guide to the China–U.S. Tax Treaty*, E. ASIAN EXEC. REP., Aug. 1984, at 10; *Tax Treaties: Reagan, Chinese Premier Sign Income Accord in Beijing*, DAILY TAX REP. (BNA), at G–5 (May 1, 1984).

The treaty has not yet been ratified by the U.S. Senate. It had initially been hoped that two additional treaties, one on nuclear energy cooperation and the other dealing with bilateral investment, would be ready for signing during President Reagan's visit to Beijing. However, although the nuclear energy agreement was initialed by the U.S. Ambassador, *U.S. and China Reach Pact on Nuclear Power*, Asian Wall St. J., Apr. 30, 1984, at 6, col. 4, it was repudiated very shortly thereafter and the Reagan Administration has refused to submit it to Congress. *See U.S.–China Nuclear Agreement Runs into Roadblock in Congress*, Asian Wall St. J., July 2, 1984, at 3, col. 1. Negotiations on the bilateral investment treaty have as yet been unable to resolve serious differences on the issues of equal treatment of investors, repatriation of currency, third-party binding arbitration, and compensation for expropriation. *See Reagan Visit to China Breaks Stalemate on Some Issues, but Problems Remain*, Asian Wall St. J., Apr. 23, 1984, at 6, col. 1; *A China Treaty the President Didn't Sign*, BUS. WK., May 14, 1984, at 55.

224. For a recent discussion of tax considerations in a variety of investment situations in the PRC, see Gelatt & Theroux, *Tax Treatment in China*, CHINA BUS. REV., Jan.–Feb. 1984, at 22. *See also* Conroy, *Joint Ventures in China and Their Tax Treatment*, 4 INT'L FIN. L. REV. 26 (1985).

225. Additionally, businesses may be subject to the Consolidated Industrial and Commercial Tax, a tax levied on the transfer of goods and services in the production process in the PRC generally. *See, e.g., Reduced Customs Levies and Turn-Over Tax for Goods Used in Petroleum Exploration*, E. ASIAN EXEC. REP., June 1982, at 12.

of China Concerning Joint Ventures with Chinese and Foreign Investment (hereinafter the Joint Venture Income Tax Law),[226] followed by a set of Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment (hereinafter the Joint Venture Income Tax Regulations).[227] Under the Joint Venture Income Tax Law, the tax is calculated on "income derived from production, business and other sources by branches within or outside the territory of China of such joint ventures."[228] Taxable income is defined as the "net income in a tax year after deduction of costs, expenses and losses in that year."[229]

Article 8 of the Joint Venture Income Tax Regulations contains formulas for calculating the taxable income for four categories of joint ventures: industry, commerce, service trades, and other trades. Purchases or construction of machinery, equipment, buildings, facilities, or other fixed assets are not included as costs, expenses, or losses in tax calculations.[230] Instead, they must be depreciated on a straight-line basis.[231] No depreciation is allowed on fixed assets remaining in use "after the full depreciation period".[232] Intangible assets such as "technical know-how, patents, trademark interests, copyright, right to use sites and other franchise counted as investment," are amortized on the basis of the value assigned to them by contract, for the period designated in the articles of association. If no period is designated, a period of ten years is used.[233]

The basic income tax for joint ventures is currently set at a flat rate of thirty percent.[234] Joint ventures are also subject to a local surtax of an additional ten percent of the income tax actually paid,[235] although local governments are free to reduce the local surtax or grant exemptions "on account of special circumstances."[236] Further, profits remitted outside China are taxed

226. Adopted at the Third Session of the Fifth National People's Congress and promulgated on September 10, 1980.

227. Approved by the State Council on December 10, 1980 and promulgated by the Ministry of Finance on December 14, 1980. Its provisions clarify many of the terms used in the Joint Venture Income Tax Law.

228. Joint Venture Income Tax Law, *supra* note 226, at art. 1.

229. *Id.* at art. 2.

230. Joint Venture Income Tax Regulations, *supra* note 227, at art. 9.

231. *Id.* at arts. 10–13.

232. *Id.* at art. 14. Depreciation periods for various categories of assets range from five to twenty years and are set forth in article 13 of the Regulations.

233. *Id.* at art. 16. The regulations contain a number of accounting requirements. Inventories are to be valued at cost and may be computed on a first-in first-out, shifting average, or weighted average basis. *Id.* at art. 18. Accounting must be performed on an accrual basis. *Id.* at art. 23. Joint ventures may carry forward losses for tax purposes for a period of not more than five years. *Id.* at art. 7.

234. Joint Venture Income Tax Law, *supra* note 226, at art. 3.

235. Joint Venture Income Tax Regulations, *supra* note 227, at art. 3.

236. *Id.* Although this could have set the stage for considerable regional competition for foreign investment, it may have given local authorities one more bargaining chip to use against foreign investors. If contract terms are sufficiently favorable to the Chinese party, it will issue the

an additional ten percent.[237] The PRC does allow joint ventures to claim taxes paid in foreign countries as credits against their PRC income tax.[238] The regulations explain, however, that credits may not exceed the tax that would have been paid on the foreign income had it been calculated according to PRC tax rates.[239] Joint ventures expected to operate at least ten years may receive an exemption under the Joint Venture Income Tax Law for the first profitable year of operation, and a fifty percent tax reduction during the next two years.[240] Low-profit joint ventures[241] are eligible for additional income tax reductions of fifteen to thirty percent for up to ten years, following the initial three years of tax reductions.[242] Continued reinvestment of profits in the PRC is encouraged by a provision that joint ventures may "obtain a refund of 40% of the income tax paid on the reinvested amount"[243] after five years of reinvestment.

B. The Individual Income Tax Law and Implementing Regulations

At the same time as it approved the Joint Venture Income Tax Law, the PRC issued the first Individual Income Tax Law of the People's Republic of China (hereinafter the Individual Income Tax Law),[244] subsequently modified by another set of Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China (hereinafter the Individual Income Tax Regulations).[245] Although the two income tax laws are general in form and do not apply solely to foreign employees, the exemptions they contain therein effectively limit the tax to those earning Western incomes.[246] The new Joint Venture Implementation Regulations also make the Individual Income Tax Law directly applicable to staff members and workers employed by joint ventures.[247] However, according to the Individual Income Tax Regulations, individuals residing in the PRC for one

necessary documentation for reduction of the local tax. *See Technology Transfer Tax*, CHINA MARKETING INTELLIGENCE, Mar. 1984, at 3.

237. Joint Venture Income Tax Law, *supra* note 226, at art. 4.

238. *Id.* at art. 16.

239. Joint Venture Income Tax Regulations, *supra* note 227, at art. 32.

240. Joint Venture Income Tax Law, *supra* note 226, at art. 5. The first profitable year of operation used for these calculations is defined in the regulations as the first profitable year *after* depletion of all losses carried forward from the initial years of operation. Joint Venture Income Tax Regulations, *supra* note 227, at art. 5. In addition, the PRC announced in 1983 that this exemption for joint ventures would be extended to the first two years of profitability and that a fifty percent reduction in tax would be permitted in the third profitable year. De Pauw, *New Tax Breaks for Joint Ventures*, E. ASIAN EXEC. REP., May 1983, at 10.

241. For example, farming, forestry, or those located in remote, economically-depressed regions. Joint Venture Income Tax Law, *supra* note 226, at art. 5.

242. *Id.*

243. *Id.* at art. 6.

244. Adopted at the Third Session of the Fifth National People's Congress and promulgated on September 10, 1980.

245. Approved by the State Council on December 10, 1980 and promulgated by the Ministry of Finance on December 14, 1980.

246. *See infra* note 250.

247. Joint Venture Implementation Regulations, *supra* note 136, at art. 70.

to five years calculate taxes "only on that part of their income received outside China which is remitted to China; individuals whose residence in China exceeds five years shall pay tax on all their income received outside China from the sixth year of residence."[248]

Individual taxable income consists of wages and salary, compensation for personal services, royalties, interest, dividends, bonuses, rents, and "other kinds of income specified as taxable by the Ministry of Finance."[249] Wages and salaries are taxed at progressive rates, varying from five percent for the increment of monthly incomes from 801 to 1500 yuan, to forty-five percent for the increment of monthly income exceeding 12,000 yuan, with a full exemption for the first 800 yuan of monthly income.[250] The remaining categories of income, including all passive income such as royalties, dividends, and interest, are taxed at a uniform flat rate of twenty percent.[251]

C. *The Foreign Enterprise Income Tax Law*

The Income Tax Law of the People's Republic of China Concerning

248. Individual Income Tax Regulations, *supra* note 245, at art. 3. The Individual Income Tax Regulations define an individual residing in China for a year as one who "resides in China for a full 365 days of a tax year;" however, no recognition is given to days of "temporary absence" from China. *Id.* at art. 2. Note also that income earned from work *performed* within the PRC is subject to taxation regardless of where payment actually takes place. *Id.* at art. 5. However, article 5 states that "for individuals whose continuous residence in China does not exceed 90 days, the above remuneration paid by employers outside China may be exempted from taxation." Again, however, it is not so much the actual days spent in the PRC as the length of stay permitted on one's visa and the intent of the individual to return to the PRC that determines the application of this exemption. Gelatt & Theroux, *supra* note 224, at 22.

The income tax treatment of foreigners in the PRC will now be modified significantly by the U.S.–PRC Tax Treaty, if ratified, which provides that salaries and wages of U.S. residents will be subject only to U.S. income tax unless the employment is exercised in the PRC, and even then will be exempt from PRC income tax if: (1) the resident is present in the PRC for no more than an aggregate of 183 days during the relevant calendar year; (2) the income is paid by or on behalf of an employer who is not a resident of the PRC; and (3) the wages are not deducted by a permanent establishment of the employer in the PRC in calculating its Chinese income tax. U.S.–PRC Tax Treaty, *supra* note 223, at art. 14.

249. Individual Income Tax Law, *supra* note 244, at art. 2. The categories, defined in the Individual Income Tax Regulations, *supra* note 245, at art. 4, are similar to standard U.S. tax treatment.

250. Individual Income Tax Law, *supra* note 244, appended tax rate table. The exemption of 800 yuan of monthly income eliminates most Chinese citizens from the roles of taxpayers. The average *annual* income in the PRC in 1983 was only 500 yuan, or about U.S. $250. N.Y. Times, March 15, 1984, at 35, col. 6. In 1984 the average annual income was 355 yuan for rural Chinese and 608 yuan for urban Chinese. *The Price of Progress*, FAR EAST ECON. REV., Apr. 11, 1985, at 74.

251. Individual Income Tax Law, *supra* note 244, at art. 3(2). This provision will also be altered by the new U.S.–PRC Tax Treaty, which reduces the maximum rate at which royalties, as defined in the treaty, may be taxed by the source country to ten percent of the gross amount of such royalties. U.S.–PRC Tax Treaty, *supra* note 223, at art. 11(2). *See also* Individual Income Tax Regulations, *supra* note 245, at art. 6, which state that individuals receiving income falling into two or more categories shall have their taxes "calculated and levied separately", presumably keeping them in lower tax brackets than if all forms of income were first aggregated.

Foreign Enterprises (hereinafter the Foreign Enterprise Income Tax Law)[252] to some extent overlaps the existing Joint Venture Income Tax Law. However, the Foreign Enterprise Income Tax Law applies strictly to "foreign companies, enterprises and other economic entities."[253]

The primary deviation from joint venture income taxation is that foreign enterprises with establishments in the PRC are subject to taxation at progressive rates, ranging from twenty percent to forty percent.[254] Taxes are paid on taxable income, defined as "the excess of . . . gross income in a tax year over . . . deductible costs, expenses and losses."[255] In many other respects, such as a ten percent local income tax, tax reductions and exemptions, tax holidays, and loss carryovers, foreign enterprises are given treatment very similar to that of joint ventures.[256]

Enterprises without establishments in the PRC must pay tax on passive income earned in the PRC, including dividend, interest, rental, and royalty payments. The tax also appears to apply to "technical training fees, fees for technical documentation, or any other fees paid for the transfer of the right to use proprietary technical information or know-how."[257] All income of this nature is taxed at a twenty percent rate,[258] and must be withheld by the entity

252. Adopted by the Fourth Session of the Fifth National People's Congress and promulgated on December 13, 1981.

253. In some respects the Foreign Enterprise Income Tax Law was seen as a response to the initial lack of success of the Joint Venture Law. Too many essential questions remained unanswered at that point for foreigners to invest in equity joint ventures. Foreign investors still appeared much more ready to invest in China via contractual joint ventures between foreign-owned enterprises and Chinese entities. At the time the Foreign Enterprise Income Tax Law was adopted, only approximately thirty equity joint ventures had been approved, whereas several hundred contractual joint ventures had been formed. *See generally* Gelatt & Pomp, *Foreign Enterprise Income Tax Law Adopted*, E. ASIAN EXEC. REP., Jan. 1982, at 3. Although the Foreign Enterprise Income Tax Law recognized the preference of foreign investors for non-equity joint venture arrangements, it continued to make equity joint ventures more attractive by imposing higher tax rates and other less favorable conditions on contractual joint ventures. *Id.* at 7.

254. Foreign Enterprise Income Tax Law, *supra* note 252, at art. 3. An enterprise with an establishment in China receiving royalties from licensed technology will be taxed on that income at a rate of up to forty percent depending on the amount of royalties; however, the same firm without a Chinese establishment will only be subject to a twenty percent withholding rate on passive income such as royalties and interest. This rate will be further reduced to a maximum of ten percent by the new U.S.–PRC Tax Treaty when it takes effect. U.S.–PRC Tax Treaty, *supra* note 223, at art. 11(2).

255. Foreign Enterprise Income Tax Law, *supra* note 252, at art. 2. But note that the new U.S.–PRC Tax Treaty will permit taxation of foreign enterprise income only to the extent such income is attributable to a permanent establishment in the PRC. U.S.–PRC Tax Treaty, *supra* note 223, at art. 7(1).

256. But note, for example, that the local tax is ten percent of taxable income whereas, for joint ventures, it is ten percent of income tax owed. Foreign Enterprise Income Tax Law, *supra* note 252, at art. 4. It applies only to the progressive income tax rates, not to passive income of foreign enterprises without establishments in China.

257. Gelatt & Theroux, *supra* note 224, at 23.

258. Foreign Enterprise Income Tax Law, *supra* note 252, at art. 11. Provisional regulations issued by the Ministry of Finance in January 1983 reduced to ten percent or eliminated the withholding tax on certain categories of foreign bank loans and foreign technology income. Provisional Regulations on the Reduction and Exemption of Income Tax on Interest Earned by Foreign Businesses from China, Ministry of Finance provisional regulations dated January 7,

paying the income from each such payment.[259]

The Foreign Enterprise Income Tax Law does not answer the crucial question of precisely what constitutes a foreign enterprise with an establishment within the PRC. This ambiguity caused much consternation among foreign legal experts and businessmen,[260] for structuring a transaction to avoid having an establishment in the PRC could mean the difference between a fifty percent progressive tax rate and a twenty percent (or lower under the provisional regulations) withholding tax rate. The Foreign Enterprise Income Tax Regulations[261] do much to settle this issue. Article 2 states that the term "establishments" refers to "organizations, places or business agents engaging in production or business operations which are established by foreign enterprises in China."[262] Although the regulations do not define "production or business", the Ministry of Finance has indicated that it accepts the customary international concept that the buying activities of a foreign entity or the operations of an independent agent of a foreign entity do not constitute an establishment for tax purposes.[263]

The new U.S.–PRC Tax Treaty will finally resolve this issue by defining permanent establishment to mean "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[264] Thus, the term would include an office, branch, factory, mine, or well.[265] It would also include any site where a construction, manufacturing, or assembly project or related supervisory activities continue for more than six months.[266]

1983, effective on January 1, 1983; Provisional Regulations on the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology, Ministry of Finance provisional regulations dated December 13, 1982, effective on January 1, 1983. *See generally Finance Ministry Reduces Withholding Taxes*, E. ASIAN EXEC. REP., Apr. 1983, at 11; Hannes, *Withholding Taxes on Interest and Leasing Income Reduced*, E. ASIAN EXEC. REP., July 1983, at 10; Hannes, *Withholding Taxes on Technology Fees and Royalties Reduced*, E. ASIAN EXEC. REP., June 1983, at 9. Initially these provisional regulations will only remain effective for agreements signed between 1983 and 1985. However, the recently signed U.S.–PRC Tax Treaty will, when effective, reduce that rate to ten percent for all income subject to withholding. U.S.–PRC Tax Treaty, *supra* note 223, at arts. 9–11.

259. Foreign Enterprise Income Tax Law, *supra* note 252, at art. 11.

260. *See, e.g.*, Gelatt & Pomp, *supra* note 253, at 5. In particular, the relationship between representative offices of foreign businesses in China, which are not allowed to "do business" in the PRC or to receive income, and the generation of income sufficient to be deemed an establishment was unclear. *Id. See also* Gelatt & Theroux, *supra* note 224, at 24.

261. Promulgated by the Ministry of Finance on February 21, 1982 [hereinafter cited as the Foreign Enterprise Income Tax Regulations]. *See generally* Nee, *Regulations to the Foreign Enterprise Income Tax Law Issued*, E. ASIAN EXEC. REP., Apr. 1982, at 5.

262. Foreign Enterprise Income Tax Regulations, *supra* note 261, at art. 2.

263. Nee, *supra* note 261, at 6.

264. U.S.–PRC Tax Treaty, *supra* note 223, at art. 5(1).

265. *Id.* at art. 5(2).

266. *Id.* at art. 5(3). Foreign enterprises can continue to maintain facilities for storage, display, and delivery of goods, purchasing activities, and can be represented by an independent agent, as long as the agent does not habitually conclude contracts, without the foreign enterprise being deemed to have a permanent establishment. U.S.–PRC Tax Treaty, *supra* note 223, at art. 5(4)–(6).

A final question is whether a foreign enterprise with an establishment in China which receives "passive income" is subject only to the twenty percent withholding tax or is taxable at the potentially higher progressive rates. This situation may arise, for example, if a company has more than one investment in China, one of which entails an establishment and one of which is a non-establishment licensing arrangement. The PRC has given mixed indications on this issue,[267] and solid precedents will develop only as China applies the regulations over time.

V
SELECTED ASPECTS OF LICENSING AGREEMENTS WITH THE PRC

Despite recent developments in Chinese foreign trade law, a number of problematic elements remain for parties attempting to negotiate licensing agreements. The remainder of this Article will examine the nature of these difficulties and the means by which they have typically been resolved.

A. Legal Contractual Parties

Through the 1970s, foreign trade corporations (FTCs) and national industrial corporations, particularly the Chinese National Technical Import Corporation (Techimport), were the sole agents of the PRC for negotiating and signing international agreements.[268] Such an arrangement inevitably produced needless complications, due to the absence of the Chinese real party in interest from the contract negotiations. By late 1980, however, foreign trade contracts were being concluded directly with ministries, provincial and municipal agencies, professional societies and research institutes, other special purpose organizations, and even end-users, without any FTC participation.[269] As one commentator noted, an increasing number of PRC entities with official to semi-official status are "gradually usurping the role of the Ministry of Foreign Economic Relations and Trade's FTCs."[270]

The proliferation of negotiating parties in the PRC has increased the number of contacts for would-be trading partners in the West and has allowed more efficient direct negotiations between foreign firms and the ultimate users of their products in the PRC. However, the uncertain legal status of most semi-official or unofficial PRC entities has also increased the risks of trading with China. Concerns of this nature, for example, very nearly defeated ARCO's efforts to negotiate an agreement with the China National Offshore Oil Corporation (CNOOC) to develop China's offshore oil

267. Nee, *supra* note 261, at 7.
268. Hsiao, *supra* note 190, at 310–11.
269. Theroux, *supra* note 2, at 196.
270. *Id.* at 196–97.

reserves.[271] Because CNOOC had only been formed in February 1982, ARCO representatives feared that CNOOC would be unable to protect long-term contracts from the vicissitudes of Chinese politics. Ultimately, ARCO successfully insisted that the contract be co-signed by the Ministry of Petroleum.[272]

B. Licensing as a Transfer of Documentation

One of the difficulties in licensing technology to the PRC is the way the PRC perceives the transaction. One commentator has suggested that the PRC views a license not as a limited right to make, use, or sell the patented product or process, but more as "the transfer of large amounts of paper, the 'technical documentation' rather than the know-how which the documentation embodies."[273] Licenses are structured as sales, with the "licensor" becoming the "seller".[274] As a result, Techimport has generally demanded that the licensor provide detailed background documentation showing how the know-how and equipment came to possess their current specifications.[275]

The arrangements made for payments under the license also illustrate the Chinese concept of licensing. Many alternative methods exist to structure the consideration paid for granting a license, including a single lump-sum payment, a fixed consideration payable in installments, or a running royalty, based on levels of production or gross sales. The Chinese prefer to structure consideration as a fixed sum, as this method is more consistent with the notion that a licensing agreement constitutes the sale of documentation. The theoretical logic of this approach is reinforced by the Chinese ideological distaste for paying royalties[276] and by Chinese concerns regarding national security if foreigners have access to confidential information of the licensee generally needed to compute royalties.[277]

The Chinese have proven to be flexible on the mechanics of fixed consideration, however, and allow lump-sum payments, installment payments, or payments linked to previously estimated production levels. In addition, the early Chinese resistance to payment of true output-related royalties has slowly given way to the preferences of foreign licensors.[278] Today, royalties

271. *China and Atlantic Richfield Sign Contract for Offshore Oil Drilling*, N.Y. Times, Sept. 20, 1982, at 1.

272. *Id.*

273. S. Lubman, Licensing Technology to China: Practical Observations 13 (unpublished manuscript).

274. *Id.* at 2.

275. *Id.* at 3.

276. *See supra* note 12.

277. *See, e.g.*, Kaman, *Practice of Licensing With China*, 15 LES NOUVELLES, J. LICENSING EXECUTIVES SOC'Y 209, 213 (1980); Ludlow, *supra* note 10, at 66. *See also supra* note 2 and accompanying text.

278. *See, e.g.*, Kemmer, *Case History: Licensing to China*, 10 LES NOUVELLES, J. LICENSING EXECUTIVES SOC'Y 24 (1975).

have been acknowledged by the PRC as the "general" method of payment for the use of technology:

> Expenses for the use of technology shall be fair and reasonable. Payments are generally made in royalties, and the royalty rate shall not be higher than the standard international rate, which shall be calculated on the basis of net sales of the products produced with the relevant technology or other reasonable means agreed upon by both parties.[279]

A further complication arises when finished products differ from contracted specifications. The Chinese consider such deviations to be the result of defects in the documentation.[280] Unlike Americans, who tend to incorporate innovations or improvements as they are developed, the Chinese view such innovative changes as departures from the agreed-upon documentation. This difference in viewpoint leads to numerous delays, as the Chinese must repeatedly be convinced of the non-breaching character of the new design.[281]

C. Choice-of-Law Clauses

Although Chinese agencies remain extremely reluctant to litigate or to arbitrate investment disputes, choice-of-law clauses have practical importance in contract interpretation and non-litigious enforcement. In the past, one of the incentives for a choice-of-law clause was the absence of a substantive Chinese contract law to explain the PRC's interpretation of contracts. To some extent, such concerns were met by the adoption of the Economic Contracts Law.[282] Additionally, the PRC began showing signs of willingness to accept contracts governed by non-PRC law and has now formally adopted that stance in the Foreign Contract Law with respect to some foreign contracts.[283]

The recently promulgated Joint Venture Implementation Regulations appear to foreclose a similar flexibility for joint venture agreements, however, by stating that the "formation of a joint venture contract, its validity, interpretation, execution and the settlement of disputes under it shall be governed by the Chinese law."[284] The effect of this restriction on the investment decisions of foreign parties remains to be seen.

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279. Joint Venture Implementation Regulations, *supra* note 136, at art. 46.

280. S. Lubman, *supra* note 273, at 5. A standard clause in PRC contracts provides that if an acceptance test shows a deviation from the contractual specifications, " 'both parties shall jointly analyze the cause, make an acceptance test again and clarify the responsibility.' " *Id.* at 6, *citing* a standard clause used by Techimport. Even if it is agreed that the defect is the responsibility of the Chinese partner, " 'the Seller shall assist the Buyer in taking means to eliminate the defects.' " *Id.*

281. Green, *China's American Residents: U.S. Company Technical Personnel in China*, CHINA BUS. REV., Jan.-Feb. 1977, at 25, 30.

282. *See supra* note 60.

283. *Foreign Contract Regulations: An Early Draft*, E. ASIAN EXEC. REP., Sept. 1982, at 7.

284. Joint Venture Implementation Regulations, *supra* note 136, at art. 15.

D. Inspection Clauses

Contract clauses relating to the inspection and shipment of goods are important because of their relevance to the issue of quality control. Many foreign investors are anxious about the quality guarantees they are required to give regarding both the performance of machines and the goods they produce. The lack of sufficient numbers of trained engineers in the PRC in the wake of the Cultural Revolution makes some investors uneasy about retaining full technical responsibility in the venture even after the Chinese have taken over management.[285]

In general, inspection clauses in contracts with the Chinese tend to be singularly one-sided. Inspection must almost always be performed within the PRC regardless of whether the PRC is buying or selling.[286] Although the Chinese agency responsible for inspections, the China Commodities Inspection Bureau, has a reputation for being compulsively honest,[287] the mere fact that inspections must take place in China, before export from or after shipment to the PRC, may disturb licensors. At a minimum, licensors should probably include clauses in their agreements specifying acceptable percentages of defective or non-conforming goods and the appropriate disposition of such goods.[288]

E. Taxation Clauses

Although much of the mystery of Chinese tax policy has been resolved through the promulgation of the tax laws and regulations discussed above, significant questions about tax consequences in the PRC remain. Much of the terminology used in Chinese statutes, for example, has yet to be fully clarified or defined. In the absence of a well-defined system of adjudication and reporting of decisions on such questions, the contract negotiator once again must bear the responsibility to minimize tax difficulties.

An approach to tax problems frequently used in license agreements elsewhere in the world is the inclusion of a clause specifying that all taxes, customs, and duties of the licensee's country arising from the agreement will be the responsibility of the licensee. The PRC has in fact agreed to clauses with similar effect in purchase agreements in the past.[289] Barring such a clause,

285. *See, e.g., Japanese Executive Warns that Concept of Joint Venture Is "Different" in China*, Asian Wall St. J., Oct. 15, 1979, at 3, col. 1.

286. Theroux, *supra* note 2, at 222.

287. Smith, *Standard Form Contracts in the International Commercial Transactions of the PRC*, 21 INT'L & COMP. L.Q. 133, 143 (1972). At times their compulsion seems counterproductive, as when questioning shipments containing newer or more units than contracted. *See, e.g.*, Theroux, *supra* note 2, at 222. One commentary notes that whereas many small items such as nuts and bolts, although sold in terms of units, are actually measured by weight in the West, the CCIB continues to count them individually by hand to insure delivery of the exact number ordered. L. ECKSTROM, *supra* note 12, at 27.03[10].

288. Cohen & Nee, *China: All About Compensation Trade, Part II*, Asian Wall St. J., July 4, 1979, at 4, col. 2.

289. Theroux, *supra* note 2, at 235.

the negotiator can clarify statutory ambiguity by incorporating defined terms from other legal systems into the joint venture contract or transfer agreement. At a minimum, negotiators must seek clarification from Chinese officials on whether the activities contemplated will be an "establishment", leading to the imposition of progressive tax rates. Local officials may also be pressed to certify the type of technology transferred as well as compliance with other requirements allowing exemptions or reductions under the various tax laws. Finally, in light of the different rates of taxation for passive income and income from business operations in China, transactions that will involve both, such as a sale of equipment and license of technology, should explicitly designate the consideration to be paid for each.

F. Technology Protection Clauses

The licensor's ultimate objective in granting a license is to guarantee a market return on the technology while protecting against its availability to users not intended by the license and to minimize the threat of competition for the licensor's own markets. In other countries efforts to protect patented know-how generally use the technique of incorporation by reference to introduce the patent into the license agreement. The absence of a Chinese patent law, until recently, has made this procedure infeasible in the PRC. However, until China's patent law is firmly in place,[290] the most a licensor can do is to refer to a patent covering the licensed technology in another country. Such reference reduces the problems of identifying the know-how, but does not confer any sort of statutory protection. Fortunately, since March 1, 1983, protection for licensed *trademarks* has been available under China's new Trademark Law and since April 1, 1985, for patents.[291]

In the absence of the protections afforded by reference to a valid patent under local law, licensors in China have largely relied on confidentiality clauses to protect their technology. A confidentiality clause typically reads along the following lines:

> Within ——— years after signing the ——— contract, the buyers shall not disclose in whole or in part to any third party the know-how, Technical Documentation and other information of the process obtained under the Contract. The secrecy does not apply to those parts . . . which become part of the public knowledge or literature. The license, know-how, Technical Documentation and other information are to be used only for the construction, operation, and maintenance of the Contract Plant.[292]

The essence of a confidentiality clause is a commitment by both parties not to disclose the licensed know-how to "third parties" unless it otherwise enters the public domain. Unfortunately, a significant problem arises as to the meaning of "third parties". China typically objects to the suggestion that

290. *See supra* text accompanying notes 203–221.

291. *See supra* notes 203–204.

292. Note, *supra* note 12, at 256. By the terms of such a provision, trademarks, trade secrets, and know-how in general are protected in addition to patented information.

proprietary knowledge be withheld by one segment of the proletariat from another. Instead, it proposes that the licensee "not disclose or publish in any form to any third party outside China the contents of the know-how supplied by the Seller to the Buyer."[293] Moreover, even when the Chinese have individually accepted the broader "*any* third party" language and have orally agreed that other Chinese entities were covered, they have been reluctant to allow that understanding to be expressed explicitly in the written contract.

The problems Sohio encountered in attempting to require a confidentiality clause binding upon employees of the Chinese licensee and others who come into contact with the technology provide a good example of the Chinese resistance to such provisions. The Chinese assured Sohio that "such agreements were not necessary in China since, when the Chinese Government gave their word that the information would be kept secret, the citizens of China would honor that commitment."[294] As a result, Sohio, like most foreign licensors, made do with oral assurances, rather than insisting on their normal contractual protections. Considering the importance given to the *written* contract in Chinese jurisprudence, such a strategy is risky at best. Additionally, as contracts are concluded at increasingly lower levels of hierarchy in the PRC, one must begin to question whether it is any longer "the Chinese Government" that has given its word.

With the opening of a new patent office and the signing in 1980 of China's first agreement to license technology to the United States,[295] it was thought that China might accelerate its efforts to provide licensors with a statutory alternative to contractual patent protections.[296] If anything, however, the new Joint Venture Implementation Regulations narrow the flexibility available in drafting contracts involving the transfer of technology to joint ventures. Unless the joint venture contract states otherwise, "the technology exporting party shall not put any restrictions on the quantity, price or region of sale of the products that are to be exported by the technology importing party."[297] Moreover, agreements to transfer technology may not generally last longer than ten years, after which time the technology-importing party "shall have the right to use the technology continuously."[298] The Joint Venture Implementation Regulations contain the further provision that "no irrational restrictive clauses prohibited by Chinese law and regulations shall be

293. Lubman, *A Question of Confidentiality*, CHINA BUS. REV., July–Aug. 1983, at 28.

294. Kemmer, *supra* note 278, at 24.

295. The agreement involved an exclusive license for advanced Chinese rice hybridization technology. The American firm, a division of Occidental Petroleum Corp., applied for a U.S. patent to be issued to the Chinese inventor, who then assigned it back to the United States company. Berry, *China's 1st Technology Transfer to the US*, CHINA BUS. REV., July–Aug. 1980, at 41.

296. It was required to do so under one interpretation of the U.S.–PRC Trade Agreement. *See supra* text accompanying notes 53–56.

297. Joint Venture Implementation Regulations, *supra* note 136, at art. 46.

298. *Id.*

included."[299] It remains to be seen how these regulations will be applied in practice and how the question of technology protection in China will be altered if the PRC successfully implements trademark and patent systems.

Even a widespread implementation of patent and trademark protections will not completely solve the issue, for the PRC still has not addressed the questions of copyright or trade secret protection. The PRC has no copyright law, nor has it signed any international copyright convention.[300] It has, however, issued a notice for the payment of royalties for the use of audio-visual materials in the PRC,[301] providing some hope that a general copyright law is being developed.

Given the Chinese reluctance to accept confidentiality clauses in specific contracts, a general system of trade secret protection seems far in the future. Acceptance by the Chinese of confidentiality and other protective clauses will probably not occur without demands from foreign investors, which are unlikely to be made in the absence of a serious mishap. However, given the effect even one serious incident would have on foreign investors, it would be extremely counterproductive for China to completely ignore this problem. Furthermore, as Ren Jianxin, director of CCPIT's Legal Department, said in 1979 of China's eagerness to develop patent law protection, "[n]ow we are importers of technology. But in the future . . . we, too, will export."[302] Hopefully, this view will spur the further refinement of China's legal system and will make the question of technology protection a much less complicated component of contract negotiation.

G. Grantback Clauses

Grantback clauses are agreements by the licensee to grant to the licensor any improvements in the licensed technology made by the licensee. Such agreements are typically made in conjunction with a similar reciprocal commitment by the licensor and thus constitute an inexpensive means for the licensee to retain access to up-to-date technology. In the past, the Chinese have been unwilling to agree to give such access to their own improvements, preferring instead to sacrifice access to the results of the licensor's continuing research and improvements.[303] The PRC has now approved grantback clauses in licensing agreements, as long as such clauses meet the test that "conditions for mutual exchange of information on the improvement of technology by both parties of the technology transfer agreement shall be reciprocal."[304] In fact, the Joint Venture Implementation Regulations appear to

299. *Id.*
300. *China's Copyright Policy Upsets American Writers*, San Francisco Chron., Jan. 17, 1984, at 14, col. 1.
301. Leung & Chan, *Copyrights on Audio-Visual Material*, E. ASIAN EXEC. REP., June 1983, at 8.
302. *Trade With China*, *supra* note 59, at 1063.
303. *See, e.g.*, Theroux, *supra* note 2, at 216.
304. Joint Venture Implementation Regulations, *supra* note 136, at art. 46.

sanction grantback provisions officially if "the terms for mutual exchange of improvements in the technology [are] reciprocal."[305]

H. Dispute Settlement Clauses

All well-designed contracts in some way provide for a means to settle any future disagreements among the parties. The Chinese, however, show an aversion to the formal means of dispute resolution relied upon in the West, such as litigation. One Chinese adage concludes that "it is better to die of vexation than to get involved in a lawsuit."[306] In commercial transactions, the Chinese prefer "friendly negotiations" as a means of dispute resolution. In the event settlement is thwarted, most contracts with the PRC provide for some form of arbitration. Many form contracts used for sales or purchases by the PRC contain arbitration clauses requiring arbitration to take place in Beijing before one of the arbitral bodies established by the PRC in 1956.[307] Unfortunately, these provisions for arbitration have often been vaguely worded or have lacked clear statements of the triggering events, the substantive governing law, or the applicable procedural law.[308] Dissatisfaction with these terms by foreign investors has gradually persuaded the Chinese to adopt a more flexible stance toward arbitration in third countries.[309]

CONCLUSION

When China opened itself to the prospect of Western investment in 1972, the only potential for satisfying investor concerns about insuring a profitable return on technology investments, avoiding know-how "leakage", and minimizing self-induced competition lay in contractual provisions and protection. Without a clearly defined judicial system, conditions of access to judicial forums, or other means of enforcing contractual commitments, Western investors were ultimately forced to rely on Chinese assurances of goodwill and honest intentions. In part, investors were also relying on the pressures of practical reality to compel compliance on the part of the Chinese.

In some respects, this situation remains the same today. The definitions of many critical terms in Chinese statutes remain unavailable. Yet, a fundamental change has taken place. Over the last five years a framework has been set in place for statutory treatment of the basic elements of corporate

305. *Id.*

306. Theroux, *supra* note 2, at 236, n.124.

307. *Id.* at 237. At present there are three such bodies: the Arbitration Committee, the Foreign Trade Arbitration Commission, and the Maritime Arbitration Commission, all located within the China Council for the Promotion of International Trade (CCPIT). *Id.* For a survey of arbitration procedures, see Surrey & Soble, *Recent Developments in Dispute Resolution in the People's Republic of China*, in LEGAL ASPECTS OF DOING BUSINESS WITH CHINA 373 (PLI 1983).

308. Theroux, *supra* note 2, at 237–39. *See also* L. ECKSTROM, *supra* note 12, at 27–03[9]; Note, *supra* note 12, at 260.

309. S. Lubman, *supra* note 273, at 12.

commercial transactions with the PRC and for access to the Chinese courts for purposes of their enforcement. Until those structures are tested, foreign investors may not be better off than under the previous regime of wholly contractual protections, and it must be conceded that much work remains to be done in order to accommodate investor's concerns in the PRC. Nonetheless, the current system has taken major strides in formally recognizing the means to enforce the contractual provisions protecting investments in intellectual property. Given China's need for outside assistance in the form of capital and technology, this trend is unlikely to be weakened in the future. In light of China's current commitment to pragmatism, foreign licensors of technology to the PRC should be able to look forward to an environment for commercial transactions that increasingly resembles that which is available in other markets around the world.