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Stanley B. Lubman

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I. Introduction

The remarkable economic reforms begun in the People's Republic of China (PRC) in 1979 have made possible transactions between Chinese and foreigners that were previously unthinkable. But the reforms have also caused, and are likely to continue to cause, dislocations and uncertainties which often impair Sino-foreign commercial relationships as they are embodied in contracts. This article discusses two different types of contracts, contracts to establish enterprises in China with foreign direct investment (investment contracts) and contracts to purchase Chinese products for export (export contracts). It further comments on why these contracts often cannot be implemented according to their terms for reasons stemming from the effects of economic reform policies.

This article suggests perspectives on contractual uncertainty which might be appropriate for foreign investors and traders, and notes the influence of several symbols and myths on Chinese and foreign perceptions of contractual relations. Although focussed on some practical aspects of the current legal environment for investment and trade in the PRC, this article also invites speculation about some of the forces that are shaping Chinese legal institutions.[1]

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* A.B. 1955, L.L.B. 1958, LL.M. 1959, J.S.D. 1969 Columbia; partner, Thelen, Marrin, Johnson & Bridges, San Francisco; Visiting Professor, Harvard Law School, spring semesters, 1988 and 1989. The author appreciates the assistance of Thomas N. Apple and Phyllis L. Chang, associates at Thelen, Marrin, Johnson & Bridges and Matthew Levine, Columbia Law School 1989, a summer associate at Thelen, Marrin, Johnson & Bridges in 1988.

1. Discrete transactions and theoretical speculation usually occur in mutual isolation, yet an understanding of the practical problem of Chinese investment and trade is essential to the scholarly study of Chinese legal institutions, while insights of practical value can be gleaned from theorizing about the functions of Chinese law in Chinese society today.

II. INVESTMENT CONTRACTS

" 'A contract never ends in China,' explained Stan Lubman, a China specialist since 1967, professor of law at Harvard University and an attorney in San Francisco."[2]

The statement quoted above and attributed to me in the *China Daily* is not exactly what I recall saying during a speech at a recent conference, at which I described the views of many foreign investors. The article failed to capture any of the explanations I gave for the fluidity of contract relations. The article did quote me as urging that it is important for the parties to insert into their feasibility studies and contracts provisions governing the management of problems when they arise.[3] Regardless of its inaccuracy, I won't disown the quotation because it captures the frustration that negotiations over investment contracts in the PRC provoke in many investors. The statement refers to the frequent renegotiation that is necessary both after Chinese and foreign parties have agreed on their contracts but prior to approval by investment authorities, and after such contracts have been approved.

Foreign investors must be prepared for considerable and persistent uncertainty given the problem of renegotiation and other problems of contractual instability that are associated in dealing with the PRC. The stability of investment arrangements can best be protected, and appropriate general standards of commercial behavior established, through careful negotiation of a detailed feasibility study and a detailed contract that provides mechanisms for subsequent adjustment and renegotiation of the obligations and relations of the parties. Moreover, Western investors and their legal advisors must be self-conscious and self-examining about the models of contractual relationships and contract practice against which they measure Chinese practice.

A. The Foreign Perspective

Renegotiation of investment contracts is often required on issues that the foreign party had assumed had already been disposed of during contract negotiations. If this occurs after the negotiations have been completed but before the contract has been approved, the approval itself must be negotiated, sometimes di-

2. China Daily, Sept. 26, 1988, (Bus. Weekly), at 3, col. 2.
3. *Id.*

rectly with the approval authority and sometimes through the Chinese partner. I was told some years ago by a European lawyer of a telex that his client received from the Chinese party to an investment contract that had been signed and was awaiting approval. The telex began: "Good news, contract approved. The following items must be renegotiated . . . ."

Even after approval, it is common for the parties to have to readjust their expectations, their method of cooperation and their mutual obligations for a variety of reasons. Sometimes action or inaction by government agencies is not anticipated by the parties. For example, a foreign exchange shortage once caused a suspension in foreign currency to A.M.C. for jeeps in the form of kits which the Beijing Jeep Company had contracted to purchase from A.M.C.[4] In another case, a Ministry of Commerce directive required that cotton be processed only at state-run ginning centers, thereby reducing the market for a Sino-American joint venture that was formed to manufacture small cotton gins for sale to peasant cooperatives.

Sometimes the foreign party may be particularly frustrated because the post-contractual difficulty was anticipated during negotiations, but the Chinese party was either unwilling to discuss the problem with the relevant Chinese agency or asserted that the problem would be solved to the satisfaction of the skeptical Western partner. For example, after foreign investors have been assured by their Chinese partners that the PRC will allocate the requisite volumes and qualities of input needed for manufacturing activities, they may still be disappointed. They may discover that after the joint venture has begun, insufficient amounts of the input have been allocated to the joint venture under the economic plan or only a portion of that allocation will actually be available. Alternatively, necessary quantities or qualities may not be available on the free market or free market prices may be so high as to impair the profitability of the joint venture.

The foreign partner may be even more frustrated if it appears that the difficulties of the new joint venture stem from acts of the Chinese partner, and for which he believes the partner should bear legal responsibility. Recourse to formal dispute settlement is very difficult even if the contract has provided for

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4. *See Jeep on a Bumpy Road*, FAR E. ECON. REV., June 12, 1986, at 132, 133; *AMC's China Strategy Seen as Test Case*, Asian Wall St. J., Aug. 22-23, 1986.

an agreed means of third party dispute resolution. An attempt by the foreign party to invoke the dispute settlement clause is often regarded by the Chinese as a hostile act, one that ruptures the relationship between the parties although the foreign party may regard the relationship as having been already broken down.

The contract-related problems of the Chinese investment environment are summarized in one recent article.[5] Among the often-discussed frustrations of foreign investors are Chinese insistence that a contract be "simple and vague regardless how complex the circumstances may be," requests by Chinese examination and approval authorities to change crucial terms to which the Chinese and foreign parties have agreed in their investment contracts and which are consistent with Chinese law, and inconsistent attitudes by different members of the same Chinese agency. Other frustrations include inconsistency of interpretation between agencies in different cities in China, interference with the autonomy of a joint venture by a local government agency,[6] and "the frequency with which either the Chinese parties or Chinese officials insist that signed and approved contracts later be renegotiated."[7]

Messrs. Cohen and Valentine recommend that "Chinese contract negotiators and officials [be] authoritatively informed that it is legitimate for contracts to be as detailed and precise as the circumstances of the investment warrant," that "Chinese contract-approving agencies should seek to minimize the number of occasions when their review leads to renegotiation of the contract already agreed upon by the parties,"[8] and that

> after a contract has been approved, its integrity should be respected. Not only the foreign party, but also the Chinese party and PRC officials should act in accordance with the contract as well as the relevant provisions of law. Officials should not interfere with legally valid arrangements that confer autonomy on foreign-related ventures.[9]

Finally in this regard, Cohen and Valentine urge that Chinese parties and negotiators recognize "in those rare instances

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5. Cohen & Valentine, *Foreign Direct Investment in the People's Republic of China: Progress, Problems and Proposals*, 1 J. CHINESE L. 161 (1987).

6. *Id.* at 199-200.

7. *Id.* at 201.

8. *Id.* at 211.

9. *Id.* at 211-12.

when a contract dispute cannot be settled by friendly consultation or informal mediation, that it is perfectly acceptable for either side to invoke the formal dispute resolution provisions of the contract.[10]

This summary concisely states the problems that have characterized investment negotiations in China since foreign direct investment first became acceptable in 1979, and the recommendations echo the reactions of frustrated foreign investors for almost ten years. Both the problems and the reactions are consistent with my own experiences in advising foreign investors since foreign direct investment became possible in the PRC almost ten years ago.

B. An Alternative Perspective

My own experience suggests that as understandable as foreign investors' frustration may be, both it and the commonly expressed sentiment that Chinese ought to have more respect for their contracts may derive at least partly from excessive impatience with some basic characteristics of Chinese law and the Chinese economy, as well as from exaggerated expectations. There are some perfectly understandable reasons why prospective foreign investors should expect to encounter the situation described, including resistance to complex documentation, renegotiation of contracts and frequent official interference with established contractual relations, as well as resistance to formal dispute settlement.

1. Contractual stability — A historical glimpse

In traditional Chinese law, a contract was not regulated by formal legal rules but by customary practice, and dispute resolution took place outside the courts.[11] This situation remained fundamentally unchanged during the years of Chinese Nationalist (Guomindang) rule.[12] In view of the Communist stamp on legal institutions since 1949 and the twenty-year hiatus in the development of chinese legal institutions that began in 1959,[13] how

10. *Id.* at 212.

11. *See, e.g.* Brockman, *Commercial Constraint Law in Late Nineteenth-Century Taiwan*, in ESSAYS ON CHINA'S LEGAL TRADITION 76 (J. Cohen, R. Edwards & Fu-mei Chang Chen eds. 1980).

12. *See, e.g.*, CH'IEN TUAN-SHENG, THE GOVERNMENT AND POLITICS OF CHINA 254-55 (1961).

13. Note that this hiatus was not limited to the years of the Cultural Revolution, as

could foreign investors expect Chinese officials to place a high value on contractual stability?

Given, too, both the novelty of foreign investment and the need to construct a legal framework for it even as policies meant to stimulate it continue to take shape, how could the environment for foreign direct investment be made stable within a short period of time? Additionally, foreign press coverage of China should be enough to suggest to prospective investors the novelty, fragility and incompleteness of economic reform itself, and should therefore lead prospective investors to expect an investment environment marked by a high degree of uncertainty.

It is necessary to understand the weakness of Chinese law in Chinese society, before and after the establishment of the PRC in 1949, and to be sensitive to the likelihood that important differences may possibly exist between Chinese and Western perceptions of contract. Even without considering historical influences and concentrating only on what the prospective investor can see and interpret in the modern foreground, much can be learned to put the investor on his guard.

2. Current Chinese attitudes toward contracts

a. Differing views of contract and of economic reform. Looking not far beyond their investment agreements to the domestic context in which such agreements must be understood and implemented, investors can readily ascertain many reasons for wariness. It might suffice here to consider the attitudes that Chinese enterprise managers are likely to have toward contracts, based on practice in contractual relations among Chinese domestic enterprises. These could be expected to influence their views of investment contracts with foreigners. That context is not a stable one, and although a new body of Chinese laws and regulations is emerging as a framework for domestic contractual relations, considerable time is going to be necessary before the new framework becomes meaningful in the sense of actively influencing the contractual negotiations and relationships of economic actors in Chinese industry.

In view of the situation described above, it is not surprising that Chinese partners in Sino-foreign joint ventures expect that contractual relationships are to a significant extent driven by administrative relationships, although Chinese doctrine main-

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official Chinese discussions sometimes state.

tains the formal notions of the contract as an agreement between two parties whose autonomy is implied.[14] Whenever state-owned enterprises are involved in domestic Chinese industrial and commercial contracts, they are in vertical authority relationships with a variety of government organizations whose decisions affect the discretion of the contracting enterprise both before and after the contract has been signed.[15] These agencies, which one observer has usefully called "secondary parties" to the contract,[16] include the administrative superiors of the enterprises, generically referred to as their "departments in charge," approval authorities, and banks.

The term "department in charge," is usually the administrative superior of the Chinese party to the venture.[17] Although the Chinese enterprise manager, including Chinese managerial personnel in a Sino-foreign joint venture, is accustomed to bargaining with such administrative superiors on a large range of issues that eventually determine the retained profits of a Chinese state-owned enterprise,[18] the foreign partner is unlikely to anticipate the extent of the involvement of the department in charge.

The lack of unanimity among leaders, legal specialists, managers and economic officials on the function of contracts in Chinese industry and commerce suggests that the notion of maintaining the integrity of a contract is unlikely to receive unambiguous support. Those who would like to see less reliance on central planning and greater introduction of market forces emphasize the importance of the contract as an expression of relationships among economic actors possessing a considerable and (they hope) growing autonomy. Others, however, more re-

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14. Contract laws are formulated in terms of agreement between the parties, without reference to superior organizations with direct authority over them, involved in the transaction. Indeed, Chinese law provides for damages in the purely domestic situation if one party is caused to breach a contract by the action of its administrative superior. *See* General Principles of Civil Law, art. 116, *translated in* Gray & Zheng, *General Priciples of Civil Law of the People's Republic of China*, 34 AM. J. COMP. L. 715, 737 (1986).

15. *See, e.g.*, H. ZHENG, CHINA'S CIVIL AND COMMERCIAL LAW 55 (1988).

16. MacNeil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 316 (1986).

17. Regulations for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures, art. 6 (promulgated by the State Council on Sept. 20, 1983), *translated in* China Laws for Foreign Business ¶ 6-550, at ¶ 6-550(7) (CCH Austl. Ltd.) (1987).

18. *See, e.g.*, Byrd & Tidrick, *Factor Allocation and Enterprise Incentives*, in CHINA'S INDUSTRIAL REFORM 60 (G. Tidrick & Chen Jiyuan eds. 1987).

luctant to abandon reliance on central planning, characterize contracts as useful augmentations of the plan, to which all contracts must remain subordinate.[19]

Underlying these issues is debate, confusion and uncertainty about nothing less than the very nature and extent of economic reform itself. From basic differences on issues associated with this theme flow specific differences on legal aspects of contractual relationships.[20] In light of the lack of consensus on the basic issues pertaining to reform, and the derivative ambiguity related to legal aspects of contracts and settlement of disputes arising from them, it should not be surprising that Chinese partners to joint ventures may exhibit rather less attachment to the details of the contract as it was negotiated than their Western counterparts.

b. Mediation instead of arbitration or adjudication. Although contracts are employed with increasing frequency and detail in industry and commerce and recourse to third-party settlement of disputes arising out of such contracts has also increased,[21] impressionistic evidence suggests that the resolution of most disputes is accomplished by mediation rather than arbitration or adjudication. Gu Ming, a Chinese official who has been particularly closely identified with the development of economic legislation, has been quoted to this effect.[22] In addition, analysis of unofficial reports of contract cases, some scattered in the press,[23] and others in published collections of cases, support this proposition.[24]

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19. *See generally* Perkins, *Reforming China's Economic System*, 26 J. ECON. LIT. 601 (1988); Pittman B. Potter, Policy, Law and Private Economic Rights in China: The Doctrine and Practice of Law on Economic Contracts (unpublished dissertation, U. of Wash. 1985).

20. *See, e.g.*, Potter, *supra* note 19 at 144-53, 590-93. These differences are central to Chinese political and economic life today. For example, whether contracts should be enforced by means of *control* exercised over them by *administrative agencies*, or through the decisions of specialized institutions of dispute-settlement in disputes over the *rights arising from contracts*.

21. *See, e.g.*, Spanogle & Baranski, *Chinese Commercial Dispute Resolution Methods: The State Commercial and Industrial Administration Bureau*, 35 AM. J. COMP. L. 761 (1987).

22. *See id.* at 795 n. 157.

23. Potter, *supra* note 19, at 637-759 (summarizes cases involving economic contract disputes published in Chinese legal, economic and general-circulation newspapers and journals in 1982-1984). MacNeil, *supra* note 16, is based on one such collection of cases decided in 1980 and 1981.

24. On some recently published collections of cases, and their proliferation, *see* Sidel, *Recent and Noteworthy Legal Works Published in China*, 1 J. CHINESE L. 251,

The importance of mediation as the dominant mode of dispute settlement is not surprising in view of the long-established preference for it in China prior to the establishment of the PRC.[25] The PRC retained mediation in forms that cloaked the coexistence of traditional values such as compromise with newer values and policies supposedly more consistent with the establishment of a socialist new order in China.[26] Nevertheless, given the continued importance of bargaining between enterprises and their superiors over the profits they will retain,[27] it is premature to assume that the commencement of economic reform has made enterprise managers welcome formal dispute resolution as a means of obtaining profits that would otherwise have been lost because of a breached contract.[28]

In this context, characterized by indecision about economic reform itself and the role in the economy of legal rules and formal legal institutions, these rules and institutions reflect the impact of a web of administrative relationships that curtail the freedom and discretion of the enterprise manager, a practice of bargaining with administrative superiors for economic benefits rather than claiming any right to them, a legal tradition in which formal adjudication of contract disputes was little known, and the novelty of legal rules enforced by new legal institutions, it should not be surprising that economic actors such as enterprise managers might not regard contract disputes from perspectives that emphasize insistence on vindicating legal rights. This, then, is the context with which the Chinese counterparts of foreign investors are familiar, and the mentality with which they are likely to approach their contractual relations with foreigners.

One might argue that to ask for stability in investment contracts is only to ask for what the Chinese leadership has promised. But like most policies since the establishment of the PRC, the implementation of investment policies has not been consistent and their courses have often changed. Beijing's control over local practice is no more monolithic in investment matters than it is in any other area of policy. To expect more is tantamount to

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258-261 (1987). It should be noted that these collections are unofficial.

25. *See, e.g.*, Cohen, *Chinese Mediation on the Eve of Modernization*, 54 CALIF. L. REV. 1201 (1966); Lubman, *Mao and Mediation: Politics and Dispute Resolution in Communist China*, 55 CALIF. L. REV. 1284, 1290-1301 (1967).

26. Lubman, *supra* note 25.

27. *See, e.g.*, Byrd & Tidrick, *supra* note 18.

28. Such an assumption is made in Spanogle & Baranski, *supra* note 21.

expecting that laws will be self-executing and to confuse law on paper with law in life.

C. *Accepting China as it is*

For both the foreign student of Chinese law and the foreign investor who requires a legal framework that will protect his investment, my argument that we must have low expectations of Chinese legality, and that we are faced with the necessity to take China as we find it, will lead to disquietude. Wariness, at any rate, is required. The investor must be prepared for instability in his contractual relationships, and for the need to engage in frequent renegotiation with his Chinese partner and with a variety of Chinese agencies. If the investor and the Chinese partner carried out a detailed feasibility study[29] setting forth their basic assumptions about the joint venture, a change in the circumstances of the joint venture that deviates from those assumptions and reduces the rate of return on an investment which was stated in the feasibility study ought to be a reason for the parties to modify their assumptions and amend their contract and other basic documents accordingly.[30] A warning that renegotiation must be kept in mind and provided for in the contract is not much comfort for the prospective investor, but it is both realistic and likely to avert disappointments caused either by legalism or by excessive and self-deceptive expectations of stability.

1. *Investment stability*

Although these difficulties of contract stability are frustrating, they inevitably raise the question of what perspectives may be appropriate. Cautioning Westerners against the difficulties that may arise in Chinese business relationships by failure to examine preconceptions about contractual relationships, or failure to consider how difficulties should be resolved, may seem obvi-

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29. On the importance of the feasibility study, see, e.g., Moser, *Foreign Investment in China: The Legal Framework*, in FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 90, at 104-05, 139-41 (M. Moser 2d ed. 1987).

30. *See* Horn, *The Procedures of Contract Adaption and Renegotiation*, in ADAPTATION AND RENEGOTIATIONS OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE 173, 174-75, 188 (N. Horn ed. 1985). Horn argues that even in the absence of an express clause calling for modification of the contract, the principle of good faith in contractual relationships recognized in civil law jurisdictions imposes on parties a duty to renegotiate when a problem of contract adaptation develops.

ous. However, the frequency of investor frustration suggests that these are important considerations.

It is easy to think of China as *sui generis* because it has so many unique characteristics. However, this thinking should not prevent the foreign investor from recalling that "in general, political changes in third world countries often have triggered the renegotiation of contracts with foreign investors."[31] The reasons for renegotiation in the PRC may be quite different from those in other Lesser Developed Countries (LDC's). For instance, other LDC's often assert that they are "perfectly entitled to invoke ideas of fairness and equity in reviewing contracts which are inimical to the national interest."[32] One scholar has commented that:

> [I]f we examine recent renegotiations, we notice that they have been based on most-favored-nation clauses, increases in the price of strategic commodities, a new wave of economic nationalism precipitated by resolutions on permanent sovereignty over natural resources and the New International Economic Order, and assertions of unequal bargaining power at the time of contract formation.[33]

The problems which foreign investors have encountered in other LDC's have stimulated the growth of a considerable body of legal literature on the adaptation and renegotiation of contracts between foreign investors and host LDC's.[34] The uncer-

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31. Horn, *The Concepts of Adaptation and Renegotiation in the Law of Transnational Commercial Contracts*, in ADAPTATION AND RENEGOTIATION OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE, *supra* note 30, at 3, 5.

32. Fath el Rahman Abdalla el Sheikh, *Legal Criteria for the Revision and Adaptation of International Commercial Contracts: The African and Arab Perspective*, in ADAPTATION AND RENEGOTIATION OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE, *supra* note 30, at 99, 101.

33. *Id.* at 106. *See also* D. SMITH & L. WELLS, JR., NEGOTIATING THIRD-WORLD MINERAL AGREEMENTS 19 (1975), which states:

> Concession agreements are affected not only by changes in the particular industry, political and bureaucratic changes within the host country, and the reduction of uncertainty as commercial deposits are identified, but also by developments in other countries. The inappropriateness of the terms of particular agreement usually becomes apparent when they are compared with terms negotiated in other countries, or even the same country. Even though the situations of the various arrangements may differ, strong pressure for renegotiation or updating results.

34. *See, e.g.*, D. SMITH & L. WELLS, JR., *supra* note 33; Horn, *supra* note 30; Moran, *The Host Country and Foreign Investors* in II NEGOTIATING FOREIGN INVESTMENTS: A MANUAL FOR THE THIRD WORLD 8 1B 1 (R. Hellawell & D. Wallace Jr. eds. 1982) (and sources cited); Smith, *Bougainville Copper Project Renegotiation Case Study*, in II NE-

tainty of the investment environment and the course of future economic reform policies in the PRC ought to be reason enough for the investor to contemplate, even before the investment contract is signed, the need to renegotiate or modify key aspects of that contract at some point during the course of the life of the joint venture. Investment in the PRC, for reasons specific to China, should be considered as a process and in this regard it is apposite to think that "[t]he initial negotiation of a contract [for a mineral concession] is merely one step in a process of unfolding relationships. The contract itself may set off a chain of events that will alter the ultimate stage of the relationship."[35]

Natural resources concessions differ from industrial or even service joint ventures because they remove irreplaceable natural resources; the joint ventures being established in China today are meant to be involved in a deeper interaction with Chinese society. Yet joint ventures in China are being inserted into an economy once totally alien to them and which still remains largely alien. The continuous nature of the reform process, including changes in policy, is bound to influence the operation of joint ventures, and any foreign investor should realize this while negotiating his joint venture. Such a perspective is necessary regardless of whether the subsequent uncertainties were considered or should have been considered by the parties, as is often the case in international contracts.[36]

2. *Investment contracts: Final comment*

The foregoing comments on the need to expect uncertainty in Chinese investment contracts are hardly likely to bring cheer to a prospective investor, who may rightly ask how he can protect his investment if he must expect both uncertainty and an inability to engage in formal dispute resolution. The inclusion of clauses on renegotiation seems to be a necessary ancillary to encouraging Chinese parties and officials to adhere to contracts without interfering with the autonomy of contracts. Such a clause could refer to an anticipated return on investment that

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GOTIATING FOREIGN INVESTMENTS: A MANUAL FOR THE THIRD WORLD, *supra*, at 8 1C 1.

35. D. SMITH & L. WELLS, JR., *supra* note 33, at 3.

36. *Cf.* Berman, *Excuse for Non-Performance in the Light of Contract Practices in International Trade*, 63 COLUM. L. REV. 1413, 1415 (1963) ("[T]he intent of the parties with respect to the allocation of the risk of liability for non-performance in international transactions . . . can always be determined by close analysis of the contractual terms in the context of the commercial custom on which they rest . . . .").

has been stated in the contract and provide that if that return is not attained within a stated period of time, or if attained is not maintained for a stated period, then the parties will be obligated to renegotiate their agreement. Termination of the agreement and dissolution of the joint venture could be the consequence of failure to agree on revised terms.

Foreign investors attempting to impress on their Chinese counterparts the necessity of adherance to investment contracts should temper their arguments. To some extent they are insisting that the Chinese should follow contract doctrine which we accept as the highest standards of commercial behavior. However, Western business practice departs from contract doctrine more often than business negotiators' rhetoric and legal doctrine admit.

Therefore, there are two fundamental observations. First, it is necessary to have realistic expectations. Too many foreign investors still enter into serious negotiations about investments in China without attempting to understand the brief and imperfect history of Chinese economic reform policies since 1978, and without trying to inform themselves on some of the salient characteristics of the Chinese investment environment.

Second, such educational efforts, if properly conducted, ought to instruct the potential investor to anticipate many uncertainties that are peculiar to the Chinese investment environment and prompt him to negotiate as carefully as possible a contract and feasibility study that take into account the uncertainties (such as failure to obtain needed input) that may be anticipated.

III. Trade Contracts

If the uncertainties of the Chinese investment environment trouble investors who are concerned about their powerlessness to prevent renegotiation, there are recent signs that augur for concern by Western purchasers of Chinese products for export who for decades have been unconcerned about contract stability.

A. Historical Chinese Respect for Export Controls

More than twenty years ago, before U.S.-China trade resumed after a long hiatus, over a period of three years I conducted a series of interviews with traders and other knowledgeable persons in the China trade who were buying Chinese

products for shipment to Western Europe, Canada and Hong Kong. My informants were nearly unanimous in their praise for the scrupulousness with which Chinese sellers honored their contracts. Many compared their experiences with the PRC with other sellers elsewhere in Asia, invariably ranking the PRC highest in reliability and honesty. Any complaints against PRC integrity were insignificant. Buyers who asserted claims, which generally involved quality rather than total failure to perform, had encountered the common response of the Chinese sellers' reluctance to pay, even when convincing proof was presented of sellers' partial non-performance. However, these problems were usually remedied by a reduction in the price of the next purchase, and their complaints did not go further.

Chinese sellers were proud of their reputation, and when Americans returned to China to trade in 1972, they were frequently lectured about Chinese contract morality. The Chinese often favorably contrasted their contract morality to the disregard for contracts which they beleived existed in capitalist countries. However, as China trade has become more complex, Chinese sellers' attitudes toward contracts have become more opportunistic.

B. Export Contracts: Current Trends

Due to causes associated with economic reform, the reasons for enterprise managers to engage in behavior that maximizes their short-term profits have increased, even at the risk of damaging long-term contractual relationships. Reform is taking place in an economy in which goods are scarce. The Chinese economy is presently one with a dangerously unstable mixture of bureaucratic and market forces.[37] The number of goods allocated under the bureaucratic planning system has been reduced and the number determined by contracts concluded between industrial enterprises and guided by market forces has increased. Currently, most commodities are available at two prices: a fixed, relatively low state plan price applicable to products to the extent they fall within planned quotas, and a higher, floating, free market price that applies to above-quota production. Such a halfway solution has stimulated volatile prices, inflation, and speculation involving not only staples and consumer goods, but also raw materials and components that are the inputs needed for indus-

37. *See* Perkins, *supra* note 19.

trial production.[38] Moreover, these events are occurring in the midst of debate and uncertainty about the continuation and direction of economic reform.

1. *Decentralization*

The Chinese foreign trade apparatus has been decentralized[39] and the former rigid Soviet-type system that was created in the 1950's has been greatly changed. The Ministry of Foreign Economic Relations and Trade and the specialized foreign trade corporations that once monopolized China's foreign trade have seen other ministries, provinces, cities, counties and even enterprises given the authority to engage directly in foreign trade transactions.

This has meant the appearance in foreign trade circles of inexperienced newcomers, who have sometimes signed contracts that they could not perform[40] or driven up the domestic prices of goods for which they compete.[41] The downfall of the old foreign trade monopoly has also brought with it a loosening of control generally over foreign trade and the growth of "parallel trade" in which Chinese exporters sell to Hong Kong companies for foreign exchange.

2. *The destabilizing impact of dual foreign exchange rates*

For enterprises that produce goods that are exported, all of the circumstances mentioned above prevail. Added complications arise from China's essentially inconvertible currency, the renminbi (RMB), and shortage of foreign exchange. In order to ease the shortages of foreign exchange at joint ventures which are selling their products on China's domestic market for RMB, the leadership has approved the creation of centers for "swaps" of foreign exchange. Joint ventures with a surplus of foreign cur-

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38. *See, e.g., A Mystery: Where is the Money Going?*, China News Analysis, Aug. 15, 1988 at 1, 2.

39. *See generally* Horsley, *The Regulation of China's Foreign Trade*, in FOREIGN TRADE AND INVESTMENT IN THE PEOPLES REPUBLIC OF CHINA, *supra* note 29, at 5, 7-13; Ross, *Changing the Foreign Trade System*, CHINA BUS. REV. May-June 1988, at 34.

40. *See, e.g., How China Trades Metals: Part 1, A Guide to the Key Players*, 1986 BUS. CHINA 169, 171; Erlich, *Metals Trade Dogged by Flood of Novices*, South China Morning Post, May 15, 1986, at 5, col. 2.

41. China Daily, Jul. 10, 1988 (price of silk cocoons driven upward by "cities, counties, townships and companies" competing with each other after signing export contracts).

rency which need local currency for their local expenses swap with joint ventures facing a foreign exchange shortage but which possess a surplus of local currency. These centers have evolved into places at which any enterprise may exchange foreign currency for local currency at a rate higher than the official rate, often double. Perhaps the most active one is in the Special Economic Zone of Shenzhen.[42]

As a result, if a factory can sell its goods through a trading company that has access to a swap market such as the one in Shenzhen, the local currency yield from the foreign exchange payment for export goods will be higher than the official rate and the factory will earn more in local currency than if it had engaged in a straight transaction with a conventional foreign trade corporation. This results in a legalized black market, prompting factories that have signed contracts for export through a trade company other than those in Shenzhen to disregard the previously signed contracts, sell their goods through Shenzhen, and obtain more RMB for the contract price.[43]

3. *The increase in breaches by Chinese exporters*

The problems summarized immediately above seem to have converged to stimulate numerous contract violations. Some of these involve delivery of inferior-quality goods, but more often, traders have alleged that non-delivery occurred because the

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42. Reviewing the history of the foreign exchange centers, but with little emphasis on the harmful short-term effects on foreign trade emphasized in the following paragraph, is Yowell, *Swap Center System to Expand*, CHINA BUS. REV. Sept.-Oct. 1988, at 10.

43. For a description of foreign exchange and foreign trade problems as they relate to domestic economic reform generally, see Yeung Wai-Hong, *Foreign Trade: A Wedge in the Reform*, 1353 CHINA NEWS ANALYSIS 1, 7 (1988), commenting on the ability of Shenzhen trading companies to outbid their competitors in China proper:

> This is, in effect, what the agency system is expected to accomplish [under which foreign trade corporations cease to have administrative authority over Chinese enterprises, but act merely as their commercial agents in foreign trade transactions] promote competition, stay in touch with international market conditions, while generally raising the level of exports. This is all to the good except for one thing: it is not fair. In this competition, the Shenzhen traders win not because they are better traders or can serve their customers better. They win for the simple reason that the U.S. dollars that they have can be exchanged for more *renminbi*, legally, while others cannot. Such a practice would merely induce the corporations to seek, through whatever means, to obtain a more favorable exchange rate.

goods in question were sold to a third party in violation of an existing contract.[44]

Generally, in the China trade, recourse to formal dispute settlement procedures by foreign buyers has been rare. Many buyers have had long-standing business relationships with their sellers, particularly some European trading companies. Most buyers have assumed that claims could be worked out in the course of ongoing business. Now, in the face of apparently increased instability of export contracts, what is the trader to do?

C. Alternatives for dispute resolution

1. Administrative

Perhaps foreign buyers should be more assertive about claims and not be content to settle for a discount on the next transaction. Vigorous complaints not only to the Chinese seller but to the organizations that have some administrative relationship to it, such as a provincial or municipal foreign economic relations commission are advisable. Notwithstanding economic reform, local administrative relationships have not been erased even though they have been weakened. Further, economic reform should make it possible to pressure particularly egregious defaulters.

However, Beijing is not necessarily irrelevant either because with decentralization, some contract problems, such as constant and repeated violations, have potentially significant policy dimensions. If corporations that sign contracts beyond their scope of authority can have their right to engage in foreign trade revoked,[45] why not invoke administrative sanctions against persistent contract violators?

2. Arbitration

Some traders have forgone attempts to settle contract disputes by use of administrative means and have instead turned to

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44. My belief that contract violations of the type discussed here have increased during 1987 and 1988 is based on the experience of numerous clients and on statements of knowledgeable diplomats in several Western embassies in Beijing during frequent visits there, several Chinese officials in Beijing, and six importers from Western countries (several of whom insisted that their experiences were consistent with that of other traders from their countries).

45. *Chinese Corporation's Right of Foreign Trade Revoked*, CHINA ECON. NEWS, Jan. 13, 1986, at 3.

arbitration. The great majority of Chinese contracts for the export of Chinese goods, for example, the simple "sale confirmations" or "sales contracts" which are based on the form contracts used by China's foreign trade corporations, are either silent on dispute resolution or provide for arbitration in China by the Foreign Economic and Trade Arbitration Commission (FETAC) of the China Council for the Promotion of International Trade. Third-country arbitration of Chinese export contracts is extremely rare. Chinese arbitration officials have indicated informally that as China's trade volume has grown, so too has the volume of cases brought to FETAC for arbitration.[46]

3. Litigation

If China's emerging judicial system continues to crystallize, more traders may begin to consider litigation over Chinese export contracts unless the parties have specified otherwise. Most export contracts do not contain a clause fixing the proper law of the contract. Regardless, a Chinese court would apparently apply Chinese law, as would most Western courts as the proper law of such export contracts because the transaction would ordinarily be most closely connected with China. Chinese law provides that if the parties have not specified the law applicable to disputes arising out of a contract, the law of the place with the closest connection to the contract will apply.[47]

Chinese doctrine, however new and untried it may be, further includes within Chinese law, applicable to contracts between Chinese and foreigners, the United Nations Convention on the International Sale of Goods. This inclusion of the Convention extends to all cases in which both parties have their place of business in countries that have signed the Convention

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46. Success in an arbitral proceeding, Chinese or foreign, may not be enough for a foreign party. See Peele & Cohan, *Dispute Resolution in China,* CHINA BUS. REV., Sept.-Oct. 1988, at 46, 47, reporting a case in which an arbitral proceeding brought in Beijing by an American company resulted in an award for the plaintiff which it was unable to enforce when the Chinese court in which it sought enforcement agreed to hear a counterclaim for nonpayment for goods sold raised by the Chinese party. See also *id.* at 47-48, discussing the refusal of a Chinese court to enforce a Stockholm arbitral award in favor of an American company against a Chinese foreign trade corporation, on the grounds that the award had been issued before the effective date of China's accession to the New York Convention on the Recognition and Enforcement of Arbitral Awards, and noting a further complication: the Chinese trade corporation was resisting enforcement on the grounds that it had never been notified of the arbitration proceeding, in which it was represented by an agent.

47. *See* H. ZHENG, *supra* note 15, at 207.

(such as the United States and the PRC). In addition, Chinese law further provides that when there is no Chinese law "stipulated" on a particular issue, "international custom" may be applied.[48]

There have been in recent months informal and formal reports of a number of suits brought by foreigners in Chinese courts.[49] Though most foreign companies remain reluctant to sue Chinese parties over alleged violations of trade contracts, a few companies have resorted to litigation and won judgments in Chinese courts. The publicity given to such cases doubtless reflects high-level Chinese concern to demonstrate to foreigners that Chinese courts will act decisively and impartially to protect contractual rights. In one case, a Japanese firm won a nine million yen judgment against a Chinese company for breach of a sales contract.[50] Disputes involving foreign litigants, entirely between foreign parties or between Chinese and foreign parties, have also begun to appear in China's young maritime courts.[51]

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48. *Id.* at 204.

49. *See, e.g.*, China Daily, Aug. 15, 1988, (Bus. Weekly), at 3, col. 1.

50. Under the contract, the Japanese company had agreed to sell 129 million yen worth of electronic musical instruments to the buyer, Zhonghua International Technology Development Corporation, who had entered into the contract on behalf of another Chinese company, Jingliao Trading Company. The Japanese company sued both Zhonghua and Jingliao after Zhonghua failed to open a letter of credit upon receipt of the Japanese company's notice of shipment, as required by the contract. Zhonghua argued that it was not liable for failure to perform the contract because it had acted only as Jingliao's purchasing agent in entering into the contract. The Beijing Intermediate Court rejected this argument, finding that Jingliao was not a party to the contract and that Zhonghua could seek compensation from Jingliao for breaching the agreement under which Zhonghua agreed to act as Jingliao's agent.

Reports of the case suggest that the court applied the principles of the Foreign Economic Contract Law (FECL) in determining compensation. Specifically, damages were based on the FECL's provisions that: 1) damages should be equal to the losses suffered by the party as a result of the breach; 2) damages should not exceed the amount of loss that the infringing party could have foreseen at the time the contract was established. The court concluded that the Japanese seller's losses were foreseeable and that they amounted to seven percent of the total contract price (nine million yen); the reports do not indicate, however, how it derived this figure. The court also ordered Zhonghua to pay all legal fees. *See* China Daily, August 15, 1988, (Bus. Weekly), at 3, col. 1.

Of interest is the fact that while the original sales contract contained an arbitration clause, the plaintiff and Zhonghua signed an agreement to delete the arbitration provision from the contract after the dispute broke out.

51. Maritime courts have been established in six cities: Dalian, Tianjin, Qingdao, Shanghai, Guangzhou, and Wuhan. The jurisdiction of these courts in matters involving foreign parties is set forth in the Supreme People's Court's "Specific Provisions on Admiralty Jurisdiction Involving Foreign Parties." *See* Bulletin of the Supreme People's Court, Issue 1, 1986, at 13. For a report of an admiralty dispute in which a foreign plaintiff sued a Chinese defendant, *see* CHINA LAW AND PRACTICE, Feb. 24, 1988, at 29-30; for a

D. Increased Litigation Over Export Contracts?

Foreigners are likely to encounter numerous difficulties in litigation in China, where they have reason to question the independence of both the judiciary and a newly emerging bar, and where the invocation of rules of law—themselves new—in support of contractual rights is not a customary mode of settling disputes. Those problems require thorough analysis which is not my purpose here, and obviously, too, the specific circumstances of particular controversies would have to be carefully considered before any decisions to sue were made. Chinese legal institutions are still so protean that it is too early even to estimate the extent to which litigation in China may produce doctrinal surprises for foreign litigants.[52]

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case involving two foreign litigants, *see* CHINA LAW AND PRACTICE, Sept. 28, 1987, at 27-30.

52. In China National Technical Import/Export Corp. (CNTIEC) v. Industrial Resources Co. (IRC), as reported in a Hong King periodical apparently relying on a Chinese account of the case, II CHINA L. AND PRAC., Aug. 22, 1988, at 26, plantiff CNTIEC had signed a contract with defendant IRC to purchase rolled steel; payment of over U.S. $2 million was made in accordance with the contract, which called for presentation of shipping documents against a letter of credit. Plaintiff did not receive the goods and it was discovered that the shipping documents were forgeries. The contract contained an arbitration clause. Plaintiff sued in Shanghai, and obtained a court order freezing over U.S. $4 million which, according to the court report "the Shanghai branch of the Bank of China had collected on behalf of the defendant as payment for goods" *Id.*

The sparse report of the decision of the Intermediate People's Court of Shanghai concluded that:

-defendant had committed a tortious act in defrauding plaintiff by means of a contract and therefore the case need not be treated as a contractual dispute. Consequently, the arbitration clause in the contract was inapplicable and the court had jurisdiction over the dispute because the tort in question had been committed in Shanghai, where the contract had been signed:

-the court rejected defendant's arguments that it had not intended to defraud plaintiff but had itself been defrauded by a third party; the account of the case mentions but does not discuss in detail communications from defendant to plantiff on which it apparently relied in reaching this conclusion;

-defendant was liable to plaintiff for the contract price (U.S. $2.290 million), interest on the bank loan which plaintiff had obtained to purchase the steel (U.S. $873,000), business losses consisting of various taxes and business expenses (U.S. $1.943 million), and legal expenses (U.S. $29,000), making in all U.S. $5.136 million).

Further information on the case is supplied by a newspaper article *Steel Fraud Case Casts a Shadow on China Trade*, South China Morning Post, Oct. 23, 1988, at 1, which raises some serious questions about the case:

Perhaps most surprising is the assertion in the article that the garnishment which the court used to obtain jurisdiction over defendant in the first place was effected against the proceeds of a letter of credit opened by a different Chinese trade corporation in favor of a sister corporation of the defendant. The court report limits itself to the words quoted above in describing the relationship of defendant to the garnished sum.

Troubling, too, was the court's refusal to give effect to the arbitration clause, which

Here I am concerned less with litigation than with attitudes toward it, particularly by foreign traders in China, some of whom have been led by the problems discussed here to begin to consider what was formerly unthinkable. If economic reform continues to provoke dislocations that lead to increased contract violations, some traders will seek vindication of their rights formally protected under Chinese law by bringing suit in Chinese courts.

IV. Conclusion

The preceding discussions of two types of contracts involving foreigners are linked by a common emphasis on the effects of domestic Chinese institutions, practices and attitudes on the implementation of Sino-foreign contracts. The effects may seem both obvious and inevitable, but a reminder of their strength seems desirable nonetheless, because in the author's experience so much foreign interest has been focused on the emerging framework for trade and investment that domestic forces have been neglected.

The Chinese leadership has itself sought to demonstrate to prospective foreign investors that it understands their concern for stable legal institutions that will both define and protect their rights. It has repeatedly sought to assure investors that it intends to create, and is creating, institutions that are required and to make them meaningful. Whenever new pieces of legislation directed to investment matters are promulgated they have been given considerable publicity in Beijing, and have thereafter been closely and publicly studied by foreign observers.

The effort devoted to creating new institutions and the flood of Chinese legislation and associated discussion and com-

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called for arbitration in Beijing (the place of arbitration was not discussed by the court). Chinese law precludes Chinese courts from assuming jurisdiction over disputes arising out of contracts that contain valid arbitration clauses; see Foreign Economic Contract Law of the PRC, art. 38 and Civil Procedure Law of the PRC, art. 192, which taken together seem to create an absolute prohibition. Even if the contract in question was void, the court must have jurisdiction to hold it void, and as stated, jurisdiction was based on the garnishment of the proceeds from an unrelated transaction, which is not discussed by the court.

Finally, the nature of the "business losses" for which defendant was held liable is not discussed in detail by the court.

In the absence of further information about the case, extended discussion here seems imappropriate. Numerous other aspects of the case as it is reported in the Hong Kong source relied on here are confused or unclear. Suffice it to say that the newspaper article referred to above stated that the case "worries many Western lawyers." *Id.*

mentary have led many foreigners to hope that regardless of the state of Chinese domestic institutions, which are in a process of evolution, attempts were being made to give to rules relating to Sino-foreign transactions the regularity and predictability which foreign traders and investors require to stabilize their expectations. Thus, however uncertain might be the operation of domestic Chinese legal institutions, PRC lawmakers and foreigners alike seem to hope that a higher level of legality, Western-style, would mark the institutions most frequently encountered by foreigners.

The discussion in the body of this article, however, suggests that Chinese institutions related to trade and investment, because they are persuasively stamped by institutions and the legal culture that lie behind them, are probably long likely to frustrate foreigners and Chinese who wish or work for an increase in Chinese legality. It is useful in this connection to distinguish here, even if in a shorthand fashion, between state and society.

At the top of the pyramid of formal governmental institutions that is the Chinese state, lawmakers promulgate rules that are directed downward to the rest of the state apparatus, to Chinese society, and to the Chinese economy, which now spans both. These new rules define rights and obligations and create institutions which are intended to be used to vindicate them.

But the apparatus of the Chinese state to which the new rules are addressed is administered by a bureaucracy that is not yet accustomed to regularizing its decisions according to standards expressed in formal legal rules. Moreover, the recent decentralization of that bureaucracy lessens the force of administrative rules generated in Beijing, not to mention formal laws. Most of the Chinese economy is still administered under a system of planning that is effectively outside the reach of new legal rules and institutions, and will not be as hospitable to them as the law-makers no doubt wish. That economy, moreover, is in the midst of dramatic change that is neither consistent nor coordinated. As a result, economic actors such as enterprise managers are subjected to considerable uncertainties produced by forces beyond their control.

In Chinese society a melange of traditional and post-1949 attitudes toward law, comprehending much more than a disregard for rights-consciousness and a preference for negotiated compromise solutions to contract disputes, remain potent social forces that blunt the effect and enforcement of legal rules. Skep-

ticism and cynicism toward legal rules and legal institutions is pervasive, and Chinese officials and populace alike commonly regard such creations by the Chinese state as formal rituals that must bend to realities of the Chinese system.

Foreigners who wish to trade or invest in the PRC should restrain their expectations about the extent to which their contractual arrangements will be protected by the Chinese legal system. The rules produced within the last ten years, for all of China as well as foreigners, provide welcome definition, albeit partial, to these arrangements. They provide considerable guidance to foreigners and their Chinese counterparts in negotiations, both before and after their contracts are signed.

Processes of implementation and formal dispute-settlement, however, are likely to remain long subject to substantial uncertainty. The approaches suggested here to the two types of contracts discussed could increase the realism with which foreign traders and investors deal with their Chinese counterparts. The extent, however, to which their uncertainty can be substantially reduced by Chinese lawmakers and by other officials in practice is not, at this time, possible to say.