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FOREIGN INVESTMENT IN CHINA: THE CROSS-CULTURAL DILEMMA

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I INTRODUCTION

Geographically, the People's Republic of China (PRC) is the world's largest market, with a population of 1.3 billion people and an area about 9,600,000 square kilometres in the southeastern Eurasian continent. Since the 'open door policy' commenced in late 1978 China has been quite successful in attracting foreign direct investment (FDI) as a new economic power. China's need for capital, raw materials, high technology, and modern management skills has opened a range of opportunities for foreign investors. According to a world-renowned consulting company A T Kearney, the result from FDI Confidence Index Monday:

indicates that while most nations' power to attract investment is in decline, in China increasing numbers of investors are expressing interest and confidence in the Chinese market.¹

Also, apart from several factors such as its populous market, economic growth, stable political situation, sound investment environment, it is no doubt that China's World Trade Organisation membership since 2001 and successful bidding for the Olympics will stimulate foreign capital. Based on data revealed at the end of January 2002:

China had approved 392,395 foreign-funded enterprises. Since the early 1990s China has been the largest FDI recipient among developing countries and the second largest (only next to the United States) in the world. China's FDI inflow exceeded \$40 billion for the first time in 1996, and has since remained roughly at that level.²

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¹ The Hong Kong General Chamber of Commerce, *Information About China*, 2002/09/24 (China Daily HK ed), <http://www.chamber.org.hk>.

² UNCTAD, *World Investment Report* (various issues) 2002.

There are a variety of forms of foreign direct investment available in China but the most common have been the Co-operative Joint Venture, the Equity Joint Venture, and, to an increasing degree, the Wholly Foreign Owned Enterprise. Each has its own dedicated legislation providing the ground rules for establishing such enterprises and operate only after obtaining appropriate government approvals and business licences.

Despite the increasing trend in the number of foreigners investing in China, the difficulties in accustoming the foreign investors to the Chinese investing environment have not ceased. Even if a foreign firm manages to set up a joint venture, it then has to meet the problems of operating in China. These problems may range from internal to external factors such as from resource commitments to technology transfer, timing of entry, the international environment and so on. However, the Chinese legal environment is one of great concern to foreign investors. As an early survey of joint ventures in Shanghai revealed:

Despite all the difficulties, foreign managers generally agree that the business climate has improved slightly over the past few years ... However, two-third said that continued improvement in Chinese business practices would be an important determinant of their future plans ... Some of the difficulties joint ventures met were legal system and the bureaucracy apart from expatriate lifestyle, personnel, materials sourcing, and financial operations.³

Daniels and Radebaugh identify six external factors to be considered when a strategic decision has been made to expand into the global arena, namely, 'political, legal, cultural, economic, historical and geographic' factors.⁴ In a study of a firm's foreign investment performance, J Li, K Lam and G M Qian proposed that 'East-West Joint Ventures can overcome the difficulty of large cultural distance by sending to China talented and dedicated managers who understand both cultures well'.⁵ Coming to terms with a different culture and accepting it as part of the legal system is an issue foreign investors must be prepared to address. In particular, joint ventures in China must function within a relatively new and incomplete legal system, which is different from the foreign investor's home country.

Although difficulties exist for foreign investors dealing with a different legal environment and changeable policy in China, there still have been a number of successful cases of foreign investment. According to Jiaqin Yang and Huei Lee:

³ S Benedict and G Ye, 'Foreign Representatives of Shanghai's Joint Ventures Rate the City's Operating Environment: A Survey of Shanghai Joint Ventures' (March-April 1988) *The China Business Review*.

⁴ J D Daniels, and L H Radebaugh, *International Business: Environments and Operations* (1992).

⁵ J Li, K Lam and G M Qian, 'Does Culture affect behavior and Performance of Firms? The Case of Joint Ventures in China' (First Quarter 2001) *Journal of International Business Studies*.

China has become one of the top three nations for attracting foreign investment in the international market since 1990. Hundreds of international corporations are currently competing for business opportunities in China in the form of joint venture or direct investment. Both successful joint ventures and failed investments have been reported. Research, addressing issues of the conflicts between different cultures, traditions, as well as value systems, has appeared recently.⁶

Therefore, from a practical point of view whether or not matters have failed or succeeded in China, some lessons are worth considering for newcomers. According to Chinese official data on Foreign Direct Investment (FDI) revealed by the Ministry of Commerce of The People's Republic of China, of the cumulative 364,055 FDI ventures by the year 2000 '56.79% of foreign investors have selected a form of Equity Joint Venture'.⁷ In 2002, cumulative FDI increased to 424,196 ventures but the share representing Equity Joint Ventures dropped to 53.25% as a result of the increase in Wholly Foreign Owned Enterprises from 29.49% in 2000 to 34.22% in 2002.⁸ These figures are not only evidence of an increasing trend to invest in China but also that the investing vehicle of Equity Joint Ventures is preferred by foreign investors. One of the reasons for this selected form is related to long-term investment planning. Cooperative joint ventures tend to be for shorter terms 'as the foreign party's investment contribution can be retrieved more quickly', however, the fixed assets revert to the Chinese party only.⁹ What these figures also reveal is the increasing trend of foreign investors to 'go it alone', which could either mean an increasing confidence in the commercial legal environment or, conversely, an aversion to joint ventures with Chinese organisations.

Due to the attitudes to law in Chinese society being different to those of westerners, foreign investors in China have a common sense of confusion about government policies and legal requirements. For instance, according to discussions at the *2003 China forum* focusing on the business trends and opportunities found in China,¹⁰ participants of the forum pointed out some key issues, such as:

- Lack of market visibility
- Is localization a requirement?
- Negotiating mutually beneficial contracts
- Can foreign companies win in the Chinese legal system?

This forum agreed that the opportunities in China also present formidable challenges. Establishing relationships and understanding the business practices of the culture takes time. Investment savvy, negotiating skills, and an ability to

⁶ J Q Yang and H Lee, 'Identifying Key Factors for Successful Joint Venture' in *China, Industrial Management+ Data Systems* (2002) 1.

⁷ *The Statistics of FDI by Form in 2000*, Authoritative Site on Foreign Direct Investment in China, 2003/05/14 <<http://www.chinafdi.org.cn/english/O1/f/22/11.htm>>.

⁸ *The Statistics of FDI by Form as of 2002*, Authoritative Site on Foreign Direct Investment in China, 2003/07/10 <<http://www.chinafdi.org.cn/english/O1/f/22/11.htm>>.

⁹ K H Wang, *Chinese Commercial Law* (2000) 126-128.

¹⁰ Optical Society of America, *2003 China Forum*, March 2003 <<http://www.osa.org/partner/china>>.

establish and monitor mutually beneficial relationships require a keen understanding of China's dynamic environment.

Surely, the legal environment should be a convincing guarantee for the newcomers. However, as a result China is a blend of growing modernization and ancient culture; a comprehension of legal system and its application in reality should be based on Chinese social and cultural background. As Jiaqin Yang and Huei Lee explained:

With 5000 years of civilization history, Chinese culture, tradition, and its value system have a significant impact on the operations of all Chinese businesses, as well as those joint ventures in China. As the largest country in population, China has 50 plus different minority groups of people each has its own culture, custom, norm, tradition, even unique holidays and languages. Also, as one of the top three nations in land size, China is geographically divided into many regional centers cross the nation – each has unique cultural aspects in terms of tradition, value, social norm, belief, and organizational features.¹¹

For these reasons this article examines the effect of Chinese social, political and cultural factors on the PRC legal system in light of foreign investors operating in China. The focus of this article is on two such factors, namely, the non-litigious nature of Chinese people and centralised political power. It is argued that the existence of these two elements in the Chinese legal environment and their roots in Chinese history are significant factors.

Anyone considering the Chinese market should never underestimate the preference for negotiation as a form of dispute settlement in a civil conflict. This is rooted in the Chinese attitude to litigation as being a shameful method for resolving disputes.¹² Good relationships between people enabling compromise rather than externally imposed decisions exemplify the importance of harmony in Chinese culture.¹³ Accordingly, this 'non-litigious nature' is reflected in the PRC Laws encouraging either consultation, negotiation or conciliation as a first method of dispute resolution before resorting to arbitration or litigation. As Kui Hua Wang points out, 'these non-litigious methods have often been accepted in foreign-related civil and commercial disputes'.¹⁴

Harmony, an influential Confucian concept throughout China's long history, is said to be at the centre of the non-litigious nature of Chinese people. As D Howard Smith concluded:

¹¹ Yang and Lee, above n 6.

¹² Wang, above n 9, 37.

¹³ Ibid 280.

¹⁴ Ibid 279. For example Article 14 in The Law of the People's Republic of China on Sino-foreign Joint Equity Enterprises, and Article 26 in The Law of the People's Republic of China on Sino-foreign Cooperative Enterprises.

The great ideals of individual perfection and a harmonious social order which Confucius inculcated are as relevant in the modern world as they were nearly 2,500 years ago.¹⁵

Confucian thought has dominated China's long history with the objectives of harmony and peace being at the centre of social norms and behavioural standards. It is inevitable that such thought also influences the PRC legal system.¹⁶

Another major influence is centralised political power. In the PRC, ultimate executive power still rests in central authority and affects every aspect in society. For instance, examination and approval power was exclusively vested with the Central Government that is, the State Council and Ministry of Commerce of The People's Republic of China. Although such power was soon delegated to Special Economic Zones (SEZs) and governments at the provincial level, these provincial governments in practice have often further delegated their approval powers to lower level authorities in accordance with their own local needs. As Kui Hua Wang stated:

There is no doubt that law has to a great extent been elevated to centre stage of society, but this elevation does not guarantee the supremacy of law in society. Party policies, governmental powers, the network of all kinds of social relations and rampant local protectionism often render law a secondary authority.¹⁷

Similarly, this feature also has its characteristics influenced by Confucian thought and Chinese feudal history. Kui Hua Wang suggests:

The feudal period of Chinese history also gave rise to many different schools of thought and these schools often involved various theories of law ... Confucianism and Legalism contributed the most to the development of the ancient Chinese legal system.¹⁸

One may argue therefore, that the non-litigious nature and centralised political power is underpinned by Chinese traditional thought and historical evolution. In practical terms, the effect of these factors on the PRC legal system, as it relates to foreign investment, will be illustrated in relation to four elements, namely Chinese negotiating style, the relationship with Chinese parties, dispute resolution and legal requirements for sino-foreign joint ventures. Finally, this article suggests that for potential foreign investors, an understanding of Chinese political and legal systems and sensitivity to Chinese social and cultural issues are indispensable to the success of doing business in China.

¹⁵ D H Smith, *Confucius* (1973) 196.

¹⁶ Wang, above n 9, 280.

¹⁷ Ibid 38.

¹⁸ Ibid 6. Cf J Chen, 'Chinese Law, Towards an Understanding of Chinese Law, Its nature and Development' in *Kluwer Law International* (1992) 2. See also Alice Erh-Soon Tay, 'People's Republic of China from Confucianism to the Socialist market Economy The Rule of Man vs the Rule of Law' in Poh-Ling Tan (ed), *Asian Legal Systems* (1997) 15.

II THE MAIN FEATURES OF THE PRC LEGAL SYSTEM

There have been a variety of legal systems employed throughout the history of China. Not unlike European development there have been feudal or slave-based societies to the current socialist system. What makes things interesting in current day China is the juxtaposition of a communist government with a market-based economic system. From the establishment of the PRC in 1949 the great influence on the legal system was Soviet law which in turn had its basis in the civil law traditions of Europe.¹⁹ Following the ‘vacuum’ of law-making, particularly during the Cultural Revolution, it took the Open Door policy at the end of 1978 to kick-start both economic reform and significant legal reform.²⁰ The civil law traditions of Germany together with Japanese law provided the mechanisms for introducing commercial law concepts quickly enabling the establishment of a market economy that welcomed foreign investment.²¹ US influences soon followed with the concerns over the protection of intellectual property rights and now, membership of the WTO and compliance with the World Trade Agreement provides the current influence over law-making in the PRC.

A *The Framework of the Legal System*

There are various levels to the governmental structure of the PRC and each have their effect on the legal system. However, when comparing the governmental structure of the PRC to that of Australia, the obvious difference is the comparison of a unitary system of the PRC to the federal system of Australia. Clearly centralised power is the major issue in PRC law-making even though there are still provincial, municipal, county and village levels of government below. It is according to these five levels of government that the various ‘political, legislative, governmental, administrative, judicial and prosecutorial structures and institutions of the PRC’ are established with the National People’s Congress (NPC) as the key legislative body, the State Council as the executive body and the Supreme People’s Court as the highest judicial authority.²² Every province, municipality directly under the central government, county and township has its own local people’s congress and local people’s government (executive body). They are also responsible to the central government. Local people’s congresses have the power to adopt and examine the plans for economic and social development and budgets of their respective administrative areas.

¹⁹ Wang, above n 9, 10.

²⁰ Ibid 11.

²¹ P B Potter, ‘The Chinese Legal System: Continuing Commitment to the Primacy of State Power’ (1999) *The China Quarterly* 10.

²² Wang, above n 9.

B The Relationship Between the Law and Executive Power

The Chinese Communist Party (CPC) is the leading political institution in China.²³ The integration of the CPC in the various aspects of PRC government does not come as a surprise when one is aware that CPC members are the occupiers of key government positions.²⁴ However, according to the Constitution, the PRC divides its governmental powers among different organisations, as mentioned above:

- The State Council and the Provincial and Municipal governments exercise administrative power;
- The NPC, Provincial and Municipal People's Congresses exercise legislative power; and
- The Supreme People's Court together with the lower People's Courts exercise judicial power.

Kui Hua Wang suggests a different style of the separation of powers, one which emphasises 'a functional difference between the legislative, judicial and administrative arms of Government'.²⁵ For example, judicial independence means that the political influence of the CPC is only present in the form of general policy directions rather than in actual decision-making.²⁶ Meanwhile the issue of judgments or opinions by the Supreme People's Court does not constitute an interpretation of the law²⁷ – this is in line with civil law influences.

III THE RELEVANT LEGAL FEATURES OF FOREIGN INVESTMENT IN CHINA

Chinese foreign investment law has been developing since 1979 alongside China's Open Door policy. As John S Mo estimated '[t]he legal framework for foreign investment in China bears the marks of the new economic policy.'²⁸ Over a period of 20 years, China has put in place an elaborate system of law for foreign investment covering a wide range of areas from investment vehicles to foreign exchange legislation to taxation, to trade and dispute resolution.

John S Mo has provided three arguments supporting the proposition that foreign investment law has been at the forefront of the development of the new Chinese legal system. The first is concerned with the shift from the executive approach to law-making to the legislative approach thereby instilling 'a sense of legislative certainty and security among foreign investors'.²⁹ The second relates to learning from the experiences of other countries in order to deal with previously non-existent

²³ See Preamble, Constitution of the People's Republic of China 1982, amended 1999.

²⁴ Wang, above n 9, 15-16.

²⁵ Ibid 16.

²⁶ Ibid.

²⁷ Ibid.

²⁸ J S Mo, *International Commercial Law* (1997) 451.

²⁹ Ibid 452.

legal issues.³⁰ And the third reflects China's integration in the world economy requiring economic reform with 'the purpose of promoting international trade and converting a state-planned economy to a free-market economy'.³¹

The primary business structures for investing in China are Equity Joint Ventures, Cooperative or Contractual Joint Ventures, and Wholly Foreign Owned Enterprises with each having dedicated laws and implementation rules governing their establishment and operation. Consisting of voluminous national and local (regional) laws, regulations and policies, Chinese foreign investment laws are made at both central and local government levels affecting foreign investment proposals and requiring approvals by relevant government departments.³² These laws and regulations comprise the largest field of Chinese law.³³

Mitchell Silk, Michael Openshaw and Virginia A Hulme stated:

There has always been a propensity in China for law to be applied in a flexible way. This is reflected both in the way in which laws are drafted and in the general legislative process. Many laws go through an initial testing period before full promulgation, providing an opportunity for authorities to tailor existing law around a particular set of circumstances.³⁴

Such 'Laws' of the PRC tend to provide general principles only, reflecting government policy. The detail is later provided by 'implementing regulations', usually passed by the State Council. As B Laurence and D R Li said:

Since opening its doors to foreign investment in 1979, China has undergone changes, and a legal system for foreign investment has been built up from a virtual void to one that is now one of the most complete legal systems for foreign investment in a developing transitional economy.³⁵

Such development can be illustrated by *The Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures* (the EJV Law) which is the basic law on establishing Chinese-foreign equity joint ventures. The EJV Law was promulgated and came into effect in July 1979 as China's first law on accepting direct foreign investment since the policy of opening to the outside world was adopted. The State Council introduced implementing regulations in September 1983 and further revised them in 1986. The EJV Law was amended and revised at the Third Session of the Seventh National People's Congress in April 1990. The EJV Law stipulated that an equity joint venture established within the territory of China must be approved by the Chinese Government and registered accordingly.

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ M Silk, M Openshaw, V A Hulme, 'The lessons of GITIC' (May/Jun 1999) *The China Business Review* 36-39.

³⁵ B Laurence and D R Li, *The Business Guide to China* (1996) 1.

Equity joint ventures in China are legal entities, taking the form of limited liability companies, and therefore subject to the jurisdiction and protection of Chinese Law. Each investor is jointly responsible for investment and management, and shares in the risks, gains and losses. All assets are liable in the payment of debts. With the recent revision of the EJV Law, China's corporate structure for foreign investments became further refined. In the future, there is likely to be no differentiation between domestic and foreign investment enterprises in China.

The collective concept of a Foreign-Invested Enterprise (FIE) encompasses three types of enterprises: Equity Joint Venture (EJV), Cooperative Joint Venture (CJV) and the Wholly Foreign Owned Enterprise (WFOE).

1 *Equity Joint Venture (EJV)*

As mentioned above, an EJV is a limited liability company owned by both Chinese and foreign investors in which the foreign investors' capital contributions should not be less than 25% of the total registered capital. The sharing of profit and risk is in accordance with equity contribution unless there is a breach of contract. All EJVs are legal persons under Chinese law once registered. The EJV is the principal form adopted by foreign investors in China so far and is designed for long-term projects.

2 *Cooperative Joint Venture (CJV)*

In a CJV the foreign and Chinese parties can operate as separate legal entities and bear liabilities independently or the arrangement can be registered as a limited liability entity. Such registration will result in attaining legal person status under Chinese law. A CJV differs from an EJV in that a CJV has more flexibility in its rules of incorporation and profit distribution and is more appropriate for short-term ventures. Further, there is no minimum foreign contribution and a CJV structure allows foreign participation in industries prohibiting foreign investment companies.

3 *Wholly Foreign-Owned Enterprise (WFOE)*

A WFOE is a business entity wholly owned by foreign investors. A WFOE shall acquire the status of a legal person if it meets the requisite conditions. Further, such enterprises are permitted where either: at least 50% of annual output is export; or operations rely heavily on advanced technology beneficial to China. A foreign investor needs to weigh up the benefit of having exclusive management and control with the lack of a Chinese partner to assist with the various approval processes.

Despite China's enormous strides in introducing new legislation, China's legal system continues to develop within the context of a planned economy moving toward a market economy along with legal reform. Further, there are a number of dominant factors operating behind the law, namely, traditional influences, internal politics and policy considerations. In particular, a complex network of informal systems operate beneath the formal legal system. Accordingly, *guan xi* (*network*)

and connections still play a very important part in doing business in China.³⁶ This raises the question of cultural influence over the practical application of the law in China and is worthy of further exploration.

IV CHINESE SOCIAL AND CULTURAL FACTORS

Undoubtedly, for foreign investors, differences in culture can be a problem when doing business in China. The differences may cover every aspect of business in a joint venture such as the relationship with Chinese parties and dispute resolution. As J Li, K Lam and G M Qian point out:

Foreign investors can encounter problems of institutional environments which are going to influence firm behaviour and performance not only formal constraints including factors such as economic, political and judicial rules but also informal constraints such as culture and ideology in a society.³⁷

In practice, the successes or failures have their various reasons. However, an understanding of Chinese social and cultural background is necessary for foreign investors because it can help them to handle the differences or difficulties in Chinese society. Professor John Child, the Chair of Commerce at the University of Birmingham and China business expert, when asked about the major impediments to successful joint venturing in China, stated:

In all joint ventures, the major impediment to success is failure to achieve an adequate 'fit' between the two partners in two areas: strategy and culture. Strategic fit encompasses such issues as compatible objectives, adequate resourcing and potential for delivery on promises. Cultural fit covers the partners' willingness and ability to work out a common system of organization and management and to subsume differences, or work through them, to build up trust.³⁸

Therefore, in order to comprehend Chinese social and cultural background, it is necessary to analyse effects of these social and cultural factors in Chinese society. This brings us back to the influence of Confucian philosophy and feudal history in China. It is suggested that these will continue to have an impact on foreign investment.

A *The effect of the philosophy of Confucius in Chinese history*

Confucius (K'ung fu-tzu), born in the year 551 BC, was neither the founder of a world religion nor a great religious genius. But his teaching and influence in China is evident. As D Howard Smith stated:

³⁶ However, this is not necessarily across the board. The once widespread and broad decision-making powers of officials have to a great extent been curtailed and reframed into procedural decision-making within the scope of the legal system.

³⁷ Li, Lam and Qian, above n 5, 116.

³⁸ J Child, *Challenges of Establishing Successful Joint Venture in China*, Spotlight on John Child, 3 Apr 2003 <<http://www.fernando.emeraldinsight.com>>.

The rich, and in many ways unique, civilisation of China, which developed through more than two thousand years of eventful history, owes more to the impress of Confucius's personality and teaching than to any other single factor. Chinese civilisation may truly be called a Confucian Civilisation.³⁹

Bruce Robert outlines Confucian teaching as follows:

The heart of the Confucius teaching is 'morality': in a world Rin. It affirms that in all mankind there are the qualities of benevolence, humanity and love and that it is the duty of governments, parents and teachers to cultivate Rin in all its aspects. In support of Rin there is Li, meaning rituals, ceremonies and how to behave. Then there is Yi, meaning duty or righteous behaviour. There is also Chi, which means wisdom, derived from both history and experience. Another virtue is Chung, meaning reciprocity: 'Do not do unto others what you would not have them do unto you'. The Confucian formula is 'sageliness within, kingliness without', affirming that each person should be both a 'sage', achieving equilibrium and content by meditation, and a 'king' in the management of public affairs.⁴⁰

Accordingly, a philosophy, a social system and a political empire developed which provided tolerance of other faiths, Taoism and Buddhism, as well as a harmonious society, not dependent on feudal or financial merit but proclaiming the ultimate goodness and moral equality of all mankind. Raymond Dawson agreed:

The importance of Confucius for China consists precisely in the transmission of these brief tags, since they have served as slogans for the guidance of Chinese social and political life throughout the ages. In imperial China the sayings of Confucius were often the ultimate authority in all spheres of social and political life. They provided inspiration for Chinese institutions and attitudes right through until the present century.⁴¹

So 'sayings and principles of Confucius' which guided Chinese wisdom for more than 2000 years are once again helping to shape modern China and to make possible the 'economic miracle' which started in Japan and now embraces the whole of the Asian Pacific Rim. For the reasons D Howard Smith pointed out:

Confucianism has usually been regarded as an ethico-political system rather than as a religion. For upwards of two thousand years it moulded and shaped the civilisation of China.⁴²

The Confucian values of the family, acceptance of authority, moderation in all things (the Middle Way) and the limits to personal ambition in favour of the good of society as a whole are seen as necessary, not only for the survival of Chinese Confucian doctrine, but as the essential core of world thinking. In this analysis, the two factors this article identifies, namely, the non-litigious nature of Chinese people

³⁹ Smith, above n 15, 1.

⁴⁰ Robert, *The Return to Confucius? History Today* (1998).

⁴¹ Dawson, *Confucius* (1981) 79.

⁴² Ibid 1.

and centralised political power, maintain this Confucian thought and have profound implications for the conduct of business and the way in which we evaluate that conduct. The following case study will illustrate this.

*B A Successful Joint Venture of Foreign Investment – German Volkswagen
Automotive Co's Investment in China*

In 1994, Volkswagen was the largest car manufacturer in China. It established two joint venture operations, one with First Auto Works (FAW), producing the Jetta and the previous-generation Audi 100 from kits, and the other with Shanghai Volkswagen (SVW), producing the 1980s model Santana.⁴³ The two plants built 130,000 cars in 1993, accounting for more than 50% of China's total car output.⁴⁴ Volkswagen's involvement in China began in 1978, when the Chinese minister of machinery and construction visited Wolfsburg. Dr Martin Posth, chairman of Volkswagen Asia-Pacific, explained in an interview:

Several years of discussion and negotiation followed until, by the end of 1981, the Chinese government and Volkswagen agree to work together. Contracts were signed in 1984 and trial assembly operations began shortly after. The first major production plant was opened in 1991. It takes a long time to set up business in China.⁴⁵

Many Western investors seeking participation in China's growth, have been disappointed. Many Western companies have spent a great deal of time and money in the region in the last few years and have little to show for it. However, Volkswagen is a significant exception. This success story is worth noting in view of the many complaints in recent years about the difficulties of operating and managing joint ventures in China. Its success has no doubt relied on significant factors such as its early entry, resourcing, effective marketing, management skills, commercial strategies. However, the major factors of success come down to Volkswagen's relationship with the Chinese government and a good understanding of the Chinese legal environment in an eastern Confucius society. Connecting and networking with the Chinese government still is a vital path to master when considering foreign investment. As John Child pointed out:

Early entry and investment in building up a good relationship with local government are significant factors for joint venture success in China. Volkswagen ... entered the Chinese market early which enabled them to build up considerable political credibility with the government authorities – an important factor in countries such as China where government still plays a major role.⁴⁶

⁴³ M Posth, 'Face to Face: with Martin Posth of Volkswagen Asia-Pacific' (1994 Fourth Quarter) *International Motor Business*.

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

⁴⁶ Child, above n 38, 2.

With respect to dispute resolution, adopting negotiation and mediation mechanisms rather than litigation, is another element relevant in developing a relationship with Chinese parties and is worth some analysis.

1 *The Non-litigious Nature of Chinese People*

Chinese culture places a premium on harmony; open conflict is something to be avoided. A non-litigious nature can be defined as a preference/propensity for negotiated settlement of disputed matters rather than legal action. This nature exists in Chinese people generally and reflects avoidance of disputes in Chinese cultural traditions. In fact, to avoid a loss of 'face', or '*mianxi*', bad news will often be delivered by an intermediary, preventing a public argument and thereby maintaining 'surface harmony'.⁴⁷ The necessity to 'save face' originates from the philosophy of Confucius, and distinguishes between one's inner and outer circles. Joyce Millet points out that:

The rules of behaviour set forth by Confucius apply to one's inner circle, i.e. family, friends, colleagues, and acquaintances. They do not, as a rule, apply to people outside the circle, i.e. strangers.⁴⁸

'*Lijie*' (polite manner) and surface harmony are important elements to balance the inner and outer circle with seeking a state of peace being the ultimate goal. Being polite and courteous and not displaying one's true emotions preserves harmony and face.⁴⁹

By establishing such a system of ethics, morals, hierarchy and behaviour, Confucius set the rules of conduct between people, establishing each person's proper place in society and thereby lessening the need for a well developed legal system. It is necessary for foreign investors in China to comprehend this cultural factor. In particular, relationship building, '*guanxi*', is considered crucial to success:

With a good network of contacts in China, almost anything can be accomplished. *Guanxi* is how things get done. The power of *guanxi* is one of the reasons given for why China does not have a reliable legal system.⁵⁰

(a) *The Chinese Negotiating Style*

The non-litigious nature of Chinese people is one result of the philosophy of harmony. Building up a good long-term relationship is preferred by Chinese people rather than the legal obligations of the parties being spelled out in a contract. This Chinese negotiating style has been experienced by most foreign investors as the

⁴⁷ Joyce Millet, 'Key Concepts in Understanding Chinese Culture' (2000) WomenAsia.com, in <http://www.culturalsavvy.com/chinese_culture.htm> 10/06/2004.

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Ibid.

emphasis is often on interpersonal relations rather than the details of a contract. Laurence Brahm and Li Dao Ran noted:

Chinese society is process-oriented. Consequently, for the Chinese, negotiations often involve understandings and intentions not spelled out in the final contract ... Because of Confucian values and the Chinese emphasis on interpersonal relations, these requests may have nothing to do with the contract terms at all.⁵¹

In the case of Shanghai Volkswagen Automotive, according to the technical executive director:

... although operations began in September 1985, the negotiations process had required several years of patience dating back to 1978 ... Perhaps somewhat in the tradition of the Confucian Dynamism, they are willing to take the long-term view and plan for a brighter future.⁵²

So the lack of concern over legal details in negotiation has its root in the long influence of Confucius. Ji Li, Kevin Lam, and Gongming Qian noted a different approach to the establishment of the 'New World' joint venture in Wuhan City:

New World set up good ties with the government in Wuhan City and other Chinese cities. These relationships proved very helpful during later negotiations in China ... They often quickly establish a JV, without careful negotiation and contracting.⁵³

Taking a long-term perspective, Joint Ventures are considered the first step in building lasting relationships. The 'New World' joint venture will rely on this rapport later to solve the problems resulted from lack of feasibility studies or clear contracts.

(b) The Relationship with Chinese Parties

A good cooperative relationship with Chinese parties also needs to consider the effect of cultural factors. 'Guanxi' or relationship is a key to successful undertakings in the Chinese culture. Although it is true that the need to develop relationships is not unique to China, it is understood that relationships play a much greater role in Chinese society than in typical Western society. To better grasp this need for cultural awareness, Hofstede stresses:

International managers and management theorists require a 'deeper understanding of the range of culture determined value systems that, in fact, exists among countries, and should be taken into account when transferring management ideas from one country to another ...'⁵⁴

⁵¹ L Brahm and D R Li, *The Business Guide To China* (1996) 103.

⁵² C D Myrna, D Raffaele, 'Cross-border Cooperative Agreements: the Case of China' (Fall 1994) *Multinational Business Review*.

⁵³ Li, Lam and Qian, above n 5.

⁵⁴ G Hofstede, *Cultures and Organizations: Software of the Mind* (1991).

It is somewhat in the tradition of the Confucian Dynamism that the Chinese are willing to take the long-term view in order to plan for a brighter future. As Cornett-DeVito Myrna and DeVito Raffaele stated:

In discussions with SVW expatriate management, it became obvious that the agreement to enter China was made with full consideration of China's long-term view. A long-range plan was implemented that would cover ten, twenty or more years.⁵⁵

On the other hand, one important implication is that foreign firms, strictly pursuing dominant control over their local joint venture partners, may fail to gain their local partners' assistance for entry into a local market. As Martin Posth said in an interview that it was necessary for Volkswagen to build up a long-term relationship with Chinese parties, especially local government:

Strategically ... the Chinese respect the fact that we took a lot of risk. We made it clear that we were willing to transfer our knowledge from the beginning. Not for one week or one year, but permanently. Since then we have done a lot more than we promised in the contract. But without the help of the Chinese government and the city of Shanghai we would be a dead duck. We rely on our partners, and that is one of the simple secrets of the success of Volkswagen in China.⁵⁶

Similarly, a good working relationship is based on an understanding of different cultural norms. John Child analysed:

We come back here to the question of whether the foreign partner seeks to dominate the joint venture, bringing in its own practices, corporate culture and so forth, or is prepared to work towards establishing a new culture for the joint venture, working with and learning from the local partner so that the two 'blend' together, adopting the best elements of both cultures.⁵⁷

However, political agendas have been accused of affecting the attitude of Chinese partners toward the joint venture resulting in a diminished level of reciprocity. Yim Yu Wong, Thomas E Maher, Richard A Jenner, Allen L Appell and Len G Hebert explained

An important reason for this is the Chinese belief that they have not been dealt with fairly over the decades and that now is time to even the score. This has exacerbated their cultural propensity to relentlessly pursue the addition, modification, or elimination of contractual terms already agreed upon rather than focus on compliance.⁵⁸

⁵⁵ Myrna, Raffaele, above n 52.

⁵⁶ Posth, above n 43.

⁵⁷ Child, above n 38, 5.

⁵⁸ Y Y Wong, T E Maher, R A Jenner, A L Appell and L G Hebert, 'Are Joint Ventures Losing their Appeal in China?' (Winter 1999) *SAM Advanced Management Journal*.

Therefore, a strategy to cooperate with Chinese parties should be based on not only the surface of obligation but also an understanding of the culture. This is important because the foreign partner will continue to depend on Chinese cooperation, or at least acquiescence, and that raises serious questions about the direction China will ultimately pursue.

(c) *The Dispute Resolution*

Although litigation is available as a means of resolving conflicts or disputes, the Chinese still prefer to avoid open conflict in dispute resolution. Alternative, more informal mechanisms such as consultation, negotiation, conciliation and arbitration are preferred. According to Kui Hua Wang:

In recent years, these non-litigious methods have often been accepted in foreign-related civil and commercial disputes. For instance, it is common to insert an arbitration clause in a joint venture contract. That is, if a dispute arises between the joint venture parties, the parties agree to take the case to an arbitration commission for resolution rather than seeking to solve the problem in the People's Courts.⁵⁹

However, compared to conciliation or mediation, arbitration has its formalities and perhaps is as close to a court adjudicated process as possible without the same cost and evidentiary requirements. The arbitration process is directly governed by *The Arbitration Law of the People's Republic of China* and rules are provided in the *Arbitration Rules of the China International Economic and Trade Arbitration Commission*. The conciliation process may take place within an arbitration tribunal and may be the first step before proceeding with an arbitration.⁶⁰ This is confirmed in the *Arbitration Rules of the China International Economic and Trade Arbitration Commission*.⁶¹ In both forms of joint venture, arbitration is an acceptable form of dispute resolution should negotiation or conciliation/mediation fail.⁶²

Harmony and good relationships are very important in Chinese culture and accordingly a business dispute is best resolved through the art of negotiation.⁶³ As Laurence Brahm and Li Dao Ran assert, '[c]hinese culture places a premium on Harmony; open conflict is something to be avoided'.⁶⁴ There are no legal or formal rules for this form of dispute resolution, accordingly one must rely on relationships built over time and an understanding of cultural nuances.

⁵⁹ Wang, above n 9, 279.

⁶⁰ Articles 51 & 52 The Arbitration Law of the People's Republic of China.

⁶¹ See Articles 46-50.

⁶² Article 14 in The Law of the People's Republic of China on Sino-foreign Joint Equity Enterprises, and Article 26 in The Law of the People's Republic of China on Sino-foreign Cooperative Enterprises.

⁶³ Perhaps the 'win win' style of negotiation espoused in American business schools has its origins in Chinese culture.

⁶⁴ Brahm, Li, above n 51, 104-105.

While the avoidance of litigation is a key aim in commercial relationships, it has become an increasingly common phenomenon in the resolution of certain types of commercial disputes in China, particularly in relation to intellectual property disputes. The significance of disputes in this relatively new field of law for China is exemplified by the need for the introduction of specialist or dedicated courts for such matters. But more often than not the parties to such litigation would be in competition with each other rather than attempting to form a business relationship with each other.

2 Centralised Political Power

For a period of 3000 years after the transition from slave to feudal society, China's political, economic and cultural development was slow.⁶⁵ Commencing with the dynasty of Zhou (1134BC-256BC), this feudal society had as its organ of power the feudal landlord state.⁶⁶ This changed with the unification of China under the first Chin emperor into an autocratic and centralised state:⁶⁷

The emperor reigned supreme in the feudal state, appointing officials in charge of the armed forces, the law courts, the treasury and state granaries in all parts of the country and relying on the landed gentry as the mainstay of the entire system of feudal rule.⁶⁸

This centralised political system helped to consolidate the feudal monarch's power, however, it was in the parallel organisational hierarchy where the administrative and political power resided. With the greatest fear being the potential secession of provincial regions, it is not hard to understand the belief in the unity of China dating back to Imperial times:

The Chinese have consistently sought to unify themselves, and from the Sui Dynasty onward have enjoyed almost unbroken rule under a single government and thus acted quickly to quash any acts that are perceived as secessionist or separatist.⁶⁹

Confucian philosophy together with a centralised political system would be a powerful combination for such a vast country like China. Legal rules would be superfluous under such a system due to the ingrained influence of Confucian philosophy. Today with the feudal system replaced by the current socialist system, nothing is changed. China still has a centralised political system and traces of the Confucian based cultural and social factors remain in Chinese society and Chinese people. However, now there is a new and complex legal system overlayed on Chinese society – a necessary addition as China becomes more externally focussed.

⁶⁵ Mao Ze-Dong, December 1939, Names in Pinyin, years added and text abridged by Chung Yoon-Ngan, *Introducing China* (3 Jan 1999). <<http://www.asiawind.com/pub/forum/fhakka/mhonarc/msg01318.html>> 11 June 2004.

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Colm Foy and Angus Maddison, *China: A World Economic Leader* (1998).

It is this mix of influences that produces difficulties for foreign investors. But once understood, the confusion should disappear.

(a) The approval requirements for a foreign investment project in China

The State Council empowers the Ministry of Commerce of The People's Republic of China to approve foreign investment projects in China. The State Council is the organisation with the greatest administrative power in the Central Government of the PRC. K H Wang notes that, according to Article 89 of the *Constitution of the PRC*:

the State Council is empowered ... to perform the following legislative activities:

- To adopt administrative measures, enact administrative rules and regulations and make decisions and orders in accordance with the *Constitution* and the law;
- To submit proposals to the NPC or its Standing Committee;
- To issue rules governing administrative affairs in respect of national economic and social development, the state budget, urban and rural development, education, science, culture, public health, sports, population control, internal affairs, public security, judicial administration and national defence;
- To alter or annul inappropriate orders, directives and regulations issued by the Ministries or Commissions.⁷⁰

This is significant executive power and quite aptly reflects centralised power over both administrative and legislative function. It is therefore not surprising that such executive power dictates the procedural requirements related to approval, registration, and form of foreign investment. As John S Mo noted:

An inseparable part of the legal framework for foreign investment is the power to approve foreign investment proposals. In China, this power is exercised by relevant government departments.⁷¹

Hence the role of the Ministry of Commerce. However, the ultimate power of the State Council should always be kept in mind.

(b) The procedural requirements of approval for foreign investment

The Regulations for the Implementation of the Law of the PRC on Sino-Foreign Equity Joint Ventures stipulate that the establishment of a joint venture in China is subject to examination and approval by the Ministry of Commerce.⁷² This includes the examination of the substantive validity of all application documents, including

⁷⁰ Wang, above n 9, 24.

⁷¹ Mo, above n 28, 453.

⁷² Article 8 Regulations for the Implementation of the Law of the PRC on Sino-Foreign Equity Joint Ventures.

the joint venture agreement and articles of association, given that a limited liability company is established for this form of joint venture. The source of the foreign investment is examined as a practical standard generally. If the investment comes from outside the territory of China, it is usually characterised as a 'foreign investment' even if it originates from Chinese nationals or companies. But before this process, Article 9 of the Regulations requires the Chinese joint venturer to submit a project proposal and report of a preliminary feasibility study, together with a memorandum of understanding between the parties, to the Ministry of Commerce for preliminary approval. The feasibility study is for the purpose of demonstrating the project's benefits to the Chinese economy and providing evidence of the co-venturers abilities to carry out the project. Upon approval of a joint venture, the Ministry of Commerce issues an Approval Certificate. Alternatively, the people's governments in the concerned provinces, autonomous regions and municipalities directly under the Central Government, or relevant ministries or bureaus under the State Council, (referred to as 'the entrusted office') may be entrusted with the power to examine and approve the establishment of joint ventures. So the establishment of foreign investment is subject to certain procedural requirements.

The common feature of the review authorities is that the power so exercised is part of the executive power and is confined to the power of the relevant local government in the Chinese political hierarchy. It is an inseparable part of the legal framework for foreign investment.

(c) The registration procedure

The EJV Law states that the registering body for joint ventures is the State Administration for Industry and Commerce (SAIC) or any of its local and regional bureaus. Such joint ventures must register within thirty days of receiving the approval certificate. This is in accordance with the provisions of the *Measures of the People's Republic of China for the Administration of the Registration of Chinese-Foreign Equity Joint Ventures*. The SAIC approves or disapproves the registration within one month of receipt of the application documents. When approved, a business licence is issued and joint venture operations can commence on the same day. However, subsequent changes to the registered information are only effective upon the approval of the relevant registration authorities.⁷³

If a joint venture desires to move to a new site, shift its production, increase or cut or transfer the registered capital, or extend the contract period, it must, with the approval documents, register the changes with the SAIC where the joint venture is located. In cases where the chairman of the board of directors or the general manager change, the joint venture must immediately register the changes and the business licence is amended. Clearly a tight reign on the activities of sino-foreign enterprises is held by the relevant government authorities.

⁷³ Anyuan Yuan, 'Foreign Direct Investments in China – Practical Problems of Complying with China's Company Law and Laws for Foreign-Invested Enterprises' (Spring 2000) *Northwestern School of Law Journal of International Law & Business*.

As described above, the centralised power plays an important role in the approval of foreign investment. Yasheng Huang notes:

China's FDI regulatory regime still imposes tight restrictions on the FIEs. Project approvals are conducted extensively on both positive and negative-list principles. There are also aggressive localization, technology transfer and other performance requirements.⁷⁴

However, it is the localisation aspect that has created confusion in the examination and approval processes. Jianfu Chen points out that:

Decentralisation of power has also led to the increasingly acute problem of local protection both in terms of the emergence of local rules and regulations in violation of national policy and law, and more seriously, in the implementation of national laws and policies.⁷⁵

The need to cut through this confusion maybe explained by Jake Stratton's observation that:

Foreign companies often choose ethnic Chinese executives, because of their linguistic abilities and cultural sensitivities, to make contacts and obtain potentially sensitive information-about government policy and operations, for example.⁷⁶

V CONCLUSION

The twenty-three year history of foreign direct investment in China has not been without its elements of drama and reports of dissatisfaction. The effects of the social and cultural factors on the PRC legal system described above have been serious obstacles for foreign investors doing business in China. Although their severity has been reduced, it remains more difficult for foreign investors to do business in China than in many other locations. However, learning to work with the system can be rewarding as illustrated by the early large joint ventures such as Shanghai Volkswagen Automatic Co Ltd which has been given an award as one of the Top Ten Joint Ventures by the China Daily.⁷⁷ The key to attracting such DFI remains China's wages, but the attractiveness of investing in China has been increased by reducing the drawbacks referred to earlier, most of all in removing most of the bureaucratic obstacles which made small investments appear not worth the effort. Small joint ventures have been successful in the coastal provinces, often repaying their initial investment within the first four years. Credit may be given to better streamlining of approval procedures by the provincial and municipal authorities in those coastal provinces.

⁷⁴ Y S Huang, *FDI in China: an Asian Perspective* (1998) 10.

⁷⁵ J Chen, *Chinese law: towards an understanding of Chinese law, its nature, and development* (1999) 221.

⁷⁶ J Stratton, 'The straight and Narrow' (Jan/Feb 1998) *The China Business Review* 24-25.

⁷⁷ R Pomfret, *Investing in China: Ten years of the 'Open Door' Policy* (1991) 127.

The most debatable consequences for China are the 'open door' policy's links to social and political change. New ideas of how to do business, exposure to images of capitalist societies, being encouraged to think on the job and having material possessions all contributed to an increased desire for the rule of law and political pluralism. FDI in China has been a success, increasing Chinese economic welfare and realizing profits for the foreign investors. It is important, however, neither to exaggerate nor to belittle this success. Not all FDI succeeds and not all of China has been attractive to foreign investors.

There is a need to carefully study the program of policies relating to the sector in which investment is intended. This is important as the elaborate legal system in place for foreign investment is still subject to the policy parameters established at the central government level. One would do well to seek the support of government officials and relevant ministries.

Although there is a need to create an appropriate legal framework for foreign investors, the process will take time, as officials need to overcome their suspicion of foreign 'capitalists' and must first understand foreign business practices. Meanwhile, potential foreign investors need to have an understanding of the effect of social and cultural factors on the legal system in China. Understanding the local culture and traditions has been well addressed in the international business literature for international corporations operating their global operations – especially in developing countries. Another key success factor for foreign ventures in China is the integration of Western and Chinese cultural elements and traditions into a company's business policies and operational procedures together with ensuring those policies and procedures are protected by local legal systems. As Jianfu Chen affirmed:

There are many issues that are important and relevant in regard to doing business in and with China. Indeed, an understanding of Chinese political and legal systems and sensitivity to Chinese social and cultural issues are indispensable.⁷⁸

⁷⁸ Chen, above n 75, 210.