ABA Section of International Law
Your Gateway to International Practice

March 2010

Volume 6, Issue 1

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CHINA LAW REPORTER
中国法律报道

REPORTING ON DEVELOPMENTS IN THE FOUR LEGAL SYSTEMS OF GREATER CHINA

On behalf of the leadership of the China Committee, we are pleased to issue the first edition of our China Law Reporter for 2010. This is the second edition helmed by the excellent editorial team of Russell Leu, Paul Edelberg, Wu Jing and Jamilia Wang. Thanks to their efforts, we have another excellent edition focused on the changing legal environment for firms and businesses operating in China.

In this edition of the Reporter, our contributors have covered the burgeoning area of outbound investment from China as well as detailing the possibilities and issues with the new Regulations on Foreign-Invested Partnerships – that may offer more flexibility than some of the existing structures for foreign investment in China. In addition, this edition features an examination of the U.S. Foreign Corrupt Practices Act (FCPA) related to persons operating in China and China's anti-corruption law. The article discusses the recent *Avery Dennison Corporation* settlement with the SEC and the conflict between business practices in China and the enforcement of these anti-corruption laws.

Since our last edition, we can report that we have followed up our successful Shanghai mixer with an equally successful installment for our Beijing chapter. More than 50 ABA members, non-members, friends and colleagues enjoyed an evening of fun, networking and wine-tasting and had a chance to meet friends – new and old. Our thanks to Beijing chapter members Steve Vogel, Wang Fei, Guo Bingna and Russell Leu for organizing this great event. Look forward to more mixers in both Shanghai and Beijing in the coming months! If a significant number of committee members are in another city in China and would like to arrange a mixer, please contact the Co-Chairs to discuss.

We encourage all of you to attend the Section's Spring Meeting from April 13-17 at the Grand Hyatt in New York City. This meeting represents the best opportunity of the year for networking with other members of the China Committee and across committees, will feature a variety of programs dealing with China law-related topics, and will include one of the major face-to-face business meetings for the China Committee for the year. If you haven't already signed up, don't delay! If you are reading this electronically, you can sign up here. (If you are reading this in hard copy, look on the last page of this edition for the link.) We look forward to seeing many of you there!

Co-Chairs Message, continued

As always, if you are looking to become more involved in the work of the China Committee, or simply have questions, concerns or ideas, please do not hesitate to reach out to either of the Co-Chairs or any member of the leadership team. (Emails for all the committee leaders are listed on the left side of the first page of this edition.) We have all found that the more you put into Committee membership, the more you will receive in return.

Elizabeth Cole, Co-Chair
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RECENT DEVELOPMENTS

AVOIDING THE PITFALLS OF "HIDDEN RULES" CHINESE GRAFT LAWS AND THE FCPA

By Robert Q. Lee, Sumeet H. Chugani, Vincent Li and Xingjian Zhao

On July 28, 2009, the U.S. Securities and Exchange Commission ("SEC") announced its settlement of civil and administrative charges brought pursuant to the Foreign Corrupt Practice Act (FCPA)[1] against Avery Dennison Corporation ("Avery"), a multinational corporation that specializes in the manufacture and sale of self-adhesive materials and office equipment.[2] From 2002 through 2005, both Avery and its local subsidiaries had engaged in a number of illegal transactions in China, Indonesia and Pakistan.[3] These transgressions included bribing government officials, paying kickbacks to the executives of its corporate customers and hosting "sightseeing trips" for local bureaucrats.[4] In one such instance, Avery executives in China agreed to pay a kickback to the project manager of a state-owned end customer. In order to conceal this illegal payment, the sales manager requested that a local distributor fill all order forms, and subsequently refund the agreed-upon kickback from the distributor's expected profit. The corrupt transaction was disguised as a sale to the distributor, rather than the state-owned end user.

In another notable instance, Avery's executives in China managed to procure two government contracts by agreeing to pay kickbacks to an institute affiliated with the PRC police ministry.[5] Avery had devised a plan to artificially increase sales prices, and then refund the surplus amount to the local institute as "consulting fees."[6] All payments were presumably made for the personal benefit of institute officials.[7] Although these illegal

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[1] *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. §§78m(b), (d)(1), (g)-(h), 78dd-1 to -3, 78ff (2002)). *See also* 18 U.S.C. §§ 1341, 1343 (2008) (related mail and wire fraud statutes), 18 U.S.C. § 1952 (2002) (providing for federal prosecutions for violations of state commercial bribery statutes).

[2] SEC Files Settled Charges Against Avery Dennison Corporation for Violating the Books and Records and Internal Controls Provisions of the Foreign Corrupt Practice Act, Litigation Release No. 21156, Accounting and Auditing Enforcement Release No. 3020 (Jul. 28, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21156.htm (last visited Feb. 8, 2010).

[3] *In re Avery Dennison Corp*., SEC Cease-And-Desist Order File No. 3-13564 at 5 (Jul. 28, 2009), http://www.sec.gov/litigation/admin/2009/34-60393.pdf (last visited Feb. 8, 2010).

[4] *Id.* at 5-6.

[5] Cmplt. at ¶ 11, S.E.C. v. Avery Dennison Corp., No. CV09-5493 DSF (CWx) (C.D.Cal. Jul. 28, 2009).

[6] *Id*.

[7] *Id*.

transactions were planned and conducted by *individual* executives at Avery's Chinese subsidiary, which is controlled by Avery's U.S. headquarters through intermediary corporate entities in Denmark and Hong Kong, the SEC nonetheless held Avery liable for FCPA violations.[8] Avery's punishments were steep: In the administrative proceeding, the SEC ordered Avery to cease and desist from further illegal conduct violating the FCPA and to disgorge $273,213 USD of its profits, along with $45,257 USD in prejudgment interest.[9] In the federal action, Avery agreed to the entry of a final judgment ordering payment of $200,000 USD.[10]

Avery, unfortunately, is not the only multinational firm that has been caught violating FCPA provisions in China. According to the *China Youth Daily*, recent commercial bribery scandals in China have implicated such prominent multinational corporations as McKinsey, Alcatel-Lucent, IBM, Walmart, Coca-Cola, the Diagnostic Products Corporation ("DPC") and many more.[11] In the DPC case, for example, the Tianjin subsidiary of the world's largest medical diagnostic equipment manufacturer was found to have paid multiple bribes in the aggregate of $1.6 million USD to a Chinese state-owned hospital between 1991 and 2002.[12] DPC used this scheme for the sole purpose of convincing these state-owned hospitals to purchase and use its goods.[13] DPC's profits from the resulting purchases amounted to $2 million USD, a sum dwarfed by DPC's subsequent disgorgement of $2.8 million USD in ill-gotten gains and its payment of upwards of $4.78 million USD in fines.[14] DPC's story exemplifies the fact that non-compliance with the FCPA is simply not worth the risk.

In the United States, businesses caught paying kickbacks or engaging in alternative forms of commercial bribery face severe civil and criminal sanctions at both the state and federal levels.[15] Unfortunately, this is not the case in China. Commercial corruption in the form of kickbacks, extravagant gifts or other less obvious means of bribery in exchange for business opportunities has been common practice for centuries and is an unavoidable norm deeply entrenched within the Chinese business culture.

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[8] *Id*. at ¶¶ 8, 19 & 21 (emphasis added).
[9] *In re Avery Dennison Corp*., *supra* note 3, at 6; *see also* SEC Files Settled Charges Against Avery Dennison Corporation for Violating the Books and Records and Internal Controls Provisions of the Foreign Corrupt Practice Act, *supra* note 2.
[10] SEC Files Settled Charges Against Avery Dennison Corporation for Violating the Books and Records and Internal Controls Provisions of the Foreign Corrupt Practice Act, *supra* note 2..
[11] *Kua guo gong si pin shang shang ye hui lu bang dan: Zhongguo shi chang qianguize zhi gou?*, [Multinational Companies Dominate List of Commercial Bribery Cases: An Indictment of the Chinese Market's Hidden Rules], Aug. 3, 2009, ZHONGGUO QINGNIAN BAO (CHINA YOUTH DAILY), *available at* http://www.chinaworks.be/index.php?option=com_content&view=article&id=38:mno&catid=1:laatstenieuws&Itemid=15 (last visited Feb. 8, 2010).
[12] Press Release, United Stated Department of Justice, DPC (Tianjin) Ltd. Charged with Violating the Foreign Corrupt Practice Act (May 20, 2005) (on file with author), http://www.justice.gov/criminal/fraud/press/2005/dpcfcpa.pdf (last visited Feb. 8, 2010).
[13] *Id*.
[14] *Id*.
[15] *See, e.g.,* 42 U.S.C. § 1320a-7b(b) (2006) (prohibiting kickbacks to induce referrals of items or services covered by federally funded health insurance programs), 18 U.S.C. §§ 1961-68 (2006), *et seq.* (the federal Racketeer Influenced and Corrupt Organizations Act [RICO Act]). *See also* FLA. STAT. § 895.03, *et seq.* (the state of Florida's parallel to the federal RICO statute).

These prevalent practices are referred to as "hidden rules," or *qianguize*, meaning unspoken rules that players in the field tacitly follow. In the medical equipment industry, for example, prevailing customs make it nearly impossible for a manufacturer to obtain purchase orders from a hospital unless it pays kickbacks to hospital administrators.[16] According to Du Zhou, a reporter/columnist for China's *IT Times*, the "kickback" rule in the medical equipment industry is so widely celebrated and practiced that it is an understatement to call it a "hidden rule."[17] It is just a rule.[18]

Accordingly, for a purchase order of medical equipment worth five million Renminbi (RMB), hospital administrators would typically demand kickbacks in the amount of one million RMB,, or twenty percent of the order's total worth.[19] These "kickbacks" are included in the price paid to the seller but are eventually refunded to the state-owned hospital's administrators. Of course, neither the seller's nor the buyer's financial records will reflect the payment of these kickbacks. Consequently, in any given transaction, a portion of the money paid by the hospital ended up in the pockets of the hospital's own administrators. The same pattern holds true in China's expanding pharmaceutical industry. Data from 2006 suggests that "China's pharmaceutical industry bribes annually robbed 772 million RMB worth of state assets, or about 16% of all taxes paid by the industry for the whole year."[20]

Although kickbacks are the most common and obvious form of commercial bribery, commercial bribery can take on many other forms, such as luxurious "sightseeing tours" disguised as business trips, corrupt payments written off as "consulting fees," hiring the bribee's relatives and paying them lavish compensations, financially supporting the bribee's children to study abroad or providing the bribee with free EMBA training.

I. Legal Risks for U.S. Companies Engaging in Commercial Bribery in China

The dilemma is obvious: either choose to conform and play by the "hidden rules," or be an outlier and refuse to follow them at the risk of incurring a severe competitive disadvantage within a business culture driven by corrupt practices. As the *Avery* and *DPC* cases have demonstrated, following "hidden rules" entails serious legal risks since such conduct will most likely fall under the purview of the FCPA. Recently, the Chinese government has also become more aggressive in implementing its own anti-commercial bribery regulations and has issued more judicial interpretations specifically targeting commercial bribery.[21] Although it is too early to predict how successful these new

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[16] Zhou Du, *You jian qian gui ze – kua guo gong si zai hua shang ye hui lu diao cha* [Hidden Rules Again – An Investigation of Commercial Bribery by Foreign Multinational Companies in China], IT SHIDAI ZHOUKAN [IT TIMES (CHINA)], Sept. 11, 2009, *available at* http://www.ittime.com.cn/content.asp?id=7423 (last visited Feb. 8, 2010).
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Commercial Bribery Serious Economic Problem*, CHINA ECONOMIC NET, Mar. 24, 2006, *available at* http://en.ce.cn/Business/Macro-economic/200603/24/t20060324_6477807.shtml (last visited Feb. 8, 2010).
[21] *See, e.g., China Busts 6,200 Briberies*, AGENCE FRANCE-PRESSE (AFP), Feb. 23, 2009, *available at* http://www.straitstimes.com/Breaking%2BNews/Asia/Story/STIStory_341996.html (last visited Feb. 9,

administrative and judicial measures will be in reforming China's long-standing business culture, they will undoubtedly alter the calculus of costs and benefits associated with the practice of commercial bribery. To multinational companies willing to play by the "hidden rules," these new measures increase the costs of conducting commercial bribery, by making such firms vulnerable to multiple sanctions imposed not only by the United States, but also by China. Moreover, investigation or prosecution in one jurisdiction may expose the firm to parallel sanctions in the other.

II. The FCPA and its Enforcement Mechanisms

Home to robust trade and ever-increasing business opportunities, China has become an extremely attractive destination for foreign business and investment. This trend, joined with widespread corruption in China and the fact that China's government has a hand in managing the nation's business and trade sector, creates a fertile breeding ground for FCPA violations.[22] Business leaders must take this overshadowing reality into account in the face of China's lure of profits and big business.

The U.S. Congress enacted the FCPA in 1977 to halt bribery and subornment by U.S. companies as a means of obtaining or preserving foreign business. Passed during Watergate's aftermath, this amendment to the Securities Exchange Act of 1934 generally prohibits U.S. citizens and corporations from corruptly paying or offering gifts to "foreign officials" directly or through third parties with the purpose of "obtaining or retaining business for or with, or directing business to, any person."[23] The FCPA also requires corporations registered or filing reports with the SEC to engage in strict record-keeping that accurately detail their corporate spending, disposition of assets and internal controls.[24] Enforcement of these statutory provisions are divided between the SEC for anti-bribery and recordkeeping functions, and the U.S. Department of Justice (DOJ) both for criminal enforcement and for civil enforcement against non-public companies and nations. Although this article will briefly highlight the FCPA's accounting provisions, it will primarily focus on the statute's anti-bribery provisions, which is more relevant to the topic of this comparative discussion.

a. Accounting Provisions

The FCPA's accounting provisions require companies registered or filing reports with the SEC to adhere to stringent accounting standards.[25] Pursuant to 15 U.S.C. § 78m(b)(2), a corporation must both create and regularly update record-keeping

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2010). *See also* Chen Feng, *China Hunts Commercial Bribery in Industrial, Commercial Sectors*, XINHUA NEWS AGENCY, Sept. 14, 2006, *available at* http://www.gov.cn/english/2006-09/14/content_389067.htm (last visited Feb. 8, 2010).

[22] *See China and India Rank in the Middle of Global Corruption Index*, 2POINT6BILLION.COM, Nov. 18, 2009, *available at* http://www.2point6billion.com/news/2009/11/18/china-and-india-rank-in-the-middle-of-global-corruption-index-3056.html (last visited Feb. 9, 2010) (China ranks as the 79th most corrupt nation out of the 180 measured). *See also* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. §§78m(b), (d)(1), (g)-(h), 78dd-1 to -3, 78ff (2006)).

[23] *See* 15 U.S.C. §§ 78dd-1 to -3, 78ff (2006) (the FCPA's anti-bribery provisions).

[24] *See* 15 U.S.C. § 78m(b)(2) (2006) (the FCPA's accounting provisions).

[25] *See* 15 U.S.C. § 78m(b)(2) (2002).

functions that accurately reflect all of its corporate transactions while maintaining an adequate system of internal accounting controls.[26] Failure to meet the high thresholds of the statute's recordkeeping and internal control standards will form a basis for both civil and criminal liability.[27] Consequently, most corporations doing business in China must create and implement adequate compliance programs evidencing corporate intention to comply with the FCPA. Regular reporting and constant self-monitoring have become not only the norm, but a necessity, when doing business in China.

b. Anti-Bribery Provisions

Pursuant to 15 U.S.C. §§ 78dd-1, -2, and -3, the anti-bribery provisions of the FCPA criminalize the use of corruptive bribery tactics upon foreign officials to induce unlawful action.[28] Essentially, the FCPA prohibits U.S. entities from engaging in illegal conduct in order to gain undue advantage over business competitors abroad. Unlike the accounting provisions, the anti-bribery provisions apply to *both* individuals and businesses. Pursuant to the 1998 amendments to the FCPA, "any person" may be held criminally liable for commercial bribery.[29] This means that individual employees, their corporate employers, and even certain stockholders may be prosecuted for FCPA violations. This prohibition also applies to businesses creating joint venture partnerships within China.[30] Many joint venture partners in China may be well-accustomed to the "hidden rules" and may themselves be – wittingly or unwittingly – practitioners of this unscrupulous custom. This acquiescence, however, violates the FCPA.[31] Such practices by the Chinese partners will undoubtedly threaten prosecution for the U.S. venture partner.

The relevant FCPA provisions apply to any "offer, payment, promise to pay, or authorization of the payment of any money . . . or gift" to any foreign official, political party affiliate or candidate for political office.[32] These conditions apply only to situations in which a "corrupt" purpose is present.[33] The payment must be intended to induce the recipient to exploit his or her official capacity and illegally direct business to either the

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[26] *See* 15 U.S.C. §§ 78m(a)-(b) (2002).
[27] *See, e.g.,* Thomas Fox, *FCPA Compliance and FCPA Enforcement: A Look Ahead to 2009 and Beyond*, CORPORATE COMPLIANCE INSIGHTS, May 19, 2009 *available at* http://www.corporatecomplianceinsights.com/2009/fcpa-compliance-fcpa-enforcement-obama-mcnulty-ashcroft-comments-on-foreign-corrupt-practices-act (last visited Feb. 9, 2010). This article discusses the 2009 charges against Halliburton, in which the company's internal controls failed to detect and prevent the bribery of Nigerian officials. Halliburton settled by agreeing to pay a fine of $402 million, plus profit disgorgement of $177 million. *Id.* This case demonstrates the sheer magnitude of the FCPA's power and impact when companies slip on compliance practices.
[28] 15 U.S.C. §§ 78dd-1 to -3 (2006).
[29] 15 U.S.C. § 78dd-1(g) (1998).
[30] Hank Bourg and Peter O'Neil, *Staying Complaint in China under the FCPA*, CHINA BRIEFING, Jul./Aug. 2009, *available at* http://www.china-briefing.com/article/staying-compliant-china-under-the-fcpa-656.html (last visited Feb. 9, 2010) (" . . . any violation of FCPA standards by one of those [joint venture] parties could result in the American company being vicariously liable under the FCPA.").
[31] *See id.*
[32] 15 U.S.C. §§ 78dd-1(a), (g) (for issuers); 78dd-2(a)(1)-(2), (f)(2)(A) (for domestic concerns); 78dd-3(f)(1), (2)(A)(B) (for any "person").
[33] *Id.*

payer or a third party. The corrupt act, however, need not succeed in its purpose for FCPA liability to attach. The FCPA's transactional prohibitions extend not only to monetary payments but far more broadly to "anything of value."[34] Note, however, that payments made to officials to secure performance of "routine governmental action" are explicitly exempted from FCPA liability.[35]

In order to violate the FCPA, the offer must be made to a "foreign official."[36] This broad definition encompasses anyone working for a government-owned or managed institution or enterprise.[37] In addition, employees of international organizations have also been interpreted as foreign officials under the FCPA.[38] This is where the perplexities of conforming to the FCPA *explode* in China. China is rife with state-owned and state-controlled enterprises.[39] This creates considerable risks to foreign companies seeking to "break bread" in China. Companies disbursing funds to assumed private enterprises pursuant to China's customary "hidden rules" may find themselves in direct breach of the FCPA. Due to China's collectivist approach, any attempt to distinguish state-owned enterprises from private ones may prove perilous without proper investigation.

Foreign companies, professional advisors and joint venture partners within China face serious legal consequences and monetary risks when they acquiesce to the customary "hidden rules" or engage in any value-backed persuasion with Chinese officials or state-owned enterprises. The terms of these "hidden rules," which are typically in breach of FCPA provisions, will render foreign corporations and their affiliates liable under the statute's anti-bribery and record-keeping functions. Such adverse consequences are not limited to the purview of the FCPA. Private litigation based on the Racketeer Influenced and Corrupt Organizations Act (RICO) has become another source of concern and panic among foreign businesses. Lastly, the Chinese government has intensified its pursuit of both civil and criminal liability for commercial bribery.[40]

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[34] *Id.*

[35] *See* 15 U.S.C. 15 U.S.C. §§ 78dd-1(b) (for issuers); 78dd-2(b) (for domestic concerns); 78dd-3(b) (for any "person"). In accordance with the 1998 amendments to the FCPA, "grease payments" or payments made to local officials to secure performance of "routine governmental action" are exempted from liability. In short, "grease payments" allow expediting an activity that a government employee should routinely do. Examples of grease payments including routine permits, visas and work orders, mail and delivery, phone service, power supply and the like. These actions are deemed non-discretionary and therefore do not encourage or award new business. However, the scope of this exception is narrow, for it does not include "any decision by a foreign official whether, or on what terms, to award new business to or to continue business with a particular party, or any action taken by a foreign official involved in the decision-making process to encourage a decision to award new business to or continue business with a particular party." 15 U.S.C. §§ 78dd-1(f)(3)(A) (for issuers); 78dd-2(h)(4)(B) (for domestic concerns); 78dd-3(f)(4)(B) (for any "person").

[36] 15 U.S.C. §§ 78dd-1(a), (f)(1) (for issuers); 78dd-2(a)(1)-(2), (h)(2)(A) (for domestic concerns); 78dd-3(f)(1), (2)(A), (B) (for any "person").

[37] *Id.*

[38] *Id.*

[39] Bourg and O'Neil, *supra* note 30.

[40] *See, e.g.,* Zui Gao Renmin Fa Yuan he Zui Gao Remnin Jian Cha Yuan guan yu ban li shang ye hui lu an jian shi yong fa lü ruo gan wen ti de yi jian [Opinions from the Supreme People's Court and the Supreme People's Procuratorate of the People's Republic of China Regarding Several Issues of the Laws Applicable to Commercial Bribery Cases] (promulgated by the Supreme People's Court and the Supreme People's

III. Anti Commercial Bribery Law in China

In China, adherence to "hidden rules" and engagement in "gift-giving" has been long understood as a necessary step towards earning a profit. This paradigm is beginning to shift. More rigorous enforcement of anti-bribery laws has led to the exposure of many corrupt business tactics employed by such established and reputable corporations as Coca-Cola and Rio Tinto. Unquestionably, the Chinese government has intensified its enforcement of anti-corruption laws in order to create a more level playing field. However, foreign companies, especially those under the purview of the FCPA, question whether China is going far enough.

China's Anti-Unfair Competition Law ("AUCL") defines commercial bribery as "secretly giving and receiving money, property, or other benefits relating to transactions between business persons and entities, unless the giving or receipt of money, property, or other benefits are reflected in the financial books of the giver and the recipient."[41] According to Article 8 of the AUCL, commissions and discounts are considered illegal bribes unless they are recorded in the company's financial books.[42] AUCL provides for criminal sanctions against those who violate Article 8 and authorizes China's State Administration for Industry and Commerce ("SAIC") to investigate violations and impose sanctions.[43] As the agency in charge of administering all industrial and commercial enterprises, the SAIC enforces Article 8 by imposing strict monetary penalties – fines ranging from 10,000 to 200,000 RMB (approximately $1,500 to $30,000 USD) and the disgorgement of ill-obtained profits.[44]

Three years after AUCL's enactment, the SAIC adopted Decree 60 – Interim Rules on the Prohibition of Commercial Bribery – to amend Article 8.[45] Decree 60 seeks to clarify the definition of commercial bribery by providing, among other things, that: (1) commercial bribery includes not only kickbacks disguised as "promotion fees," "advertising fees," "support," "research and development fees," "labor fees," "consulting fees," and hidden commissions, but also "free sightseeing tours" or similar less tangible benefits; (2) gifts to customers and/or their representatives are prohibited, unless such gifts qualify as "small advertisement items" pursuant to trade custom; (3) commercial bribery committed by employees will be imputed to their employers as violation of AUCL; (4) secret refund, which is defined as "unrecorded refund of cash or property representing a percentage of the purchase price to the customer company or any individual employee," is considered commercial bribery and thereby prohibited;

Procuratorate, Nov. 20, 2008), *available at* http://www.china.com.cn/policy/txt/200811/25/content_16820528_2.htm (last visited Feb. 10, 2010).

[41] Zhonghua Renmin Gongheguo fan bu zheng dang jing zheng fa [People's Republic of China Anti Unfair Competition Law] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993), *available at* http://www.law-lib.com/law/law_view.asp?id=245 (last visited Feb. 10, 2010).

[42] *Id.* at art. 8.

[43] *Id.* at arts. 17-19.

[44] *Id*. at art. 24.

[45] Guan yu jing zhi shang ye hui lu xing wei de zhan xing gui ding [Interim Rules Prohibiting Commercial Bribery] (promulgated by China's State Administration for Industry and Commerce, Nov. 15, 1996), *available at* http://library.jgsu.edu.cn/zscq/04/Product3/Law/18_Oppose_dump/18_Oppose_dump1899.htm (last visited Feb. 10, 2010).

(5) recipients of cash or property given to them as bribes will be liable to the same extent as the briber; (6) as a safe harbor rule, discount on and/or refund from purchase prices are permissible as long as the giving and the receipt of such discount/refund is recorded in both the seller and buyers' financial books in accordance with accepted accounting standards; and (7) commissions to middlemen are permissible, so long as payment of such a commission is disclosed in the company's financial books.[46]

Notably, the AUCL curtails "under-the-table" payments that are made to influence business decisions. This provision only targets the "hidden rules" and does not prohibit certain traditional business practices such as open rebate, open discount or commission payment.

If the amount seized in a corruption investigation is "substantially large," criminal prosecution will ensue. China's Criminal Code[47] outlines prosecution for eight corruption-driven offenses: (1) acceptance of bribes by non-government (or "enterprise") employees [Art. 163]; (2) offering bribes to non-government employees [Art. 164]; (3) acceptance of bribes by government employees [Art. 385]; (4) acceptance of bribes by organizations [Art. 387]; (5) offering bribes to government functionaries [Art. 389]; (6) paying bribes to organizations [Art. 391]; (7) introducing a briber to a government employee [Art. 392]; and (8) payment of bribes by an organization [Art. 393].[48]

To amount to a "prima facie" claim, an offense must involve an amount that is either "substantially large" or "huge."[49] For the acceptance of bribes by non-government employees, the sentence is between from one month and five years for a "substantially large" infraction and five years or above for an amount designated as "huge."[50] If an individual is found to have paid bribes to non-government employees, the sentence ranges between one month and three years if the amount involved is "substantially large," and between three to ten years if the amount is designated as "huge."[51] The provincial judiciary, in conjunction with provincial law enforcement agencies, is empowered to establish the precise thresholds for "substantially large" and "huge."

In Shanghai, for example, the standard for "substantially large" as set forth in the Opinions Regarding the Applicable Standards in the Prosecution and Trial of Certain Crimes – jointly issued by the Shanghai High People's Court, Shanghai High People's Procuratorate, Shanghai Public Security Bureau and Shanghai Department of Justice – is 15,000 RMB (about $2,100 USD), while an amount of 100,000 RMB (about $15,000 USD) qualifies as "huge."[52] By these standards, a person *receiving* $15,000 USD in

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[46] *Id.* arts. 2-8.
[47] *See* Zhonghua Remin Gongheguo xing fa [Criminal Law of the People's Republic of China] (enacted by the Second Session of the Fifth National People's Congress ("NPC") on Jul. 1, 1979, as amended by the Fifth Session of the Eighth NPC on Mar. 14, 1997), *available at* http://www.colaw.cn/findlaw/crime/criminallaw1.html (last visited Feb. 10, 2010).
[48] *Id.*
[49] *See, e.g., id.*
[50] *Id.* at art. 163.
[51] *Id.* at art. 164.
[52] Guan yu ben shi ban li bu fen xing shi fan zui an jian biao zhun de yi jian [Opinions Regarding the Applicable Standards Governing this City's Prosecution of Certain Crimes] (promulgated by the Shanghai

bribes from a customer would face at least five years in prison, while a person *giving* the same amount in bribes *may* face a sentence of three years.

Economists believe that the sheer prevalence of corrupt practices in China's cloudy business world renders the enforcement of Chinese government laws against bribery particularly difficult. However, a recent upswing in commercial bribery enforcement actions against large corporations has heightened the fear of prosecution. According to a May 15, 2009 press release from Xinhua,[53] administrative authorities in China prosecuted 583 enforcement actions for anti-bribery violations during the first quarter of 2009.[54] Among those cases, 19.01% involved retail business, 11.30% involved telecommunications businesses, 7.36% involved construction businesses and 6% involved medical equipment and pharmaceutical businesses.[55]

Prosecutions against multinational companies for commercial bribery are also prevalent. For example, in one high-profile case from 2007, a Shanghai-based IT company was discovered to have bribed employees of various multinational companies, including McKinsey, McDonald, Whirlpool and Xerox, to procure IT network installation contracts.[56] In another case involving Coca-Cola, two former employees of Shenmei, Coca-Cola's primary local bottler in Shanghai, were detained and investigated for extracting kickbacks from suppliers.[57] The recent prosecution of Stern Hu, an Australian citizen and the British-Australian mining giant Rio Tinto's chief representative in China, also includes commercial bribery charges based on bribes given to senior managers of Chinese steel enterprises in exchange for business contracts. The message is clear: the government can pursue anyone at any moment. The increasing rate of prosecutions for commercial bribery offenses in China illustrate that the Chinese Government is ready and willing to do so.

In a Judicial Opinion regarding the Applicable Laws Governing Commercial Bribery Crimes, the Supreme People's Court and the Supreme People's Procuratorate identified several industries of particular concern: medical institutions, schools and educational institutions, and public bidding.[58] One provision within this Judicial Opinion distinguishes bribery from a *bona fide* gift by using a four-factor test:

Municipal High People's Court, Shanghai Municipal High People's Procuratorate, Shanghai Municipal Public Security Bureau, and Shanghai Municipal Department of Justice on Oct. 25, 2000), *available at* http://www.ronglaw.com/news/info.asp?id=477 (last visited Feb. 10, 2010).

[53] The Xinhua News Agency is the PRC government's official press agency.

[54] Yi ji du gong shang ji guan cha chu shang ye hui lu an jian 584 jian [State Administration for Industry and Commerce Authorities Investigated and Handled 584 Commercial Bribery Cases During the First Quarter], *available at* http://news.xinhuanet.com/newscenter/2009-05/15/content_11378239.htm (last visited Feb. 10, 2010).

[55] *Id*.

[56] Qing Lei, *Zai hu wai qi juan ru "xing hui men"* [Foreign Enterprises in Shanghai Involved in Bribery Scandals], CBF ZHONGGUO JINGMAO JUJIAO [CBG China Economics and Trade Focus], Mar. 2007, at 88-89, *available at* http://www.gotoread.com/vo/4599/page480539.html (last visited Feb. 10, 2010).

[57] *Coca-Cola Probe Leads to Multiple Bribes*, CHINA DAILY, Sept. 17, 2009, *available at* http://www.china.org.cn/china/news/2009-09/17/content_18543520.htm (last visited Feb. 10, 2010).

[58] Opinions from the Supreme People's Court and the Supreme People's Procuratorate of the PRC Regarding Several Issues of the Laws Applicable to Commercial Bribery Cases, *supra* note 41.

> (1) The nature of prior transactions and the relationship between the parties, including family connections and friendship; (2) the value of the gift; (3) the reason for, timing of, and means of gift-giving, and whether the recipient is requested to confer a reciprocal benefit to the giver based on the recipient's position; and (4) whether the recipient actually used his/her position to confer a benefit upon the giver.[59]

The question remains as to how this Opinion can be reconciled with Decree 60, which contains a blanket prohibition on the exchange of gifts other than small advertisement items.[60]

IV. Compliance

Undoubtedly, the FCPA puts U.S. firms and citizens at a competitive disadvantage when operating in China's business and trade sector. To the extent the "hidden rules" remain customary practices within China's business community, it harms foreign businesses, which must not only comply with China's anti-corruption laws but also with analogous and possibly more stringent laws – such as the FCPA and its various counterparts – promulgated within their home countries. If China is indeed serious in its more rigorous enforcement of anti-corruption laws, then this creates a more equitable business landscape for multinationals. Some Chinese legal scholars have commented on the lax enforcement of corruption laws and are calling for more rigorous enforcement measures.[61] Others suggest that new legislation, such as a more articulate "Anti-Commercial Bribery Code," will further combat and penalize commercial bribery.[62] The Chinese government's recent zeal in prosecuting commercial bribery cases evidences China's movement towards more stringent regulation. Presumably, new legislation will be enacted to codify the current anti-commercial bribery sentiment. Yet precisely how effective the existing and anticipated legislative and enforcement efforts will be in curbing and eradicating the "hidden rules" remains to be seen.

Backed with a strong sentiment for the rigorous legislation and enforcement of an effective anti-corruption regime, multinational companies and foreign businesses hold the key to China's future progress in this domain. The persistence of these foreign firms in unilaterally eliminating unethical business conduct will contribute significantly to the general business environment by making less room for the "hidden rules." A platform for multinational companies to meet and discuss business ethics and compliance with anti-corruption laws, and to engage in concerted policy-making and action, may be necessary to accomplish this purpose. Institutions such as the American Chamber of

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[59] *Id.* at art. 10.
[60] Interim Rules Prohibiting Commercial Bribery, *supra* note 45.
[61] Wang Shichuan, *Bu pa qian gui ze, jiu pa gui ze qian* [What is Scary is Not the Hidden Rules, but the Fact that the Rules are Hidden], CHINA NEWS DAILY, Aug. 4, 2009, *available at* http://finance.sina.com.cn/review/20090804/07156566814.shtml (last visited Feb. 10, 2010).
[62] Qing, *supra* note 56, at 89.

Commerce and the American Bar Association can and will play a facilitating position in bringing together representatives or in-house counsels of multinational companies to create compliance action plans.

For individual companies, compliance and risk prevention can be accomplished through better training, more effective management and increased legal sensitivity. With respect to training, it is important to formulate a clear anti-corruption policy and train employees at all levels, especially the mid-level locally recruited managers, in business ethics and anti-corruption laws. Managers should be apprised of the severe consequences of engaging in commercial bribery under not only Chinese, but also U.S. law.

As to management, attention should be paid to the marketing department, the sales department, the procurement department, the human resources department, the finance and accounting department and the IT department. Strict accounting and reimbursement rules must be instituted to carefully examine, categorize and record all incomes and expenses, especially funds and reimbursement requests from the marketing and sales departments. Each item or payment involving high-risk categories, especially "promotion fees," "consulting fees" and "marketing expenses," must be backed by invoices and other underlying transactional documents. Complete and accurate bookkeeping is also essential to preserve evidence of legal compliance and to enable the company to both keep track of and improve its compliance program.

Effective hiring is another important component of the risk prevention program. Understanding that connections and relationships are important in China's business culture, some companies make hiring decisions based solely on candidates' capabilities and social/business connections, without reference to important ethical considerations. In making hiring decisions, it is imperative to ensure that the candidate agrees with and is willing to abide by the company's ethical standards, rather than follow the "hidden rules" in pursuit of greater profits. It is not only a good practice, but an essential one, to incorporate a pledge to abide by ethical practices into all employment contracts. For those working in such sensitive positions as marketing, procurement and sales, it is important that the employee's compensation be based not only on revenues, but also on his or her ability to adhere to the company's own ethical standards.

Finally, a company should institute a compliance program closely supervised by legal professionals who carefully and continuously monitor the most recent developments in anti-corruption legislation within both China and its home country. These experts must continuously update the corporate policies and compliance measures to minimize legal risks in light of an ever-changing legal landscape, and provide informed, competent advice to management and the operational departments regarding anti-corruption compliance. Anti-corrupt business practices should also be included in the company's periodic auditing, which is another important component of the compliance program.

V. Conclusion

Without a strong, workable and carefully designed compliance program, foreign businesses conforming to China's "hidden rules" are caught between the onerous choices

of profit maximization and legal compliance. Choosing to maximize profit without due regard for legal constraints may not only cost a company dearly in terms of revenue, but also result in graver long-term consequences such as damaged good will and stigmatized brand image. Although many foreign companies thrive amongst the shadows of both China's anti-corruption laws and the FCPA, the risk of companies' acquiescence to the "hidden rules" is undeniable. China's new round of legislation in promulgating anti-corruption laws to parallel the FCPA may help foster an entirely new business environment in China. Only time will tell whether China's business playing field will truly level out based on increased enforcement of local law, or whether the long-entrenched "hidden rules" will continue to threaten foreign businesses with crippling prosecution.

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GOING GLOBAL -- A REVIEW OF RECENT PRC LEGISLATION FOR OUTBOUND INVESTMENTS

By Li Zengli and Eliot R. Clauss

I. Going Global

China's outward investment has increased enormously and attracted considerable attention in recent years. (For the purposes of this article, outward investment refers to non-financial investment.) Under the government's "Go Global" policy, offshore investment grew from almost zero to a record US$12.4 billion in the first half year of 2009[63], making China one of the source countries with the fastest growing outward direct investment in the world.

"Going Global" has become a key strategic component of China's economic development. The old management system of overseas investment, which was centered on complex and time-consuming approval procedures, no longer fits the "Go Global" strategy.

China's government is striving to streamline the procedures for overseas investments, providing more efficient services and easing restrictions. Many policies and guidelines have been made and measures have been taken to achieve theses goals. Since 2009, a series of landmark policy pronouncements and regulations, as listed below, have been issued by the Chinese government, demonstrating that a new overseas investment regime has been established, which will further intensify China's emerging outbound investment. Among the key new pieces of legislation are the following:

a) On March 16, 2009, the Ministry of Commerce ("MOFCOM") promulgated the *Administrative Measures on Overseas Investment* ("MOFCOM Outbound Investment Measures"), effective as of May 1, 2009;

b) On June 8, 2009, in an effort to lower the investment risks faced by Chinese enterprises, the National Development and Reform Commission ("NDRC") announced the establishment of the preliminary risk assessment procedures applicable for overseas M&A and bidding that are subject to verification and approval by NDRC or the State Council (see below for the details) in the *Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects* ("NDRC Circular");

c) On June 9, 2009, the State Administration of Foreign Exchange ("SAFE") issued the *Circular on Several Issues Concerning the Administration of*

[63] Please refer to http://www.gov.cn/xwfb/2009-07/15/content_1366347.htm.

Foreign Exchange in Outbound Lending by Domestic Enterprises ("Outbound Lending Circular"), effective as of August 1, 2009; and

d) On July 13, 2009, SAFE issued the *Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions* ("**SAFE Outbound Investment Regulations**"), effective as of August 1, 2009.

This paper will outline the regulatory framework for outbound investment, review the liberalized external investment procedures and reflect on the effectiveness of the new framework in facilitating successful outbound investment by Chinese companies.

II. Legislative Framework

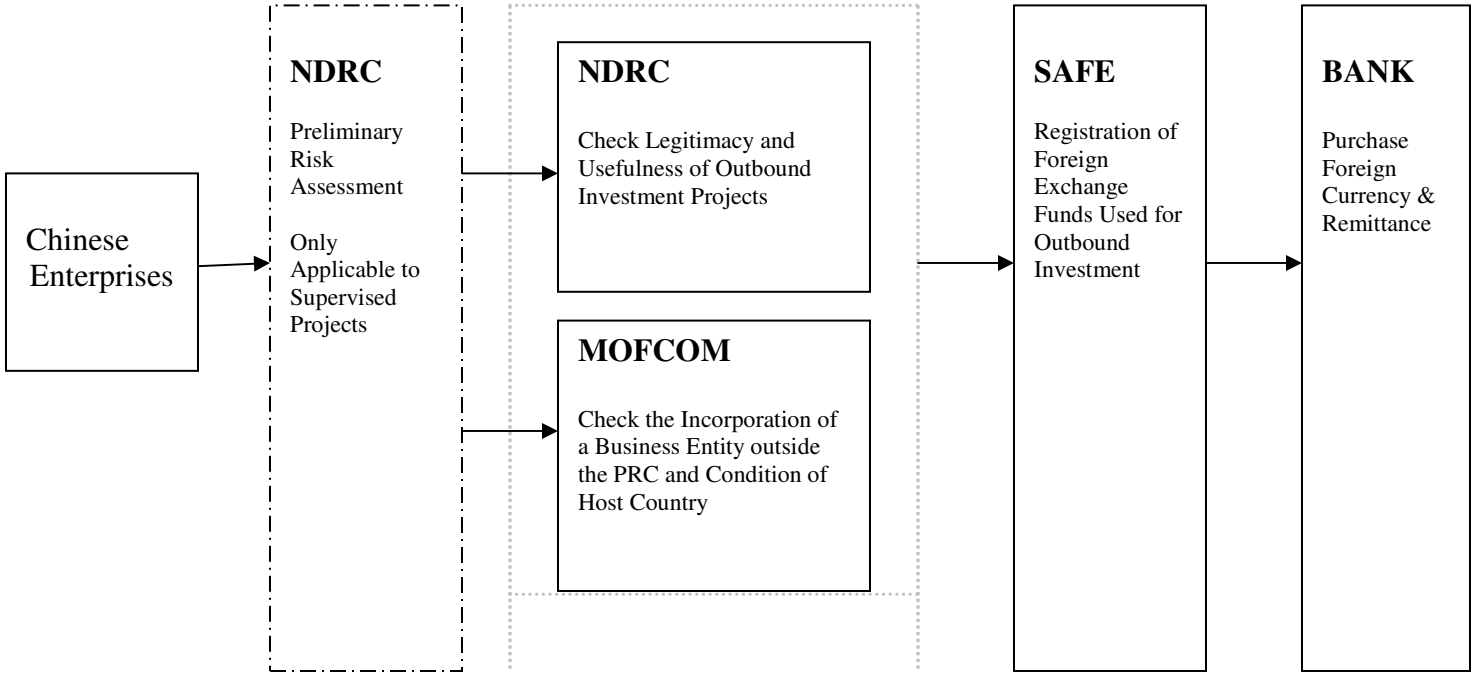
The "legislative framework" for any industry in China typically falls into two categories: actual legislation issued by the National People's Congress specifying basic statutory requirements and provisions and granting certain authority to a particular ministry within the Government, and implementing rules and regulations issued by the relevant ministry, which traditionally contain the detailed rules setting forth the steps required to effectuate compliance with the legislation. Often there is some overlap in the requirements of the legislation and the implementing regulations promulgated by the different ministries.

There are three principal government bodies responsible for overseeing outbound investment by Chinese enterprises – the NDRC, MOFCOM and SAFE – each having a different mandate regarding outbound investment.

The NDRC and MOFCOM share the power of vetting the legitimacy of outbound investment proposals. Each outbound investment project must be examined and approved by MOFCOM under the new MOFCOM Outbound Investment Measures. There is obvious overlap and a potential for confusion between the MOFCOM Outbound Investment Measures and the NDRC Measures (see definition below). This remains to be clarified.

SAFE is the government agency responsible for China's foreign exchange control system, and is accordingly in charge of regulating the use of foreign exchange in outbound investment projects. After obtaining approval from the NDRC, MOFCOM or both, all outbound investment projects shall be registered with SAFE to obtain a foreign exchange registration certificate, which is a prerequisite to remitting any currency overseas.

The illustration below shows the approval procedures for outbound investment projects:



A) NDRC Requirements

Pursuant to the *Tentative Measures on Administration of Approval for Outbound Investment Project i*ssued by NDRC **("NDRC Measures")** in 2004, Chinese overseas investors need to seek NDRC approval for natural resources-type outbound investments when the Chinese party's investment amounts to at least US$30 million or other types of outbound investment of at least US$10 million.[64] Where the outward investment by the Chinese party equals or exceeds US$200 million for natural resources-type investments or US$50 million for other types of outbound investments (collectively, "**Key Projects**"), these Key Projects are subject to approval by the State Council after initial examination and approval by NDRC.[65] Approval from the provincial-level counterparts of NDRC would be sufficient only for natural resources-type outbound investments with a total investment of less than US$30 million or for other types of outbound investments of less than US$10 million.[66]

Furthermore, the NDRC Circular requires that a written report ("**Report**") shall be submitted by the Chinese enterprise to NDRC prior to commencing material commercial activities if the proposed overseas investment projects are outbound M&A and bidding of Key Projects ("**Supervised Projects**").[67] The

[64] Article 4, Tentative Measures on Administration of Approval for Outbound Investment Projects.
[65] Article 4, Tentative Measures on Administration of Approval for Outbound Investment Projects.
[66] Article 5, Tentative Measures on Administration of Approval for Outbound Investment Projects.
[67] Article 3, Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects.

Report must contain basic information on the investors involved in the project, a description of the project and the acquisition or bidding target and a basic plan and timeline for the acquisition or bidding.[68]

According to the NDRC Circular, "material commercial activities" refers to the execution of a binding agreement, the issuance of a binding offer, the submission of a formal application to overseas governmental authorities or the submission of a formal bid.[69]

It is also worth noting that, if the NDRC determines that there are "substantial adverse factors" affecting a Supervised Project, it will make note in its written acknowledgment of receipt of the Report that the Supervised Project involves potential risks, and the Supervised Project will be subject to strict review during the rest of the authorization process.[70] This provision has engendered uncertainty as to NDRC's standards for "substantial adverse factors", and the extent to which such determination will affect the Supervised Project's ultimate prospects for authorization.

The NDRC Circular also outlines the consequences for failing to submit a Report as required. The consequences include, without limitation, prohibiting domestic financial institutions from financing the Supervised Project and imposing economic penalties on the project's Chinese party or liabilities on responsible persons if any material losses were caused thereby.[71] Therefore, we understand that the NDRC Circular strengthens the regulation of the rapidly proliferating forms of overseas acquisition and bidding.

B) New Rules on Outbound Investments Issued by MOFCOM

MOFCOM issued the MOFCOM Outbound Investment Measures, which became effective as of May 1, 2009. Under the MOFCOM Outbound Investment Measures, outbound investment is defined as any one of the following activities carried out by duly established Chinese enterprises:[72]

a) setting up a new offshore non-financial company;

b) acquiring an existing offshore non-financial company; or

c) gaining rights to own, control or manage an existing offshore non-financial company.

[68] Article 4, Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects.
[69] Article 3, Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects.
[70] Article 7, Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects.
[71] Article 11-12, Circular on Issues Relevant to Improving the Administration of Outbound Investment Projects.
[72] Article 2, Administrative Measures on Overseas Investment.

The MOFCOM Outbound Investment Measures simplify approval procedures and decentralize certain types of approval authority. Henceforth, central level MOFCOM will only review the following applications for outbound investments:[73]

a) outbound investments in countries with no diplomatic relation with China;

b) outbound investments in specific countries or regions which will be listed subsequently;

c) outbound investments at or above US$100 million;

d) outbound investments involving more than one country or region; or

e) overseas enterprises established as special purpose vehicles, which refer to overseas enterprises directly or indirectly controlled by domestic enterprises for the purpose of overseas listing.

Where the proposed outbound investment project is more than US$10 million but less than US$100 million, Chinese enterprises have to apply for approval at the provincial level MOFCOM. This also applies to projects in energy and mineral resources and projects to be promoted to solicit prospective PRC investors.[74]

A spokesman for MOFCOM estimated that more than 85 percent of applications for outbound investment will be examined by the provincial level MOFCOM.

For the above types of the outbound investments, Chinese enterprises shall apply for examination and approval by written applications to MOFCOM or its provincial authorities. After MOFCOM or its provincial authorities accept the application of Chinese investors, they will decide on the grant of the approval within 15 working days and issue the Enterprise Outbound Investment Certificate ("**Certificate**").[75]

For projects that do not require written examination and approval of MOFCOM or its provincial offices (i.e., projects less than US$10 million), only an application form is required to be submitted to MOFCOM or its provincial offices via an electronic administrative system on the internet ("**System**"). The central state-owned enterprises shall submit applications to MOFCOM via the System, while the local enterprises shall submit applications to the provincial level MOFCOM via the System. If the application forms have been duly

[73] Article 6, Administrative Measures on Overseas Investment.
[74] Article 7, Administrative Measures on Overseas Investment.
[75] Article 13-15, Administrative Measures on Overseas Investment.

completed in accordance with the legal format, MOFCOM or its provincial office will examine the application within 3 working days and issue the Certificate.[76]

It is worth noting that the Measures are not directed to individuals but only to companies established in accordance with Chinese laws. Furthermore, SAFE regulations also do not address external investments by Chinese individuals. Therefore, movement of money for outbound investments by PRC individuals is highly restricted in any event (i.e., purchase of properties by Chinese individuals in overseas market). Nevertheless, individual Chinese investors may directly in certain scenarios or indirectly invest in overseas-listed shares and mutual funds, structured products provided by overseas financial institutions, and small quantities of swaps, futures and derivatives, by way of purchasing products offered and managed by Qualified Domestic Institution Investors ("**QDII**") in China. Chinese QDII covers: qualified commercial banks, securities institutions and insurance companies.

C) *Further Simplifying Foreign Exchange Examination for Outbound Investment and Approval Process for Outbound Lending by SAFE*

The continuing trend toward liberalization of the legal environment for outbound investment by Chinese enterprises has been confirmed and advanced by SAFE in its SAFE Outbound Investment Regulations, which became effective as of August 1 2009, and brought the following major changes:

a) Sources of foreign exchange funds that may be used for outbound investment have been significantly expanded. Pursuant to the SAFE Outbound Investment Regulations, a Chinese enterprise may use the following to make outbound investments: (i) its self-owned foreign exchange funds; (ii) onshore foreign exchange loans; (iii) foreign exchange funds converted from RMB; (iv) in-kind assets; (v) intangible assets; and (vi) such other foreign exchange assets as SAFE may approve. Profits of the Chinese enterprises generated from outbound investment can be deposited offshore for the purpose of making further outbound investment.[77]

b) SAFE will no longer examine and approve sources of foreign exchange funds prior to the approval of NDRC and MOFCOM. The Chinese enterprise will be required to register with SAFE and explain its sources of foreign exchange only after it has obtained the outbound approval from NDRC and/or MOFCOM.[78]

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[76] Article 8 and Article 16, Administrative Measures on Overseas Investment.
[77] Article 4, Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions.
[78] Article 7, Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions.

c) The Chinese enterprises that make the outbound investment are allowed to grant loans to, as well as to provide guarantee/collateral for, their directly invested offshore subsidiaries.[79]

d) SAFE approval is no longer required in order to remit foreign exchange out of China for outbound investment purposes. The Chinese enterprise can remit funds out of China after an approval has been secured from NDRC and/or MOFCOM and a registration with SAFE is completed.[80]

e) Subject to SAFE approval, certain foreign exchange payments (deposits, legal fees, etc) which need to be made in connection with the outbound investment prior to the establishment of the offshore project or subsidiary can be remitted out of China even before NDRC and/or MOFCOM issues approval, provided that (i) such amount of payments generally should not exceed 15 percent of the total amount of outbound investment, and (ii) in the event the Chinese enterprise fails to complete the approval process for the outbound investment project within 6 months after the remittance of such payments, it must transfer the residual amount in the offshore account back to its foreign exchange amount onshore.[81]

In addition, in an effort to help Chinese enterprises invest abroad, SAFE has issued the Outbound Lending Circular, which enables Chinese enterprises ("**Lender**") other than financial institutions to provide loans to their wholly owned foreign subsidiary, overseas branch or foreign company in which they hold financial interests ("**Borrower**").[82] A key change in the Outbound Lending Circular is that it allows Chinese enterprises either to use their own foreign currency deposits or to convert RMB funds to foreign currency for foreign loans.[83] Outbound loans must still, however, be within limits (quota) approved by SAFE or, in most cases, provincial SAFE branches. This quota will be valid for a term of two (2) years and may be extended upon application within one month before its expiration.[84] The total amount loaned is generally limited to the lower

[79] Article 11, Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions.
[80] Article 7, Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions.
[81] Article 14 and Article 16, Administrative Regulations on Foreign Exchange Used in Outbound Direct Investment by Domestic Institutions.
[82] Article 1, Circular on Several Issues Concerning the Administration of Foreign Exchange in Outbound Lending by Domestic Enterprises.
[83] Article 6, Circular on Several Issues Concerning the Administration of Foreign Exchange in Outbound Lending by Domestic Enterprises.
[84] Article 4, Circular on Several Issues Concerning the Administration of Foreign Exchange in Outbound Lending by Domestic Enterprises.

of: (i) 30 percent of the Lender's ownership equity interest in the Borrower or (ii) the Lender's duly registered outbound investment quota.[85]

III. Conclusion

Renovation of China's regulatory framework to enhance and simplify China's Going Global initiative has given great impetus to Chinese enterprises desiring investment overseas. As government controls on outbound investment have been steadily relaxed, China's outbound investment has become more and more driven by Chinese enterprises' own commercial motivations, rather than the government's political agenda. However, most Chinese enterprises seeking to invest and operate abroad are facing a common problem that cannot be addressed by legislation or implementing regulations: going global is much more difficult than they have expected.

Outbound investments by Chinese enterprises are hindered by a number of non-legal factors, such as politics, market stability, investment target (natural resource, brand and/or core technologies) as well as experience in establishing, operating and managing projects in a foreign environment. Just as American and European companies operating in China have learned that local advisors and local business partners are essential to setting up and successfully operating in China, Chinese companies would do well to learn that seeking guidance from local advisors (bankers, lawyers, business consultants and accountants) can reduce risks and gain ground gradually when going global.

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The authors wish to acknowledge and thank Sylvia Li, an associate at Yao Liang Law Offices, for her contributions to this article.

[85] Article 5, Circular on Several Issues Concerning the Administration of Foreign Exchange in Outbound Lending by Domestic Enterprises.

FOREIGN-INVESTED PARTNERSHIPS IN CHINA: AN OVERVIEW OF THE CURRENT LAW

By R. Alex Clar

In August 2009, China's State Council adopted *The Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals* (**"Measures"**). Having become effective as of March 1, 2010, this is the first national law explicitly allowing foreign companies and individuals to set up or participate in a business structure known as a partnership. Prior to the adoption of the Measures, foreign investors in China were mostly limited to equity joint ventures, cooperative joint ventures and wholly foreign owned enterprises.

Under the Measures and the law it supplements, *The Partnership Enterprise Law* (adopted 2006; effective June 1, 2007), the foreign-invested partnership will enjoy many of the basic characteristics and advantages of the partnership concept as is commonly known in the United States and other foreign jurisdictions.[86] Some of the characteristics of Chinese partnerships include the following: profits and losses divided amongst the business owners, liability for the business will be limited only to the partners, liability amount may be limited to the respective investment amount of each partner, and the partnership will not be directly taxed but rather the tax burden will be passed unto the partners.

The 1997 and 2006 Partnership Enterprise Laws:

The option of partnership as a business organization was available to domestic investors since the original promulgation of *The Partnership Enterprise Law* in 1997 (**"1997 Law"**). However, some of the characteristics of partnerships under the 1997 Partnership Law were fairly unattractive. For example, only natural persons could be partners, partnership liability was unlimited, and the partnership was taxed as an enterprise as opposed to the partners. Lastly, there was also no mention in the 1997 Law about whether or not foreign companies or individuals could set-up or be involved with partnerships. As a result, no foreign invested entities ("FIE") were structured as partnerships.

The general lack of an attractive partnership structure in China changed with the much anticipated passage of the *Partnership Enterprise Law of the People's Republic of China* in 2006 (**"Partnership Law"**), which came into effect on June 1, 2007. In general, the Partnership Law corrected the drawbacks of its predecessor and set forth, for

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[86] As a basic concept, the Uniform Partnership Act, which has been adopted by a majority of jurisdictions in the United States, defines a "partnership" as "an association of two or more persons to carry on as co-owners a business for profit…" UPA, Section 101(6) (1997).

the most part, a clear list of characteristics of a partnership, its structure and the setup process.

One of the key improvements of the Partnership Law included the establishment of "pass through" taxation for partnerships - taxation on the partners, not on the entity itself (Article 6 of the Partnership Law). For many business owners, this is often a key advantage of entering into a partnership as opposed to other forms of business structures.

Another improvement under the Partnership Law is a clearly defined limitation of liabilities for specific types of partners, depending on the type of partnership structure. The Partnership Law introduces 3 types of partnerships: 1) common partnership enterprise; 2) limited liability partnership enterprise; and 3) special common partnership enterprise. In a common partnership enterprise, all partners are "common partners" and they each hold unlimited and joint liability. In the limited liability partnership enterprise, there must be at least one common partner (holding unlimited and joint liability), with the remainder of partners classified as "limited partners". Liability for limited partners is limited to the extent of each partner's respective capital contribution (Article 2).[87]

While the other two types of partnerships have no limitation on the type of businesses that can choose such structures, the third type of partnership known as a "special common partnership enterprise" is only applicable to businesses that are "a professional service institution, which provides its clients with paid services on the basis of professional knowledge and special skills" (Article 55). The key difference for this type of partnership as compared to common and limited liability partnerships is the treatment of liability. Partners in a special common partnership hold unlimited liability or unlimited and joint liability for one's intentional or wrongful acts. The other partners will only be held liable to the extent of their investment. In regards to debt, all partners bear unlimited and joint liability for debt due to intentional or wrongful acts (Article 57).

Another improvement of the Partnership Law is the introduction of bankruptcy provisions. It should be noted that this was an area that the 1997 law did not address. In comparison, the Partnership Law devotes an entire section, Chapter 4, to the area of bankruptcy and dissolution of the partnership.

On top of the above improvements over its predecessor, the Partnership Law is relatively flexible in terms of set up and structuring by its investors. It leaves to agreement amongst the partners issues such as amounts of contribution and payment schedule for payment of contribution, distribution of profits and losses, and certain aspects of new partner admission and partners leaving the business (Article 18). Articles 16 and 64 of the Partnership Law allow partners to make their capital contribution by currency, intellectual property rights, land use rights, other properties and even by labor (common partners only).

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[87] The Partnership Law refers to partnerships and partnership businesses by the use of the term, "partnership enterprise" in the English translations and in Chinese: 合伙企业. For the purpose of this article, the term "partnership" is used interchangeably with "partnership enterprise".

From the perspective of foreign companies and individuals, the Partnership Law is significant in that Article 108 leaves open the door for foreign participation. Article 108 states: "The measures for the administration on the establishment of partnership enterprises by foreign enterprises or individuals shall be formulated by the State Council." As a result of this specific article, it was anticipated that the Chinese government would eventually issue additional guidance specifically allowing foreigners to be involved with partnerships in China. This guidance came last year with adoption of the Measures.

The New Law on Foreign Partnerships

The Measures allow for both foreign companies and individuals to act as partners and to participate in partnerships in China. Under the Measures, foreigners may participate in three different ways: 1) foreigners partnering with foreigners; 2) foreigners partnering with Chinese partners; and 3) foreigners entering into a pre-existing domestic partnership.

It should be noted that the Measures, as is typical with many Chinese laws and regulations, is fairly short and general, with only 16 brief sections or articles. As a result, it defers much of the details concerning foreign-invested partnerships to already existing laws, in particular, the Partnership Law. For example, Articles 1 and 3 make reference to the Measures being formulated in accordance with the Partnership Law, and that one should refer to the Partnership Law along with any other "relevant laws, administrative regulations and rules and regulations, as well as the relevant industrial policies on foreign investments" (Article 3). Furthermore, on details on the registration process for setting up a partnership, Article 10 refers to the *Administrative Measures of the People's Republic of China for the Registration of Partnership Enterprises* (*Revised 2007*) and "other relevant provisions of the state." Lastly, in regards to tax, Article 11 leaves it to the relevant tax laws.

Regardless of its brevity, there are some key points to note in the Measures. One is the initial registration process of the partnership. Unlike setup of other foreign invested structures such as the JV and WFOE, which require pre-approval by the Ministry of Commerce (MOFCOM) or its local branches, foreigners can directly register and apply for a business license for their proposed partnership with the local branch of the State Administration of Industry and Commerce (SAIC). MOFCOM will still review the registrations filed with the SAIC, but the investors need only deal with the SAIC (*see Article 5*).

Another feature of the Measures is that it allows foreign partners to be flexible in the type and amount of capital contributions to the partnership. The Measures only mention that foreign investors who wish to make cash contributions must do so by RMB or other "freely convertible currency" (Article 4). As the Measures defer to the Partnership Enterprise Law, the foreign partner is also allowed to contribute property, IP rights or labor (in the case of common partners). A clear advantage over other FIEs is the fact that neither the Measures nor the Partnership Law places any maximum limit on

making non-cash contributions. In comparison, FIE laws limit a maximum value of 70% of the total registered capital on non-cash contributions.

A final key point of partnerships to note under the Measures is the lack of a mandatory time limit to make the capital contributions to the partnership. Unlike the FIE laws, neither the Measures nor the Partnership Enterprise Law sets forth any time limits to complete one's capital contributions. It is left up to the partners to agree on a schedule and to draft such details in their partnership agreement.

Assessment

The introduction of the partnership option for foreigners in China is a welcome addition to the FIE vehicles currently available. Furthermore, the Measures in tandem with the Partnership Enterprise Law initially appear to provide an attractive alternative structure for foreigners. As previously mentioned, some of its positive features are the pass-through taxation, some limits on partner liability, easier registration of the entity, the ability to make non-cash contributions, the lack of time limits to make contributions, and the ability to structure the partnership as per internal agreement. However, how this will work in practice remains to be seen as foreigners begin to set up partnerships after March of this year. As is often the usual practice, the authorities will inevitably issue subsequent clarifications and additional laws to flesh out the missing details.

As a last point, it should be noted as a caveat to foreigners that the Measures are intentionally vague on treatment of foreign partnerships in certain specific areas which the authorities may view as sensitive or untested in terms of foreign participation. In areas such as tax, accounting, foreign exchange and customs, the Measures refer to "the relevant laws, administrative regulations and relevant provisions of the state" (Article 11). For partnerships set up solely for "investment" in China such as acquisition of interest in domestic companies, the Measures have a specific section, Article 14, which also advises foreigners to check "provisions of the state" and notes that the Measures cannot run contrary to such laws. In the end, it remains to be seen how the authorities will treat foreign-invested partnerships in all of these above-mentioned areas.

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ITEMS OF INTEREST

Selected Recent English Language Books on Chinese Law

Anti-Dumping Law and Practice of China, by Xiaochen Wu, Kluwer Law International 2009 430 p. ISBN: 9789041127907

http://www.kluwerlaw.com/Catalogue/titleinfo.htm?ProdID=9041127909&name=Anti-dumping-Law-and-Practice-of-China

From the publisher: "For over a decade China has been globally recognized as the leading recipient of antidumping measures. On the other hand, China's use of antidumping measures is equally noteworthy. *Xiaochen Wu's* timely book takes a very practical approach as it examines its subject in a broad context. Besides providing a rich and detailed interpretation of the legal provisions, it discusses complex technical aspects of the Chinese antidumping law in a very pragmatic way, notably by providing actual instances of their application in the antidumping investigations conducted by the Chinese Ministry of Commerce (MOFCOM)."

China's Legal Soul: The Modern Chinese Legal Identity in Historical Context, by John Head, Carolina Academic Press 2009 234 p. ISBN: 9781594606366

http://www.cap-press.com/isbn/9781594606366

From the publisher: "Professor Head's new book (following his earlier work, Law Codes in Dynastic China) examines…China's "legal soul" by which he means the set of fundamental and animating legal principles or values that give a society its unique spirit and character. His lively and insightful comparison of contemporary Chinese law with dynastic Chinese law readily accessible by (and written for) non-specialists addresses these central questions: (1) what sort of a "rule of law" does today's Chinese legal system hope to achieve against its ages-old Legalist-Confucianist background; and (2) is there any modern correlative to the Imperial Confucianism that gave dynastic China its "legal soul" or is today's China soul-less, as some would claim? In addressing these questions, Head insists on looking beyond easy assumptions and assertions found in much Western legal literature about China and its law; instead, he relies heavily on leading contemporary legal scholars at Chinese universities and their views on politics, constitutionalism, and rule of law in China."

Chinese Investment Treaties: Policies and Practice, by Norah Gallagher & Wenhua Shan, Oxford University Press, 2009 330 p., ISBN: 9780199230259

http://www.oup.com/us/catalog/general/subject/Law/InvestmentandFinanceLaw/?view=usa&ci=9780199230259

From the publisher: "This book will provide a detailed review and analysis of China's approach to foreign investment. It will consider the current role of investment treaties in China's foreign economic policy, analyze and interpret the key provisions of the BITs, and discuss the future agenda of China's investment program. It will look at how this investment regime interconnects with the domestic system and consider the implications for a foreign investor in China."

Criminal Justice in China: A History, by Klaus Mühlhahn, Harvard University Press, 2009 376 p., ISBN: 9780674033238

http://www.hup.harvard.edu/catalog/MUHCRI.html

From the publisher: "In a groundbreaking work, Klaus Mühlhahn offers a comprehensive examination of the criminal justice system in modern China, an institution deeply rooted in politics, society, and culture… Mühlhahn reveals the broad contours of criminal justice from late imperial China to the Deng reform era and details the underlying values, successes and failures, and ultimate human costs of the system. Based on unprecedented research in Chinese archives and incorporating prisoner testimonies, witness reports, and interviews, this book is essential reading for understanding modern China."

Selected English Language Legal Articles

Andrew Godwin, *The Professional 'Tug of War': The Regulation of Foreign Lawyers in China, Business Scope Issues and Some Suggestions for Reform*, 33 MELBOURNE UNIVERSITY LAW REVIEW 132 (2009). From the author: "This article looks at the regulatory framework governing foreign law firms in China and the unique challenges that this poses for foreign lawyers, Chinese lawyers and the Chinese regulators. The challenges are unique because of the significant gap between, on the one hand, the strict letter of the law in terms of what foreign law firms are permitted to do and, on the other hand, the liberal interpretation and enforcement of the law in practice by the relevant regulatory authority -- the Ministry of Justice. The article concludes by considering various models for reform to the regulatory framework and providing suggestions as to the appropriate choices."

Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASHINGTON UNIVERSITY GLOBAL STUDIES LAW REVIEW 241 (2009). From the author: "One solution to the problem of under-enforcement caused by limited information and resources on the part of government agencies is to enlist the aid of non-governmental parties, who have different sources of information, and to give them incentives to monitor and engage in enforcement actions. The goal in these circumstances is not to protect private rights or citizens' rights as such; without the public-policy purpose, one might not even want to give them rights at all. But in order to achieve the public-policy goal of effective monitoring and enforcement, the state enacts a structure of incentives (which may or may not include legal rights to sue in court) designed to mobilize citizens and other entities (companies, non-profit organizations, etc.) to engage in activities that will result in greater enforcement of the legal obligations of certain regulated parties, with the

desired result of increased social welfare. The shorthand term for such an institution (at least where it includes the right to sue in court) is the "private attorney-general" ("PAG").

The PACIFIC MCGEORGE GLOBAL BUSINESS & DEVELOPMENT LAW JOURNAL has published a symposium issue on *Experiential Education in China: Curricular Reform, The Role of the Lawyer and the Rule of Law* in volume 22, 2009. Articles include:

- Introduction, Brian K. Landsberg, p. 1
- Experiential Learning: A Critical Element of Legal Education in China (and Elsewhere), David F. Chavkin, p. 3
- Methods of Experiential Education: Context, Transferability and Resources, Julie A. Davies, p. 21
- Practice in Legal Education: International Experience and Chinese Response, Qingjiang Kong, p. 35
- Strategies to Increase the Availability of Skills Education in China, Brian K. Landsberg, p. 45
- Experiential Education and the Rule of Law: Teaching Values Through Clinical Education in China, Elliott S. Milstein, p. 55
- On Practical Teaching Modes: Experience from the China University of Political Science and Law, Shuzhong Li, p. 63
- The Reform Strategy of Legal Education in China, Shiwen Zhou, p. 69
- An Institutional Inquiry into Legal Skills Education in China, Su Li Zhu, p. 75

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Volume 6, Issue 1
March 2010

China Law Reporter
中国法律报道

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Mark Your Calendars!

ABA International will host its 2010 Spring Meeting in New York from April 13-17. The Spring Meeting will feature a variety of programs dealing with China law-related topics and will include one of the major face-to-face business meetings for the China Committee for the year. We encourage you to visit http://www.abanet.org/intlaw/spring2010 for more information about the Spring Meeting.