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Chapter 1

Legal Developments in China: Law and Society Developing Together

The law must serve the society. Not the other way around.

This principle is understood rather well in China, and effort has been put into making the rule of law a constructive one, rather than a traditional one. While much has been learned from examination and study of foreign legal systems, Chinese law-makers have also put much thought into structuring a rule of law by and for China. It is because the Chinese legal system is very much a system of law with Chinese characteristics that foreign businesses and their advisors must be careful not to jump to conclusions about how things are in China. The only way to really understand Chinese law is to understand Chinese society, or at least the Chinese business environment.

People who study Chinese society come to this study from very many standpoints. The basic assumptions vary greatly, and of course the choices of basic assumptions determine the conclusions reached. This book is based on experience gained from helping foreign investors set up business transactions, resolve disputes and pull out of China. On this basis, the book is very much directed to the foreigner. Chinese people study their own laws for somewhat different purposes, and of course reach somewhat different conclusions. Even though perhaps the conclusions or observations set out in this book might be of interest to Chinese nationals, they are written for the benefit of foreigners who wish to set up and properly manage businesses in China.

One can relay observations on the business environment in China without reaching conclusions such as whether foreign business is good or bad for China. However, it appears that the growing interaction between China and world, through healthy business relations, has been beneficial for all parties concerned.

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A Legal System Under Development

This interaction has taken place during a time of growth and development of China's legal system. It is almost never possible to comment accurately on the Chinese legal system because it is almost never possible to quite determine where that system has gotten to. High quality legislation is produced well ahead of its assimilation. Reading the legislation alone, one concludes that the legal system is soundly based. Looking at enforcement alone, one concludes that the legal system is poorly assimilated. Which conclusion is accurate; which conclusion should determine the answer to one's questions?

China's legal system as such is already rather well developed. Human rights in the occidental sense are another matter. China has redefined human rights as the right to eat and congratulates herself on meeting minimum requirements. Due process is not a right in China the way it is in the United States, nor is transparency of official action, or official accountability.

The Inconveniences of Operating in China

Chinese society is not one characterised by a multitude of time-saving devices. Everyday events take longer in China, from bus riding, to shopping, to paying taxes, to getting money into or out of the bank. Many ordinary activities involve interactions with people who expect little (or large) gifts. China is a place that is full of red tape. In such an environment, the legal system works rather better than many other social functions. From the perspective of an ordinary Chinese, it would be inaccurate to state that the legal system is much worse than all the other challenges of getting along in the world. The people who sometimes complain about the legal system in China are the Westerners, not the Chinese.

Overall, Westerners are treated rather better than the average Chinese in China. Westerners are given privileges. They are often forgiven their mistakes and ignorance, especially if the person is perceived to mean well. Westerners do not know how good they have it in China because they have no basis of comparison within China. The only basis of comparison used is comparison with 'home' and all its comforts.

Law with Chinese Characteristics

The Chinese legal system does have special characteristics. The most notable of these is the multitude of approvals which must be obtained to accomplish so many ordinary things, from paying for a purchase in a department store (usually one must go to at least two counters to do this) to transferring cash out of the country (which can involve several days worth of meetings and red tape).

Certainly the approval system slows things down. Approvals are likely to stay, if for no other reason than that too many people benefit from them. Many people are employed in the business of either getting or giving approvals. Government officials view approvals as a useful means to collect information about what is going on. Government officials also feel they are in control when they have to approve everything that is done. Granting approvals confirms the power and authority of the government on a daily basis. It is the basis for the dictatorship of the 'people' (who, of course, are only those 'people' who make decisions within the government).

Onto this system of approval granting has been placed a developing network of laws, regulations and official policies, some of which are strongly influenced by legal developments in the West.

Since the approval processes are unlikely to disappear any time soon, the logical approach to this aspect of the system is to make it work for you. A manager should get to know the authorities and remain on good terms with them. It is usually possible to vigorously negotiate for what you want and still keep the respect of government officials.

Foreign businessmen can offer to share the successes of their China business by reporting important transactions, important hires, or important new technological developments with the authorities they deal most closely with. Letting those officials get credit for reporting such successes to their senior authorities is an easy way to make the local government happy. Making an impression on the people who have the power to permit or deny the growth of your company is always good business.

One could say that the Chinese legal system is neither good nor bad, per se. It is a system that makes sense within the context of its own terms. When you 'know the system' you can make or let it work to your advantage. When you do not know what to expect from the Chinese system, it will seem full of inexplicable surprises. It might be expected that academics make judgments about the legal system in China, but business people profit little from judging the system. For business, it is more important to work with the system, whatever it is, and learn to make system work for business.

A Practical Understanding of the Legal Environment in China

This book is designed to convey, in detail, a sense of what the legal system in China demands of people and of how people negotiate within the system without breaking rules. The book is intended to protect foreign businesses in China by pointing out where they might take a wrong step without realising it. By knowing this in advance, wrong steps can be avoided. By pointing out where trouble lies, the intention is to help foreign investors avoid that trouble, to structure around the trouble, or sometimes to report the trouble in advance and get a waiver for it. None of these useful results would be likely from a description of what is right with China.

Academics can debate the perfections and lack of perfections to be found in one legal system or another. Since human beings are essentially changing creatures, and modern society is constantly developing, it would be artificial to have a legal system which failed to adapt to the changes of the people who need to use it. People who use the law on a daily basis should know that the issue is not whether a law is perfect or otherwise, but rather, whether the law or legal procedure works. The legal system in China works, overall, at least for people who make efforts to abide by it.

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What is Special About Chinese Society?

If we agree that law must work for society, what is it about Chinese society which dictates the nature of its laws and legal system? Nobody seems to be able to pidgeon-hole Chinese society convincingly, much less the Chinese legal system. Publications such as *Asiaweek* and the *Far Eastern Economic Review* regularly try to define what Asia and Asian countries are all about. More questions than answers have arisen from the effort.

The amusing part of this game of Asian self-identity is that it is not necessary to play the game in order to invest in Asia. There is another sort of society in the world, the society of international business. There are certain expectations held by international businessmen that are broadly carried about from country to country. These expectations are the most useful basis for foreign businesses to proceed into China.

However, the international expectations are the starting point, not the ending point, for business in China. Even though 'international expectations' are not really something that can easily be listed in one place, and even though the details of such a list would be debated, exceptions drawn, and differences of opinion accounted for, foreign businessmen seem to have a sense of what the international market means and how it works. It may be hard to define, but people think they know it when they see it.

In writing this book the author assumes that the readers know the international scene. From such a base of knowledge and experience, certain 'mistakes' can be

predicted in the course of business activities in China. The book sets out some of the more common misunderstandings about the Chinese legal system and suggests ways to resolve the dilemmas thereby created.

Even though one may wish to gain an overall understanding of China, the best way to do this is through attention to details. Cao Guofan, a Chinese wise man, once said, 'Those who have achieved success since ancient times began their tasks through diligent work on the smaller issues, for they knew that the building of a tall edifice has to begin with its foundation, and a piece of silk of a thousand metres has to be made by accumulating the weaving of every thread.'[1] This book is only about Chinese laws and how they work in Chinese society. Extending the discussion further to the nature of Chinese society would be like describing that piece of silk before the threads are woven.

Each chapter in this book contains a discussion of how the subject matter of the chapter relates to international business and investment in China. By focusing on concrete examples, written rules and actual experiences of businesses in China a more practical approach is possible. The chapters avoid theoretical musings on the nature of Chinese people and their society. For that reason, a few comments on Chinese society as a background for its law are suggested here in the introduction.

The legal system in China has been fitted over an ancient culture where many laws existed but were not very humanely put into practice. Even today, China sometimes has difficulty enforcing laws in the spirit of benevolence, though the modern day effort is to do just this. A large proportion of current law in China derives from some other country. While it has been given 'Chinese characteristics', the law in China is essentially based on foreign legal learning. It is not a native phenomenon. This does not mean it is not going to work. Chinese people love foreign things, and have for centuries, even while they occasionally worry about the integrity of their own culture. But just as it is easy for foreign businessmen to misunderstand how a Chinese law or regulations will be put into practice in China, the Chinese themselves sometimes interpret laws and regulations differently from the way similar laws and regulations are interpreted in other countries. By anticipating some of these cultural differences, one can save oneself from making a lot of mistakes.

Comparisons with the Legal System in Hong Kong

I want to avoid the anthropologist's habit of examining another strange or unfamiliar culture from the standpoint of one's own familiar values. This approach tends to result in either criticism or utopian conclusions, depending on the mood of the examiner. In order to avoid these unhelpful inquiries, it may be of use to briefly review some points which arise in a Chinese society which seems more familiar.

Having lived in Hong Kong for the last ten years, I would like to temporarily open the inquiry of law and society to include Hong Kong's legal system. Hong Kong has now become a part of China, after all. More to the point, from Hong Kong's process of adjustment to its new Chinese ruler we can learn something about the integration of the cosmopolitan and the communist.

1 From Zeng Wen Zheng Gong Quanji, quoted at p 68 of *Chinese Maxims, Golden Sayings of Chinese Thinkers Over Five Thousand Years* (Huayu Jiaoxue Publishing House, Beijing, 1994).

Hong Kong on 30 June 1997 was removed from its benevolent colonial government under the British and inserted into the Chinese 'command' style of governance. It looked somewhat as though China was taking on Hong Kong as a colony. The same atmosphere of rulers considering the 'colony' as 'different from us' not only prevailed, but intensified. The 'one country — two systems' style of governance clearly proclaims that Hong Kong is to be run differently from the rest of China. Clear details of the differences were never provided. Broad stroke differences have been promised, however.

Hong Kong's legal system is to be kept autonomous from the Chinese legal system, except in the areas of national defence, national pride and in terms of human rights. Differences in the two systems' approach to human rights have not yet been fully worked out and some are highlighted in other chapters in this book, especially the chapter on criminal liability.

The key to understanding the situation lies in noticing the direction of change. Hong Kong is a common law system that is probably headed toward long term convergence with China's legal system. How could such acute differences survive for long in one country? China is a civil law system that is headed toward long term legal assimilation of 'international practice'. Hong Kong is known as a cosmopolitan international city. It is a city where 'international practice' may be found. Reluctantly, perhaps, China's legal practice will in the long term converge with many of the practices to be found in Hong Kong law and society.

These observations are not new. Let us examine a few parts of the process of this likely convergence more closely.

Roda Mushkat summarises the Hong Kong situation this way:[2]

> The post-1997 Hong Kong predicament may be said to constitute what has been termed in jurisprudential discourse a 'hard case'. The novel formula of 'one country — two systems' cannot be placed within a clear set of unambiguous rules or established conventions of international law, nor can authoritative guidance be derived from international practice and precedent. The search for 'theoretical reinforcement' to Hong Kong's case for autonomy is therefore open and may encompass not only specific theories of political autonomy but also so-called theories of hard cases, as well as general theories of international law and relations.

Mushkat finds that the 'Hong Kong case' strains the notion that international law and State sovereignty are complimentary to each other.[3] This is because international law is viewed as a restraint on the exercise of sovereign rights, in the interest of preserving smooth function for the international society and the states based therein. The Chinese government has not willingly accepted the concept of outside restraints on authority. It is worth considering whether the image of tolerance reflected in the 'one country — two systems' slogan might double as a model for the international scene in years to come.

If the China-Hong Kong political model is what we are looking at, it would be quickly rejected as a proposed world model. No one envisions a future international society ruled by a dictatorship of the Chinese governing people. However, when the model is viewed as a method for co-existence of legal systems, the details start to look more interesting.

2 At p 307, 'Hong Kong's Quest for Autonomy: A Theoretical Reinforcement' in Wacks, Raymond *Hong Kong, China and 1997, Essays in Legal Theory* (Hong Kong University Press, Hong Kong, 1993).

3 Ibid, p 324.

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Chapter 4

Liability Arising from Technology Transfer into China

How can technology create liability? In China, the transfer of technology into China that generates an unusual scope and degree of liability, because of statutory warranties which apply to the transfer whether or not the parties to the transfer know it. There are also other possible means of encountering liability from technology transfers. Knowing the sources of liability enables one to devise strategies to avoid unnecessary liability. This chapter reviews technology transfer liabilities over and above the simple risk of conducting business in China.

What is Technology Transfer?

Technology transfers occur more often than many people realise. Many kinds of modern equipment contain built-in software which, though not sold separately from the hardware, constitutes technology which is assigned or transferred with a sale of the equipment. Some transfers of technology are labelled as such in technology contracts, but not all are identified this way. A transfer of technology which is not made by contract, or if made by contract is not approved by the Technology Division of the local Commission of Foreign Trade and Economic Cooperation, does not necessarily escape the regulations pertaining to technology transfer into China. Transactions which appear to be simple sales of concrete objects such as machines or equipment might also be transfers of technology.

Technology is a form of intellectual property. Like all intellectual property, it is difficult to protect. There is likely to be room for misunderstanding as to which elements of the technology constitute proprietary property and which elements are either public knowledge or are otherwise freely available for use by anyone. Of course it is difficult to put these distinctions into words suitable for a business transaction, even though a well-drafted contract transferring technology would constitute an attempt to do this. The result almost always has to be a lot of all-encompassing clauses broadly drafted so that parts of the technology and other intellectual property do not accidentally fall outside the scope of protection of the contract.

Some aspects of technology receive statutory protections of a sort in China. There are laws governing the use and protection of patents, trade marks, copyright and business secrets. But these categories do not comprise all there is to technology, and therefore other means are needed to obtain protection from accidental, incidental or intentional piracy. The Law of the People's Republic of China Against Unfair Competition[1] constitutes a fair trade law of sorts. Even this law fails to fill all the

1 Adopted by the Standing Committee of the National People's Congress on 2 September 1993 and effective as of 1 December 1993.

gaps between the other intellectual property laws. Such gaps should be filled by contract. For this and various other reasons discussed below, the techniques of drafting of technology transfer contracts are of great importance.

Chinese Technology Legislation

The principle is that proprietors are responsible to society, to customers and to their own staff and workers for the safety, efficacy and profitability of technology. Thus the technology transfer laws and also the environmental laws, safety laws, product liability laws, labour laws, consumer protection laws and the like all create liability which applies to technology.

However, the following technology transfer laws create liability through warranties:

(1) The Law of the People's Republic of China on Technology Contracts (1 November 1987, applicable to contracts among Chinese individuals and/or legal persons only and not to contracts to which a foreigner is a party);
(2) The Regulations on the Administration of Technology Import Contracts of the People's Republic of China (24 May 1985) (the Technology Regulations);
(3) The Detailed Rules for the Implementation of the Regulations on the Administration of Technology Import Contracts of the People's Republic of China (20 January 1988) (the Technology Rules); and
(4) some local regulations.

Warranties

The above legislation imposes many statutory warranties. The effect of such provisions may be expanded or reduced in the technology contract.

Note that a technology transfer contract itself may create warranties. A good contract drafter working on behalf of the technology transferor will make such self-created warranties limited in number and effect.

The transferor of technology must be prepared to show that technology to be transferred is advanced and appropriate to the circumstances of the recipient.[2] These two requirements are statutory warranties. But, how advanced must the technology be? No answer to this question is given in the legislation so within reason the matter may be determined by contract. Therefore a technology transfer contract should state in which respects the technology is advanced and state any special requirements respecting the recipient's proposed use of the technology in order to show how the technology is useful to the circumstances of the recipient. Sometimes it may be necessary to state that certain information concerning the recipient's use of the technology has not been made available for the supplier, so that the supplier has been forced to make certain stipulated assumptions concerning the circumstances in which the technology may be used.

A technology transfer contract is required to specify the technical targets which can be reached with the use of the technology, the time limits within which such targets can be reached, and the procedures needed for achieving those targets. These statements amount to warranties and if not met, the licensor or transferor of the technology may be liable for losses such as payment of the

2 Art 3, Technology Regulations.

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transferee's lost profits.[3] The best way to handle these statutory requirements is to set out the assumptions upon which the required target projections are based, making it clear that if the assumptions are not met, the targets cannot be met either. This tends to exonerate the technology supplier in case the targets are not met.

In addition a supplier of technology is required to warrant that the technology is complete, correct, effective and capable of accomplishing the technical targets specified in the contract.[4] These warranties should also be qualified by specific operating assumptions expressly stated in the contract in a way that makes it clear that should the operating assumptions fail to be met, the technology performance cannot be assured. Such qualifications should be drafted so that they appear reasonable to the government officials who must review and approve the contract.

Although the Technology Regulations do not elaborate on the procedural means by which such warranties may be enforced, under the General Principles of the Civil Law of the People's Republic of China, breach of regulations is enforceable in the People's Courts of China. In other words, the statutory warranties are not meaningless contract fillers.

Restrictions on the Recipient, Restrictions on the Supplier

The most important restrictions contained in the Technology Regulations are set out in Article 9. Under this provision the supplier of technology may not impose unnecessarily restrictive requirements on the recipient of the technology. For example, the supplier may not require the recipient to purchase unnecessary technology along with the subject technology, or purchase technical services other than those needed or requested by the recipient. The supplier may not request the purchase of special raw materials not wanted by the recipient, and may not require the recipient to purchase special equipment which the recipient does not wish to purchase. The supplier may not pressure the recipient of the technology to purchase other kinds of products if the recipient does not want them.

From the Chinese recipient's point of view these provisions may seem reasonable but there certainly exist circumstances when the forbidden supplier-imposed restrictions are very necessary. For example in the case of equipment which cannot be used properly or safely unless the handlers are properly trained, it is logical to require that the recipient sign on for training and possibly for post-training services to install and commission the equipment and ensure its compatibility with other equipment being used by the recipient and the like. Similarly it may be quite logical for the supplier to limit the recipient's freedom to choose raw materials, if use of the wrong or of inferior quality raw materials might cause damage to equipment, make the technology malfunction, and jeopardise the various warranties which are required of the supplier, not to mention posing a danger to the safety of workers operating the related equipment or to consumers using the related products.

Under Article 9 the supplier is not permitted to restrict the recipient's choice of raw materials, parts and components or other equipment which the recipient may wish to obtain from other sources, and this obligation can make it difficult or impossible for the supplier to fulfill the statutory warranties previously discussed.

3 Art 5, Technology Regulations.
4 Art 6, Technology Regulations.

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Article 9 also prohibits restrictions on the development or improvement of the technology. In practice this may mean that the supplier is restricted from preventing the recipient from misusing the technology in the name of 'further development' or 'improvement'. Under this restriction, a supplier may not even be able to prevent the recipient from carrying out activities with the technology which make the technology incapable of meeting the conditions which the supplier must warrant. A supplier of technology is also not permitted to restrict the quantity, variety or sales price of products manufactured by the recipient with the transferred technology, or restrict sales channels or export markets for such products regardless of the quality of the recipient's production, packaging, marketing techniques and the like, and regardless of commitments made to other distributors in specified markets. Among the many disadvantages of this provision is the possibility that the supplier's reputation may be harmed if substandard or defective products labelled as made with the supplier's technology are put onto the market.

Under Article 9 a recipient of transferred technology must be free to acquire technology from competitors of the supplier or from other sources, even though this might result in leakage of trade secrets proprietary to the supplier. This probably also applies to parts and components as well. This requirement can, however, be adjusted a little to the actual circumstances of the transaction, thereby containing, though not eliminating, the risk generated by the requirement.

Any sort of 'non-reciprocal' terms of exchange in the technology transfer contract (especially with respect to improvements) are prohibited, though this provision is never used to restrict the recipient of transferred technology. This, ironically, may result in a supplier having to purchase unwanted 'improvements' back from a recipient as a condition of the recipient's access to improvements of the supplier. A supplier is generally not permitted to deny access to its own improvements, but sometimes these improvements may not work in China due to unsteady electricity supply, dusty factory environment, or other production conditions which the supplier may not be in a position to control.

A supplier may not forbid use by the recipient of the technology after expiration of the technology transfer contract. Thus to this extent, a supplier's intellectual property rights in the technology are statutorily waived under Chinese regulations.

The Statutory Warranties and Restrictions Do Not Really Protect the Customer

The restrictions and warranties embedded in the Chinese technology transfer legislation are designed to protect unsuspecting Chinese purchasers or licencees of foreign technology from the problems which so frequently derive from technology from which all the 'bugs' have yet to be worked out. The problem is not unique to China. In an article by Bernard Wysocki Jr entitled 'Pulling the Plug, Let Down by Computers, Some Firms "De-Engineer"' in the 4 May 1998 *Asian Wall Street Journal*, discussing American firms, the author stated:

> They often fall victim to a deadly combination: a fast-changing business landscape, an increasingly complex array of software, and technology boosters' can-do mentality, even when they can't. The waste is staggering. A 1996 survey of 360 companies by the research firm Standish Group International Inc in Dennis, Massachusetts, found that 42% of corporate information-technology projects were abandoned before

completion. US companies spend about $250 billion annually on computer technology. The bigger the projects are, the more frequently and expensively they tend to fail. 'People get seduced by the technological imperative: Because we can, we do,' says Robert Charette, a Springfield, Virginia consultant who advises large companies on ways to reduce computer-project risks.

China some time back took the conservative approach of legislating some degree of protection against this kind of business risk. For one thing, there is a feeling that many Chinese businesses, coddled as they have been by their government's subsidies and supportive policies, are less than fully prepared to deal with the over-confidence of the international salesman. Perhaps some xenophobic motives were present as well. Experience suggests that other factors have been predominant in causing problems with technology transfers: for example, less than complete disclosure of operation conditions. (Nervous businesses, especially state-owned enterprises, are often uncertain which information might be classifiable as state secret and which information, if disclosed would put the company at a competitive disadvantage.) When production or operations projections are based on unsound assumptions, the promised performance results would typically fail to materialise.

One could conclude that many of the problems are as much due to the inept handling of production by the Chinese licencee as the over-enthusiastic opinion of the technology as expressed by the licensor. But beyond the unproductive activity of laying blame, it is likely that in most cases greater 'due diligence' investigations on both sides prior to consummation of the transaction would have avoided subsequent disappointments. In other words, legislating to protect Chinese businesses against shoddy technology is not necessarily the best way to proceed.

The descriptions 'good' or 'shoddy' are most effectively made if based on certain criteria. So, for example, some 'old fashioned' technology may work better than the most 'modern' technology for certain applications. While consultants advising companies on the purchase of technology should know the relevant technology market, the creators of the technology do not necessarily know all the alternatives to their own technology. There is no reason, however, for the parties not to know the operating conditions of the recipient and the recommended operating parameters under which the technology will work best. It is probably true that increased disclosure increases the possibility that in unscrupulous hands, some form of industrial sabotage may occur. However, inadequate disclosure certainly increases the probability that the technology may malfunction due to ignorance of how to use it.

The Examination and Approval Process

A lot of change has occurred in the manner in which technology transfer projects are examined for approval. During the 1980's a rather suspicious and argumentative approach was typically taken by the Technology Division of the Commissions of Foreign Economic Relations and Trade, with concern directed not towards encouraging more investment into China, but rather towards protecting unsuspecting Chinese state-owned enterprises against paying for fake technology. Since fake technology typically could not be detected in advance, and people tended not to realise that nearly all cutting-edge technology comes with 'bugs' in it, requiring continual adjustments in order to make it work, so many technology transfer projects resulted in dissatisfaction on all sides. Economically satisfactory projects tended to be limited to relatively simple technology, identifiable as not the latest

technology. Recognising that such projects failed to suck in the latest and greatest technical wizardry, the Chinese officials complained that second-rate technology was being foisted off onto the Chinese. However, the technical support was often not available locally for the most sophisticated technology, and environmental factors often were inadequate. Too many technicians had to be brought to China from abroad at great cost, and language barriers hindered training efforts. The more sophisticated projects tended to be economic losers.

In the 1990's however, the combativeness of the official reception for foreign technology has relaxed somewhat, assisted by the increasingly obvious failures of Chinese state-owned companies to make it on their own. As the reception to foreign investment is presented with a less suspicious attitude, foreign investors have become cautious about investing technology in China with fears of economic unfeasibility, piracy of technology and intellectual property, and general disappointment at Asia's inability to follow the industrial progress of the western world (as evidenced by financial disasters in Indonesia, Thailand, Malaysia, the Koreas, Japan, and by the ongoing political disasters of Cambodia, Burma and Vietnam). Although China's actual attractiveness may have increased as a site for the investment of technology, public confidence in China has faded.

The 22 January 1990 Circular on the Publication of the Guidelines for Executing and Approving Technology Import Contracts gives a good feel for the underlying concerns which Chinese parties carry with them to the negotiating table. As these Guidelines are written primarily for the Commissions which approve the contracts, and also to assist Chinese parties receiving technology transfers from abroad, the scope of matters covered ranges from the elementary to the devious.

To analyse a simple example, in Article 7 the principle that contracts should not be breached is stated. This statement conveys a policy which is different from what is practised in parts of China (where a contract does not seem to mean anything) and is also different from common law juridical thinking which admits the possibility of 'economic breach'. The principle that when a contract is signed, it is to be followed, is evidently a principle which Chinese authorities had to be informed of in 1990, probably in response to complaints that Chinese parties were not abiding by contracts.

Before analysing the Guidelines in more detail, we note that they are difficult to assess, first because they are not promulgated legislation but only guidelines, and second because they contain a large number of 'requirements' which are not in practice required. For example, the importance of providing a term for the preservation of confidentiality is mentioned in Article 9. Many contracts which are drafted by foreign lawyers for use in China provide that business secrets and confidential technical information must be kept confidential forever or until such material comes into the public domain. However, technology transfer contracts are often understood by the Chinese authorities to be, in effect, instalment purchase contracts. Even though the technology is not paid for upfront, the annual royalties are viewed not as licence payments but as payments for a product which will belong to the Chinese party at the end of ten years. Thus it is naturally assumed that all of the confidential information conveyed in the course of the ten-year period of effectiveness of the technology transfer contract will become the property of the Chinese party after the contract is ended.

Foreign businesses usually have a different understanding. They expect to license technology to the Chinese party for ten years, at the end of which the licensor will still have full ownership and control of the technology.

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Chapter 8

Advertising in China

The purpose of this chapter is to identify the limitations and restrictions under Chinese laws and regulations which are imposed on the advertisements placed by foreign companies or sino-foreign joint ventures in China. Advertising is a marketing method used by many foreign investors in China, and therefore the need to understand the restrictions which the legislature places on the scope and content of advertising is important for most foreign businesses in China.

Liability Generated Through Advertising

The advertising market in China could be called 'advertising with Chinese characteristics'. The right to advertise in China includes a responsibility to ensure that the content of any advertisement is accurate and that any activities advertised are in full compliance with all relevant Chinese laws and regulations. A business can be held liable for a vast array of misdeeds through the Advertising Law of the People's Republic of China. This problem will be analysed in detail below.

This responsibility or liability is placed on the party placing the advertisement, the party designing and producing the advertisement, and the party running the advertisement campaign. In order to avoid liability, the party placing the advertisement must have an extensive knowledge of Chinese law. Furthermore, how can an advertising agency know whether advertisment content is accurate or whether advertised activities are in full compliance with the law? There are no special concessions for foreign advertisers. All of the relevant regulations must be followed.

In practice, advertising agencies and their clients must keep comprehensive 'due diligence' files, files which can be shown to Chinese officials who wish to inspect for compliance. These files should contain documentary proof that inquiries were made into key elements pertaining to the content of an advertisement, and showing what assurances were given in response to the inquiries. The process should resemble the verification notes obtained by Hong Kong lawyers prior to a listing. Master lists or pro-forma models of such material keep changing, so it is not useful here to try to detail what such inquiries should include and what documents should be requested to satisfy all of the obligations arising from the advertising regulations. Such lists would vary depending on the industry involved, the activities described in the advertisement, and other factors, including the availability of particular kinds of documents. What follows herein is intended to serve as a guideline to help parties figure out where to begin the task of satisfying their legal responsibilities.

Forbidden Content

The following content is completely forbidden and may not be included in any advertisement. Although the list seems understandable on its face, one must take care with respect to how the items on the list are interpreted.

(1) No representation of the national flag, the national emblem nor the tune of the national anthem may be used in an advertisement. Some advertisement vetting departments have extended this prohibition to exclude red backgrounds in advertisements.

(2) The names of government organs or government functionaries may not be mentioned in commercial advertisements. This prohibition is designed to discourage false testimonials or testimonials by government officials which reflect badly on the dignity of the government office. Testimonials are not permitted to appear in cosmetics advertisements at all.

(3) Superlatives may not be used. Descriptions such as 'national level' or 'highest level' or 'the best' are forbidden regardless of whether or not the description is true.

(4) Any language or other symbol considered by the authorities to be threatening to social stability, capable of presenting a danger to the Chinese people or property, or capable of harming any public interest may not be used. One should be aware that the concept of public interest may be interpreted as the interest of central and local governments and the officials comprising those governments. One should be aware that Chinese officials have been known to claim hurt feelings over a variety of apparently innocuous subject matter. There is no way to be sure what will or will not hurt the feelings of someone in the government, so the parties involved must rely on the administrative approval process (discussed below) for assurances that any particular advertisement copy is to be considered suitable for public display.

(5) Language or symbols considered contrary to approved or accepted conventions may not be used. The challenge here is to determine what is meant by the definition. This requires a good sense of Chinese social conventions, which can vary from location to location within China. Actual determinations of what is and is not acceptable are made locally, and there are disparities nationwide.

(6) Language or symbols considered obscene, superstitious, supportive of terrorist activities or otherwise violent or just plain wrong is forbidden. Again, determination of what kind of material fits these forbidden categories is made locally and varies from place to place within China.

(7) Evidence of discrimination among China's national minorities, races, or discrimination on the basis of religion or gender may not appear in advertisements.

(8) Advertisements must not contain anything injurious to the environment or to natural resources in China.

(9) Advertisements must not harm the feelings or interests of underage or disabled persons.

(10) Untruthful statements may not appear in advertisements, especially untruthful statements which pertain to patents (under a special provision in the Patent Law of the People's Republic of China).

(11) Disparaging comments about competitors' goods or services is forbidden. In practice most kinds of comparisons are forbidden, lest disparagement be implied or imputed. Even when the purpose of the comparison is not to disparage another product or service, for example, in the case of comparisons between different methods of accomplishing a stated goal, the use of comparisons is frowned upon. It is explicitly forbidden in the case of medical products even if there is a scientific basis to the comparison.

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(12) Advertisements may not be disguised as newspaper reports. This prohibition is often honoured in the breach, but the more effective way to accomplish the objective is to pay for the newspaper report to say complimentary things about the advertiser. Then the report is treated as a report and not an advertisement.
(13) Names or pictures of people may not be used except with permission from such people.
(14) Claims of efficacy or usefulness of medical products may not be made in advertisements.
(15) Cure rates or claims of treatment effectiveness may not be made in advertisements, regardless of whether such statements might be true.
(16) Pictures of medical research institutes, academic institutions, medical organisations or pictures of medical experts, pictures of doctors or pictures of patients may not appear in advertisements, nor may the names of any of the same.
(17) Medical or pharmaceutical warranties or promises may not be given in advertisements. Charts or data showing cure rates are also forbidden.
(18) Advertisements for medical products or services may not contain suggestions that if the product or service is not purchased, the consumer might come down with a disease or other problem. Thus vaccination programmes may not be advertised, at least not without special permission.
(19) Advertising of prizes and awards is considered unsuitable, particularly in the medical field.
(20) Advertisements for foods may not claim that slimming can be achieved through use of the product. Advertisements may not note the product as low in cholesterol or free of sugar except with a special permit issued by hygiene supervision authorities.
(21) Medical terminology may not be used in connection with advertisements for food.
(22) No food products banned by law (for example, the meat of endangered species) may be advertised.
(23) Advertisements for human milk substitutes are forbidden.
(24) Medical terminology is restricted in advertisements for cosmetics, especially if the use of such language might create the impression of medicinal results.
(25) Claims which cannot be proven are also restricted, as is language such as 'newly invented', 'newly manufactured', 'made from natural products', 'free of side effects' and the like.
(26) Statistics or sales data or data on the effects of using a cosmetic product may not appear in advertisements.
(27) Some brand names may not be advertised if the name implies exaggerated claims of effectiveness. This is important to keep in mind when choosing the Chinese translation of a name.
(28) Assertions of safety or toxicity may not appear in advertisements for farm chemicals.
(29) Assurances of effectiveness of farm chemicals may not be made in advertisements. Neither may any suggestions that the usual safety procedures need not be followed.
(30) No advertisements at all are permitted for veterinary anaesthetics.

The Approval Process

The limitations and restrictions mentioned above are enforced through a baroque network of approvals through which an advertisement must be guided by the advertising agency.

One can apply for two different types of approval for an advertisement under the State Administration of Industry and Commerce's Opinion Regarding the Inspection Work in Some Cities Trying out the System of Using Advertising Agents and Advance Approvals of Advertisements (effective as of 15 July 1993) (the Opinion). The first kind of approval is applied for after a draft of the advertisement has been completed. The second kind of approval is applied for when all the details of the advertisement have been prepared. The authorities are encouraging the second method on the understanding that subsequent to approval, fewer further changes are likely to be made. Under the Opinion, the second type of approval is valid for a year. However, it is difficult to estimate how long it might take to get the approval and this uncertainty has led to a good deal of 'guanxi building', some of which borders on corruption. An ethical investor should be wary of the means used by its advertising agency to obtain clearance for an advertisement.

The requirement that approvals be obtained means that, in practice, the advertising agency is used as an intermediary for the procurement of approvals (in addition to the other functions of designing, producing and running advertisements). Although in theory applications for approval can be made directly by the party on whose behalf the advertisement is to be run, in practice the time and effort involved make it desirable to use an agency for this task.

The government department to which application should be made may go by different names in different places. Usually there will be an application form to be filled out. The advertisement copy must be attached along with the business license of the advertiser and all of the certificates required under any applicable laws or regulations, together with any other items which may be requested by the authorities.

The application need not be accepted for review until the application package is complete. The possibility of unforeseeable requests for additional documents adds to the time it may take to get an advertisement approved, and adds to the value of the advertising agency's good relations with the officials who approve the application to run the advertisement.

Approvals are made only in writing. Verbal assurances have no legal or enforcement value, and should not be relied upon.

Even after approval is granted, if the content of the advertisement changes or if there is a change to the approval pertaining to the product advertised, or the service being advertised, then a new approval for the advertisement should be obtained. Of course, a new approval must be obtained if an existing approval expires due to lapse of time.

An approval may be withdrawn if the standards pertaining to the product or the advertisement change, or if for any other reason the authorities decide to re-investigate the product or the advertisement. If this happens, the advertisement may not be run again until the re-examination process is finished and the approval is re-issued. There is the usual administrative appeal process which may be resorted to in the event that the advertiser is dissatisfied with the results of the review. Of course, this process takes additional time. Thus there may be delays to the planned advertisement campaign. It should be obvious that approvals obtained on the strength of 'guanxi' rather than merit are somewhat more likely to be subjected to re-investigation.

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How to Certify the Accuracy of the Content of an Advertisement

The business licence of the advertiser (or the equivalent in the case of advertisers with no Chinese place of business) should always be presented in order to prove the existence of the advertiser. The following list is indicative of the types of certificates which may be collected to prove the accuracy of advertising content. Other sorts of certificates could be requested. Of course, there is no guarantee that all of the relevant certificates will be requested.

(1) In the case of an advertisement of a product which has won a prize or some particular honour, the advertiser must present the certificate attesting that prize or honour, and showing the time it was granted, the details (for example, the level of excellence) of the award, and showing the name of the party which issued the certificate. Such certificates are issued with some frequency in China but may be rather more unusual in other countries.
(2) If the product being advertised has been certified as high grade, the certificate of that high grade should be produced. The certificate should show the name of the party which issued it and should show the date of the award.
(3) If the product has been patented, a copy of the patent certificate should be submitted.
(4) Evidence of ownership of trademarks used should be submitted. In case another party owns the trademark rights, evidence of the advertiser's right to use the relevant trademarks should be submitted.
(5) Evidence of copyright ownership should be submitted if copyrights are involved, for example, in the case of advertisements of computer software, video or cinematographic works, sound recordings, and the like.
(6) In the case of food products for sale in China, a hygiene certificate should be presented.
(7) In the case of most kinds of products, the certificate of product inspection should be presented. This inspection may have to be specially requested.
(8) Advertisements for imported products should be supported by the certificates proving the country of origin, proving that the product passed the import inspection, and proving that the packaging and package labelling are consistent with Chinese regulations.
(9) Advertisements for medicines for animals or humans should be supported by approvals from the relevant hygiene or husbandry bureaux.
(10) Advertisements for real property should be supported by planning, quality, zoning, presale and other certificates as noted in a previous section of this chapter.

The Advertising Law of the People's Republic of China

While there are many laws and regulations which govern the issuance of advertisements in China, the Advertising Law of the People's Republic of China is the advertising law of 'highest' authority, having been adopted by the Standing Committee of the 8th National People's Congress for effect as of 1 February 1996. Sometimes foreign investors fail to appreciate how the vague or innocuous-sounding provisions in this law can generate liability, so it will be useful to go through the law and show how it should be interpreted.

Advertisements covered by the Advertising Law include commercial advertisements, in other words, advertisements produced for the purpose of marketing or selling a product or service. Political and propaganda advertising, for example, and public announcements, fall outside the definition of 'advertisement' used in the Advertising Law. The Advertising Law is of special importance to three categories of businesses, defined in the Advertising Law. An 'advertiser' is the legal person or organisation which designs, produces and publishes the advertisement. The advertiser might also engage another company to design, produce or publish the advertisement.

Advertising is regulated in the Advertising Law much like the activity of publishing. In China publishers are responsible for ensuring that publications which they publish are in full compliance with the law.[1] This requirement can best be understood if one realises that during recent history, legitimate publishers have been considered to serve as propaganda arms of the Communist Party in the dissemination of information and culture. The publisher is responsible not only for the form of the publication, but also for information disseminated in the publication.

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Similarly, advertising agencies (the term is sometimes translated as 'advertising operators') and the organisations which disseminate advertisements are, along with the companies which place the advertisements, liable for the accuracy of the contents of the advertisement. This is what is meant by the phrase in Article 2 of the Advertising Law: 'Advertisers, advertising agents and disseminators that engage in advertising activities in the People's Republic of China shall abide by this [Advertising] Law.'

The issue of advertising content regulation is approached from a different angle in Article 3 where the same parties become responsible for ensuring that 'advertisements are truthful, lawful and meet the requirements for the development of "socialist spiritual civilization"' and in Article 4 where those parties must ensure that 'advertisements do not contain false information or deceive or mislead consumers'. In addition, 'advertisers, advertising agents and disseminators of advertisements shall observe the laws and administrative regulations and shall abide by the principles of fairness, good faith and trustworthiness when engaging in advertising activities.'

While, no doubt, all advertising agencies consider themselves trustworthy and fair, the business of interpreting these terms is more complicated and less predictable when it is left up to Chinese government officials. How can an advertising agency prove its trustworthiness or fairness? How many advertising agencies actually know what individual Chinese government officials think fairness or trustworthiness is? These uncertainties add a bit of adventure to the process of obtaining approvals. The adventure is not limited to the experience of the advertising agency but also to the experience of its clients who wish to have their advertisement run in China in a timely manner.

Article 7 of the Advertising Law sets out some of the specific standard prohibitions, already listed above. The point to bear in mind is that the list is not exhaustive, and new prohibitions may appear in other legislation at any time.

The requirement in Article 4 that advertisements not be false, deceptive or misleading is the key requirement. The approach usually taken by the authorities

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1 See chs 7 and 8, M Riley *Protecting Intellectual Property Rights in China* (Sweet & Maxwell, Hong Kong, 1997).