COMPANY LAW DISPUTES

[¶10-001] Shareholders v Hainan Heping Industrial Holding Co Ltd, Li Zhoushu & Zhou Yuanquan

Theme: Shareholders protection under the PRC Company Law

Author: Jingzhou Tao[1]

Based on this case (I), the present article will analyse the relationship between shareholders and management as well as the civil enforcement framework under the *PRC Company Law* (II), before commenting on the decision itself (III) and eventually giving some recommendations as how to deal with non-competition issues in China (IV).

I. Summary of the case

On 19 September 1995, Li Zhoushu (Li) and Zhou Yuanquan (Zhou), Chairman and Vice-Chairman of Hainan Heping Industrial Holding Co Ltd (Heping Industrial) respectively, approved the transfer of the vice-president of Heping Industrial, Ji Guirong (Ji), back to his previous job.

On 3 November 1995, Heping Industrial's President Liu Jingfan (Liu) sent a letter to Zhou saying that in view of the perceived weakness in the management at Heping Industrial, he believed that the vacant post should be filled, and recommended Shao Huitian as a candidate. He also said in the letter that he needed preliminary approval so that the post could be filled immediately. Formal approval could then be obtained at the next Board meeting.

On 10 November 1995, Zhou approved this preliminary appointment in the following words: "In view of the fact that Ji Guirong has left the position of Vice-President and as the work of the company so requires, upon recommendation by Liu Jingfan, Li Zhoushu and I now decide after discussion to appoint Shao Huitian as vice-president of Heping Industrial".

On 15 December 1995, Sanya People's Insurance Company and 17 other shareholders of Heping Industrial made a joint appeal to Heping Industrial for an emergency shareholders' meeting. The appeal requested Heping Industrial to hold such a meeting in Hainan before 25 February 1996 in order to discuss the safeguarding of the shareholders' legitimate rights and interests, the standardisation of the decision-making process among the Board of Directors, and the check on the company's operations generally.

On 10 February 1996, Heping Industrial held an emergency Board meeting in Beijing to discuss how to answer the request presented by some shareholders on 15 December 1995 for an emergency shareholders' meeting. The Board decided that the requested emergency meeting could and should be held at the same time as the annual shareholders' meeting scheduled in April 1996.

On 19 March 1996, Heping Industrial published an announcement in the Hainan Daily on the upcoming fourth shareholders' congress, according to which participants of the congress were limited to shareholders with more than 100,000 shares. Shareholders with less than 100,000 shares could join forces by their own will with other shareholders and choose a representative to participate in the congress once the number of their combined shares reached 100,000, or they could authorise legitimate participants of the congress to exercise their rights by proxy. This announcement was criticised by some shareholders. In view of this, Heping Industrial published another announcement in the

Hainan Daily on 23 March, which content was revised and a note was added saying, "the problems were caused by organizers of the congress and today's announcement should be used as the final information reference for shareholders."

On 19 May 1996, Heping Industrial held a Board meeting in Shenzhen where Ji's dismissal and Shao's appointment as Executive Vice-President were formally approved.

Several shareholders of Heping Industrial initiated a lawsuit against Heping Industrial as well as Zhou (Chairman of the Board) and Li (Vice-Chairman of the Board) on 17 September 1996 with the Xinhua District People's Court of Haikou City, Hainan Province (Xinhua Court), during which they complained that:

(1) although the shareholders had requested an emergency meeting, such meeting was not held within two months after the request, as required by the *Company Law*, and the legitimate rights and interests of the plaintiffs were thus infringed;

(2) the decision to remove the former vice-president and to appoint a new one was made in violation of relevant stipulations of the *Company Law* and of the articles of association and was thus null and void; and

(3) the public announcement made by Heping Industrial on 19 March 1996 was made in violation of the relevant provisions of the *Company Law* and seriously infringed upon the shareholders' decision-making rights and their right to participate in the shareholders' congress. Although Heping Industrial did publish another announcement with revised content, it did not make any public apology to the shareholders, thus causing damage to the reputation of the shareholders.

In view of the above, the plaintiffs requested the court to decide the following that:

(1) the defendants Zhou and Li make a public apology to all shareholders;

(2) the appointment and removal of vice-president of the company should be made invalid; and

(3) Heping Industrial should hold an emergency shareholders' meeting right away in accordance with relevant provisions of the *Company Law*.

The defendants Zhou and Li claimed that the plaintiffs did not possess *locus standii* to bring proceedings against the two board member defendants. According to provisions of the *Company Law*, the Chairman of the Board of Directors and the Board itself are only liable to the company. The *General Principles of the Civil Law* stipulate that the legal representative of the company only bears the company's administrative and criminal responsibilities. Therefore, the plaintiffs cannot sue individual board members. The decision to let vice-president Ji return to his previous job and appoint Shao as the new vice-president was later approved by the Board of Directors and is thus legitimate and valid.

The defendant Heping Industrial claimed that at the time when the case was submitted to the court, the shareholders' congress had already been held and the main items on the agenda raised by the shareholders in their original suggestion were already included in the agenda of the congress. Thus, the substantive rights of the plaintiffs as stated in the suggestion were not violated. After the announcement in the *Hainan Daily* on 19 March 1996 to hold the fourth shareholders' congress which was criticised by some shareholders, the company published another announcement and made an apology. As a matter of fact, all shareholders participated in the congress. Therefore, the shareholders'

rights and interests were not violated, nor was their reputation damaged. In view of the above, the defendant believed that the plaintiffs' claims were unreasonable and should be rejected by the court.

The Xinhua Court held as follows:

(1) The right to hold a shareholders' meeting rests with the Board of Directors, not the Chairman or Vice-Chairman. The Chairman and Vice-Chairman were elected by the Board and are thus responsible only to the Board, not the shareholders. There are not sufficient legal grounds for the claim by the plaintiffs that Zhou and Li shied away from their responsibilities, which led to the emergency shareholders' meeting not being held within the legitimate period of time and the rights and interests of shareholders being violated. Nor are there any legal grounds for the plaintiffs to ask Zhou and Li to make a public apology. Therefore, the court cannot support the claims by the plaintiffs.

(2) The acts of defendants Zhou and Li to approve Ji's transfer and Shao's appointment without discussion by the Board is improper, but the decision was later formally approved by the Board and should thus be legal and valid. There is obviously no legal ground for the plaintiffs to ask the court to invalidate the decision. Therefore, the court cannot accept such request by the plaintiffs.

(3) Though the announcement by Heping Industrial in the *Hainan Daily* on 19 January 1996 violated relevant provisions of the *Company Law*, Heping Industrial later made a new revised announcement with a note saying that the problem was caused by the inefficient organisation of the congress. In addition, the shareholders did participate in the congress. Therefore, the right of shareholders to participate in the congress was not violated and their name and reputation were not damaged.

(4) The *Company Law* does provide that shareholders with over 10% of the company's shares are entitled to request the company to hold an emergency shareholders' meeting, but there is no stipulation on how to realise such right of the shareholders when the Board rejects the request or deliberately delays execution of the request. Therefore, it is still difficult at this stage for the court to support the plaintiffs.

The Court therefore rejected all claims by the plaintiffs.

II. The legal issues at stake

The main issue at stake is the protection of shareholders' rights and their enforcement against a management that does not comply with the law and/or the articles of association. This question is particularly interesting in the light of the recent revision of the *PRC Company Law* in 2005, and which entered into effect from 1 January 2006 (2006 Company Law).

Under the former *Company Law* which was revised in 2004 for the second time after its promulgation (2004 Company Law), although shareholders were conferred certain rights, those rights were provided mainly without corresponding civil remedies leaving the door wide open to abuses by members of the management. The *2006 Company Law* introduced new rules governing the relationship between shareholders, ie investors, and the management, accompanied by direct and indirect civil remedies. In the light of the

case at stake, which was decided upon under the *2004 Company Law*, the present analysis will show where the deficiencies lay and in how far these have been cured by the *2006 Company Law*.

A. Shareholders' rights and management liabilities under the 2004 Company Law

Under the *2004 Company Law*, the shareholders meeting was the authoritative organisation of the company and the law contained several provisions on the holding of shareholders' meetings, their organisation and the participation thereto (Art 37–44). Besides the annual meeting, the law also provided for the possibility of a so-called "interim" shareholders meeting upon request by shareholders holding 10% or more of the company's total share capital. Upon such request, the Board of Directors shall organise a shareholders' meeting within two months (Art 104).

Further, shareholders had the right to review the minutes of meetings of the shareholders meeting and the financial and accounting statements of the company (Art 32).

Finally, the *2004 Company Law* also set forth a series of obligations and liabilities of the management, such as:

(1) Directors, supervisors and manager of a company shall abide by the articles of association, perform their duties faithfully, and safeguard the interests of the company. They are not allowed to exploit their positions and powers in the company for personal gains. Directors, supervisors or manager of a company shall not exploit their position to accept bribes or other illegal income or wrongfully take over the company property (Art 59).

(2) Directors or manager of a company are not allowed to misappropriate the funds of the company or loan such funds to others. Directors or manager of a company are not allowed to deposit the assets of the company in their own or other personal bank accounts. Directors or manager of a company shall not provide assets of the company as guarantee for the debts owed by shareholders of the company or by others (Art 60 and 214).

(3) Directors or manager of a company shall not engage on their own behalf or on behalf of others in any businesses that are the same of that of the company or activities that are harmful to their own company. The proceeds from any such businesses or activities shall belong to the company. A director or a manager shall not enter into any contracts or transactions with the company except otherwise provided for in the articles of association or with the consent of the meeting of association or with the consent of meeting of shareholders (Art 61).

(4) A director, a supervisor, or a manager of a company shall not divulge secrets of the company except according to law or with the consent of the meeting of shareholders (Art 62).

(5) Where a director, a supervisor, or a manager of a company violates the law, administrative decrees, or the company's articles of association in performing his/her official corporate duties resulting in harm of the company, such director, supervisor, or manager is liable for compensation for the damage (Art 63).

(6) Directors and manager of a company shall abide by the provisions of the articles of association, faithfully perform their duties, protect the interests of the company and may not exploit their positions and powers to seek personal gains (Art 123).

Thus, although the *2004 Company Law* clearly put limits to the powers of the management and provided for a liability in case of violation of the managers' duty, it did not specifically provide for a civil enforcement mechanism at the disposal of the shareholders. Thus, although a director who violated the articles of association or a provision of the Company Law was to be held liable for damage deriving therefrom, it was unclear who was entitled to sue him/her and under what procedural rules.

Article 111 of the *2004 Company Law* further provided that if resolutions of a shareholders' meeting or of the board of directors have violated the law, administrative decrees or encroached upon the legitimate rights of shareholders, the shareholders concerned have the rights to sue at the people's courts, to demand that such acts of violation or infringement be stopped. Although this article seemed to give a direct right to the shareholders to sue before the court, the defendant to such lawsuit would be the company itself and not the faulty managers. Moreover, courts, including the Supreme People's Court, were very reluctant to accept such cases[2].

This is exactly what happened in the present case, where the court acknowledged that the management had not acted appropriately and in accordance with the law and articles of association, but nevertheless was not willing to take any specific actions and grant the plaintiff's requests.

In summary, the *2004 Company Law* contained few provisions protecting shareholders' interests and almost completely lacked civil enforcement remedies against misbehaving management members.

B. Shareholders' rights and management liabilities under the 2006 Company Law

The *2006 Company Law* clearly reinforces the concept of corporate governance and grants shareholders extensive rights to bring civil lawsuits to force compliance with corporate governance matters.

Articles 20, 21 and 149 of the *2006 Company Law* provide for minority shareholder protection by imposing stricter liabilities on majority shareholders and management:

(1) The shareholders of a company shall abide by laws, administrative regulations and the articles of association of the company, exercise their rights according to law, and shall not abuse their rights to damage the interests of the company or other shareholders nor abuse the independent status of corporate legal person and shareholders' limited liability to damage the interests of the company's creditors. The shareholders, who abuse their rights so as to cause losses to the company or other shareholders, shall undertake the liability for compensation. If the shareholders of a company abuse the independent status of corporate legal person and shareholders' limited liability to avoid debts and damage the interests of the company's creditors, they shall undertake the joint and several liability for the company's debts (Art 20, so-called doctrine of "piercing the corporate veil").

(2) The holding shareholders, actual controllers, directors, supervisors, senior executives of a company shall not, by taking advantage of their affiliate relationship, damage the interests of the company. They shall, in violation of the provisions of the preceding Paragraph, undertake the liability for compensation if any loss is caused to the company thereby (Art 21).

(3) The directors, supervisors and senior executives of a company shall not commit any of the following acts:

- Misappropriate the company's funds,
- Deposit the company's assets in their own personal accounts or in personal accounts of other individuals,
- In violation of the company's articles of association and without the consent of the shareholders meeting or the shareholders general meeting or the board of directors, lend the company's funds to others or use the company's property to provide guarantee to others,
- In violation of the company's articles of association or without the consent of the shareholders meeting or the shareholders general meeting or the board of directors, enter into contracts or conduct transactions with the company,
- Without the consent of the shareholders' meeting or the shareholders' general meeting, by taking advantage of their positions, seek for themselves or others the commercial opportunity that should belong to the company, or operate for themselves or others the same category of business as that of the company,
- Accept and possess the commission in the transaction between others and the company,
- Disclose the company's secrets without authorisation, and
- Commit other acts in violation of the duty of loyalty to the company.

The *2006 Company Law* then provides the shareholders with explicit civil remedies:

(1) Shareholders of the company may, within 60 days upon the date of making the resolution, request the people's court to cancel resolutions of the shareholders' meeting or the Board of Directors if the convening procedures and voting method were taken in violation of the laws or articles of association, or the contents of such resolutions are in violation of the articles of association (Art 22).

(2) Where directors, supervisors and senior executive of a company violate the laws, administrative regulations or the articles of association of the company in performance of their functions and thus cause loss to the company. In such cases, the responsible member of management is liable for compensation and the *2006 Company Law* introduces a derivative action, according to which shareholders may directly initiate legal proceedings in the people's court in their own name for the benefit of the company (Art 152).

(3) Further, where directors, supervisors and senior executives of a company violate the laws, administrative regulations or the articles of association of the company in performance of their functions and thus cause loss to the shareholders directly, the latter are given now the possibility to sue directly on their own behalf the responsible management staff (Art 153).

C. Procedural aspects

These provisions provide for a direct and a derivative action in favour of shareholders fulfilling certain requirements, such as having held 1% of the shares of the company for at least 180 consecutive days as concerns companies limited by shares. The standing to sue belongs to the shareholders directly and more specific guidelines in this respect have been issued by the Supreme People's Court in its *Provisions on Several Issues concerning the Application of the PRC Company Law* of 28 April 2006, the defendants to such action being the directors, senior officers or supervisors of the company.

As of today, the law does not provide that majority or otherwise controlling shareholders may be subject to derivative or direct actions. Further, it is still unclear which role the company will hold in a derivative action, whether it should be co-defendant with the concerned staff of the management, or whether it shall act as co-claimant, or simply as a third party without independent claim. It is to be seen how this issue will be handled by the various courts.

However, in any case, before initiating a derivative action, shareholders must first either:

- ask the company's board of supervisors to initiate a lawsuit against the concerned members of the management, or
- file a request with the board of directors to cause the company to sue the offending supervisors (so-called "demand requirement").

Only if the board of supervisors or the board of directors refuses or fails to take action within 30 days upon receipt of the request, can the demanding shareholders bring a derivative action on the company's behalf against the concerned members of the management.

As concerns the statute of limitation, since the *2006 Company Law* does not provide for any specific limitation period, the general rule of two years apply (Art 135, *General Principles of Civil Law*). The limitation period is usually calculated from the day the entitled person knew or should have known about the damage (Art 137, *General Principles of Civil Law*). The problem is that in a derivative action the damage is caused to the company, but the action is initiated by the shareholders. So whose knowledge of the harm is relevant? The company's or the shareholders'? The shareholders, and in particular minority shareholders, are not always immediately informed of a harm caused to the company, and it would therefore seem somewhat unfair to have the limitation period start on the day the company, ie the faulty management, knew or ought to have known about the damage, whereas the shareholders may remain in the dark for several months or years. It will be interesting to see how Chinese courts will deal with this issue and whether it will be necessary for the legislator to provide for a specific limitation period.

III. Commentary on the decision

The decision in itself may seem disappointing to the western legal scholar, but it is not surprising taken into account the legal framework in place at the time the decision was rendered. The way the *2004 Company Law* was conceived was not corporate governance friendly and was not supposed to give shareholders direct rights to interfere with the company's management. However, with the economy developing so quickly, shareholders got more educated and started to claim their rights, which put the courts in a delicate situation pushing them to make a choice between extrapolating the law and ignoring the needs of the shareholders. Not surprisingly, courts mostly chose to ignore the needs of the shareholders. The same thing happened in the present case. The decision of the Xinhua Court was all the more unspectacular as the lawsuit was filed after a shareholders' meeting had in the meantime ratified the controversial decisions taken by the management, so that besides a public apology from part of the concerned members of management for their wrongdoing, nothing else could really be done to revoke these decisions.

IV. Recommendations

As mentioned above, the *2004 Company Law* contained few provisions with regard to the protection of the shareholders' interest and lacked civil enforcement remedies against the misbehaviours of the company management members. It is good to see that the *2006 Company Law* has made some "revolutionary" revision in reinforcing the protection of the shareholders' interests and providing the shareholders with some explicit civil remedies.

However, there still remains some loopholes in the protection of the shareholders' rights and interests in the current Chinese legislation, in particular in the procedural aspects which may need to be enriched in the course of court practice and the confirmation in the judicial interpretations.

Further, it is also worthy to note that the *2004 Company Law* has remained almost unchanged for the past ten years regardless of the significant changes in social activities, resulting in Chinese company law lagging behind these developments for almost 10 years. Therefore, it would be more practical for the legislator to amend the *2006 Company Law* regularly to meet the requirements of social development.

Footnotes:

1 The author gratefully acknowledges the assistance of his colleagues, Clarisse von Wunschheim and Edward Hillier, in the preparation of this paper.

2 See the *SPC Circular on Temporary Dismissal of Securities-related Civil Remedies Cases* issued on 21 September 2001, which stated that judicial remedies to illegal securities activities such as insider trading, fraud and market manipulation were new issues that should be looked into by the people's courts, but that the latter were not yet in a position to accept and hear cases due to the existing legislative and judicial limitations.

ARBITRATION DISPUTES

[¶40-001] Sino-French joint-venture v Jiangmen Farun Glass Co Ltd

Theme: Validity of an arbitration clause that refers to the specific arbitration rules without designating an arbitration institution

Author: Jingzhou Tao[1]

Based on the facts of the case at stake (I), this article will introduce the legal regime of the People's Republic of China concerning the validity of an arbitration agreement[2], in particular the provisions of the *PRC Arbitration Law* and the latest developments in the judicial interpretations of the China Supreme People's Court (SPC) (II). The article will then comment on the decisions made by the Chinese courts in the present case (III), and conclude by issuing several recommendations regarding how to draft a valid arbitration agreement under Chinese legal system in view of current court practices (IV).

I. Summary of the case

On 15 August 2003, a Sino-French joint-venture (the Seller) signed an equipment purchase contract (the Contract) with Jiangmen Farun Glass Co Ltd (Farun) concerning the sale of a set of hot end equipment at the price of RMB65 million. Article 9 of the Contract provided as follows:

> "Any and all disputes under this contract or in connection with this contract which cannot be solved in a friendly manner shall be settled by arbitration. The arbitration shall be conducted in accordance with the Conciliation and Arbitration Rules of the China International Economic and Trade Arbitration Commission. The arbitration shall be conducted in Beijing. The arbitral award shall be final and binding upon both parties."

After signing the Contract, the Seller delivered all equipments to Farun according to the requirements of the Contract. Farun paid the majority of the purchase price and refused to pay a balance of over RMB11 million.

In March 2003, the Seller initiated an arbitration procedure against Farun before China International Economic and Trade Arbitration Commission (CIETAC) Beijing Headquarter according to the arbitration clause provided in Art 9 of the Contract, claiming payment of the outstanding purchase price and the default penalty stipulated in the Contract. The CIETAC accepted the case and sent an Arbitration Notice to the parties.

However, Farun, upon receiving the Arbitration Notice from the CIETAC, brought a lawsuit against the Seller before the Jiangmen Intermediate People's Court, Guangdong Province (Intermediate Court) requesting the Court to confirm that the arbitration clause in the Contract was invalid and that the CIETAC had no jurisdiction over the case. In June 2006, the Intermediate Court made a civil ruling (the Ruling of First Instance) holding that the arbitration clause in the Contract was invalid on the grounds that the parties failed to expressly designate an arbitration institution.

The Seller refused to accept such a ruling and filed an appeal against it with the High People's Court of Guangdong Province (Guangdong High Court) which, surprisingly, issued in September 2006 a final ruling (the Ruling of Second Instance) rejecting the Seller's appeal and upholding the Ruling of First Instance.

Thanks to the intervention of the SPC, the Guangdong High Court, in April 2007, decided to re-examine the case and constituted a new collegial bench for this purpose. The Guangdong High Court then rendered a ruling (the Retrial Ruling) in September 2007, cancelling the Ruling of First Instance and the Ruling of Second Instance, and confirmed the validity of the arbitration clause in the Contract in accordance with the relevant provisions of the *Arbitration Law* and the Judicial Interpretations of the SPC.

II. The legal regime in China regarding the issues at stake

The present case provides significant insight into whether an arbitration agreement that refers the disputes to the arbitration rules of an arbitration institution without expressly designating the arbitration institution is valid under PRC laws. The CIETAC and the local courts of the first and the second instance were of different opinions regarding the validity of the agreement, which is evidenced by the CIETAC's decision to accept the Arbitration Request filed by the Seller in accordance with the arbitration clause in the Contract and the Ruling of First Instance and the Ruling of Second Instance made by the local court confirming the jurisdiction of the court over this case.

This case raises doubts as to whether arbitration institutions and local courts apply the same standard and legal provisions when determining the validity of an arbitration agreement. To understand why courts and arbitration institutions sometimes arrive at different conclusions regarding the validity of an arbitration agreement, it is necessary to explain the current legal climate in relation to this issue.

A. The Arbitration Law

Pursuant to Art 16 of the *Arbitration Law*, an arbitration agreement should contain the following three particulars:

(1) an expression of the parties' intention to submit to arbitration;

(2) the specific arbitration matters; and

(3) a designated arbitration commission.

It is obvious that, compared with the definition of an arbitration agreement given in the *Convention on the Recognition and Enforcement of Foreign Awards*[3] (New York Convention) and the *UNCITRAL Model Law on International Commercial Arbitration*[4] (the Model Law), the Chinese laws apply stricter rules in regards to the definition of a valid arbitration agreement by requesting the parties to expressly designate an arbitration institution in their arbitration agreement, or, failing that, to reach a supplementary agreement concerning the choice of the arbitration institution.

Article 18 of the *Arbitration Law* provides that if the matters for arbitration and/or the arbitration institution are not agreed upon by the parties in the arbitration agreement — or if the relevant provisions are not clear — the parties may supplement the agreement. If the parties fail to reach a supplementary agreement, the arbitration agreement shall be invalidated. As applied to the designation of an arbitration institution, Art 18 of the *Arbitration Law* means that if the parties fail to designate an arbitration institution in the arbitration agreement, or if such designation is unclear, the arbitration agreement will be considered invalid unless the parties reach a supplementary agreement.

Article 18 of the *Arbitration Law* does not state the extent to which a lack of clarity of the arbitration clause can be bridged and overcome through interpretation, nor does it clarify whether any ambiguity whatsoever justifies the annulment of the arbitration clause. Although the *Arbitration Law* seems quite clear regarding the fate of ambiguous arbitration clauses, there is still a need for interpretation of Art 16 and 18 of the *Arbitration Law*.

B. The judicial interpretations on the application of the Arbitration Law

The *Interpretations of the Supreme People's Court on Certain Issues Concerning the Application of the Arbitration Law of the People's Republic of China* issued on 8 September 2006 (SPC Interpretations 2006) was one of the most important judicial interpretations explaining the application of the *Arbitration Law* rendered by the SPC. The *SPC Interpretations 2006* provides valuable explanations and guidance on a number of contentious issues related to the application of the *Arbitration Law*. It focuses on four areas: validity of the arbitration agreement, preservation and investigation of evidence, cancellation of the arbitration award, and enforcement of the arbitration award.

In regard to the validity of the arbitration agreement, the *SPC Interpretations 2006* extended the scope of validity of an arbitration agreement as compared to the wording of 16 and 18 of the *Arbitration Law*:

- Article 3 of the *SPC Interpretations 2006* provides that, if the name of the arbitration institution agreed to in the arbitration agreement is not accurate but the specific arbitration institution that will examine the dispute can be determined, it shall be deemed that an arbitration institution has been duly designated.

- Article 4 of the *SPC Interpretations 2006* provides that, where the arbitration agreement only refers to the arbitration rules applicable to the dispute, it shall be deemed that no arbitration institution has been agreed upon, except (1) where the parties concerned have reached a supplementary agreement, or (2) the arbitration institution can be determined according to the arbitration rules that have been selected.

- Article 6 of the *SPC Interpretations 2006* provides that, where the arbitration agreement specifies that the arbitration shall be handled by the arbitration institution at a certain location and there is only one arbitration institution at that location, that arbitration institution shall be deemed to be the arbitration institution agreed upon by the parties. Where there are more than two arbitration institutions at that location, the parties may choose by agreement one of the arbitration institutions to apply for arbitration; where the parties fail to reach an agreement on the arbitration institution, the arbitration agreement shall be deemed invalid.

In practice, arbitration agreements are often challenged because the content of arbitration agreements is flawed in some way. To some extent, the above *SPC Interpretations 2006* reduces the risk of challenges of pathological arbitration agreements and constitutes a step towards more arbitration-friendly practices.

III. Commentary on the decisions

In the present case, according to the decisions made in the Ruling of First Instance and the Ruling of Second Instance (Decisions), it was deemed that the arbitration agreement in the Contract was invalid for the following reasons:

(1) The parties failed to designate an arbitration commission in the arbitration clause, which violated the essential conditions for a valid arbitration agreement provided in Art 16 of the *Arbitration Law*.

(2) The parties' agreement on the arbitration rules applied did not necessarily mean that the parties had chosen CIETAC as the arbitration institution because even if the parties select another arbitration institution they may also agree to apply the *CIETAC Arbitration Rules*.

(3) Although it was agreed to in the arbitration clause that "the arbitration shall be conducted in Beijing," the arbitration institutions in Beijing include the CIETAC, the Beijing Arbitration Commission and others. Therefore, it is still impossible to conclude which is the arbitration commission selected by the parties from this clause.

(4) The parties have not reached any supplementary agreement thereafter concerning the selection of the arbitration commission according to Art 18 of the *Arbitration Law*.

The above reasons given by the Intermediate Court and the Guangdong High Court concerning the invalidity of the arbitration clause are not convincing for the following reasons:

A. Violation of the relevant provisions of PRC law

Based on the circumstances of the case, the court should have come to the conclusion that the arbitration clause sufficiently and clearly identified the CIETAC as the competent arbitration institution. The following legal basis supports this conclusion:

- Article 5 of the *Arbitration Law* provides that: "*A People's Court shall not accept an action initiated by one of the parties if the parties have concluded an arbitration agreement, unless the arbitration agreement is invalid.*"

- Article 4 of the *SPC Interpretations 2006* clarified that, where the arbitration institution is not clearly designated in the arbitration agreement but can be determined according to the arbitration rules agreed upon between the parties, the arbitration agreement shall be deemed valid. Thus, the simple fact that the parties referred to the rules and did not expressly designate the arbitration institution is in and of itself not sufficient to invalidate the arbitration agreement. It is further necessary that the chosen arbitration rules may not allow to clearly identify the competent arbitration institution.

- Article 4.3 of the *CIETAC Arbitration Rules* (effective as of 1 May 2005, ie when the Seller submitted his Request for Arbitration) provides that: "*Where the parties agree to refer their disputes to arbitration under these Rules without providing the name of an arbitration institution, they shall be deemed to have agreed to refer the dispute to arbitration by the CIETAC.*"

Thus, based on this provision of the *CIETAC Arbitration Rules*, a choice of such rules by the parties should have been interpreted as a clear designation of the CIETAC as the competent arbitration institution. Based on Art 4.3 of the *CIETAC Arbitration Rules*, it follows that the Decisions made by Jiangmen Intermediate Court of Guangdong province in the Ruling of the First Instance and Guangdong High Court in the Ruling of the Second Instance regarding the invalidity of the arbitration clause and jurisdiction were wrong and in violation of the stipulations in Art 4 of the *SPC Interpretations 2006*. It was wrong for the court to assert that the choice of these rules was not sufficient to deem the CIETAC as the designated arbitration institution because the *CIETAC Arbitration Rules* could be used by other arbitration institutions as well.

The arbitration clause at stake did fully correspond to the exception listed in Art 4 of the *SPC Interpretations 2006*. Thus, the Decision that the above arbitration clause has not provided for a definite arbitration institution, is therefore invalid, and violates Art 5 of the *Arbitration Law* and Art 4 of the *SPC Interpretations 2006*.

B. Distinction between place of arbitration and seat of the arbitration institution

For the Decisions being discussed, the courts supported their position with the further argument that there were several arbitration institutions at the designated place of arbitration, Beijing, and that it was therefore impossible to determine with certainty the arbitration institution meant by the parties.

In this regard, the wording "the arbitration shall be conducted in Beijing" contained in the arbitration clause is merely an agreement of the parties regarding the place of arbitration. The seat of arbitration institution and the place of arbitration are two different legal concepts. The parties are fully free to select the arbitration institution in City A and meanwhile agree on City B as the place of arbitration. Therefore, there is no direct legal relationship between the place of arbitration and the arbitration institution, and the courts should not make a presumption as to the arbitration institution based on the place of arbitration. Instead, it should determine the arbitration institution based on the parties' clear selection of the arbitration institution, the arbitration rules agreed by the parties, and the relevant procedural law of the place of arbitration. It is without basis for the courts to determine that the arbitration institution agreed upon by the parties is not clear by the reason that there are two arbitration institutions at the place of arbitration.

C. The intervention of the SPC

Fortunately, after consulting with the SPC, the Guangdong High Court initiated a retrial procedure and formed a new collegial bench to re-examine the case. It eventually rendered a retrial ruling cancelling the Ruling of First Instance and the Ruling of Second Instance, and clarifying the position of the Chinese courts in the implementation of the judicial interpretation of the SPC.

The intervention of the SPC was made possible because of the procedure for trial supervision provided for in Art 177 of the *Civil Procedure Law*[5]. According to the principle of trial supervision, if the SPC finds an error in a legally effective judgment or order of a local people's court at any level, or if a people's court at a higher level finds some errors in a legally effective judgment or order of a people's court at a lower level, it shall have the power to bring the case up for trial itself or direct the people's court at a lower level to conduct a retrial (Art 177 sec 2, *Civil Procedure Law*). The ways in which

a higher court or the SPC may know about errors in judgments rendered by inferior courts vary, such as via complaint of a party requesting a re-trial (Art 178, *Civil Procedure Law*), a complaint by a people's procuratory (Art 185, *Civil Procedure Law*) or via any other formal or informal way, including inter-court procedures in which the lower court may ask the higher court for guidance on a specific case.

Although the procedure for trial supervision has been criticised for undermining the *res iudicata* effect of legally effective judgments[6], it can be a helpful emergency valve in a still developing judicial system where courts are rendering decisions in fields they are not familiar with and where they lack specific expertise, such as that of international arbitration.

IV. Recommendations

Although the SPC Interpretations are a valuable tool for the development of arbitration in China, they are not always satisfactory. The guidelines as provided in the *SPC Interpretations 2006* concerning the validity of arbitration agreements that are relevant in the present case are all based on the same scheme, including a principle and an exception:

(1) The principle: An ambiguity in the arbitration agreement will usually lead to its invalidity, unless the parties remedy such ambiguity by a supplementary agreement.

(2) The exception: In certain specific cases the ambiguity in the arbitration agreement can be bridged and overcome through interpretation despite the absence of a supplementary arbitration agreement.

There is a serious lack of general interpretation guidelines as to how to approach unclear arbitration agreements in general. This is a big difference when compared to international arbitration practice. In international arbitration practice, an ambiguity in the arbitration agreement will not lead to the invalidity of the arbitration agreement *per se*. Invalidity of the arbitration agreement will only be admitted if, based on the interpretation of the arbitration agreement and all relevant surrounding circumstances, no common agreement of the parties as to the arbitration proceedings can be ascertained. Most countries will apply the same principles of contract interpretation to the arbitration agreement, including but not limited to the principle of interpretation in good faith, the principle of effective interpretation, the principle of interpretation *contra proferentem*, etc. The approach is different in China. The SPC and the local courts seem to apply the principle of severability of the arbitration clause to such an extent that they rarely apply contract interpretation principles, almost forgetting that an arbitration agreement is, indeed, a contract. The Chinese courts should adopt a more arbitration-friendly attitude by simply and consistently applying the principles of contract interpretation to arbitration agreements.

Moreover, in order to ensure that the Chinese arbitration system more closely resembles international commercial arbitration practice, the Chinese legislator should consider amending the *Arbitration Law* and give a more flexible definition of a valid arbitration agreement instead of placing an additional burden on the parties who expect to have their disputes resolved through arbitration in mainland China. In this regard, the new amendment made in Art 7 of the *Model Law* may serve as a good example.

Until this happens, if the parties have agreed to refer their disputes to arbitration in mainland China, an experienced counsel should always remind the parties to pay attention to the specific requirements of Art 16 of the *Arbitration Law*, and recommend them to expressly designate the arbitration institution to be referred to in order to avoid the risk of having an invalid arbitration agreement.

Footnotes:

1 The author gratefully acknowledges the assistance of his colleagues, Yi Kang, Clarisse von Wunschheim and Edward Hillier, in the preparation of this paper.

2 The term "arbitration agreement" includes the arbitration clause in a contract and the separate arbitration agreement.

3 See Art 2 of the *New York Convention*, which provides that: "Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration.
The term "agreement in writing" shall include an arbitral clause in a contract or an arbitration agreement, signed by the parties or contained in an exchange of letters or telegrams.
The court of a Contracting State, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of this article, shall, at the request of one of the parties, refer the parties to arbitration, unless it finds that the said agreement is null and void, inoperative or incapable of being performed."

4 See Art 7 of the *Model Law* which provides that arbitration agreement is an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not. An arbitration agreement may be in the form of an arbitration clause in a contract or in the form of a separate agreement.

5 For more information on the procedure for trial supervision, see Xuzhou City Huajian Real Estate Development Co Ltd v Xuzhou City Lubao Transportation Installation Manufacture Co Ltd at ¶50-001.

6 For more information on the criticism, see Xuzhou City Huajian Real Estate Development Co Ltd v Xuzhou City Lubao Transportation Installation Manufacture Co Ltd at ¶50-001.

[¶40-002] Sichuan Provincial Euro-Asia Economy and Trade General Company v Korean Shinho Company

Theme: Validity and operability of an arbitration agreement under PRC laws

Author: Jingzhou Tao[1]

Based on the present case (I), the present article will analyse the concept of a valid arbitration agreement under international conventions and PRC laws, and the basic building blocks to draft a valid and operative arbitration agreement[2] under PRC laws (II), before commenting on the decision made by the court in the present case (III), and concluding with several recommendations regarding how to draft a valid and operative arbitration agreement (IV).

I. Summary of the case

From September to October 1997, Korean Shinho Company (Shinho), the seller, had executed four sales contracts (Contracts) with Sichuan Provincial Euro-Asia Economy and Trade General Company (Euro-Asia), the buyer, in Chengdu city, Sichuan province. According to the Contracts, Euro-Asia should make the payments by a Letter of Credit (L/C) and Shinho is obliged to deliver the goods to Shantou, the destination port, by the end of October 1997.

After the conclusion of the Contracts, Euro-Asia applied to the International Business Department of Sichuan Provincial Branch of the Agricultural Bank of China (Issuing Bank) for the issuance of five L/Cs in the amount of USD9,867,601.93 with the National Agricultural Cooperative Federation of Korea (Negotiating Bank) as the negotiating bank. However, Shinho failed to make any delivery of the goods under the Contracts from January to December 1997 despite the demanding letters it received from Euro-Asia. Meanwhile, Shinho prepared false Bills of Lading (B/L) and other documents required by the L/C and had the Negotiating Bank submit the documents to the Issuing Bank for the purpose of the payments under the five L/Cs.

On 6 November 1998, Euro-Asia applied to the High People's Court of Sichuan Province (Sichuan High Court) for the termination of the payment under the five L/Cs mentioned above. The Sichuan High Court rendered a ruling on 18 November 1998 that froze the total amount of the price of the goods under the Contracts in the amount of USD9,867,591.83.

Shinho raised an objection to the jurisdiction of the Sichuan High Court on the grounds that there was an arbitration clause in the Contracts stipulating that any dispute arising from both parties shall be arbitrated in accordance with the commercial arbitration clause by the commercial arbitration committee of a third country which shall make a final award. Shinho was therefore of the opinion that the disputes arising out of the Contracts were to be settled through arbitration and that, due to this, the Sichuan High Court did not have jurisdiction over the case.

However, the Sichuan High Court held that said arbitration clause in the Contracts was unclear and irrelevant to the disputes of this case. Further, by choosing to bring a lawsuit with a court instead of an arbitration institution, Euro-Asia had waived its right to negotiate with Shinho for the clarification of the arbitration clause. Eventually, the Sichuan High Court rejected the objection raised by Shinho in accordance with Art 18 of the PRC *Arbitration Law* and Art 38 and Art 249 of the *Civil Procedure Law*.

Shinho refused to accept the ruling of the first instance made by the Sichuan High Court and appealed to the Supreme People's Court (SPC). However, the SPC denied Shinho's appeal and supported the decision made by the Sichuan High Court in accordance with Art 145 of the *Opinions of the Supreme People's Court on Some Issues Concerning the Application of the Civil Procedural Law of the People's Republic of China* (SPC Interpretation on Civil Procedure Law).

First, it is recommended that specific detailed implementation rules are promulgated in order to instruct the judges at local courts on how to interpret the general rules and principles contained in the *Civil Procedure Law* and the bilateral treaties. With such implementation rules, the courts would not be able to simply and cursorily exercise their discretion to interpret the general rules and principles on their own.

Second, like the reporting system concerning recognition and enforcement of foreign arbitral awards, a positive step would be for the Chinese courts to establish a similar reporting system to avoid any local protectionism or misunderstandings by local judges due to their lack of advanced legal knowledge. Such a reporting system would provide more confidence to the foreign parties in commercial relationships with Chinese parties.

Third, as stipulated by the *Civil Procedure Law*, there must be a legal basis to recognise and enforce foreign judgments. Since China has yet to enter into any international conventions with regard to judicial assistance or recognition and enforcement of foreign judgments, if there are no bilateral treaties between China and the country from which the applicant originates, in principle, the Chinese courts will refuse to recognise and enforce foreign judgments, which is not consistent with the trend of worldwide economic globalisation. Therefore, China may need to consider ratifying international conventions regarding judicial assistance in order to promote judicial cooperation between China and other foreign countries.

Last but not least, despite the deficiencies of the current legal regime, parties wishing to enforce foreign judgments in China need to get prepared before the application of recognition and enforcement of foreign judgments, for example, by making sure that all the requirements stipulated by the *Civil Procedure Law* or the relevant bilateral treaties are satisfied; by providing sufficient evidence based on the requirements to avoid any possible challenge from the Chinese courts; or by engaging external legal counsel to prepare or scrutinise all documents to be submitted to the Chinese courts in advance.

Footnotes:

1 The author gratefully acknowledges the assistance of his Jones Day colleagues Fang Yao and Edward Hillier in the preparation of this paper.

2 Usually translated as the "Paris Tribunal of First Instance".

3 Promulgated by the Standing Committee of the National People's Congress dated 28 October 28, 2007.

4 Ratified by China on 2 March 1991.

5 The *Civil Procedure Code of France* was promulgated in 1807; afterwards, several amendments were made, in particular, the material amendments made after 1969, which led to the formation of the *New Civil Procedure Code of France*, effective as of 1 January 1976.

INTELLECTUAL PROPERTY LAW DISPUTES

TRADEMARK DISPUTES

[¶60-001] Tetra Pak v Hongdu Lile Co

Theme: Conflict between trademark rights and enterprise name (trade name) rights

Author: Jingzhou Tao[1]

Both trademarks and trade names are used to define an enterprise's individuality. By establishing definite characteristics, they convey distinct impressions to the public so as to distinguish themselves from the products or services of other enterprises. Since trademarks and trade names themselves are an embodiment of creative work, they have been incorporated into the scope of regulation for intellectual property law in the *Convention Establishing the World Intellectual Property Organization*. Trademarks and trade names play a very important role in establishing and enhancing a company's market position and expanding the influence of its products and services. With the continuous development of the market economy and the intensification of competition among enterprises, conflicts between trade name and trademark rights have emerged and their importance is not to be underestimated.

Based on the case (I), the present article will show the problems related to and explain the reasons of conflicts between trademark and trade name rights under Chinese laws (II), before commenting on the decision itself (III) and eventually giving some recommendations as how to prevent such conflicts (IV).

I. Summary of the case

The plaintiff, Tetra Pak, a Swedish company, entered into China in 1998 and applied to register the trademark "Tetra Pak" in Chinese. During the years following its entry into the Chinese market, the plaintiff conducted intensive advertising and marketing and acquired a relatively high reputation, with good brand recognition.

In the meantime, a Chinese enterprise Hongdu Lile Co (defendant) registered its enterprise under a name which was identical to the plaintiff's trademark in Chinese, and used it prominently on its products. The defendant was registered after the plaintiff's entrance into the Chinese market and the registration of its trademark.

The plaintiff brought the case to the court claiming that the defendant had infringed the plaintiff's trademark and requesting the court to order the defendant to compensate it for the related economic losses.

The defendant insisted that its trade name was legally registered with the municipal administration for industry and commerce and its use of the trade name was a justified and lawful act, therefore it did not infringe the plaintiff's trademark rights.

Lacking relevant provisions in the applicable legislation concerning intellectual property rights, the court based its decision on Art 5(1) of the *Anti-unfair Competition Law*, according to which one should not feign others' registered trademark, and ruled in favour of the plaintiff.

II. The legal issues at stake

This is a typical case of conflict between the trademark rights of one enterprise and the trade name rights of another enterprise.

Before examining the reasons for such a conflict, we shall first give a brief overview of the concept of trademark and trade name rights under Chinese laws.

A. Concepts of trademark rights and trade name rights

Currently, the basic law in China for regulating trademarks is the *PRC Trademark Law* effective from 27 October 2001 (2001 Trademark Law), and the law for regulating enterprise names is the *Administrative Regulations governing the Registration of Enterprise Names* of 1991 (Regulations on Enterprise Names).

"Trademark right" refers to the right of the owner of the trademark to possess, utilise, gain and dispose over its own registered trademark, while "enterprise name" (trade name) refers to the exclusive right of a duly approved and registered enterprise over its name in the regions falling within the scope of registration.

According to Art 8 of the *2001 Trademark Law*, "an application for trademark registration may be filed for any visible sign including word, design, letter, number, 3D (three-dimension) sign or color combination, or the combination of the above-mentioned elements, which can distinguish the goods of the natural person, legal person or other organization from those of others. . ."

An enterprise name (trade name) is a sign that distinguishes an enterprise from other enterprises or social organisations, which is usually composed of four parts, ie "administrative division + trade name + industry + organizational form" (see Art 7 of the *Regulations on Enterprise Names*), among which the "trade name" is used to draw a distinction between different enterprises, and is the most crucial core of it. Only the trade name bears the true identification value of the enterprise. Ordinary consumers may only remember the trade name of an enterprise rather than its full name. According to Art 8 of the *Implementation Measures on Registration and Administration of Enterprise Names* effective from 1 July 2004 (Implementation Measures on Enterprise Names), "enterprise names shall be in Chinese characters which conform to the norms of the State, and may not use foreign words, the Chinese phonetic alphabet or Arabic numbers..." Contrary to trademarks, trade names may not contain designs, numbers, colour combinations, etc, but only Chinese characters.

Thus, from the perspective of their formation, the only common constituent elements of trademarks and trade names are Chinese characters. That is to say, as concerns the part in Chinese characters, it may be part of a trademark, as well as a trade name.

Trademarks are used to distinguish between different goods and trade names are used to distinguish between different enterprises. However, since goods are manufactured by enterprises, and China allows enterprises to use a simplified name, which will often be identical to the trade name, consumers usually link trademarks and trade names, hence it causes the confusion. Meanwhile, since both trademarks and trade names contain the goodwill of a company which takes shape through an enterprise's long-term operations, they can attract consumers and bring about favourable economic benefits. Therefore, for ordinary consumers, trademarks and trade names both represent the business reputation of an enterprise. Thus, to a large extent, trademark rights and trade name rights share similarities in form and function, which also makes conflict of rights between trademarks and trade names possible.

B. Reasons for conflict of rights between trademark rights and trade name rights

"Conflict of rights" refers to two or more rights legally derived from the same object contradicting or conflicting with each other. With regard to trademark rights and trade name rights, conflict of rights refers to the conflict between trademark rights and trade name rights obtained by different civil subjects on the basis of the same object according to legal procedures. There are various causes of the conflict between trademarks and trade names, including subjective reasons such as the similarities between trademarks and trade names, and also reasons of a more objective nature, such as the imperfect character of the protection of intellectual property rights and the deficiency of Chinese laws and regulations.

a) Similarities between trademarks and trade names

As explained above, although there are distinctions between trademarks and trade names, for example concerning the procedures, the applicable law, etc, as stated above, they share a similar function. For instance, they both have an identification function and constitute business identification signs. Based on the trade name, a commercial subject can be directly identified, whereas based on the trademark; the providers of goods or

services of the same kind can be distinguished. As for quality assurance, both trademarks and trade names have the function of carrying the business reputation enjoyed by a commercial subject and may influence the consumer choice. Hence the public tends to confuse enterprise names with trademarks without making any distinction. Simultaneously, both trademark rights and trade name rights are a kind of intellectual property, and the intangibility is their essential characteristic. These similarities create a risk of conflict between the two rights.

b) Deficient legislation

Although the case at hand took place in 1998 and was thus subject to the *PRC Trademark Law* of 1983 (1983 Trademark Law), which was in force at the time, the situation has not really changed since then despite the issuance of new legislations, namely the revision of the *2001 Trademark Law*, the *Regulations for the Implementation of the Trademark Law* effective from 15 September 2002 (Trademark Law Implementation Regulations) and the *Implementation Measures on Enterprise Names* effective from 1 July 2004. The situation will therefore be analysed on the basis on the current legislation.

The relevant laws and regulations still fail to pay enough attention to the conflict between trademark and trade name rights.

(1) The *2001 Trademark Law* does not expressly provide that previous registration of an enterprise name will prevent another enterprise from registering a similar/identical trademark, nor does the law provide rules concerning potential conflicts between trademark and trade name rights. It only states in Art 31 that, "anyone applying for trademark registration may not damage the existing rights of others obtained by priority ... ".

In addition, the *Trademark Law Implementation Regulations*, as the auxiliary regulation to the *Trademark Law*, only contain one single provision concerning conflicts between trademark and trade name rights, which only applies to conflicts involving "well-known trademarks". Art 53 of the *Trademark Law Implementation Regulations* provides that, where the owner of a trademark believes that his/her well-known trademark is registered as an enterprise name and where this is likely to deceive or mislead the public, he/she may file an application with the competent authority for the registration of enterprise names for cancellation of the registration of the enterprise name. The competent authority for the registration of enterprise names shall then handle the matter pursuant to the *Regulations on Enterprise Names*.

(2) The *Regulations on Enterprise Names* do not clearly prohibit an enterprise from registering and using an enterprise name, which is similar or even identical to a previously registered trademark. In the same manner, it does not expressly provide for rules concerning potential conflicts between trademark and trade name rights.

Moreover, the *Implementation Measures on Enterprise Names*, as the auxiliary regulation to the *Regulations on Enterprise Names*, only provide that an enterprise name must not be identical to nor contain another enterprise's name (Art 7 and 31). Article 31(5) however provides that the registration of an enterprise name will be refused if it would violate other laws or administrative regulations.

Obviously, these simple provisions can by no means satisfy the need for resolution of the cases in respect of conflict of right.

c) Different competent authorities

The State Trademark Office is the only authority that grants or refuses registered trademark certificates. The local trademark administrative authorities subordinated to the State Administrations for Industry and Commerce (SAIC) may only administer the normal use of trademarks, and may not approve or grant trademarks.

In various regions however, the administrative authorities for industry and commerce are competent to register and approve names of enterprises located within their own jurisdiction.

Because the right-granting procedures, authorities and right protection scopes concerning trademark and trade name rights are administered separately, the occurrence of conflicts between enterprise name (trade name) rights and trademark rights is naturally unavoidable.

d) Conclusion

In recent years, enterprises have paid close attention to the economic benefits that trademarks and trade names can bring about. Trade names are important carriers of goodwill, which is closely linked with the development of a commercial subject. The identification function of trade names may not only promote and enhance the quality of goods and services of an enterprise and increase the goodwill contained in the trade name, but more importantly, it may also influence consumer choice, expand the social popularity of the enterprise and thus improve its own market competitiveness. Trademarks possess the same important distinction value as trade names to a certain extent. It is evident that trademarks, particularly those representing an assurance of high quality, will play an important role when consumers choose goods or services. Therefore, since related laws remain imperfect, some operators avail themselves of loopholes in the law when registering trademarks and trade names by registering publicly known trademarks as their own enterprise names or by registering trade names that enjoy high goodwill as their own trademarks to mislead consumers, so as to easily snatch the huge commercial benefits brought about by the well-known trademarks, famous trademarks and trade names of renowned enterprises that have been created by the hard work of others.

III. Commentary on the decision

Due to a lack of interaction between the *Trademark Law* and the regulations applicable to trade names, the court could not find a solution to the present case in the regulations. However, as it was obvious that the plaintiff's right needed protection and in order to prevent parties from using defects in current legislation to circumvent prohibitions, the court looked to other laws and regulations in order to find a suitable solution. That is why the court eventually applied Art 5 of the *Anti-unfair Competition Law*.

The court's decision should be approved. However, the means used by the court reveals a deep deficiency in the Chinese trademark and trade name protection system. It is not normal to have to randomly look for provisions in other legislation in order to appropriately protect trademark rights. Such proceedings are linked with great legal uncertainty, which is detrimental to the healthy development of the economy.

IV. Recommendations

Commercial entities must be able to seek and to obtain efficient protection of their commercial rights, in particular intellectual property rights, without having to depend on the good will of the courts because of deficient legislation.

Moreover, litigation should be a final resort for the parties concerned because of its significant financial costs. The law should provide for efficient remedies, so as to discourage parties from violating it. The preventive effect of the law should not be underestimated.

In order to prevent problems related to conflicts between trademarks and trade name rights, the following suggestions can be made:

First of all, the existing trade name and trademark administration mechanism should be reformed as soon as possible in order to adapt it to the rapid development of the market economy. Above all, a national enterprise name registration and inquiry center should be established at the SAIC, and the administrative authorities for industry and commerce in various regions should conduct a trade name conflict check from an electronic database maintained by the inquiry center. On a similar basis, an electronic conflict check for enterprise names and registered trademarks, especially against well-known and famous trademarks, should be established. In the meantime, the administration system for enterprise name registration could refer to the related provisions of the *Trademark Law* and introduce a similar *ex ante* announcement and dissent procedure as well as *ex post* dispute procedures in order to allow a party to contest the registration of enterprise names when conflicting with a pre-registered trademark or trade name.

Second, trade names should be given their deserved legal status. So far no Chinese law expressly provides for protection of trade names from infringement by other intellectual property rights. In fact, trade names are not even regarded as a kind of intellectual property right, which runs counter to the provisions of international conventions. A trade name is the assurance for the intangible assets and goodwill that an enterprise relies on for sustenance and the issue of trade name rights is drawing much attention. Compared with trademark rights, trade name rights are still at a great disadvantage in respect of legal protection in China, and the asymmetry in legal status is an obstacle to the reasonable resolution of conflicts between trademark and trade name rights.

Third, the scope of the "right of priority" should be definitively stipulated in trademark legislation. The *Trademark Law* does not make a clear-cut definition in respect of the scope of the "right of priority", which causes many difficulties in practice, and is also an obstacle in resolving the continuing occurrence of conflicts between related rights. It is necessary to define the scope of the "right of priority" in the form of law.

All these legislative and administrative reforms, even if undertaken, will take time to be implemented. In the meantime, in order to provide for maximum protection of trademark and trade name rights, an enterprise facing competition should therefore simultaneously register its trademark as a trade name, and vice versa. The advantage of doing so is that, once another person registers his enterprise name with the registered trademark of the enterprise, he will infringe the latter's trade name right and be in violation of the *Regulations on Enterprise Names* and the *Implementation Measures on Enterprise Names*. Hence when the court decides on such a tortuous act, it will have a direct remedy and will not need to look for indirect ways to prevent abuses.

Footnotes:

1 The author gratefully acknowledges the assistance of his colleagues, Clarisse von Wunschheim and Edward Hillier, in the preparation of this paper.

[¶60-002] Jiangsu Rugao Printing Machinery Factory v Jiangsu Rugao Yide Goods and Materials Co Ltd

Theme: Scope of the exclusive right to use a trademark

Author: Jingzhou Tao[1]

Based on the case (I), the present article will analyse the right to the exclusive use of a trademark under the PRC *Trademark Law* (II), before commenting on the decision itself (III) and eventually giving some recommendations as how to improve the judicial system (IV).

I. Summary of the case

On 10 June 2003, Jiangsu Rugao Printing Machinery Factory (Factory) brought a lawsuit against Jiangsu Rugao Yide Goods and Materials Co Ltd (Yide Co) for infringement of the Factory's trademark "Yinzhi". The Factory claimed that Yide Co did not respect the Yinzhi trademark when it refurbished second-hand Yinzhi machines.

The Factory initiated court proceedings against Yide Co before the Intermediate People's Court of Nantong City, Jiangsu Province (Nantong Intermediate Court), requesting Yide Co to immediately cease the infringement of the Factory's trademark right and claiming compensatory payment of RMB50,000 for losses, RMB5,000 for lawyer's fees, RMB10,000 for the collection of evidence and covering of the case acceptance fee and other litigation costs.

The Factory is an enterprise engaging in the production and sale of printing machinery. On 20 December 1991, it obtained the "Yinzhi" trademark for printing machines through assignment by the original owner of this trademark, Nanton Mine Machinery Factory. The Factory used this trademark by writing it on a nameplate, which is then affixed to the printing machines and also mentions the technical parameter of the product and the Factory's own name. Yide Co was registered and established in July 1997, with the scope of business covering assembly, repair and sale of printing machinery. Both companies are operating in the same area of Nantong City in Jiangsu Province.

The Factory alleged that since 2001 Yide Co had purchased, refurbished, and resold several Yinzhi brand printing machines manufactured by the Factory. In the process of refurbishing the machines, Yide Co had removed the Yinzhi trademark and did not reapply it after completing repair and/or refurbishment. The Factory claimed that such acts had impeded the Yinzhi brand and market share from broadening and infringed upon the Factory's right to the exclusive use of the Yinzhi trademark.

Yide Co's response in court was that it only repaired printing machines for its clients and charged a corresponding repair fee, but there was no sales relationship between Yide Co and its clients and it therefore did not infringe upon the Factory's right to the exclusive use of the trademark. Yide Co further alleged that it was not possible to match the concerned printing machines sold by the Factory with the ones repaired by Yide Co, and that the Factory had therefore failed to prove any economic loss.

The Nantong Intermediate Court held that a commodity trademark is only valuable insofar as it is attached to the concerned commodities and circulates along with the commodities, so that the commodity users may identify the commodity manufacturer and appreciate the entire value of the commodities. Thus, the commodity trademark would be inseparable from the commodity itself, and the trademark owner shall have the right to demand protection of the integrity of its commodity trademark at any stage of the circulation of the commodity. The Nantong Intermediate Court then rejected Yide Co's argument according to which it was only repairing the Factory's old machines. The court held that the act of repair referred to the mere provision of labour services and did not change the ownership of the concerned commodity; however, in the present case, Yide Co first bought, then repaired and finally resold the machines under its own name, which clearly goes beyond the mere activity of repair.

Thus, by removing the original trademark, and then selling the machines under its own name (although not using any other trademark), Yide Co not only violated the Factory's right to exclusive use of the trademark but also prevented the commodity users from knowing the commodity's actual manufacturer, therefore ending the market extension of that commodity and damaging their economic benefits. Furthermore, because both the Factory and Yide Co were both located in the same area, Yide Co's sale of refurbished machines would undoubtedly affect the printing machine market.

On 24 October 2003, the Nantong Intermediate Court ordered that Yide Co stop infringing on the Factory's registered Yinzhi trademark, that Yide Co compensate the Factory RMB40,000 for losses, plus RMB12,000 for reasonable expenditures within five days of the date of the delivery of the judgment.

II. The legal issues at stake

The present case is interesting insofar as it is a peculiar case of trademark infringement. Contrary to usual infringements, where trademarks are copied, misused, or illegitimately reproduced, the present infringement concerns the non-use of a trademark.

The relevant legal framework is the *Trademark Law* of 27 October 2001 and the *Interpretations of the Supreme People's Court on Several Issues concerning the Application of the Law to the Trial of Civil Dispute Cases Involving Trademarks* promulgated on 12 October 2002 and effective from 16 October 2002 (SPC Interpretations).

Issues of concurrence of claims exist in the second abovementioned situation. In this case, as regards the act of infringement committed in the training courses by Xi'an Jiuxiang Co and Wang, GE's choice of copyright infringement, which resulted in the right to claim compensation, did not violate provisions of the law. What is worthy of note is that although the first and second situations occurred in the same case, as the infringing parties had carried out different acts of infringement, the Court, when applying statutory compensation, separately considered and determined the amount of loss compensation for each act of infringement. The issue of concurrence of claims did not arise.

BANKING DISPUTES

[¶120-001] City Commercial Bank Bao'an Branch v Hunan Changlian Xingchang Group Ltd

Theme: Bank's civil liability relating to issuing false capital certificates

Author: Jingzhou Tao[1]

During the negotiation of transactions, one party may require confirmation of another party's ability to fully discharge its responsibilities under the contract. In this situation, a capital certificate demonstrating the amount of such party's cash deposits formally issued by a bank can significantly allay any doubts.

In the present case, a "false capital certificate" is a capital certificate issued by a bank when the depositor has not deposited all or part of the money certified in such capital certificate. In recent years, some banks have been involved in lawsuits due to issuing false capital certificates. The Supreme People's Court (SPC) has thus issued three judicial interpretations regarding how to determine a bank's civil liability in these cases.[2] However, local courts have different understandings of these judicial interpretations and have rendered different decisions on this issue.

I. Summary of the case

According to four cooperation agreements signed from 2001 to 2003, Hunan Changlian Xingchang Group Ltd (Xingchang) entrusted Shenzhen Minxin Industrial Co Ltd (Minxin) to manage a fund containing RMB130 million (Capital). On 31 December 2003, when the last cooperation agreement expired, Minxin had still not repaid the Capital to Xingchang.

On 1 January 2004, Xingchang signed a repayment agreement with Minxin and Guangdong Jinhuiyuan Investment Guarantee Co Ltd (Jinhuiyuan) which provided that Minxin would repay the Capital to Xingchang on 30 September 2004, and that Jinhuiyuan would undertake joint and several liability for the guaranty of such repayment. On the same day, Xingchang signed a guaranty agreement with Jinhuiyuan.

Before the signing of the guaranty agreement, on 18 December 2003, Jinhuiyuan had decided to increase its registered capital from RMB50 million to RMB300 million. Shenzhen City Commercial Bank BaoAn Branch (Shenzhen Commercial Bank) issued a capital certificate to certify receipt of the increased capital on 6 February 2004, based on which Shenzhen GuoAn Accounting Firm (Shenzhen GuoAn) issued a capital verification report. It later became apparent, when Xingchang asked Jinghuiyuan to undertake joint and several liability for the guaranty, that the shareholders of Jinhuiyuan had not deposited the proposed investment with the Shenzhen Commercial Bank.

On 23 November 2005, Xingchang brought proceedings before the High People's Court of Hunan Province (Hunan Court), pleading that Minxin and Jinhuiyuan should repay the Capital according to the repayment agreement and the guaranty agreement.

Xingchang further pleaded on 30 November 2005 that (1) for the part that Minxin and Jinghuiyuan could not repay, the shareholders of Jinhuiyuan should undertake the repayment liabilities within the amount of the falsely verified investment; and that (2) for the part that the shareholders of Jinghuiyuan could not repay, Shenzhen Commercial Bank and Shenzhen GuoAn should undertake repayment liability within the amount of the false capital certificate and the false capital verification report.

Hunan Court dismissed Xingchang's pleading on Shenzhen GuoAn's supplemental repayment liability and supported the other pleadings. Shenzhen Commercial Bank was hence adjudged to have a supplemental civil liability to Xingchang within the amount of the false capital certificate, on the basis that the Hunan Court determined that a causal relationship existed between the false capital certificate and Xingchang's financial losses. Shenzhen Commercial Bank appealed to the SPC and the SPC revoked the Hunan Court's decision on the supplemental civil liability of Shenzhen Commercial Bank, on the basis that the SPC came to the conclusion that the causal relationship found by the Hunan Court had not been sufficiently established.

II. The legal issues at stake

The ultimate basis for a bank assuming civil liability because of issuing false capital certificates may be Art 106 of the *General Principles of the Civil Law*, which states that "Citizens and legal persons who violate the property of the state and collective or the property and person of other people shall bear civil liability". According to this provision, the act of a bank issuing a false capital certificate is a general civil tort and the liability of the bank is different to the bank's liability under a bank guaranty.

Based on the above fundamental legal provision, the SPC has issued three judicial interpretations which provide the legal requirements relating to banks undertaking civil liability for issuing false capital certificates:

> "[If] . . . the company cannot repay all its debts and causes losses to its creditors, the financial institution shall undertake the corresponding civil liability according to its fault within the amount of the false capital verification report.[3]
>
> [If] . . . financial institutions and accounting firms (Capital Verification Institutions) issue false capital verification reports or false capital certificates to a company, and the company cannot then repay all its debts, the Capital Verification Institution shall assume supplemental civil liability within the amount of the false capital verification report and the false capital certificate. If the cumulative total undertaken by the Capital Verification Institution to one or some creditors is equal to the amount of the false capital verification report and the false capital certificate, the Capital Verification Institutions' civil liability to other creditors will cease.[4]
>
> [If a] . . . false capital certificate is used and financial losses are caused during business dealings due to the false capital certificate, the financial institution shall assume civil liability within the amount of the false capital certificate, provided that the assets of the company and its investor(s) cannot repay all financial losses after compulsory enforcement. This civil liability is not a liability under a guaranty and financial institution only undertakes civil liability after a court so decides. In addition, if the company's investor(s) inject the unpaid capital after the company is registered, or the contract which is the foundation of claim for the party who suffered losses is invalid, the financial institution's civil liability shall be exempted." [5]

Based on the above judicial interpretations, the legal situation can be summarised as follows:

(1) a bank must undertake civil liability if it issues a false capital certificate when it knew or should have known that the certified money was not fully or partly deposited, and the false capital certificate was actually used by the receiving party during business dealings with the company in favour of whom the false capital certificate was issued, and the receiving party suffered financial losses because it relied upon such false capital certificate;

(2) a bank's civil liability is supplemental in nature and can be undertaken only after the company and company's investors cannot repay debts; and

(3) a bank's civil liability can be exempted if the company's investor(s) inject the unpaid capital into the company after the official registration of such company according to certain requirements or the contract that the claim for demanding the bank to undertake the civil liability is founded upon is invalid.

A noteworthy feature of this case is that the decisions of the two courts are totally different on the point of the civil liability of the Shenzhen Commercial Bank.

The Hunan Court held that even if the false capital certificate was issued after Xingchang signed the guaranty agreement with Jinghuiyuan, it could still be considered to be verification of Jinghuiyuan increasing its capital, so the Hunan Court therefore determined that the false capital certificate was actually used by Xingchang and was instrumental in creating Xingchang's belief that Jinghuiyuan was able to bear joint and several liability for the guaranty. The Hunan Court thus decided that Shenzhen Commercial Bank should assume supplemental repayment liability within the amount of the false capital certificate.

However, the SPC held that Shenzhen Commercial Bank issued the false capital certificate on 6 February 2004 while Xingchang signed the guaranty agreement with Jinghuiyuan on 1 January 2004, which means that the false capital certificate could not actually have been used by Xingchang as the basis for signing the guaranty agreement. The SPC hence determined that Shenzhen Commercial Bank should not assume any civil liability.

According to the above discussion, whether the false capital certificate was actually relied upon by Xingchang when it signed the guaranty agreement with Jinghuiyuan is crucial in determining Shenzhen Commercial Bank's civil liability. The false capital certificate was issued on 6 February 2004 and the guaranty agreement was signed on 1 January 2004, so it follows that it was impossible for Xingchang to use the false capital certificate as a basis for its decision to sign the guaranty agreement. In addition, Xingchang could not provide enough evidence to show that the false capital certificate was the basis for its decision to sign the guaranty agreement. The mere issuance of a false capital certificate would not automatically mean that the certificate was actually used, and thus would not necessarily expose Shenzhen Commercial Bank to liability. The reliance of the receiving party on the false capital certificate is the determining factor for the bank's civil liability.

III. Commentary on the decisions

In this case, the applicable laws didn't clearly dictate how the court should determine whether a false capital certificate had actually been used. Consequently, a different court would have trouble determining the existence of causal relationship between the false capital certificate and the receiving party's financial losses.

But if we look at the decision of the Hunan Court in another way, it seems that the Hunan Court made the decision in favour of Xingchang in spite of a lack of evidence. According to Art 64 of the *Civil Procedure Law of the People's Republic of China* and Art 2 of the *Several Provisions of the Supreme People's Court on Evidence in Civil Proceedings*, the evidential burden rests on the party who alleges, and where no evidence is produced in support of the claim or the evidence produced in support of the claim is insufficient, the party that bears the evidential burden must bear any unfavourable consequences. Therefore, if Xingchang didn't produce sufficient evidence to show that it relied upon the false capital certificate issued by Shenzhen Commercial Bank when signing the guaranty agreement with Jinghuiyuan, the Hunan Court should not have found Shenzhen Commercial Bank liable for issuing a false capital certificate. Why the Hunan Court decided in favour of Xingchang in spite of the lack of evidence that the false capital certificate was relied upon in the transaction is unclear.

IV. Recommendations

Even though a bank and its employees may be exposed to administrative responsibility [6] and/or criminal sanctions [7] when a false capital certificate is issued which causes financial losses to the receiving party, the crucial point is on which grounds to claim against the bank for compensation for the suffered loss.

In order for a bank to be liable for issuing a false capital certificate, the court must first find that a false capital certificate has actually been used and must then find that there has been a reliance on such false capital certificate by the receiving party when it enters into a contractual relationship with the company presenting the false capital certificate. The criteria for making the assessment of whether this factual situation exists are vague in the currently applicable law and judicial interpretations. It is to be hoped that in due course, the SPC or other legislative institutions will establish more detailed guidelines to help local People's Courts correctly understand cases involving this issues.

Given the limitations of the judicial interpretations in this regard, and the fact that the receiving party usually has little choice but to trust the bank not to issue a false capital certificate, the receiving party would be well advised to be cautious when relying on a capital certificate.

One point which the case report does not discuss for obvious reasons is how the situation may arise that a bank issues a false capital certificate. It makes sense that there must be some incentive for the bank, or at least for someone at the bank, to issue a false capital certificate. One possible scenario would be that the certificate is issued by a bank employee who has a personal relationship with someone at the company whose capital is being certified. This arrangement could obviously benefit both parties — the bank employee might take a commission on the transaction, and the company would have

access to business opportunities and transactions which depend on being able to demonstrate its financial viability.

Following on from this point, it is suggested that a party wishing to conduct a transaction of the basis of a capital certificate should take several steps. The first point holds true as general commercial advice: parties to transactions would be well advised to do a thorough risk assessment and due diligence on the party they are contemplating a business relationship with. This is particularly true in an environment where regulation and enforcement are weak. The best way to protect the parties' interests is to avoid the risk in the first place. The second point is that if the parties do decide to go ahead, it would be wise for the parties to make the existence of the capital certificate issued by the bank a closing condition of the contract, or even to attach the capital certificate as an annex to the contract. This would save the receiving party time and expense, if it does subsequently discover that the capital certificate is false, by clearly demonstrating the causal relationship between the false capital certificate and the receiving party's financial losses.

In addition, as issuing a false capital certificate could potentially harm the interests of the bank, the receiving party, and the company presenting the certificate, it is in the interests of all parties concerned to ensure that their own internal corporate governance and legal compliance mechanisms are up to the task of preventing either the dishonest issuing of a false capital certificate, or the dishonest reliance on such a certificate.

Footnotes:

1 The author gratefully acknowledges the assistance of his colleague Chen Hong in the preparation of this paper.

2 The SPC issued these three judicial interpretations in 1996, 1998 and 2002 separately. This article will discuss them in section II.

3 *Official Reply of the Supreme People's Court regarding the Responsibility of Financial Institutions in Issuing False Capital Verification Report to Companies Established with Approval of Relevant Administrative Authority* issued on 27 March 1996.

4 *Official Reply of the Supreme People's Court on How the Capital Verification Institutions Undertakes Liability to Several Creditors* issued on 13 January 1998.

5 *Circular of the Supreme People's Court on How the Financial Institution Undertake the Civil Liability When They Issue False Capital Verification Report or False Capital Certificate to the Company* issued on 9 February 2002.

6 Article 13 of the *Measures for Punishing Illegal Financial Activities*: "Financial institutions may not issue financial instruments such as letters of credit, letters of guarantee, negotiable instruments, certificates of deposit or certificates of creditworthiness, etc, that do not agree with the facts. If a financial institution that practices fraud by issuing a financial instrument such as a letter of credit, letter of guarantee, negotiable instrument, certificate of deposit or certificate of creditworthiness, etc, that does not agree with the facts, it shall be given a warning and its illegal income shall be confiscated; in addition, it shall be subject to a fine of not less than one time but not more than five times the illegal income or, if there is no illegal income, it shall be subject to a fine of not less than RMB100,000 but not more than RMB500,000; the senior management employees of the financial institution directly responsible, other persons in charge who are directly responsible and other directly responsible persons shall be subjected to the disciplinary sanction of dismissal; if the criminal offence of illegally issuing a financial instrument or another criminal offence is constituted, criminal liability shall be investigated according to law."

7 Article 188 of the *PRC Criminal Law*: "Any employee of a bank or of any other financial institution who, against regulations, issues letters of credit or other letters of guaranty, negotiable instruments, deposit certificates or certificates of financial standing, thus causing relatively heavy losses, shall be sentenced to fixed-term imprisonment of not more than five years or criminal detention; if heavy losses are caused, he shall be sentenced to fixed-term imprisonment of not less than five years."