



ENVIRONMENTAL LAW **54** ★ LABOR & EMPLOYMENT **60** ★ MERGERS & ACQUISITIONS **64** ★ BANKRUPTCY **68** ★ CHINA PRIMER **72** ★
IP **52** ★ LEGAL REFORM **88** ★
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CHINA
The Report



Over the past several years, U.S. companies have raced to capitalize on the potential of China's burgeoning marketplace—establishing more than 20,000 joint ventures and wholly foreign-owned enterprises in mainland China and pouring an estimated \$48 billion into the country, according to the U.S.-China Economic and Security Review Commission. 華 Seduced by the tremendous promise of doing business in China, many of those companies rushed in without a firm grasp on the tumultuous legal and regulatory situation they would face when trying to set up shop there. One thing those companies quickly learned is that the law in China is rarely as it seems. 華 “The China Report” gives you an overview of China's rapidly evolving legal landscape and some of the major challenges U.S. companies need to be aware of as they establish a foothold in this unfamiliar territory.

Lujiazui Financial District in Pudong, Shanghai



Legal Reform

China takes a slow path to an independent and impartial judiciary.

BY ADELE NICHOLAS

- ★ Communist Party still influences court system
- ★ Shanghai bolsters judicial independence
- ★ Supreme People's Court sets ambitious goals for reform

WHEN CHINA JOINED THE WTO in 2001, the global business community turned a spotlight on the nation's previously clandestine court system. What that light showed was a structure of decision-making skewed by rampant influence peddling, inscrutable customs, local politics and the watchful eye of the Communist Party.

With foreign companies suddenly clamoring to do business in China's burgeoning marketplace and demanding fair venues to resolve disputes, judges, lawyers and politicians across the country recognized an acute need for reform of China's courts. The WTO accession gave the vague reform efforts that had been underway since the late 1970s new urgency and purpose.

As a result, China's Supreme People's Court (SPC) promulgated an ambitious five-year plan in 2005 to reform China's court system. This plan calls for a large slate of reforms meant to improve the quality and fairness of decisions rendered in the courts—including reducing the influence of the Communist Party over judges; selecting judges that have better training and qualifications; and implementing standards for hearing evidence. But sometimes these well-intentioned plans have unintended consequences that make justice in China's courtrooms even more illusory.

"The implementation at the lower levels rarely reflects the top-level decisions," says Mei Ying Gechlik, a non-

resident associate at the Carnegie Endowment for International Peace who has written extensively on China's courts. "The norm in China is that when they abolish one system, they create a new one that is almost the same."

So although China's judiciary has recognized the need for reform, it's going to be a long, slow road to a truly fair and impartial court system in China.

Party Power

Perhaps the most pernicious problem plaguing China's court system is undue political influence on low-level judges from the local branches of the Communist Party. Local Communist organiza-

tions appoint and control the retention of judges in the lower courts. They also allocate money and resources among courts and determine which judges get promoted to intermediate courts.

In most provinces, judges are poorly paid and desperately need the support of the local party organization. Therefore, local judges rarely contravene suggestions from government officials about how to adjudicate issues. This means the Party can enforce protectionist policies on the courts, making it difficult for for-

eign parties to get fair hearings.

"The judiciary is essentially an agent of the government," says Judge Timothy Gailey of the Chelsea, Mass. District Court, who has been involved with judicial exchange programs with China. "The international community does not see that as judicial independence."

But growing international awareness of this problem and pressure from the WTO has led China to consider serious reforms. The most effective remedy

The implementation at the lower levels rarely reflects the top-level decisions.

for the problem of political influence is higher compensation for judges to reduce their reliance on the local Communist Party organizations for funding.

"Increased salaries really help reduce judicial corruption and political influence," Gechlik says. "Shanghai is the first province to do this. Its courts are the most impartial and independent because their judges are well-paid and highly respected."

However, even where courts are capable of acting independently, China's so-



A Chinese soldier acts as chief justice at a moot court in Nanjing, Jiangsu.



called “adjudication committees” give the Communist Party the final say on most significant legal issues. The adjudication committees are panels of senior judges in the intermediate courts that are responsible to the central government. Any case that the government deems “major and complex” goes directly to the intermediate courts, where the adjudication committees make a final decision.

“There is no clear definition in Chinese law of what a ‘major and complex’ issue is,” Gechlik says. “Therefore, any sensitive issue gets decided by these committees, which the Communist Party controls.”

While the SPC’s 2005 five-year plan suggests that the courts “explore” reform of the adjudication committee system, experts believe the central government will not give up control easily.

“Shanghai particularly is trying to reform and improve its legal institutions,” says Jerome Cohen, professor at New York University School of Law and an adviser to the U.S. Congress’ Executive Committee on China, which monitors human rights and the development of the rule of law in China. “But it’s difficult to effectuate reforms within China’s political, social and economic context.”

Reverse Reforms

Another significant impediment to judicial independence in the low-level courts is a by-product of a judicial reform effort implemented in the 1990s. Because most of China’s lower-level judges have never practiced law, the international business community is wary of their competence to decide complex issues. To improve the quality of decisions rendered by lower courts, the SPC created an incentive system that tied bonuses and promotion opportunities to the frequency with which a judge’s decisions are upheld on appeal.

While the intention of this reform was to ensure judges’ decisions were based on sound legal reasoning, the unintended consequence was that lower-court

AMBITIOUS PLANS

The Superior People’s Court of China set 50 goals for legal reform in its 2005 five-year plan. Among them are:

- ★ Taking steps to implement the principle of open trials.
- ★ Exploring simplified litigation procedures for civil cases.
- ★ Reforming the system of court adjudication committees.
- ★ Constructing responsibility systems for judges to independently decide cases.
- ★ Perfecting the procedure for enforcing judgments.
- ★ Establishing judicial disciplinary rules and standardizing conditions for penalizing judges.

judges began consulting with judges in the intermediate courts for advice and direction on how to decide cases—essentially destroying the integrity of the appeals process.

“Court-responsibility systems discipline judges for a range of errors, including appellate reversals for legal error,” the Congressional Executive Committee on China noted in its recent annual report. “This practice harms judicial fairness by making subsequent appeals a formality.”

But a recent push for the appointment of better-qualified judges is reducing the impact of this policy. According to statistics the SPC maintains, 40 percent of judges in China now have four-year degrees—a significant improvement over 1998, when only 19 percent had those qualifications. These more educated judges are more likely to trust their own judgment rather than turning to the

higher courts for help.

Furthermore, this growing population of educated judges is attuned to the needs of the international business community and is creating internal momentum to modernize China’s legal systems and procedures.

“These younger judges are very much interested in moving toward the rule of law and adopting the best they can find from Europe and the U.S.,” Gailey says. “For example, we’ve seen certain judges adopting rules that allow live testimony and cross examination of witnesses.”

Rising Profile

Perhaps the most significant driver for reform in China’s courtrooms is increased transparency and openness to the public. The SPC directed lower courts to begin publishing their decisions on the Internet in 2000. Although courts initially resisted this idea, some courts began to do so last year. For example, the Kunming Intermediate People’s Court has published a portion of its civil decisions online since February 2005.

In addition, China has begun to open its courtrooms to the media in an unprecedented manner over the past several years.

“Court proceedings are the subject of increasing attention from the press,” Gailey says. “Hong Kong newspapers, which are somewhat independent and circulate throughout China, are having a particularly significant impact on judicial accountability.”

But as promising as this new openness to the public may be, it’s not a panacea for the problems in China’s judicial system.

“The fundamental problem that remains unsolved is the institutional reform. If you want to stop government interference, you have to remove the mechanism through which Party organizations control the personnel and financing of courts,” Gechlik says. “This is not easy to accomplish. Reallocating power is a drastic change, and it all needs to be approved by the central government.” 華



Intellectual Property China's IP protections are improving, but enforcement remedies remain weak.

BY MICHAEL BURR

- ★ Chinese patent filings are on the rise
- ★ Legal protections for inventors remain weak
- ★ U.S. companies turn to licensing rather than lawsuits to protect rights

“MADE IN CHINA.” These ubiquitous words have come to signify both China's rising status as a commercial powerhouse and one of its biggest frustrations as a developing nation. China has become the world's factory, turning out container loads of manufactured goods, from chewing gum to MP3 players. But as China's leaders know, achieving sustainable economic development will require more than just low-paying production jobs. It will require innovation, and lots of it.

“The only choice [is] to shift from ‘made in China’ to ‘invented in China,’” said Tian Lipu, commissioner of the State Intellectual Property Office (SIPO), in a February 2006 online interview posted at GOV.cn—the central government's Web site. Tian said the central government made a “strategic decision” in its latest five-year plan to transform China into an innovation-driven economy to be more competitive on the world stage with Japan, Europe and America.

To some degree, this strategic decision simply recognizes the innovation explosion already underway in China. SIPO granted nearly 172,000 patents to domestic Chinese inventors in 2005, twice as many as it did five years earlier. And during the same period, exports of IP-intensive high-tech products grew by nearly 630 percent—from \$35 billion in 2000 to \$220 billion in 2005.

“China will continue to manufacture a lot of technology goods that are

designed elsewhere, but we soon will see China developing next-generation technology,” says Gary Locke, former governor of Washington, and now a partner with Davis Wright Tremaine in Seattle.

This evolution toward an innovation-driven economy is changing the competitive landscape in China and also is fostering a more robust regime for protecting IP rights. “As China's people innovate and create, they won't want to be ripped off and counterfeited,” Locke says. “China knows its own economic interests are served by improving the rule of law.”

Such advancements take time however, and meanwhile U.S. companies doing business in China will face a dynamic and dangerous IP landscape.

Weak Structure

China's aspirations toward innovation-driven growth are remarkable for a country that only 25 years ago didn't recognize IP rights. Although China's IP laws are far from perfect, they have come a long way since the country entered the WTO in 2001. And IP law in China continues improving steadily.

With increasing volumes of IP filings and disputes, China is expanding its administrative and adjudicative systems. From 2002 through 2005, SIPO trained more than 1,100 new examiners. And in 2005, the Supreme People's Court



Chinese government officials destroy pirated music and video discs in Jinan, Shandong.

designated nearly 150 intermediate and primary courts to handle specific types of IP cases.

These developments notwithstanding, IP owners still experience delays as government officials tackle nearly half a million new patent applications, a million trademarks and tens of thousands of administrative cases each year.

“China's economy has expanded much more quickly than the institutions that administrate IP rights,” says Michael Fedrick, a partner with Sheldon & Mak in Pasadena, Calif. “Only in the past 10 years has there been enough commerce in China for commercial disputes to arise, and the number of judges with significant experience is relatively small.”

That experience is growing at an accelerating rate as more Chinese companies pursue growth through innovation. And the central government is working on legal changes to further modernize the IP system. Unfortunately the amendments, proposed in July 2006, leave intact many aspects of China's IP laws that tend to disadvantage foreign IP owners.

For example, China's first-to-file system puts the burden on foreign IP owners to invalidate local filers' claims. Foreign licensees of Chinese IP are treated dif-





ferently than domestic licensees of the same IP. And most importantly, remedies for infringement are meager by U.S. and European standards; damages awards are severely limited; injunctions are not a presumed remedy for infringement; and compulsory licensing is commonplace.

“From the U.S. point of view, it’s a weak patent system and is biased against foreign entities,” says Steve Schreiner, a partner with Hunton & Williams. “Compulsory licensing is anathema to U.S. and European companies, but it is part of China’s statutory structure.”

Legal Surprises

Despite the persistent weaknesses in China’s system of IP laws, more companies are filing IP claims in China based on the expectation of continued progress toward better enforcement. Several recent IP disputes wending their way through China’s courts indicate these expectations might not be just wishful thinking (see “Mainland Justice”).

“The received wisdom used to be that litigating IP disputes in China was pointless because you couldn’t get redress in Chinese courts,” says Jim Altman, a member with Miller & Chevalier in Washington, D.C. “Now, although you will have trouble in the courts, there is a legitimate prospect for success.”

However, because damage awards under current laws often are too small to justify the cost of litigation, many IP owners still won’t bother suing for infringement in Chinese courts. Instead they will continue relying on negotiation and offshore remedies. At the same time, domestic Chinese companies are becoming more adept at using the system to serve their own business interests—often to the chagrin of their U.S. rivals and customers.

“We’re seeing Chinese companies filing patents on what U.S. companies are doing, based on mere specifications,” says Bruce Schelkopf, chief IP counsel for Cummins Inc., an Indiana-based engine manufacturing company. “This has blindsided U.S. companies.”

For example, when an American com-

MAINLAND JUSTICE

Disputes in recent years have tested the strength of China’s patent-law system. Many decisions thus far are encouraging for IP owners seeking to protect their interests in China.

PFIZER’S VIAGRA PATENT

★ A Beijing court in June overturned the State Intellectual Property Office’s decision to invalidate Pfizer’s Viagra patent. Chinese drug makers are appealing the decision.

GM DAEWOO V. CHERY

★ After suing China’s Chery Automobile Co. in Beijing Intermediate People’s Court for infringing the design of the Daewoo Matiz and Chevrolet Spark minicar models, General Motors announced a settlement agreement with Chery in late 2005. Details were not disclosed, but reports indicate Chery will not sell the QQ vehicle outside China.

LEGO V. COKO TOY

★ In early 2003, Interlego AG of Denmark won a final judgment against Tianjin Coko Toy Co. Ltd., for infringing the “applied art” copyright on sets of Lego bricks. The High People’s Court enjoined Coko Toy from selling its knock-off sets, levied RMB 50,000 in damages and required Coko to publish a formal apology in the *Beijing Daily* newspaper.

pany enters an agreement with a Chinese manufacturer to produce a component, the Chinese company might claim a patent based on the specifications in the contract or improvements to them. The U.S. partner might not learn about such claims until it seeks to renegotiate the contract or take its business to another manufacturer.

“Unless the contract provides otherwise, all improvements belong to the party who actually made the improvement,” says Zhu (Julie) Lee, senior partner with Foley & Lardner in Milwaukee. “That unfortunately is an unpleasant surprise for a lot of companies.”

Enforcement Weapons

The IP strategies of Chinese companies are becoming increasingly sophisticated, providing yet another signal of the direction China is heading. And as China’s innovation-driven strategy bears fruit, strong IP protections will become more important for the country’s development plans.

“When Chinese firms feel they are under attack, that will spur the horse forward,” says Jerry Wald, senior manager with Ernst & Young’s fraud investigation and dispute service practice. “As more Chinese companies litigate IP infringement, the system will improve more dramatically.”

Until that happens, lawsuits might remain a marginal enforcement tool in China. But even so, filing patents and trademarks will help U.S. companies strengthen their negotiating positions against Chinese companies increasingly determined to become innovation leaders—and tougher competitors.

“Lawsuits may not be your best weapon,” says Tom Li, corporate counsel with Agilent Technologies in Palo Alto, Calif. “If the infringer is a state-owned company, or a company you’ve worked with before, you might be able to talk it out and get a license.

“These are delicate issues with political considerations,” he adds. “You have to evaluate the situation before riding into a legal fight.” 華



Environmental Law

After decades of leniency, the central government gets serious about environmental protection.

BY JULIE MILLER

- ★ Beijing Olympics spur environmental cleanup
- ★ Central government bolsters resources at regulatory agency
- ★ Environmental permit enforcement on the rise

AT 1:15 P.M. ON Nov. 13, 2005, a series of explosions rocked China's northeast Heilongjiang Province. A mechanical failure coupled with human error at a state chemical plant caused the blasts, which released 100 tons of carcinogenic chemicals into the Songhua River, cutting off drinking water to approximately 4 million residents. The situation became so dire it garnered international attention and led to the resignation of China's top environmental official.

That's only one aspect of China's environmental woes. According to the Chinese Academy on Environmental Planning, air pollution was responsible for 411,000 premature deaths in 2003. In addition acid rain affects about one-third of the country and one-third of the country's rural community lacks clean drinking water.

"The environment is getting unbearable," says Jung Ge, director of legal affairs for Intel China. "There are all sorts of problems—water pollution, acid rain and water and energy shortages."

To combat the environmental degradation plaguing the country, China has taken some serious strides toward strengthening its environment regime. And while some legal experts may have called Chinese environmental law an oxymoron in the past, a slew of recent, high-profile enforcement actions against environmental violators have proven this

is no longer the case.

"In this past year, there has been heightened attention toward enforcement," says Lester Ross, partner in Wilmer Hale's Beijing office. "And there is greater awareness of the problems associated with environmental degradation."

Although China's environmental enforcement regime remains at a nascent stage, experts warn that foreign entities can no longer take a laissez-faire attitude toward complying with China's environmental laws.

Going Green

A major impetus for China's growing focus on the environment was Beijing's fight to host the 2008 Olympics. The International Olympic Committee Evaluation Commission thrust the country's environmental problems under the microscope. After pushing for a "Green Olympics," China's capital won the bid, sending a powerful message across the globe that China was ready to address some of the colossal environmental challenges it faced.

While the "Green Olympics" is having somewhat of a catalytic effect on the efforts to reverse this trend, these green roots were planted prior to the Olympic bid. According to Tad Ferris, partner at Holland & Knight, a rise in registered NGOs promoting environmental protec-



The Daqing Hongwei thermal power plant in Daqing, Heilongjiang

tion and Europe's increased influence over China's legal regime due to increased trade and interaction between China and the EU are strengthening China's environmental enforcement regime.

As a result of these pressures, the central government is now taking a more active role in enforcing environmental policies, whereas in the past the provinces were free to either deal with violations or sweep them under the rug. The central government is infusing China's top environmental watchdog, the State Environmental Protection Agency (SEPA), with more power and resources.

"Although SEPA is still a relatively weak agency, its status has gradually increased over the years," says Alex Wang, staff attorney for the Natural Resources Defense Council.

One way SEPA has grown is that the agency has opened regional supervisory offices. While the agency once struggled to regulate activities in the provinces, it now has co-appointment authority over provincial environmental administrators. This allows the agency to force provinces to be more responsive to the central government.



"In the Chinese administrative systems, the central government's mandate doesn't necessarily extend very far," Ross says, adding that the central government bureaucracies tend to be small and understaffed. "They care a great deal about the things that threaten the political legitimacy of the system, but with respect to ordinarily administrative matters ... a great deal of the authority and discretion rests with the provincial authorities."

Further demonstrating SEPA's growth is a proposal that would give SEPA a seat in the state counsel's cabinet. Although the agency was elevated to "ministry status" in 1998, which is directly under China's leading governmental body the State Council, it still lacks the power of being in a full ministry role.

"In the past [a SEPA administrator] was just an observer of the state counsel. He wouldn't have any voting power,"

Ge says. "So there are discussions on how to fix this problem from a structural standpoint. [If this happens] you are going to see more enforcement actions."

A Higher Standard

SEPA is already exercising increased power, especially in the area of environmental permits. In January 2005, for example, SEPA halted 30 large-scale construction projects that failed to meet environmental impact assessment (EIA) standards.

This action—which included the shut down of the \$5 billion Xiluodu hydro-power plant project—demonstrated that environmental compliance is no longer taking a backseat to economic growth in China.

The EIA standards, which the central government revamped in 2002, require a project owner to submit an "EIA document" to SEPA or its local counterpart and receive a permit before commencing any construction project in China. SEPA has the power to immediately halt a construction project and

REGULATION ON THE RISE

According to the "Environmental Protection in China" white paper issued by the State Council Information Office, China's State Council has formulated or revised more than 50 administrative regulations to protect the environment since 1996.

Other key figures include:

★ China has closed down 16,000 enterprises for having discharged pollutants in violation of the law.

★ There are 3,226 environmental protection administration departments in China, with 167,000 staff members.

★ Between 1996-2004, China invested \$119 billion into environmental pollution control.

assess fines. For example, it fined each of the 30 above-mentioned companies \$24,000.

"The EIA must be completed before you begin a construction project, and that is where a lot of folks get tripped up," Ferris says. "Then if there is a spill or an accident, that's when the enforcement agents come in. If they find that you don't have this permit, that's when the big clubs come out."

SEPA's shutdown of the 30 construction projects garnered a lot of media attention in the U.S. and EU. However, the projects that SEPA halted were predominately Chinese-owned. Although foreign investors have been fairly lucky so far in avoiding major run-ins with Chinese regulators, the changing

enforcement environment means that foreign projects will be subject to more scrutiny.

"Foreign companies are held to more rigorous permitting standards because the assumption is that they are bound by their own domestic laws and internal corporate ethics to comply with local standards," Ross says.

In addition to holding foreign companies to heightened standards, the Chinese government is eager to make an example of foreign violators.

"All large multinationals are going to be quite vulnerable because of their deep pockets," says Seung Chong, partner in White & Case's Hong Kong office.

More Work Ahead

While China continues to have a love-hate relationship with U.S. enterprises operating in its backyard, the bottom line is that U.S. investors need to take their environmental compliance efforts to a higher standard than they have in the past.

"You need to be well informed, well prepared and know where to go and what to do if problems or discrepancies arise," Ge says. "And finally, you need to be patient."

But even if a company does all of its research, it's challenging to keep up with the rapidly evolving law and enforcement landscape.

"One problem is that there is too much law," Ferris says. "They are coming out with laws everyday and people don't know how many laws there are. In addition, the laws can be hard to access."

One thing is certain: the world is taking a closer look at China's environmental woes and SEPA finally has the resources and will to respond.

"There is no doubt that there is increasing rhetoric, policy and regulatory action regarding environmental enforcement," Wang says. "In-house counsel for foreign companies or joint ventures should be concerned if their operations are not in compliance with environmental laws." 華



Labor & Employment

Chinese unions gain strength from government directives and proposed law.

BY MARY SWANTON

- ★ Government pressures foreign firms to recognize unions
- ★ Draft labor law will give unions more power
- ★ Employers face rising labor costs

WAL-MART'S ANNOUNCEMENT that it will work closely with the Chinese government to establish labor unions at its stores in China was a wake-up call for foreign-owned businesses that might have doubted the Beijing government's commitment to unionization.

The retailer, which has successfully fended off powerful unions elsewhere, said in an Aug. 9 statement it would form an alliance with the government-backed All-China Federation of Trade Unions (ACFTU) to create "an effective and harmonious way of facilitating the establishment of grass-roots unions" at its stores.

Wal-Mart agreed to foster unions in its 64 stores in China less than two weeks after employees at one store formed the first Wal-Mart union in China, and workers in several other stores followed suit. Chinese law required the company to recognize unions, but did not compel it to actively participate in union formation.

Labor attorneys see Wal-Mart's concession as a sign the Chinese government will pressure high visibility foreign firms to form unions in an effort to convince workers the government is still on their side. This comes at a time when the government is putting the finishing touches on a labor contract law that, if enacted, will give both individual workers and unions more leverage with employers.

"The Communist Party has been concerned that if employees do not have representation, there will be pressure

to form independent labor unions," says Andreas Lauffs, partner in Baker & McKenzie's Hong Kong office. "Ultimately, that would be a threat to the Communist Party."

Union Push

Until recently, few unions existed outside of the state-owned enterprises, and the unions in those were primarily engaged in organizing social activities.

With non-union privately held Chinese firms or foreign-owned companies employing a growing portion of the workforce, the ACFTU, the only authorized union organization in China, lost membership and relevance. At the same time, the media was spreading stories of worker exploitation, especially of migrant workers who are flocking to the cities from the countryside. The government passed a law giving unions more powers in 2001, but both foreign-owned firms and privately held Chinese companies largely ignored it.

"In the past, the government has taken a laid back approach to foreign-invested companies," says R.Z. Margaret Lu, partner in Davis Wright Tremaine. "But now there is a push from the highest levels of the central government to make foreign companies comply with the law regarding trade unions."

The push dates to 2004, when the National People's Congress, the Communist Party-controlled legislature, decided to strengthen labor unions and blacklist big companies that resisted unionization efforts, according to Lauffs.



Opening ceremony for a Wal-Mart Supercenter in Beijing in 2005

"Wal-Mart was No. 1 on the blacklist," he says. Lauffs adds that later that year, after the government concluded that Wal-Mart was dragging its feet on unionization, government officials held up approval for new Wal-Mart stores in Shanghai for at least two months.

The government raised the stakes in July when it issued a regulation barring the practice of including managers in unions, increasing the odds that the ACFTU unions will change from management-friendly social clubs to workers' rights organizations with collective bargaining authority. Concurrently, the ACFTU for the first time showed its skill in grass-roots organizing by succeeding with the Wal-Mart workforce.

For foreign firms, the changes could be costly, says Meg Utterback, partner in Thelen, Reid & Priest in Shanghai, especially for companies that previously managed human resources issues from overseas.

"Having labor unions involved means employers will need a human resources team here on the ground," Utterback says. "It's not so much that any one provision is the death knell for foreign business, but the cumulative effect is fairly significant."

Employee-Friendly Law

Unveiled in March and under revision at press time, the proposed labor contract



law contains several factors expected to escalate costs for employers in China.

Current Chinese law requires employers to have individual contracts with their employees, a requirement companies often ignored and rarely committed to writing. It allows employers to draft a “fixed term” contract for a specified time period, typically one to three years, after which companies can terminate employees without severance by simply letting their contracts expire. Companies rarely use open-term contracts because they are difficult to terminate.

The proposed law removes the incentive for fixed-term contracts by requiring employers to pay severance of one month’s salary for each year of service if the company does not renew the contract.

It also has costlier requirements for non-compete agreements, requiring the employer to pay 100 percent of the severed employee’s salary to make the agreement enforceable while reducing the time period for such agreements to two years from three years. In addition, it caps damages an employer can collect if the employee breaches the non-compete.

While the provisions on fixed-term contracts and non-competes are not directly related to unions, other provisions of the draft law give unions increased power. For example, it requires negotiations with the union if a company is laying off more than 50 employees. It also calls for management to consult the union on the content of employee handbooks. This is likely to cause problems for Western companies that typically have a standardized, universal handbook covering a wide range of business practices.

“The Chinese are not used to doing business as we do it in the West,” Utterback says. “They may balk at the way things are done in the U.S.”

Of course, U.S. companies are also balking at doing business the way China wants it done. The Chinese government received more than 190,000 comments on the draft labor contract law from

interested parties. The U.S.-China Business Council cautioned that “the draft law may reduce employment opportunities for PRC workers and negatively impact the PRC’s competitiveness and appeal as a destination for foreign business.”

Among the council’s objections were provisions that strengthened the role of unions, including the requirement that employers negotiate the terms of large layoffs. Union approval of company handbooks, the council said, would remove employer control over policies and practices for which the employer is legally responsible and liable.

“Businesses have many complaints,” says Bruce Quan, who teaches law at University of California-Hastings and Beijing University Law School. “They want at-will employment because it allows the market economy to exist at its most efficient level. But China says the socialist economy means we protect workers, and the first level is a labor contract.”

Approval Ahead

So despite objections, the bill is not expected to change significantly on most

key provisions. Final approval is now expected in mid-2007—possibly timed to coincide with Labor Day on May 1.

And, in the wake of the Wal-Mart announcement, labor attorneys in China report many calls from companies reporting that regional labor organizations have approached them. That trend is expected to continue.

“Chinese labor law is changing toward being more pro-labor,” says Yingxi Fu-Tomlinson, partner in Kaye Scholer’s Shanghai office. “U.S. companies should realize when they enter China or reorganize their operations in China, they need to keep the labor issue on their list. They need to have a good plan.”

Quan advocates a good offense as the best defense. He recommends a strong social responsibility policy that requires compliance with both local laws and internationally accepted standards of humane treatment for workers.

“Abuses are being highlighted in the Chinese media,” he says. “Employers should consider a program that insulates them from criticism.” 華



WORKERS’ RIGHTS

China’s proposed labor contract law, which is expected to be implemented in 2007, strengthens the rights of workers by:

- ★ Requiring a written contract between employers and employees.
- ★ Requiring an employer to pay the equivalent of 100 percent of the former worker’s annual salary to make a non-compete agreement enforceable and capping damages an employer can collect if the employee breaches the agreement.
- ★ Requiring an employer to pay severance to workers whose fixed-term contracts are not renewed.
- ★ Requiring negotiation with the union for layoffs of more than 50 workers.
- ★ Requiring an employer to directly hire any employee obtained through a labor agency after one year of employment.
- ★ Providing that any ambiguities in the law are to be construed to the benefit of the employees.

Mergers & Acquisitions China creates new hurdles for foreign investment.

BY MARY SWANTON

- ★ Law seeks to protect 'national economic security'
- ★ Government requires new layers of approval for foreign acquisitions
- ★ New rules allow share exchanges

WITH THE 2008 OLYMPICS turning Beijing into one big construction site, building machinery is in demand. So Xugong Construction Machinery, China's largest manufacturer of cranes, road compactors and other heavy equipment, must have looked like a tempting target to the Carlyle Group. In October 2005, the Washington, D.C.-based private equity firm agreed to pay \$375 million for an 85 percent share in Xugong.

But one year later, Carlyle reportedly offered to reduce its proposed stake to 50 percent. The move came after two setbacks: China's Ministry of Commerce (MOFCOM) refused to approve the deal in March, and the State Council, the top executive body, issued a statement in June asserting that major equipment makers should remain in Chinese hands.

The problems Carlyle encountered are symptomatic of the unsettled M&A atmosphere in China, where nationalistic sentiments are clashing with the economic need for foreign investment. The storm clouds gathered last year after the U.S. Congress scuttled the Chinese National Offshore Oil Corp.'s attempt to purchase the California-based oil company Unocal.

"This did not play well in China," says Jon Christianson, a Beijing-based partner in Skadden, Arps, Slate, Meagher & Flom. "The business community was very worked up about it. As a

result, it will be hard for U.S. companies to do big deals, and private equity firms (like Carlyle) will be hurt."

The Chinese government underscored that concern when it issued revised M&A regulations in August that require foreign firms to jump through more hurdles for most acquisitions. In late June the State Council also released a draft anti-monopoly law designed to preclude foreign domination of any industry sector (see "China Ponders Anti-Monopoly Law," p. 66).

"Doing a major acquisition in China has just gotten more complicated," says Richard Goetz, partner in Dykema Gossett's Detroit office. "If you are buying

a million dollar company that makes a common component, it's not a big deal. But if you are buying a billion dollar company that makes something not so common, it probably is a big deal."

Layers of Complexity

China's revised M&A rules, which took effect Sept. 8, reflect the government's concern that it has sold state-owned assets too cheaply and that foreign investment will result in mass layoffs, leading to social unrest.



A bank worker counts U.S. currency at the Agriculture Bank of China's Shandong branch.

"China's economic system is changing so quickly that it is terrifying a lot of government officials," Christianson says. "They are trying to rationalize their industries, and they know foreigners can help. But they also realize it is easy for foreigners to take over and hard for the industries that are left to compete."

As a result, China's 2003 M&A law bars or severely limits foreign investment in many "new economy" sectors, including Internet-related business, telecom-

China's economic system is changing so quickly that it is terrifying a lot of officials.

munications, energy, health services, media, insurance and banking.

However, like many Chinese laws, the 2003 law was ambiguous, and regional officials interpreted it as they saw fit. Therefore, a deal that regulators approved in one region might be struck down elsewhere in the country. The revised regulations attempt to impose some uniformity on the process.

"In the past, we were doing deals in the dark, with no real assurance things would stick afterward," says David Tang,



partner in Preston Gates & Ellis in Seattle. “Now there is some certainty about what we can and can’t do.”

The downside is that the revised rules add new layers of complexity. Depending on the industry sector and size of the deal, six or more central government agencies may get to veto a transaction viewed as impacting a key domestic industry, national economic security or well-known brand name. The regulations leave the definition of what companies fall into those categories up to interpretation.

“The new M&A law is a piece of work,” Goetz says. “There will not be unanimity in the many agencies that will be involved. And it will be up to bureaucrats to decide what constitutes a danger to the economic security of the country.”

The new law also allows companies to make acquisitions with share exchanges, whereas previously they had to pay cash, but the rules are not clear. For example, the rules require that public company shares used in any transaction be “stable.”

“We don’t know what that means,” says Rocky Lee, partner in DLA Piper’s Beijing office. “We think it means stable in price. But then, are Google shares stable?”

Rough Road Ahead

Clarification of the new regulations will come in time, but China M&A experts fear the transaction climate will remain difficult. As China tries to re-direct foreign investment to remote, underdeveloped areas of the country and to “old economy” companies that need an infusion of western technology, attractive targets will be hard to acquire.

“My sense is that China is going to try to do what Japan has done—have an open market that really isn’t open,” says Bruce Quan, who teaches law at the University of California-Hastings and Beijing University Law School. “Americans complain about invisible barriers in Japan. In China, MOFCOM will decide

what is open and what isn’t.”

At the minimum, foreign companies undertaking acquisitions in China will need patience.

“Everything in China takes longer

than people thought in the first place,” says Goetz, who warns that any transaction may take two to three years to accomplish. “As they say in China, ‘Nothing is easy, but nothing is impossible.’” 華

CHINA PONDERES ANTI-MONOPOLY LAW

Like the revised M&A regulations, China’s proposed anti-monopoly law seeks to curb foreign domination of key business segments. After 13 years of consideration, the ruling State Council submitted the draft law to China’s legislature, the National People’s Congress, in late June. More revisions are expected before the Congress approves the measure, probably next year.

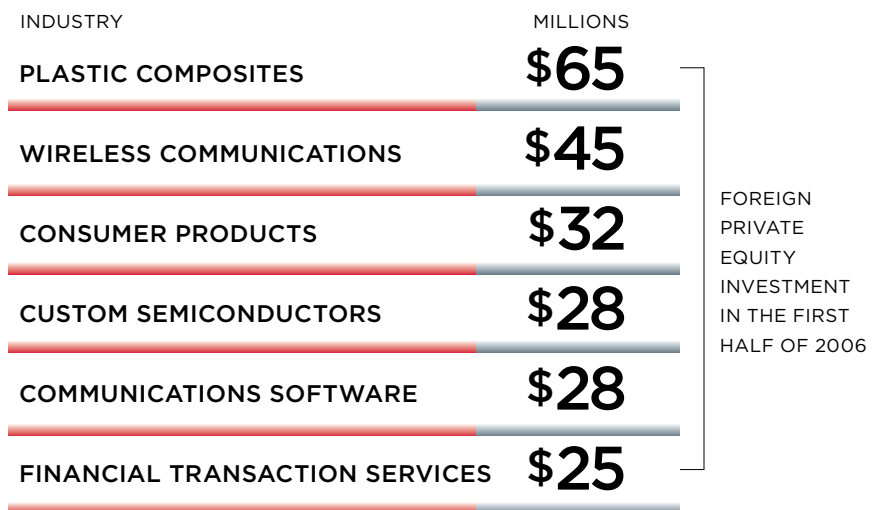
The draft law bans price-fixing and provides for the investigation and prosecution of monopolistic practices. Companies deemed to have created an illegal monopoly could be fined up to 10 percent of their prior year’s revenue in the relevant market.

It also creates an Anti-Monopoly Authority to review proposed acquisitions, regardless of size, where the acquiring company has more than \$1.5 billion in sales globally or more than \$100 million in sales in China. Currently, acquisitions under \$30 million need only local government approval.

“The draft law sets a low threshold,” says Kevin Qian, partner in AllBright Law Offices in Shanghai. “All Fortune 500 companies will fall under this.”

CASH INFUSION

Although China is trying to curb foreign investment in “new economy” sectors, cash from abroad is still pouring into the country’s high tech industries.



Source: Thompson Financial



Bankruptcy China passes its first unified bankruptcy law.

BY MARY SWANTON

- ★ China adopts Western bankruptcy concepts
- ★ Secured creditors get priority over workers
- ★ Legislation leaves details open to interpretation

WHEN CHINA PASSED its first comprehensive bankruptcy law, no one was more surprised than Charles Tabb, a University of Illinois Law School professor who advised the Chinese government as it was drafting the law.

It had been more than four years since he and three other bankruptcy experts spent a week going through the proposed law step by step with the Finance and Economic Committee of the People's Congress, hashing out what would work and what wouldn't. And it had been more than two years since Chinese officials announced a "final draft" of the legislation. Then word came that the Chinese government would approve the law by the end of 2005.

When the news finally broke Aug. 28 that the Enterprise Bankruptcy Law had passed, Tabb was well aware of what the hang-up had been. He was just amazed the government had overcome it.

"The most remarkable thing is that they were actually able to relegate the priority of the workers behind the creditors," he says. "This was a huge sticking point politically. In our discussions, that point was bracketed. They knew they needed to do it if they wanted to play on the world stage. They just didn't know if they could make it happen."

By making it happen, China took a major step toward becoming a 21st century economy. Previously, with no assurance that secured creditors would

be paid because workers had priority, investment in China was a risky business. And while, like other new Chinese laws, this one will be subject to future refinement and interpretation, U.S. bankruptcy experts are optimistic it will provide a solid foundation for Western investors.

Borrowed Concepts

Taking effect next June, the new legislation replaces piecemeal rules and interpretations with a unified body of law. The old rules applied only to state-owned enterprises (SOEs), while the new law also covers privately owned companies, which are typically the businesses of interest to Western investors.

"Before, there were serious questions about the bankruptcy process in China,"

says Lynn P. Harrison III, partner in Curtis, Mallet-Prevost, Colt & Mosle in New York. "If I put my money in, how would I get my money out if things went sour? Now a businessperson can assess the risks and put together a workable exit strategy."

Most importantly, assurances that secured creditors will get priority (except in 2,000 financially ailing SOEs

exempted from the new rules if they file for bankruptcy before the law takes effect) will go a long way toward making doing business in China like doing business in the West.

"The new law is based on the Western bankruptcy process," says Ted Osborn, head of Pricewaterhouse Coopers' business recovery practice in Hong Kong. "Most of it will be recognizable to anyone who has gone through the process in the West."

For example, the new law gives the debtor three choices in filing an application with the court for bankruptcy: reor-

ganization, liquidation and conciliation.

"Reorganization is similar to Chapter 11 [in the U.S. Bankruptcy Code]," says John Rapisardi, partner in Weil, Gotshal & Manges in New York. "It affords the opportunity for state-owned enterprises to restructure and stay in business. Liquidation is similar to Chapter 7—the company shuts down and the assets are sold. Conciliation is an out-of-



Representatives from 12 Chinese banks and financial institutions met in Liaocheng, Shandong in 2005 to discuss the bankruptcy of Shandong Shuangli Group Co. Ltd.



court restructuring that gives unsecured creditors the opportunity for a quick and dirty settlement while the debtor continues to operate. It is similar to a prepackaged restructuring here.”

Under all three options, the court appoints an administrator to manage the debtor’s property and business when the court accepts the application. The new law provides for a modified version of the debtor-in-possession concept. However, a debtor in China must ask the court for permission to take possession back, with oversight from the administrator. This differs from Chapter 11 filings in the U.S., where the debtor automatically stays in possession under the eye of a trustee.

The law also gives creditors the ability to initiate an involuntary proceeding against the debtor for liquidation or reorganization.

Hurdles Remain

The details of exactly how the court will handle the bankruptcy process, however, are missing in the new law. For example, while the law requires the court to appoint an administrator to run a bankrupt company, it doesn’t say how the court should select an administrator or who will pay that person.

“They are interpreting our law and putting some of their words in, but they don’t come out with the same level of specificity,” Rapisardi says. “Some of that is intentional, because they want flexibility, and some of it is unintentional.”

A dearth of trained bankruptcy administrators and a judiciary unfamiliar with bankruptcy concepts are other major hurdles China must overcome.

“The big concern still is having the expert personnel to manage the system,” Tabb says. “They acknowledge that. In a country where many judges did not go to law school, it’s a huge, huge problem. The stuff they’re doing is market friendly, but they don’t have a judiciary trained to handle the new laws they

are passing.”

But even though it may take several years to fill in the gaps and work out the kinks, U.S. bankruptcy lawyers think China’s new law is a big step forward.

“In the U.S., everyone knows how

the game is played,” Harrison says. “We have a transparent process that allows both foreign and domestic investors to play on a level field. With the passage of the Enterprise Bankruptcy Law, that transparency is coming to China.” 華

CHINA’S BANKRUPTCY SOLUTION

China’s Enterprise Bankruptcy Law, passed in July, provides the nation’s first comprehensive system for dealing with insolvent companies. The far-reaching law is expected to give lenders confidence that they can recover on their claims in the event of a bankruptcy filing. Highlights include:

- ★ Basing the process on Western bankruptcy practices thereby protecting the rights of secured creditors
- ★ Introducing the concept of adequate protection for secured creditors
- ★ Granting creditors the power to initiate involuntary bankruptcy proceedings
- ★ Giving the debtor three choices—reorganization, liquidation or conciliation—that closely parallel options in Chapters 11 and 7 of the U.S. Bankruptcy Code
- ★ Allowing a modified version of the “debtor in possession” concept common in the U.S.
- ★ Providing for an automatic stay, once the court accepts the application, barring unsecured creditors from seizing assets,
- ★ Requiring appointment of an administrator upon acceptance of a bankruptcy application
- ★ Stopping the accrual of interest on the debtor’s loans, giving debtors a breathing spell

BANKRUPTCY: CHINA V. UNITED STATES

28 months in China	22% in China	\$0.32 in China
Average time it takes for a company to complete bankruptcy proceedings	Average cost of a bankruptcy proceeding as a percent of the estate	Recovery rate for claimants in cents on the dollar
18 months in U.S.	7% in U.S.	\$0.77 in U.S.

Source: World Bank Group’s *Doing Business 2007* report



China Primer

Facts and figures on China's economic and legal landscape.



THE RUSH FOR CHINA

U.S. companies are pouring billions into China—and foreign investment is growing every year.

<p>\$3 Billion</p> <p>★ The amount U.S. companies invested in China in 2005</p>	<p>22,000</p> <p>★ The number of joint ventures U.S. companies have formed with Chinese companies</p>	<p>6%</p> <p>★ The rate at which U.S. direct investment in China is growing annually</p>	<p>32,000</p> <p>★ The number of wholly foreign-owned enterprises in China</p>	<p>\$211 Billion</p> <p>★ The total value of U.S.-China trade in 2005</p>
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Source: The U.S.-China Economic and Security Review Commission

DOMESTIC HELP

The following are China's most powerful domestic law firms:

KING & WOOD

Offices in Beijing, Shanghai, Shenzhen, Chengdu, Guangzhou, Tokyo, Hong Kong and Palo Alto, Calif.

JUN HE LAW

Offices in Beijing, Shanghai, Shenzhen, Dalian, Haikou, Hong Kong and New York

ALLBRIGHT LAW OFFICES

Offices in Shanghai, Beijing and Hangzhou

LI WEN & PARTNERS

Offices in Beijing and Shanghai

COMMERCE & FINANCE (TONGSHANG)

Offices in Shanghai and Shenzhen

FANGDA PARTNERS

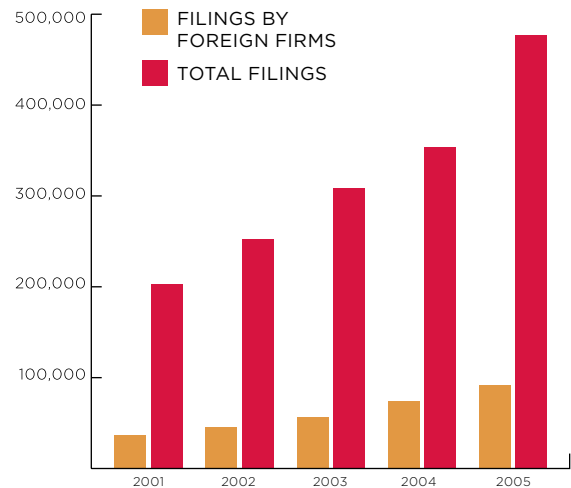
Offices in Shanghai, Beijing and Shenzhen

ZHONG LUN LAW FIRM

Offices in Shanghai, Beijing, Shenzhen and Guangzhou

PATENT PUSH

Between 1985 and 2005, foreign firms applied for **503,674** Chinese patents. 2005 alone accounted for **93,107** of those.



Source: China State Intellectual Property Office

FUTURE VISION

China's 11th Five-Year Plan, unveiled by Premier Wen Jiabao in March, sets out ambitious goals for economic growth.

<p>★ China's GDP will double from the 2000 level to \$2.14 trillion</p>	<p>★ The proportion of urban residents will reach 47 percent</p>	<p>★ The government will increase education spending by \$27 billion</p>	<p>★ Annual economic growth will average 7.5 percent</p>
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Source: The U.S.-China Business Council

