

# Dealing with commercial legal risks in the People's Republic of China: a primer for Australian businesses

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# Contents

|  |           |
|--|-----------|
| <b>Executive Summary</b>   | <b>1</b>  |
| <b>1. Introduction</b>   | <b>2</b>  |
| <b>2. Rule of law ‘doesn’t apply’ in the PRC...or does it?</b>                   | <b>3</b>  |
| 2.1 China’s commercial litigation system works well                              | 4         |
| 2.2 Continuing defects: criminal and corruption cases                            | 5         |
| 2.3 Rule of law...with Chinese characteristics                                   | 5         |
| <b>3. Political influences, or ‘socialist rule of law’</b>                       | <b>6</b>  |
| <b>4. The influence of personal relationships on the legal system</b>            | <b>8</b>  |
| <b>5. Corruption and the impact of the anti-corruption campaign</b>              | <b>11</b> |
| <b>6. Corruption vs. building personal relationships: is there a difference?</b> | <b>12</b> |
| <b>7. Other risks for foreign business managers: extra-legal detention</b>       | <b>14</b> |
| <b>8. Alternative dispute resolution or litigation?</b>                          | <b>15</b> |
| <b>9. Avoiding disputes in the first place: language/culture issues</b>          | <b>16</b> |
| <b>10. Conclusion</b>  | <b>18</b> |
| <b>About the author</b>  | <b>19</b> |
| <b>References</b>  | <b>20</b> |

## Executive Summary

- Doing business in the People's Republic of China (PRC) can be a minefield and there have been a number of high-profile cases in recent years where employees working for foreign companies have fallen foul of the Chinese legal system. These include multinationals such as pharmaceutical giant GlaxoSmithKline and financial firm JP Morgan, as well as major Australian firms like Crown Resorts and Rio Tinto.
- The PRC has its own distinctive rule of law system – though one that has defects and does not work in the same way as Australia. When one understands and adapts to the key differences, the system becomes more predictable, at least when it comes to civil and commercial law disputes.
- At its most basic level, rule of law means that the PRC has courts, lawyers, written laws and regulations, and formal procedures for dealing with disputes, none of which are radically different from other countries, except in minor details.
- Commercial litigation in PRC courts is much more transparent than it would have been even 10 years ago, business entrepreneurs in the PRC generally perceive the courts to be fair and effective, and according to the World Bank, the PRC ranks among the top ten globally in commercial contract enforcement, significantly higher than the United Kingdom and Canada.
- However, the PRC legal system still has defects that may lead to serious injustice for individuals, corporations and targeted social groups.
- This report identifies three major external factors that regularly interfere with the administration of justice in the PRC. These include politics, especially Chinese Communist Party influence, which plays a major role in some sensitive cases; strong personal relationships that may influence PRC judges' behaviour; and webs of corruption that encompass both government officials and legal institutions, what one academic has called 'crony capitalism'.
- To minimise the risks of harmful legal disputes and being sucked into corrupt networks, foreign investors must spend considerable time developing and carefully assessing relationships with potential PRC business partners and officials based on mutual trust and willingness to contribute to the local Chinese community. Companies can safeguard their business and their employees by carefully following advice from China law experts and taking the time to understand and work within the system.
- Making the effort to become fluent in Mandarin is also highly recommended, but at the very least, all foreign investors in the PRC and anyone who trades with the PRC must hire language-competent colleagues with cross-cultural management skills.
- Finally, if a foreign investor does get into a legal dispute, they will need to hire a well-connected PRC lawyer and possibly make a rapid departure from the country.

## 1. Introduction

Many Australians will recall the sudden arrest of 18 Crown Resorts managers and employees in the People's Republic of China (PRC) in 2016, including three Australians. Most of the defendants were convicted of illegally promoting gambling in the PRC and sentenced to jail terms of 9-10 months (Wen and Choahan, 2016; Birtles, 2017).

Those with longer memories may recall mining company Rio Tinto's (Rio) rejection of an offer from PRC state-owned enterprise (SOE) Chinalco to buy a large minority chunk of Rio's shares in 2009. Just one month later, in apparent retaliation, four managers in Rio's mainland China office were arrested, and among them Australian citizen Stern Hu was jailed for 10 years for accepting bribes from private mainland Chinese steel companies and stealing commercial secrets (Pomfret, 2010; McGregor, 2010; Birtles, 2018).

These kinds of high-profile incidents stoke fears among Australian businesspeople that the PRC legal system is arbitrary and unpredictable. After the Rio case, some commented that the PRC was 'using its security services to punish Rio for making a large profit' at the expense of Chinese SOEs (Pomfret, 2010). And on the heels of the Crown Resorts arrests, one academic, PRC tax law specialist Professor Nolan Sharkey, claimed this was 'a

stark example of how foreign businesses aren't always successful in navigating a system where the rule of law doesn't apply...Businesses from Australia or other countries often rely upon law and formal institutions to dictate how their employees should behave overseas and provide certainty. However, in China these norms don't exist' (Sharkey, 2016).

It is true that foreign citizens have been detained in the PRC through no clear fault of their own. Following the December 2018 arrest of Meng Wanzhou, the Chief Financial Officer (CFO) of PRC company Huawei Technologies by Canada at the request of the United States, the PRC government abruptly detained two Canadian citizens, Michael Kovrig and Michael Spavor, in the PRC on unsubstantiated charges of stealing state secrets (Jiang and Westcott, 2019). There is little doubt that these Canadians are being held as political hostages to pressure the Canadian government to release Meng.

Likewise, political arrests of foreign citizens who publicly criticise the Chinese Communist Party and its leadership still occur, as we have seen with the ongoing detention for over a year without trial or legal representation of Yang Hengjun, an Australian citizen, whose only apparent 'fault' was to publish a blog calling for democracy in the PRC (Doherty, 2019).

However, such politically motivated arrests of foreign citizens are relatively rare in the PRC and while detention of foreign business



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executives does occur, it is generally the result of clear criminal behaviour, or alternatively, because of a refusal to pay a debt, two topics that we will discuss in more detail below.

Much more common is for Australian and other foreign investors to get involved in regular commercial disputes with their PRC business and trading partners, or to experience legal and extra-legal obstacles when dealing with Chinese regulators and government officials.

This paper focuses on what to expect from the PRC legal system when you get into these kinds of disputes or face these obstacles, and how to maximise the chances of avoiding them in the first place.

We will start with a brief survey of recent developments in PRC law, especially the growing importance of courts, lawyers and formal legal procedures in the PRC over the past decade. This is designed to qualify the claim made by a number of commentators that China has no rule of law.

We then show that PRC-style rule of law sometimes works very differently from Australian rule of law. This is due to three major external influences on the working of the PRC legal system: personal relationships; political pressure on courts and judges; and corruption. We discuss how these external factors may influence the outcomes of commercial disputes and require foreign investors to alter their business and dispute resolution strategies. We also explain how the massive anti-corruption campaign ongoing in the PRC since 2013 has changed the way these factors operate and how foreign investors can use this campaign to their advantage.

Finally, building on this knowledge, we provide tips on how to avoid legal disputes in the first place, focusing especially on building strong relationships and overcoming linguistic and cultural barriers.

## 2. Rule of law ‘doesn’t apply’ in the PRC...or does it?

We already quoted one China specialist stating that ‘rule of law doesn’t apply’ in the PRC (Sharkey, 2016), and it is common to hear such statements among blogosphere pundits and some academics (Pei, 2016; *The Australian*, 2017).

Rarely defined is what ‘rule of law’ means, and the fact is, the concept is hard to pin down. Whole books have been written on whether the PRC has a ‘*thin* rule of law’ or a ‘rule *by* law’ system (Peerenboom, 2002; 2010; Kent, 2009); or is it simply a corrupt mafia-like kleptocracy that only pays lip service to law in a desperate bid to shore up the Communist Party’s power? (Pei, 2016)

The fact is, over the past three decades the PRC has developed a sophisticated legal system that works in a *relatively* predictable way in the *majority* of *non-criminal* cases.

At its most basic level, rule of law means that the PRC has courts, lawyers, written laws and regulations, and formal procedures for dealing with disputes, none of which are radically different from other countries, except in minor details.

The transparency of this system has improved since 2014, with all courts now required to upload their judgments to a national online database, which now contains over 89 million judgments (Finder, 2017; China Judgments, 2020). My recent interviews with PRC judges and lawyers made it clear that they all use cases from this database as ammunition when arguing or deciding legal disputes.<sup>1</sup> This is because judges’ interpretations of written laws are supposed to be consistent throughout the nation, and lawyers can easily find previous decisions by the same court or higher-level courts on the same points of law. The risk of having their decisions overturned on appeal – which impacts negatively on their annual

<sup>1</sup> Interviews conducted by the author with eight judges from three levels of court in Beijing (June 2018), as well as individual judges and lawyers in Shenzhen and Guangzhou (December 2018). The PRC legal system was originally based on the European continental system of countries such as Germany, where judges are supposed to decide cases based on enacted laws and regulations, and they are not bound to follow previous judgments of their court or higher courts. However, the availability of searchable online court judgments has increasingly led Chinese judges to follow previous decisions of their own or higher-level courts, in order to avoid the risk of being penalised for wrongful convictions or judgments, a practice that Finder (2017) calls an emerging ‘soft precedent’ system.

evaluations and may affect their promotion chances – means judges will generally follow the previous decisions of their own or higher-level courts.<sup>2</sup>

Numerous other reforms have taken place over the past two decades to improve the quality of judges, to train hundreds of thousands of new lawyers, and to revise procedural laws to make it much harder for PRC judges to decide cases in an arbitrary way. Likewise, since 2015 millions of PRC court trials have been streamed live online and made available on a freely accessible public website called China Open Trials Network, a practice that encourages PRC judges to follow fair legal procedures in the court (China Open Trials Network, 2020).

## 2.1 China's commercial litigation system works well

For foreign investors, this means that with the help of a well-qualified PRC lawyer, litigation in PRC courts is much more predictable than it would have been even 10 years ago.

Peerenboom and He provide some interesting figures and surveys demonstrating that the PRC legal system performs well in comparison to other countries. One large survey concluded: 'Courts are generally perceived as effective and

fair, despite the popular lore about corruption' (Peerenboom and He, 2008). In another survey of business people in Shanghai and Nanjing, almost 75 percent gave the court system a 'very high' to 'average' rating, compared to 25 percent who rated the system 'low' or 'very low'. These figures compare favourably to similar surveys conducted in the UK, France and Belgium (ibid; citing Clarke et al., 2006).

In contract enforcement, an area of law especially relevant for foreign investors, several mainland Chinese and foreign surveys have also rated the PRC highly. One study concluded that in urban areas more than half of creditor-plaintiffs managed to recover 100 percent of the money claimed in their lawsuits, and three-quarters received partial enforcement (He and Peerenboom, 2008; cf. He, 2009). And the World Bank's *Doing Business 2019* survey ranked China 6<sup>th</sup> out of 190 economies in enforcement of contracts, significantly better than the US (16<sup>th</sup>), the UK (32<sup>nd</sup>) and Canada (96<sup>th</sup>), and only one place behind Australia (5<sup>th</sup>) (World Bank, 2019).<sup>3</sup>

This relative effectiveness of legal enforcement doubtless explains why so many mainland Chinese citizens now bring lawsuits against each other, around 11 million first instance

- 2 Of relevance to Australians, in the recent controversy involving Wang Liqiang, a self-proclaimed 'defector' and PRC 'spy', the PRC government countered Wang's claims that he was working for their security services by citing a 2016 fraud case in which he was found guilty and given a suspended sentence. Overseas PRC media outlets quickly located the criminal judgment of the local court in Fujian Province on the China Judgments Network, which did indeed refer to someone named Wang Liqiang (although this is a common name in the PRC, with almost 10,000 other cases on the Network involving other people with the same name) (Guangze Court, 2016; Kankantw, 2019).
- 3 China's ranking for contract enforcement on the World Bank survey has improved steadily. Back in 2008, it was ranked only 20<sup>th</sup> (He & Peerenboom 2008). The lower rankings for the UK, US and Canada are largely due to high costs of litigation and lengthy resolution times. China still struggles in other business areas relevant for foreign investors, including trading across borders (ranked 65<sup>th</sup>), taxation issues (114<sup>th</sup>) and obtaining construction permits (121<sup>st</sup>) (World Bank, 2019).



civil cases in 2017 alone, among which approximately 7.5 million were commercial and contract lawsuits (Supreme People's Court, 2018). These statistics make it clear that there is no longer any cultural aversion to litigation among mainland Chinese citizens (Fan, 2013), and government efforts to encourage mediation of disputes instead of litigation have not stemmed the tide of lawsuits (Hawes and Kong, 2013; Minzner, 2011).

## 2.2 Continuing defects: criminal and corruption cases

Of course, the PRC legal system does have serious defects. In criminal cases, despite recent reforms to protect accused defendants, the system is heavily weighted in favour of the prosecution, and torture or other illegal treatment of criminal suspects by police is still widespread (Human Rights Watch, 2015; Human Rights in China, 2019).

Likewise, in official corruption and political dissent cases, suspects are detained incommunicado by shadowy 'discipline inspection committees', and frequently subjected to sleep deprivation and other physical and psychological abuse to elicit 'confessions' (Mai, 2018). In high-profile cases, they may be forced to repeat these confessions for broadcast on national TV (Fiskesjö, 2017). It is likely that Yang Hengjun, despite being an Australian citizen, has been subjected to some of these abusive interrogation and confinement practices over the past year, with the aim of forcing him to confess to trumped up espionage charges (Doherty, 2019). Indeed, Australian Foreign Minister Marise Payne confirmed in December last year that Dr Yang was subject to 'daily interrogation, including while shackled' (Payne, 2019).

None of these practices comply with the *PRC Criminal Procedure Law* or the *PRC Supervision Law* that applies to anti-corruption cases, and they all occur before the suspects are formally charged with any crime and handed over to prosecutors. Yet attempts by suspects to challenge the legality of confessions and evidence obtained through such abuses rarely succeed (Daum, 2011; Zhang, 2016).

Such practices add weight to claims that the PRC has no rule of law, and they seriously damage the PRC's international reputation. They are also ineffective, as they have led to numerous wrongful convictions (including death penalties), which undermine PRC citizens' confidence in the legal system and the Communist Party (He, 2015).

Yet unlike these criminal law and anti-corruption cases, in the area of civil and commercial law, the legal system is relatively predictable and fair in comparison to many other countries.

## 2.3 Rule of law...with Chinese characteristics

Even those who question rule of law in the PRC acknowledge that its legal system does have predictable qualities. Professor Sharkey, for example, states:

Business can make significant mistakes in China by either thinking that the Chinese law will provide certainty or by thinking that China is free of constraints as the law does not work. In the first case businesses may think they can cleverly plan around the law of China to achieve their outcome. In the second case, they may think they can simply do as they please. (Sharkey, 2016; cf. Sharkey (ed.), 2012)

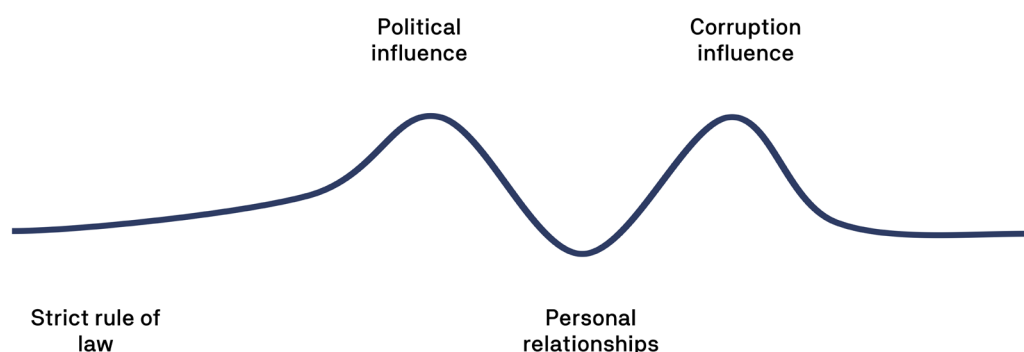
To paraphrase this somewhat intricate statement, a rule of law system does exist in the PRC, at least in some form – one that has defects and that does not work in the same way as Australia. When one understands and adapts to the key differences, the system becomes more predictable, at least when it comes to civil and commercial law.

The most significant differences all involve external influences on the legal system, including political influence, personal relationships, and corruption.

If we put this in the form of a diagram (Figure 1), it means that in many legal cases, the system works according to what we would view as strict rule of law principles, but political sensitivities may distort the court's decision; likewise, strong human relationships (*guanxi*) may distort



Figure 1. External influences on the PRC's legal system



Source: Author (2020)

the court's decision to benefit certain parties in the case; and corruption may exert yet another distorting influence. In all these situations, the judges still have to express their decisions with reference to the law, but they tend to use their broad discretion to slant the law in favour of externally specified outcomes. In some cases, these external influences may overlap or compete with each other, forcing judges to balance them or prioritise one over the other.

To avoid getting into serious trouble during legal disputes, all Australians doing business in the PRC need to grasp these major external influences and try to minimise their negative impact. The next sections will provide examples of how each of them impacts the working of the Chinese legal system and business environment.

### 3. Political influences, or 'socialist rule of law'

The PRC government does not hide the importance of political influence on law: it calls its legal system 'socialist rule of law with Chinese characteristics' and distinguishes it from a liberal Western separation of powers system (Peerenboom, 2014).

The word 'socialist' has largely lost its traditional connection to workers' rights and social welfare. These days, it indicates that the ruling Communist Party maintains close supervision over society and over the operation of the legal system. This includes supervising courts and judges (Peerenboom, 2014).

Though the *PRC Judges Law* states that PRC courts should be independent of any other organisation, it also requires all judges to uphold the *PRC Constitution*, which declares: 'The leadership of the Communist Party of China is the most essential feature of socialism with Chinese characteristics. Disruption of the socialist system by any organisation or individual is prohibited' (*Constitution of the PRC*, 2018; *Judges Law of the PRC*, 2017).

This means that PRC judges will not decide cases in a way that challenges the authority of the Party, otherwise they can be removed from their positions by the government at the same level as their court (*Judges Law of the People's Republic of China*, 2017).

In most commercial cases there won't be any political factors involved, so judges can decide purely based on the law. But any case that involves political sensitivities or affects the interests of the local or national government, will not be decided without careful consideration by the court's political and legal committee, and possibly also negotiation with local government leaders (He and Ng, 2017; Peerenboom, 2014).

This does not mean that a plaintiff will always lose if they sue a politically connected defendant, such as a large SOE.<sup>4</sup> But it does mean that political pressure may be put on the plaintiff to accept a negotiated settlement rather than insisting on their full legal compensation right.<sup>5</sup>

The dangers of refusing to accept a compromise judgment are clear in the recent case of Robert Lloyd Schellenberg, a Canadian convicted of drug smuggling in China (*Canadian Broadcasting Corporation (CBC)*, 2019; Proctor, 2019). Schellenberg was originally arrested in 2015 as part of a drug ring with two Chinese accomplices, but was not tried until 2018, which suggests disagreement among prosecutors and the local government on how to sentence him. This may be because the Communist Party had been waging a strike hard campaign against drug offences and wanted to seek the death penalty, but the circumstantial evidence against Schellenberg and his status as a Canadian citizen made this politically unpalatable. In his first trial in November 2018, the court sentenced him to 15 years in jail, significantly less than his two mainland Chinese accomplices, who received life imprisonment and a suspended death sentence respectively (*British Broadcasting Corporation (BBC)*, 2019).

Schellenberg, who already had a long criminal record of drug offences in Canada (Proctor, 2019), decided to appeal his conviction, claiming that he was innocent. The appeal court then applied the full force of PRC law – influenced by deteriorating Canada-China relations following the arrest of Meng Wanzhou

– and in January 2019 the Dalian intermediate court sentenced Schellenberg to death. He is currently attempting to appeal, but expert commentators do not hold out much hope of success (*CBC*, 2019).

The cases of two Canadians, Michael Kovrig and Michael Spavor, detained in China in December 2018 in retaliation for the Canadian arrest of Huawei's CFO; and the case of Yang Hengjun, detained on murky charges of espionage, are typical examples of political influence over the PRC legal system. Within the PRC, the mass detentions of its Turkic Muslim minority in Xinjiang since 2017 and of over 200 human rights defence lawyers since 2015, are also primarily motivated by political pressure rather than legal factors (Nebehay, 2018; Fu, 2018).

To avoid falling into these political traps, foreign investors in the PRC must keep themselves informed about the main hot-button issues – such as Taiwan, Hong Kong, Tibet and, more recently, Xinjiang – and pay attention to shifts in political winds and Communist Party policies – such as the focus on anti-corruption and emphasis on undivided loyalty to Xi Jinping since 2013. Both foreign investors and their mainland Chinese employees must also avoid any overt political commentary or activism that would risk detention and harsh treatment under the current political-legal system.

<sup>4</sup> This point is discussed further below.

<sup>5</sup> This 'socialist' political influence also explains why challenges to illegally obtained evidence in official corruption cases rarely succeed, as the evidence has been provided to the courts by the Communist Party's 'discipline inspection committees'. To exclude it for being 'illegal' would be to challenge the Party itself. Courts often fudge the issue by concluding that even though the accused's confession should be excluded, there is enough supporting documentary evidence to prove guilt without it (Wu, 2016).

## 4. The influence of personal relationships on the legal system

The PRC government frequently declares that its legal system has ‘Chinese characteristics’ (Peerenboom, 2014). One characteristic that is hard-wired into the PRC’s political and legal systems is a strong reliance on personal relationships or social networks (*guanxi*).

True, human relationships are important everywhere, but in the PRC they influence law and politics in a more obvious way than in Australia. This is not officially approved, and in fact there are detailed rules in place to try and prevent personal relationships from interfering in the judicial process. For example, the *Judges Law* states that judges are prohibited from meeting parties that they are adjudicating or their agents outside formal court processes, or attending dinners or accepting presents given by those parties or their agents, or taking advantage of their powers to seek gain for themselves or other people (*Judges Law of the People’s Republic of China*, 2017). One mainland Chinese scholar has counted up over 20 laws and regulations designed to prevent relationships from influencing judicial decisions in the PRC (Wang, 2015).

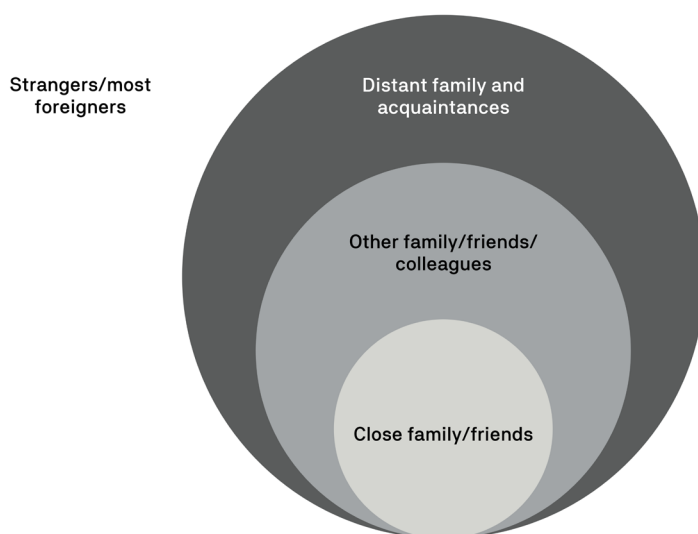
Such rules don’t seem to be very effective, however. The famous sociologist Fei Xiaotong (1910–2005) argued that placing human ties above general rules is a fundamental cultural trait going back over 2000 years to the time of Confucius (Fei, 1992). In a famous incident recorded in the Confucian *Analects*, someone asked Confucius whether a son who saw his father stealing a sheep should report him to the authorities. Confucius replied: ‘In my home town, the father covers up his son’s misconduct, and the son covers up his father’s misconduct: that is upright behaviour’ (*Analects of Confucius*). This does not mean Confucians supported criminal behaviour, but only that human relationships were more important than abstract laws and regulations.

According to Fei (1992), relationships in China tend to be placed in a series of concentric circles, as illustrated in Figure 2.<sup>6</sup>

The closest circle includes immediate family members: parents and children, grandparents and grandchildren, for whom you will always fulfil requests without questioning them, and they will do the same for you. Other people may join this inner circle of strong personal relationships if you totally trust them, such as best friends from high school, university

<sup>6</sup> Fei wrote this book in 1948, prior to the founding of the PRC, and was referring to what he called Chinese people more generally (the 1992 publication date of the source is for the English translation of Fei’s book)

Figure 2. Circles of personal relationships in China



Source: Fei (1992)

room-mates or neighbours from the same small village.

The next circle outwards belongs to less close but still influential relationships, such as more distant family members, other friends and work colleagues who can impact your career.

Further out still are distant acquaintances and work colleagues who would have little influence on one's career prospects, and right on the outside are strangers, which would certainly include the vast majority of foreigners.

Every person has their own set of concentric relationship circles, and the different circles mingle together in highly complex linked patterns of interference, exerting an important impact on peoples' decision-making.

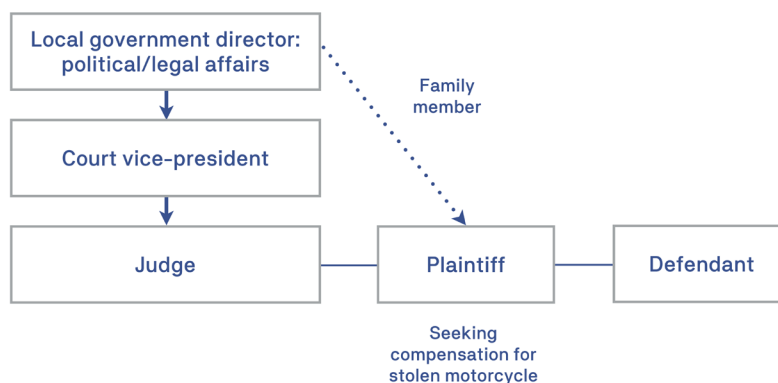
How does this cultural tendency affect the legal system? Academics Xin He and Kwai Ng conducted a survey of the impact of personal relationships on judges in three Chinese cities (He and Ng, 2017). The results are fascinating but also shocking. In all three cities, judges would alter the outcome of cases to favour requests from people with whom they had 'strong' relationships. Those people included close family and friends – 'non-supervisory' relationships – and also senior work colleagues who could influence the judges' career prospects – 'supervisory' relationships. Either of these kinds of strong relationship would be very effective in influencing judges' decisions about legal cases. By contrast, weak relationships, such as more distant

acquaintances or lower-level work colleagues, would be much less likely to influence judges' decisions, even when accompanied by monetary bribes.

To give just two examples, in one case a man claimed compensation from a residential development when his uninsured motorcycle was stolen. He tried to prove that the motorcycle was in the car park of the residence when it was stolen, but his 'witness statement' from the car park manager turned out to be fake. The judge wanted to throw out the man's claim, but her supervisor, the court vice-president, told her to award the compensation because the claimant was a family member of the director of political/legal affairs in the local city government. The judge had little choice but to follow orders, otherwise she would have risked losing her job. The relationship here was a strong supervisory one between the court vice president and the judge. There was also a strong supervisory relationship between the director of political/legal affairs and the court vice president, and a strong (non-supervisory) relationship between the director and his family member, the plaintiff in the case. All these worked together to alter the result of the case (He and Ng, 2017).

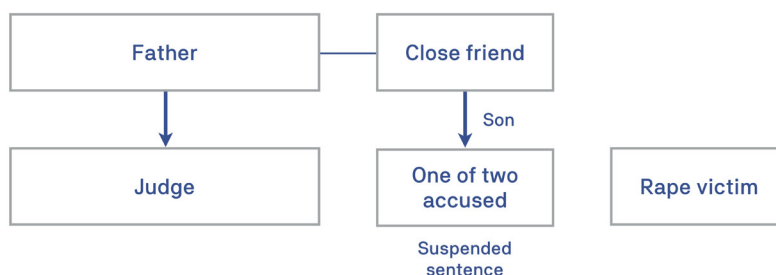
In another case from Guangdong Province, two men were accused of raping a woman. The father of one of the two defendants was a close friend of the father of a judge who worked at an intermediate court in the same region. The judge could not refuse when his father requested help for his friend's son,

**Figure 3. Motorcycle compensation case**



Source: He and Ng (2017)

Figure 4. Rape case



Source: He and Ng (2017)

due to their close family and friendship ties ('non-supervisory' relationship). The judge was not in charge of the case and he couldn't prevent a guilty verdict, but he was able to use his connections in the trial court to help the defendant get a suspended sentence and avoid prison (He and Ng, 2017).

While the judges still have to work within the law to justify these kinds of decisions, they are able to use their discretion in deciding the amount of compensation, acceptance or rejection of evidence, or sentencing of offenders to alter the outcomes of cases. Those who did not have strong personal relationships obviously lost out, having to pay extra compensation, or in the case of the rape victim, seeing one of her rapists avoiding jail time.

There are two lessons for foreign investors here, both equally important. One is the need to build strong personal relationships with local government officials and other influential people in the regions where you are doing business. This requires spending considerable time in the PRC and, to put it frankly, looking for legal ways that you can provide favours for those officials and/or their family members.

A couple of interesting suggestions are provided by Gavin Crombie, an Australian who spent many years running a business in the PRC. He recalls giving hundreds of English-language lessons to the children of influential government officials, as this 'affords access to the inner circle of the family', and 'giving your time to a person's family is considered a very gracious act, and one of friendship.

Getting close to top officials in this manner also ensures that you often meet other powerful people who are guests in their homes. Meeting people socially, rather than in a business environment, makes it easier to develop a true friendship' (Crombie, 2005). This advice may not be practical for most foreign investors, but other less time-consuming possibilities include inviting a mainland Chinese friend to your home country for a visit, helping their child to deal with the complexities of applying to study at a foreign university, or arranging for your company to donate to an official mainland Chinese charity, such as the Hope Project, which builds schools in impoverished rural areas. The crucial point is that if foreign investors don't get to know their mainland Chinese business partners and key political contacts personally, and give them reasons to trust you, their businesses will likely face numerous obstacles in the PRC. Just as important, notes Crombie, you must continue to 'tend' these relationships, show gratitude for favours, and be prepared to give in order to receive, otherwise the trust you have built up will be lost (Crombie, 2005)

The other key lesson is that if a foreign investor becomes embroiled in a legal dispute in the PRC, it is advisable to retain a Chinese law firm that has both specialised legal expertise and very strong relationships with people who can influence the judges. This may not totally alter the outcome of the case, but is likely to have some benefits and lead to a speedier and more favourable resolution.<sup>7</sup>

<sup>7</sup> This point was emphasised to the author by partners at a Chinese commercial law firm in Guangzhou (interviewed in December 2018).

## 5. Corruption and the impact of the anti-corruption campaign

Corruption is a serious problem in the PRC. The latest annual *Corruption Perceptions Index* produced by Transparency International places China 87<sup>th</sup> out of 180 countries and territories, slightly better than Southeast Asian countries such as Indonesia (89<sup>th</sup>), the Philippines and Thailand (equal 99<sup>th</sup>), but significantly worse than Malaysia (61<sup>st</sup>), South Korea (45<sup>th</sup>), Taiwan (31<sup>st</sup>) and Japan (18<sup>th</sup>) (Transparency International, 2018).

Previous studies of anti-corruption efforts in the PRC concluded that they were largely ineffective, as government officials faced a very small risk of being criminally prosecuted (McGregor, 2010). However, since 2013 under Xi Jinping's leadership, the anti-corruption campaign has gone into overdrive, with over 1.3 million PRC officials investigated and disciplined and several hundred thousand criminally prosecuted (Zheng, 2019; Zhou, 2018). These have included dozens of senior Party leaders, such as provincial governors and Party secretaries, military generals, Communist Party Central Committee members and chief executive officers of major state-owned and private enterprises, who have been sentenced to lengthy jail terms (Mai, 2018). Judges and prosecutors have not escaped the law: several hundred have been criminally prosecuted each

year, including a vice president of the Supreme People's Court (Zhou, 2018).

The PRC government has made it clear that the anti-corruption campaign is ongoing, with many more 'tigers and flies' (senior and junior officials) still to be investigated (Zheng, 2019).

What does this mean for foreign investors in the PRC? Obviously, they need to take care not to get sucked into anti-corruption cases. This was the problem with Crown Resorts, which was encouraging 'high-rolling' mainland Chinese gamblers to visit its casinos in Australia and Macau while turning a blind eye to where those gamblers obtained their funds (Patty, 2013; McKenzie, 2020). In several high-profile cases that Crown likely would have been aware of, Chinese high-rollers in Macau were betting or laundering money they had corruptly siphoned away from the SOEs they managed (Azevedo, 2013; Rovnick, 2013; Berzon et al., 2012). Crown Resorts was too slow to realise that the political wind was changing, and the the PRC government was cracking down on dubious cross-border transactions and the casinos that enabled them as part of its expanding anti-corruption campaign.

Foreign businesses in the PRC should not ignore warnings about corruption from their mainland Chinese employees and government regulators. The multinational pharmaceutical firm GlaxoSmithKline (GSK) was forced to pay



approximately US\$500 million in fines, and five of its PRC-based executives were found guilty of bribery. They had set up a scheme whereby mainland Chinese doctors and hospital officials were rewarded with lavish gifts and holidays if they prescribed GSK's drugs, sometimes for unauthorised clinical uses (Barboza, 2016).

An employee whistleblower had alerted GSK's senior executives to the corruption in early 2013 in detailed emails, but instead of cleaning up the problem, GSK fired the employee they suspected of writing the emails (she later turned out *not* to be the whistle-blower). They then bribed several Shanghai government officials to try and make their investigation go away. As a detailed analysis of this scandal in *The New York Times* pointed out, this kind of unscrupulous behaviour may have worked in previous years, but under the new anti-corruption regime, it only strengthened the PRC government's resolve to publicly prosecute a multinational pharmaceutical firm and clean up the notoriously corrupt PRC health sector (Barboza, 2016).

Besides ignoring the warning signs, GSK's other mistake was to fire a mainland Chinese employee in its government relations department without cause (the suspected whistleblower), and then hire a private investigation firm to dig into her personal life and find incriminating evidence against her. GSK should have known that the employee had very strong personal relationships within the Shanghai government – her father was a senior health official there. The subsequent arrest and two-year imprisonment of the private investigator, Peter Humphrey (*BBC*, 2014; Barboza, 2016), for illegally obtaining confidential information, and the harshness of the prosecution against GSK partly stemmed from this basic ignorance about the dangers of destroying such personal relationships.

## 6. Corruption vs. building personal relationships: is there a difference?

It can be difficult to draw the line between building strong personal relationships and engaging in corruption. This is because building relationships often requires doing favours for one's friends and family members, and these favours may benefit them financially – for example, a judge awarding compensation to an undeserving plaintiff in the case described earlier. Likewise, GSK may have thought its 'rewards' of holidays to doctors and officials were just helping to build relationships, just as many corporations in Australia invite valued clients to share the VIP box at sports events or join the company's annual awards banquet.

Corruption is obviously a crime in the PRC. The definition of corruption in the *PRC Criminal Law* includes many detailed provisions on PRC public officials receiving bribes or embezzling public funds, but the most relevant ones for foreign investors are Articles 389–93, dealing with giving bribes. In short, giving any form of assets whose value adds up to more than RMB10,000 to a staff member or official of a government institution, including to their family members or to people with whom they have any 'close relationship', or any form of illegal commission or fee to a government unit, an SOE or other public body, in order to obtain some kind of inappropriate benefit can result in jail time and fines for all individuals and organisations involved.

Punishments vary depending on the value of the assets, but include up to three years in jail for less serious offences and life imprisonment for 'huge' bribes.<sup>8</sup> It is a defence if it can be proved that the public official forcibly extorted the bribe, but that would require more than just showing that the official made a simple request for money.

Even if not caught by PRC anti-corruption laws, foreign investors engaging in inappropriate 'relationship building' in the PRC may breach international laws such as the *US Foreign*

<sup>8</sup> The threshold amounts for each penalty are set out in a 2016 Supreme People's Court Interpretation (Supreme People's Court, 2016): 'huge' amounts would normally mean bribes over RMB5 million (approx. A\$1 million).

*Corrupt Practices Act* (FCPA).<sup>9</sup> For example, several international banks including JP Morgan, Barclays and Deutsche Bank, were fined millions of dollars for hiring numerous sons and daughters of senior PRC officials. Hiring well-connected employees was not problematic in itself, but the banks did so with the express intention of receiving investment banking business through the employees' parents (PRC government officials), and in some cases, the employees were unqualified to work in a bank: the jobs given to them were merely paid sinecures (Guilford, 2013; US SEC, 2020).

With the PRC government enforcing these corruption laws more strictly, it would be extremely foolish for a foreign investor to give or offer any kind of bribe to an official, either directly or through their close acquaintances, or to turn a blind eye to behaviour of any agent or intermediary who offers to help get government licences or approvals through the 'back door'. To reduce risks, foreign investors also need to adopt a rigorous internal anti-corruption policy that is clearly communicated to all their employees and agents in the PRC.<sup>10</sup>

The good news is foreign lawyers based in the PRC have confirmed that requests for unlawful payments are not common any more, at least in the large coastal urban regions.<sup>11</sup> And if such a request does occur, there are so many cases of PRC officials being criminally prosecuted that foreign investors can easily point to them when politely refusing. *ChinaFile* has compiled a useful database of almost 2500 such cases, searchable by location and official rank (*ChinaFile*, 2018).

Instead, foreign investors must find other ways of strengthening personal ties with key PRC officials that don't involve financial inducements or expensive gifts. As mentioned above, the gift of time spent assisting officials and their families with English-related issues is one invaluable option.

Another approach is to pay attention to the annual evaluation and promotion system of

local PRC officials. This now includes mandatory performance indicators for environmental sustainability and social harmony, unlike the previous system that focused mainly on short-term economic growth (Wang, 2013). This provides an opportunity for foreign investors to contribute financially or in-kind to local community support or sustainability initiatives, in consultation with local government officials, to help them meet their annual evaluation targets, yet without seeking any obvious quid pro quo. It is a legal and socially beneficial way to build strong local relationships and ongoing support for the foreign business and to give local officials 'face'. The aim should be to create a 'community of mutual interests' (*liyi gongtongti*), whereby the corporation, the environment and local governments all benefit without engaging in risky and destructive corruption (Hawes, 2012).

<sup>9</sup> The FCPA applies not only to US businesses but any business that engages in transactions via the US, such as having a bank account in a US bank. See the list of dozens of penalised businesses, including many non-US corporations, at US Securities Exchange Commission (2020).

<sup>10</sup> For useful tips on developing anti-corruption policies, see Transparency International (2011).

<sup>11</sup> Interviews with China-based foreign lawyers in Sydney (August 2017) and Beijing (June 2018).



## 7. Other risks for foreign business managers: extra-legal detention

We noted earlier that it is extremely rare for foreign business investors to be charged with crimes in the PRC, and generally the warning signs will be very evident before it happens.

However, for foreign investors who default on contracts or refuse to pay debts, the risks of extra-legal detention are much higher and have increased significantly in recent years, according to China-based foreign law and risk advisory firms, who frequently deal with several cases *each week* (Harris, 2013).

This kind of detention is unlawful, but local police and officials may be paid off to assist in the operation or to turn a blind eye. Other times, the creditors will simply hire private enforcers (semi-organised gangs). The normal process is for the creditor to invite the foreign investor to a meeting in the creditor's home city to 'negotiate a settlement', and when the foreigner arrives, they are forcibly detained in a hotel room without any means of communication with friends, family, lawyers or embassy staff, until they agree to transfer full payment of the amount owing. Generally, no

physical violence is involved, but the foreigner is guarded round the clock and simply not permitted to leave until the dispute has been resolved (Harris, 2013).

It is not only foreigners who encounter these kinds of 'self-help' debt collection methods; creditors use similar strong-arm tactics against mainland Chinese debtors too (He, 2009; Clarke, 2010). But the key reason for detaining foreigners is that once they leave the PRC, it will be extremely difficult and expensive for the Chinese party to recover the debt, unless the foreign business is still operating in the PRC.

If a foreign investor is about to get into a financial dispute with a person or company in the PRC that will make them a debtor, the advice of Dan Harris, an experienced China-practice lawyer, is: (1) Stay away from the PRC, and get all your staff out of the PRC immediately, even if you believe you are in the right; (2) If you really have to go to the PRC, consider hiring bodyguards, and do not visit your mainland Chinese counterparty in their home region or city; (3) Seek expert legal advice from experienced PRC-based lawyers or risk advisory firms *before* you get detained, as they can assist you to settle the dispute (Harris, 2017).



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## 8. Alternative dispute resolution or litigation?

Of course, assuming the foreign investor is the plaintiff rather than a debtor refusing to pay, they will need to use some kind of legal process to enforce their rights and get their money back. What is the best way to do this?

Until recently, received wisdom was that foreign investors should first attempt to negotiate or mediate the dispute, and if that failed, go to arbitration. This is because arbitration is a private process where the rules can be much less complicated; the two parties would have already chosen an arbitration forum such as the China International Economic and Trade Arbitration Commission (CIETAC); most CIETAC arbitrators were experienced in dealing with commercial disputes and not biased against foreign plaintiffs (unlike many PRC judges); the arbitration award could be enforced in the PRC; and overall it was quicker, simpler and cheaper than litigation (CIETAC, 2015).

However, the situation has changed now, according to experienced PRC commercial lawyers.<sup>12</sup> Certainly mediation is still a crucial first step, and this is where strong personal relationships with local PRC officials will help,

as they may put pressure on the counterparty to settle the dispute amicably (Crombie, 2005).

But if mediation fails, bringing a lawsuit in the court is now preferable to arbitration in the vast majority of cases in major urban centres.

There are several reasons for this. First, PRC judges in urban courts are much better qualified than before and they now hear hundreds of commercial cases every year, so they have far superior legal knowledge and adjudication experience than most arbitrators. By contrast, the PRC arbitration system has split into numerous local branches of CIETAC, and the selection criteria and quality of arbitrators in each place varies greatly. Second, there are increased procedural protections in courts, such as requests to freeze the defendant's assets and the option to appeal decisions to the next level, which are not available in arbitrations. Third, due to strict court deadlines for resolving cases, most lawsuits in the PRC are concluded within 3-6 months from initial filing, so the process is just as quick as arbitration and court fees are not high unless the amount claimed is huge.<sup>13</sup> Fourth, the greater availability of highly qualified lawyers with commercial litigation experience, plus access to previous court judgments online and good personal

<sup>12</sup> The following information about dispute resolution is mainly based on the author's interview with lawyers at a prominent PRC commercial law firm in Guangzhou with many foreign clients.

<sup>13</sup> Court fees are calculated as a percentage of the amount claimed by the plaintiff. For lawsuit time limits, see He (2009).



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relationships with local courts means that the result of the litigation is much more predictable, unlike with arbitrations where previous decisions are not published and legal reasoning is not required.

The other surprising development emerging from interviews with mainland Chinese commercial lawyers is that winning a lawsuit against an SOE is often easier than one against a private PRC firm. This goes against the received wisdom that PRC government entities will always win in the courts, but it is supported by more recent empirical studies of PRC commercial court judgments (Lin, 2019; Hawes, 2015). The reasons for this are that SOE managers have less of a personal stake in the outcome than private entrepreneurs because they are not the owners of the firm. In fact, one mainland Chinese lawyer recalled a case where the manager of the SOE defendant voluntarily provided the plaintiffs (his clients) with crucial evidence to speed up the lawsuit, as it was distracting him from his day-to-day work duties.<sup>14</sup> With cases involving foreign plaintiffs, SOEs may also wish to settle disputes quickly to avoid making the local region look like an unwelcoming environment for foreign investment.

## 9. Avoiding disputes in the first place: language/culture issues

Of course, even if a foreign investor wins a lawsuit, it is still a stressful and time-wasting experience. To minimise the risk of disputes, it is worth spending more time getting to know potential mainland Chinese business and trading partners first before signing any contracts. If the foreign investor doesn't know them well, they will likely be treated as a member of the outermost relationship circle, with minimal obligations to honour the agreement.

Paul Midler's book *Poorly Made in China* (2009) is a cautionary tale about the disastrous results of rushing into deals with Chinese business entrepreneurs without developing strong personal relationships with them first. Midler was an agent for several cosmetics and shampoo/soap suppliers to large US department stores. The suppliers were also foreign investors, but they did not have any employees on the ground in the PRC. They hired Midler to find mainland Chinese factories that could produce the goods cheaply and efficiently, and then deal with any quality or distribution issues that came up later. He quickly found some factories that could do the job in Guangdong province, and the suppliers placed their orders without even meeting the factory owners. The prices were extremely cheap. Once they got going, however, the factories regularly altered the ingredients in the cosmetics and shampoos and reduced the thickness of plastic in the bottles to save costs, leading to constant quality recalls by the department store buyers. They also colluded with the local government and customs officials to delay export of the goods until the suppliers agreed to pay higher prices. In the end, the suppliers did not save any money and were forced to look for more reputable factories in a different city (Midler, 2009).

Contrast this approach with a firm like the investment bank Goldman Sachs, which hired highly qualified native Chinese-speaking staff with excellent local personal relationship networks, and then spent several years

<sup>14</sup> Interview with Guangzhou commercial lawyer, December 2018.

cultivating close personal relationships with PRC bank executives and government financial regulators, including providing hundreds of seminars to them on capital markets and public listing of SOEs, and agreeing to assist with restructuring the EMBA program at Tsinghua University's School of Economics and Management. They were rewarded with the chance to buy a hugely profitable stake in ICBC, the PRC's largest bank, and become co-lead underwriters for the public listings of Bank of China and China National Petroleum Corporation (Paulson, 2015).

Not many foreign investors would have the financial resources of Goldman Sachs, but the basic principle of developing strong relationships of trust with potential business/trading partners before signing any major contracts still holds good at lower levels of the investment ladder. This, of course, requires a major time commitment and highly developed cross-cultural communication skills.

That brings us to the other common cause of disputes in the PRC: the language barrier. Many foreign investors underestimate the difficulties of dealing within a bilingual business environment. Space does not permit a full discussion of this issue, but the basic rule should be: if the foreign investor is not totally fluent in spoken and written Chinese themselves, they need to hire competent colleagues who are totally fluent; preferably people they have known for some time already and deeply trust. Otherwise they will open themselves up to numerous legal and commercial risks. It is not sufficient to rely on freelance translators who don't understand their business and have no personal stake in their success.

To finish with a couple of examples of legal issues caused by language errors, I was once asked to review a bilingual contract where the calculation of the price was different in the Chinese and English versions, which would have led to a several hundred thousand dollar shortfall for the client (the Chinese version of the contract was the 'official' version). Luckily, the client hired our law firm to do the review before they signed the contract, but it showed that they did not have any Chinese-speaking staff who could read even the basic

terms of a legal agreement, like the price. I was not optimistic about their future business prospects dealing with China.

Another Canadian company was not so lucky. In the English version of the contract, their 'proprietary technology' was to be kept confidential 'except when demonstrated to employees of the licensee'. But in the Chinese version, it said 'except when employees of the licensee demonstrate it to the public'. After the mainland Chinese licensee used this and other ambiguous terms of the contract to sell the proprietary technology to another Chinese firm, the Canadian owner demanded compensation, and it took several years of arbitration and expensive legal fees before they recovered some of the money. I was asked to be an expert witness in the case to compare the English and Chinese versions of the licensing agreement. The differences between the two versions would have been immediately obvious if the Canadian company had hired competent Chinese-speaking employees with some basic legal knowledge before they got involved in the PRC market.

## 10. Conclusion

It should be clear from this discussion that the PRC has its own distinctive rule of law system. Politics still plays a major role in some sensitive cases, and strong personal relationships can also influence PRC judges' behaviour, but courts in urban regions now generally decide commercial disputes based on relatively predictable legal reasoning.

To minimise the risks of legal disputes and avoid getting sucked into the anti-corruption campaign, foreign investors must spend considerable time developing relationships with potential business partners and Chinese officials based on mutual trust and willingness to contribute to the local Chinese community.

Making the effort to become fluent in Mandarin is highly recommended, but at the very least, all foreign investors in the PRC and anyone who trades with the PRC must hire language-competent colleagues with cross-cultural management skills.

Finally, if a foreign investor does get into a legal dispute they will need to hire a well-connected Chinese lawyer and possibly make a rapid departure from the country.

# About the author



## Colin Hawes

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Dr Hawes joined the UTS Law Faculty in 2005 after obtaining his PhD at the University of British Columbia and practising law in Vancouver, Canada. He has published numerous articles on Chinese law and society, and his second book, *The Chinese Transformation of Corporate Culture* traces the emergence of a uniquely Chinese hybrid corporate form that combines economic, social and political ends.

His recent research focuses on the Chinese corporate ecosystem, the creative interpretation of corporate law by Chinese judges, and the impact of technology on the operation of the Chinese legal system.

Colin has been invited by leading international universities to teach law courses or to conduct research as a visiting professor, including Oxford University (UK), China University of Politics & Law (Beijing), South-Western University of Politics & Law (Chongqing), University of British Columbia and Simon Fraser University (Canada), and National Taiwan University in Taipei. He also regularly acts as an expert witness or legal consultant for China-related legal cases.

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