DISPUTE AVOIDANCE AND DISPUTE RESOLUTION

While conducting business in China, foreign companies occasionally find themselves embroiled in disputes with Chinese individuals, companies, or the Chinese Government. The number of cases involving the first two categories far exceeds those of the third. The best approach in dealing with individual disputes varies from case to case. Nevertheless, Department of Commerce (DOC) officials with extensive experience with such disputes have prepared the following guidelines to assist U.S. companies doing business in China.

I. Dispute Avoidance

Good planning can help you avoid disputes. DOC officials recommend U.S. companies consider the following:

1. Have clear contract terms. Specify exact terms of payment and performance standards. Set time lines. Include specific dispute resolution clauses, including details on the procedure and maintenance of operations during the pendency of a dispute. Pay careful attention to details, such as initialing pages of contracts and signing properly. Make sure the Chinese version of the contract is consistent with the English version. Do not attempt to enter into an agreement without sound legal advice.

2. Make certain your project is economically viable by its own terms. Profitability of a project or the sale of goods and services should be based on sound economic criteria. Do not rely on promises of subsidies, special considerations, or non-market sources of income to generate a profit.

3. Make sure you know your partner. Do your “due diligence" and do it well. Choose your partner carefully and only after a careful examination of experience and dependability. Check the reliability of the data your partner provides from independent sources. Avoid being "stovepiped" - talking only to those people to whom your partner or buyer directs you.

4. Make sure you get paid. A contract with an insolvent partner or customer is worthless. Pay careful attention to how you get paid, when you get paid, and in which currency. If you have agreed to be paid in Chinese Yuan, verify that you can convert profits to U.S. dollars. Use letters of credit or other financial instruments to protect yourself.

5. Do not enter into prohibited agreements. American companies have often entered into agreements with promises from local officials that central government rules will not be enforced in the provinces. While this is sometimes true, problems may arise when these rules are suddenly applied--sometimes retroactively--leaving the company with little recourse. In particular, you must be prepared to obey the central government's implementation of revised laws, regulations and practices as China meets its World Trade Organization (WTO) obligations, regardless of promises to the contrary by local officials.

6. Be careful not to base your business on WTO-noncompliant rules. The U.S. Government cannot support you if you are relying on a business plan that is dependent on Chinese regulations that violate the WTO. As such rules are replaced, you may find your competitive advantages eroded.

7. Search for problems before they materialize. In addition to creating *pro forma* balance sheets, spend some time at the beginning of a project to examine what you will do if things go wrong. Try to anticipate possible problem areas. If you can't find any, you are not looking hard enough. Create a strategy to deal with potential problems. You know how much profit you want to make. Know your company's limits on losses as well.

8. Do a thorough risk analysis. Be realistic about how much risk you are willing to accept in your business venture. Make sure you use reliable sources for this assessment. Use more than news media sources or your immediate partners to evaluate the risk.

9. Limit your exposure. Set milestones in the project for performance. Have an escape strategy for each stage of the project, even though you don't plan to use it.

10. Mind the store. Projects and sales in China require constant attention. Do not assume they will run themselves.

II. Disputes with Chinese Companies or Individuals

There are four primary ways to resolve a commercial dispute in China:

A. Negotiation

Simple negotiation with your partner is usually the best method of dispute resolution. It is the least expensive and it can preserve the working relationship of the parties involved. In fact, most business contracts in China include a clause stipulating that negotiation should be employed before other dispute settlement mechanisms are pursued. When a foreign firm experiences difficulty in directly negotiating a solution to a dispute with its Chinese partner, companies sometimes seek assistance from Chinese government officials who can encourage the Chinese party to honor the terms of the contract. Companies should specify a time limit for this process. Unfortunately, negotiations do not always lead to resolution.

B. Mediation

The principle of mediation is that the parties may present their proposals to the mediator who suggests a solution based on those proposals. Mediation is by definition non-binding and has achieved great success as a means of settling commercial disputes between foreign and Chinese parties. In both the arbitration and litigation contexts, mediation represents an early step in the resolution of the dispute. In arbitration before a Chinese arbitral tribunal or in litigation before the Chinese courts, parties are encouraged to participate in mediation with mediators selected by the arbitral panel or during an in-court session, respectively. The less confrontational nature of mediation may also help preserve the commercial relationship.

C. Arbitration--Chinese, International and Enforcement

1. Chinese Arbitration. Arbitration is the *preferred method* of dispute resolution in China, and approximately 90% of China-related disputes are resolved inside China. Since it is rare for the parties to agree on arbitration after the dispute has arisen, the underlying contract or separate agreement must expressly provide that disputes will be resolved through arbitration. In China, a valid arbitration agreement must reflect a clear intent to arbitrate and clearly identify the arbitration institute that will administer the case. If so, arbitration will be the only available binding means of dispute resolution available under the contract; otherwise, the dispute must be resolved by the courts.

There are important differences in arbitration in China versus arbitration in other countries. For example, ad hoc arbitration is not recognized in Chinese law when it takes place within China. Rather, arbitration may be conducted only by officially recognized arbitration institutions. As a consequence, parties selecting China as their arbitration location will be constrained in their choice of applicable procedural and substantive rules, and, if an arbitration is necessary, will be required to choose arbitrators from lists maintained by the arbitration institution they select.

In China, arbitration offers many advantages over litigation. A major advantage is the finality of the rulings. Court rulings are subject to appeal, which means litigation may continue for years. Judges in China are often poorly qualified, while arbitration panels are made up of a panel of experts, which improves the quality of the hearing. In addition, the proceedings and rules of arbitration are often more transparent than litigation.

The latest and perhaps most troubling concern about arbitration in China is a recently adopted regulation that limits the ability of foreign counsel to appear as party representatives/advocates. Historically, many U.S. companies agreed to Chinese arbitration based in large part upon their ability to engage foreign counsel. However, under the new regulations that became effective as of September 1, 2002, foreign lawyers are limited in their ability to appear as counsel in arbitration proceedings, though we have received anecdotal reports that foreign lawyers have been allowed to continue on as counsel in proceedings commenced prior to the enactment of the regulations.

1a. Chinese Arbitration: CIETAC - Although the distinctions no longer apply, Chinese arbitration institutions were traditionally divisible into those handling "foreign-related" disputes and those handling purely domestic disputes. "Foreign-related" disputes are those in which at least one party is a foreign person or entity, the contract was formed, modified or terminated in a country other than China, or the object of the action is in a foreign country. A foreign-invested enterprise (FIE) in China is not a foreign entity for these purposes, and as an organization established under Chinese law, it is considered a domestic entity. The two arbitration institutions originally designated to hear "foreign-related" disputes are the China International Economic and Trade Arbitration Commission (CIETAC) and the China Maritime Arbitration Commission (CMAC).

CIETAC, whose jurisdiction has expanded to include domestic disputes, is China's most well-known arbitration body. According to rankings with the International Chamber of Commerce (ICC) and the Stockholm Chamber of Commerce (SCC), CIETAC is one of the busiest arbitration institutions in the world based on the number of cases handled per year.

As with other Chinese arbitration institutions, CIETAC maintains a list of arbitrators from whom parties must choose. Unlike local arbitration commissions (discussed below), CIETAC includes a considerable number of foreigners on its list, which as of September 2001 featured 147 foreigners (from other than Hong Kong and Taiwan) among its 518 potential arbitrators. Nevertheless, due in part to the fact that compensation for foreign arbitrators is quite low by international standards, foreign arbitrators rarely serve in CIETAC proceedings. In addition, while CIETAC will now hear disputes between FIEs and other Chinese entities (i.e., disputes where neither party is technically foreign) arbitrators for such disputes must be chosen from a special list that excludes foreign arbitrators.

In contrast to the procedures of most international arbitration institutions, CIETAC assigns important roles to CIETAC as a body, as opposed to the arbitration panel itself. CIETAC, not the arbitrators, decides such matters as the existence and validity of an arbitration agreement and fixes the dates for hearings. Furthermore, the arbitrators are empowered under CIETAC's rules to make an award on the basis of the "principles of fairness and reasonableness" in addition to applicable facts, contractual terms and law. General international practice is for an arbitration panel to take equity into account only when the parties have explicitly empowered it to do so. On the whole, however, CIETAC seems to be moving gradually toward increased party autonomy over the terms of the arbitration.

For example, CIETAC allows parties to specify the nationality of members of the arbitration panel in their arbitration clauses, and has enforced clauses stipulating that two of the three arbitrators, including the presiding arbitrator, must be non-Chinese, and CIETAC need not pre-approve any such contractual stipulations. CIETAC has published rules that govern the selection of a panel if the contract does not specify how the choice of arbitrators will be handled. Further, as noted above, CIETAC's list of arbitrators for foreign-related disputes, from which CIETAC's arbitrators must be chosen, includes many non-Chinese arbitrators. Nevertheless, many foreign experts believe that some aspects of CIETAC need to be improved. For a more detailed discussion of the specific areas of concern, please see the Annex to this document entitled "CIETAC Areas of Concern."

1b. Chinese Arbitration: Local Commissions - In addition to CIETAC and CMAC, there are over 140 local arbitration commissions that have been established in most major cities, including Beijing, Shanghai, Guangzhou and Shenzhen. Originally designed to hear purely domestic disputes only, these commissions can now hear "foreign-related" disputes as well. The most active of these in "foreign-related" arbitration is the Beijing Arbitration Commission (BAC).

While the local arbitration commissions are in principle civil institutions and not government units, they remain closely tied to government in a number of ways, including financing and personnel appointments. Their quasi-government status is also evident in their rules – those of the BAC, for example, purport to give jurisdiction to Intermediate Level People's Court's to resolve certain issues arising during the course of arbitration. At least some of the commissions are on their way to financial independence. According to the BAC, it has been fully self-financing on the basis of arbitration fees since August 1999.

Despite initial misgivings in the foreign investment community about the quality of arbitration by local commissions as opposed to CIETAC, experience thus far indicates that at least some commissions, such as the BAC, are performing better than expected. However, the BAC still does not include foreigners in its listing of potential arbitrators.

2. International Arbitration. ICC, SCC, the Hong Kong International Arbitration Center (HKIAC), the Singapore International Arbitration Centre and the American Arbitration Association (AAA) among others are international alternatives to Chinese arbitration at CIETAC or the local commissions. Convincing a Chinese party to agree to offshore arbitration, however, may be difficult at best. Moreover, gaining a Chinese party's participation in an offshore arbitration is also problematic because of actual or perceived foreign travel restrictions or other concerns.

For detailed information on any of the above-mentioned institutions, please consult the institution's website and/or legal counsel. A few points, however, bear mentioning here.

Most ICC arbitration, like all CIETAC arbitration, is administered, although ad hoc arbitration is allowed. Alternatively, approximately 90% of HKIAC arbitration is ad hoc, with the parties enjoying complete autonomy over the process. Like CIETAC, HKIAC provides a list of more than 300 approved arbitrators from all over the world.

AAA arbitration is probably the most "foreign" to Chinese parties. The role of the U.S. courts, the breadth of discovery and the reliance on evidence and testimony may seem overwhelming if not frightening to the average Chinese company.

Each of the above arbitration institutions calculates arbitration fees by reference to the amount in dispute. SCC and ICC arbitration have the reputation of being much more expensive than CIETAC, and in cases involving smaller sums, CIETAC may indeed be more cost-effective. HKIAC arbitrators are paid according to time actually spent on the case, making it extremely difficult to accurately estimate costs.

3. Arbitration Enforcement. One of the most frequently cited difficulties of arbitration in China is enforcement. Once a domestic arbitral award is issued, securing payment is beyond the powers of the arbitration commission. As a result, the prevailing party most often must apply to a court to have the award recognized and enforced. Foreign awards that are not paid voluntarily also may be filed with a court to compel enforcement. Because China has acceded to the 1958 UN Convention on Recognition and Enforcement

of Foreign Arbitral Awards, commonly referred to as the New York Convention, CIETAC and local commission awards are enforceable in other signatory countries on the basis of reciprocity. While in principle the same should apply in China, in practice, enforcement is problematic.

Although China does not maintain any centralized record of enforcement of arbitral awards, existing evidence seems to confirm that enforcement is poor. China's Chamber of International Commerce reports that one in four applications are denied, but anecdotal information implies the number may be much higher. It appears that enforcement is easier to secure in major cities such as Beijing, Shanghai, and Guangzhou, and smaller awards appear more likely to be enforced than larger ones. This fact is not surprising given that the primary reason for non-enforcement appears to be insolvency on the part of the Chinese party.

CIETAC and local commission awards are not enforceable in China under the New York Convention, but rather under Article 260 of China's own Civil Procedure Law, which, much like the New York Convention, allows courts to refuse enforcement only for a limited number of procedural reasons. The problem lies, however, in the greater relative weight accorded by Chinese judges to foreign awards made by arbitral bodies outside China versus that given to foreign and foreign-related awards coming from within. In addition, now that CIETAC's jurisdiction has expanded to include commercial disputes between FIEs and other domestic legal entities, uncertainty exists as to whether the resulting awards should still be classified as "foreign-related" or should actually be termed domestic awards, thus giving Chinese courts greater leeway to overturn them.

While courts are required to receive approval from the Supreme People's Court prior to refusing to enforce a foreign arbitral award, courts have occasionally circumvented this requirement by employing delaying tactics when local interests are adversely affected by the arbitration rulings**.** The Supreme People's Court has issued new guidance to limit the ability of local courts to refuse and delay enforcement of "foreign-related" domestic awards and this appears to have had a positive effect.

Since the return of Hong Kong to Chinese sovereignty, there remains a concern that some Chinese courts could determine that, unlike a foreign award, it can refuse to enforce a Hong Kong award without getting clearance from the Supreme People's Court. (Arbitral awards from Hong Kong are enforceable on the mainland through an agreement between the Hong Kong government and the government in Beijing.) At this point, the problem remains theoretical and may be addressed in guidance to be issued by the Supreme People's Court in 2003.

Enforcement in Chinese courts is complicated by the same factors that make parties unwilling to litigate disputes in these same courts (see below). Court officials often lack sufficient legal training and, according to reports, inadequate training has led to delays of more than one year in accepting or processing an application for arbitral enforcement. Local protectionism, the influence of party officials, lack of professional ethics, and inadequate authority may complicate enforcement even when the staff is well trained.

D. Chinese Litigation

A final way to resolve a commercial dispute in China is through litigation in Chinese courts. In China, foreign individuals and companies have the same ability to bring action in court as Chinese citizens and companies. There are four levels of courts in China. Every major city has basic courts and intermediate courts. Supervising these courts are the provincial high courts. The Supreme People's Court, located in Beijing, has appellate jurisdiction over all courts in China. Cases involving foreign interests can be filed in either the basic-level courts or intermediate courts, depending on their nature. Most observers agree that Chinese courts are not up to international standards. For instance, most judges have minimal or no legal training and observers have stated those poorly trained court officials are susceptible to corruption and regional protectionism. Also, courts are funded by local governments, undermining their independence.

III. The Role of the U.S. Government in Commercial Disputes

American companies involved in a dispute often approach the DOC and other U.S. government agencies in China or the United States for assistance. DOC can provide companies with assistance in navigating China's legal system, provide a list of local attorneys, and share basic information on potentially applicable trade agreements and relevant Chinese business practices. DOC is not able to provide companies or individuals with legal advice.

American companies that have disputes with private firms often request U.S. Government intervention with Chinese authorities on their behalf. Such intervention is rarely appropriate unless the company has exhausted all remedies under China's legal system. DOC's efforts in assisting with commercial disputes are aimed at achieving a fair and timely resolution in accordance with Chinese law and advancing both countries' interest in adequate legal and judicial protection for all parties.

When a dispute is in the Chinese court system, Embassy officers will intervene on behalf of an American company only in extremely limited circumstances and in accordance with U.S. government guidelines.

IV. Disputes Involving the Chinese Government

When a U.S. firm has a dispute with the Chinese Government, a Chinese state-owned enterprise, or a government-subsidized project, the most effective initial step is to quietly raise the issue with the entities involved, citing the importance of foreign companies' investment in China. The firm should explain its situation to the Chinese entity, and offer to work with it to resolve the problem amicably. This allows for a more aggressive approach at a later date, if necessary. *The firm should be aware of domestic laws and international trade agreements that govern matters pertaining to the dispute*. DOC can work with companies in considering the best strategy.

While China is obligated to implement fully the terms of its trade agreements, including the WTO agreements, differences over implementation may arise. In such circumstances, DOC is committed to working with firms and the Chinese Government to ensure full compliance. Generally, U.S. Embassy staff and Washington agencies will work directly with concerned companies, or the industry association, to identify solutions and formulate strategies. If appropriate, the Embassy will advocate on behalf of the American companies with Chinese officials. If the dispute cannot be resolved at this level, and additional U.S. Government support is appropriate, the U.S. involvement will usually involve increasingly senior level officials of the appropriate U.S. Government agencies. If compliance with WTO obligations underlies the dispute, the U.S. Government will examine the possible use of WTO dispute settlement procedures. In reaching a dispute resolution strategy, a firm should consider all possibilities, including negotiation, mediation, arbitration or litigation, and the time and expense that it may take to resolve the problem.

Last updated April 2003

Annex to DISPUTE AVOIDANCE AND DISPUTE RESOLUTION

CIETAC Areas of Concern

- CIETAC and the local commissions have drawn criticism for providing parties with only minimal information about potential arbitrators' backgrounds, affiliation and expertise. The following is an example of a typical entry on CIETAC's arbitrator list: "Prof. (Arbitrator Name), International Trade, Arbitration (U.S.A.)." This extremely limited information handicaps parties' ability to determine accurately the level of an arbitrator's expertise or assess any actual or perceived bias.

- Both foreign and Chinese parties have questioned the fairness of CIETAC proceedings stemming from inadequate procedural and professional standards. Although empirical data is scant, critics cite the prevalence of *ex parte* communications, breaches of confidentiality and conflicts of interest, asserting that these reflect a low level of institutional ethics and compromise the quality of CIETAC awards.

- With regard to procedure, many lawyers with CIETAC experience have commented on the insufficient time allowed for hearings, which in some cases is as little as three hours. CIETAC practice also diverges from that of other international bodies in that it typically dispenses with pre-hearing meetings at which the mechanics of the arbitration process (and sometimes issues to be addressed) are clarified. Parties may find that CIETAC proceedings more closely resemble a business negotiation rather than an arbitration proceeding. This is evident in CIETAC's eagerness to settle cases prior to issuing awards, and its rules against publishing dissenting opinions in cases where the decision is not unanimous.

- Foreign companies have also questioned Article 53 of CIETAC's rules requiring arbitrators to decide cases in accordance with "the principle of fairness and reasonableness." At other arbitration institutions, arbitrators would employ this principle only if explicitly permitted to do so by the parties. Otherwise, the arbitral panel should make its decision based on the strict letter of the law governing the contract and the contract provisions.

- Foreign companies have reported that, due in large part to the absence of substantive evidence rules, false testimony and evidence tampering are not uncommon during arbitration, and CIETAC has no requirements that documents be authenticated. There are unsubstantiated claims that local protectionism and corruption are pervasive, with foreign parties reporting that local officials are prone to falsify documents or refuse to provide evidence that might damage the case of a local company.