

# **Break Through the Chinese Wall**

**- Legal and practical guidelines  
for establishing a company in China**

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## About the book

“Break Through the Chinese Wall” is an accessible handbook which provides an introduction to the fundamental rules, regulations and common practices related to establishing and running a business in China. The handbook provides answers to the most frequently asked questions from our clients.

The handbook has been jointly written by Capital Associates and NCO China. Capital Associates is a Chinese law firm specialised in providing commercial legal services and assistance to foreign companies investing in and trading with China. NCO China is a consulting firm that offers corporate services with regard to the establishment of an enterprise in China, Hong Kong etc., and provides accounting, tax and HR services to foreign investors in China. Both Capital Associates and NCO China serve a variety of clients; from large multinational companies to small and medium sized enterprises.

China’s rapid development means that regulations and practices are constantly changing. The handbook is meant to be an introduction to the current laws and practices in China. Updates and further information regarding the subjects covered by the handbook can be obtained from our offices or websites. Please refer to the contact information in the back of the book.

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# The legal system in China

The Communist Party of China (CPC) is involved in all levels of legislative, administrative and judicial functions. From central to local governments, in ministries and commissions, and people's courts, members of the CPC hold central posts with few exceptions.

Both the national State Council, including the heads of its ministries and commissions, and the Supreme People's Court are responsible to the National People's Congress, where members of the CPC hold power. At provincial, municipal, county and village levels, local governments and people's courts are responsible to local people's congresses dominated by CPC-members.

For these reasons the CPC holds much decision-making power in all major matters concerning China, and the concept of separation of powers between legislative, judicial and executive institutions is not well-established as in most western countries.

However, it is evident that the open door policy and the impressive economic growth during the last 30 years have had a significant influence on the legal system in contemporary China. In order to attract foreign investment and maintain a stable and modern business environment, the Chinese government has been working hard to adopt a more transparent judicial framework to replace a regime based mainly on political decrees. Over the years, the Chinese government has adopted - and still is adopting - a large number of new laws and regulations, many of which are strongly influenced from the West.

## **Legal instruments**

China's highest legislative authority is the National People's Congress (NPC). It has the right to revise the Constitution and create major legal codes referred to as "basic laws". Apart from this, the NPC also enacts laws, rules and resolutions.

Chinese government directives exist in a hierarchy, which is defined by the Legislation Law of the People's Republic of China. The hierarchy of regulations are:

1. The Constitution.
2. National laws, which are issued by the NPC.
3. Administrative regulations, which are issued by the State Council.
4. Local decrees, which are issued by local people's congresses.
5. Administrative and local rules, which are issued by an administrative agency or by a local People's Government.

In China, laws are usually broadly drafted with much discretion left to implementing authorities. Some laws amounts to little more than statements of principle, so real clarity exists only at the level of administrative rules, circulars or bylaws.

## **State structure**

Besides the CPC, the primary organs of state power are the National People's Congress (NPC), the President (the head of state) and the State Council.

Other important organs are the people's courts and the people's procuratorates.

## **National People's Congress**

The National People's Congress (NPC) is defined in the 1982-constitution as "the highest organ of state power" without being identified, as it was in the previous 1975-constitution, as "under the leadership of the Communist Party of China." Although the trend has been to enhance the individual role of the NPC, the given image of a true and democratic parliament is somewhat theoretic. With the CPC exerting full control of the NPC, the NPC is perceived by many observers as nothing but a base for the CPC to legitimize and exercise their powers.

The formal functions of the NPC are as follows:

- To amend the state constitution and enact laws governing criminal offences, civil affairs, the state organs and other matters
- To supervise the enforcement of the state constitution and the law
- To elect the president and the vice president of the republic
- To select the Premier of the State Council upon nomination by the president
- To elect major officials of the State Council, commissions, courts, and procuratorates
- To examine and approve national economic plans and budgets
- To supervise the Standing Committee and the State Council

3.000 deputies of the NPC serve 5-year terms and are elected by people's congresses at the provincial level and by the armed forces. The deputies, who meet once a year, are organized into delegations according to the units they are elected from. Each delegation is headed by a chairman and a number of vice chairmen.

Because of its infrequent meetings, the NPC functions through a permanent organ called the Standing Committee, and several other committees. The Standing Committee is composed of the Chairman, Vice Chairmen, Secretary-general and members. The constitution

empowers the Standing Committee to enact and amend laws, with the exception of those, which should be enacted by the NPC, thus giving the Standing Committee extensive legislative powers. The Standing Committee is responsible to and reports to the NPC on a regular basis.

The NPC establishes special committees to examine, discuss and draw up relevant bills and draft solutions under the direction of the NPC and its Standing Committee.

According to the Legislation Law of the People's Republic of China, the following four steps are required for a bill to become legislation:

1. Submission of the bill to the NPC by qualified persons or organizations such as the President of the NPC, the State Council, or a delegate to the NPC.
2. Discussion and deliberation on the bill by the delegates, the relevant special committees and the NPC's Law Committee. The Law Committee shall submit a report on the results of the deliberation and a revised draft law to the President.
3. Adoption and voting on the bill at the NPC. The bill will be passed if a majority of the NPC-delegates votes in favour of it. If a majority votes against it, the law will be either rejected or referred back to the drafting committee for further discussions.
4. Promulgation of the law by the President of the PRC after the NPC has approved the final version.

The legislative procedure under the Standing Committee is very similar to the one under the NPC.

## **State Council**

The State Council of the People's Republic of China is the highest organ of state administration in China, equivalent to a cabinet or council of ministers in most other countries.

Members of the State Council include the Premier (the head of government), a variable number of vice premiers (at present 4), five state councillors, a number of ministers (at present 25), the Auditor-General, the governor of the People's Bank of China and the Secretary-General of the State Council who is responsible for the day-to-day work of the State Council.

Although the NPC and its Standing Committee are the main legislative bodies, the State Council is empowered by the constitution to perform the following legislative activities:

- To adopt administrative measures, enact administrative rules and regulations, and issue decisions and orders.
- To submit proposals to the NPC or its Standing Committee.
- To issue rules governing administrative affairs with respect to national economic and social development, the state budget, urban and rural development, education, science, culture, public health, sports, population control, internal affairs, public security, judicial administration and national defence.
- To alter or annul inappropriate orders, directives and regulations issued by the ministries or commissions.

## **People's courts**

The court system in China is divided into four levels, from top to bottom, as follows:

- The Supreme People's Court at the national level.
- The Higher People's Courts at the provincial level.
- The Intermediate People's Courts at the municipal level.
- The Basic People's Courts at the county or district level.

Special courts (Courts of Special Jurisdiction) have been set up separately to handle matters affecting the military (Military Court of

China), railway transportation (Railway Transportation Court of China), maritime law (Maritime Court of China) and forestry.

Local people's courts are responsible to and report on their work to the local people's congresses at corresponding levels and their standing committees, while the Supreme People's Court is directly responsible to the Standing Committee of the NPC, which elects the court's president.

Within each court, there are usually several divisions, such as civil, economic, criminal, administrative, and enforcement divisions. Simple civil cases and minor criminal cases can be tried by a single judge, whereas bigger and more complicated cases and second trial cases are heard by a panel of three to five judges.

The Supreme People's Court is the highest judicial organ in China. Located in Beijing, it has jurisdiction over all lower and special courts, for which it serves as the ultimate appellate court.

The court employs over 200 judges who meet in smaller tribunals to decide on cases. The Supreme People's Court has a criminal division, a civil division, and an economic division. It may create other divisions if deemed to be necessary.

According to the constitution and statutes, the main responsibilities of the Supreme People's Court are as follows:

- Handling legal cases that:
  - a) are of the greatest influence;
  - b) are appeals or protests against judgements and orders of Higher People's Courts and special courts;
  - c) are deemed by it that it should try.
- Supervising the administration of justice by local people's courts and special courts at all levels.
- Giving judicial interpretation of questions concerning specific applications of law in judicial proceedings.

In the Chinese adjudication system, a case is decided after two trials. This means, first, that a judgment or order of a first instance court must come from a local people's court, and that a party may bring an appeal only to the people's court at the next higher level. Secondly, judgments or orders of the first instance of the local people's courts at various levels become legally effective if, within the prescribed period for appeal, no party makes an appeal. Thirdly, judgments and orders of the court of the second instance shall be seen as final decisions of the case. However, any judgments and orders rendered by the Supreme People's Court as the court of the first instance shall become immediately legally effective.

The Chinese legal system is a civil law system. It does not contain the doctrine of stare decisis. There is no legal precedent or standards from higher courts for inexperienced judges to follow and no guidance system to ensure uniformity in the interpretation and application of the law. Only selected court decisions from the Supreme and Higher People's Courts are released to the public.

### **People's procuratorates**

A hierarchy of prosecuting organs called people's procuratorates parallels the court system. At the apex of this structure stands the Supreme People's Procuratorate.

The people's procuratorates are state organs for legal supervision. Besides having the overall responsibility for public prosecution, including the combat of corruption, bribery, tax-related fraud and other economic crimes, the procuratorates exercise legal supervision over activities conducted in prisons and reform-through-labour institutions.

The Supreme People's Procuratorate is responsible to the NPC and the Standing Committee.

## **Provincial and local government**

China has 22 provinces, 5 autonomous regions, including Tibet, and 4 municipalities directly under the State Council (including Beijing and Shanghai).

The governors of the provinces and autonomous regions and mayors of the centrally controlled municipalities are appointed by the central government after receiving consent from the NPC.

The provinces and autonomous regions are divided into autonomous prefectures, counties, autonomous counties and cities, and the counties and autonomous counties are divided into townships, ethnic townships and towns.

The municipalities directly under the Central Government and large cities in the provinces and autonomous regions are divided into districts and counties; and autonomous prefectures are divided into counties, autonomous counties and cities.

People's congresses are established in provinces, autonomous regions and municipalities directly under the Central Government, autonomous prefectures, counties, autonomous counties, cities, municipal districts, townships, ethnic townships and towns. Standing committees are established at people's congresses at and above the county level.

Local people's congresses at various levels ensure the observance and implementation of the Constitution and the law and the administrative rules and regulations in their respective administrative areas. Within the limits of their authority, they adopt and issue resolutions and examine and decide on plans for local economic and cultural development and for the development of public services.

The people's congresses of provinces, autonomous regions, municipalities directly under the Central Government of cities which

are capitals of the provinces or autonomous regions as well as large cities approved by the State Council have the right to adopt local regulations in the light of their regional political, economic and cultural characteristics.

Local people's congresses at their respective levels elect and have the power to recall governors and deputy governors, or mayors and deputy mayors, or heads and deputy heads of counties, districts, townships and towns. Local people's congresses at and above the county level shall examine and approve the plans for economic and social development and the budgets of their respective administrative areas and examine and approve the reports on their implementation. They have the power to alter or annul inappropriate decisions of their own standing committees. While most of the jurisdictions are run by appointed officials, some lower-level jurisdictions have direct popular elections.

### **Hong Kong and Macau - Special Administrative Regions**

The Hong Kong and Macau Special Administrative Regions (SARs) have some local autonomy since they have separate governments, legal systems, and basic constitutional laws. They are, however, under Beijing's control in matters of foreign affairs and national security, and their chief executives are handpicked by the central government.

Hong Kong and Macau have their own separate judicial systems based on British common law traditions and Portuguese civil law traditions respectively, and are out of the jurisdiction of the Supreme People's Court and the People's Procuratorate.

## Frequently Asked Questions

### 1. *Can I expect a fair trial if I take legal action in a Chinese court?*

In general, you can expect a fair trial in developed places such as Beijing, Shanghai, Guangzhou and Shenzhen. In these cities, courts are capable of handling most business-oriented disputes in a legally satisfactory way, with better facilities and better educated judges than in other parts of the country.

However, in terms of judiciary independence, the Chinese courts do not meet the standard of courts in western countries. The lack of fundamental checks and balances in the legal system, poor funding of the courts and the judges, and a heavy influence from the CPC, local governments and other powerful institutions, can make it difficult for courts to deliver judgements based solely on a strict application of law.

### 2. *Is litigation the typical means for dispute resolution in China?*

Traditionally, China has placed less emphasis on litigation and more reliance on alternate dispute resolution mechanisms such as mediation. Resolving a legal dispute in court is not considered a serious option by most Chinese people and enterprises.

By opening up to foreign investments and introducing new laws and regulations, the traditional approach to dispute resolution is now less prevalent. Nowadays, the need for formal dispute resolution mechanisms in China is in demand, and many companies use Chinese courts to seek remedies despite their inherent weaknesses.

In order to obtain a fair, swift and flexible settlement of commercial disputes, foreign enterprises often make use of arbitration clauses when entering into commercial agreements.

China has a variety of local arbitrations commissions, however only two of them are internationally recognized: the China International Economic and Trade Arbitration Commission and the China Maritime Arbitration Commission.

3. *Do all courts in China have jurisdiction to handle foreign related cases?*

No, according to the Chinese Law on Civil Procedure, only Intermediate and Higher People's Courts have jurisdiction to give first instance decisions in foreign related cases. Basic People's Courts, however, may also have jurisdiction if approved specifically by the State Council.

4. *Is it difficult to enforce court decisions in China?*

Yes. Even with a clear court order in hand, the enforcement of it may turn out to be difficult, sometimes even impossible.

The reason is usually attributed to corruption, local protectionism and various conflicts of interest rather than insufficient means of enforcement provided by law. Despite the fact that the Chinese government and the Chinese media have brought these problems into focus, they still exist in the Chinese judicial system, especially outside major cities.

In the following situations, enforcement obstacles can be expected:

- Due to limited jurisdiction, court orders from one province have little chance of being enforced in another province.

- Court orders made against persons or enterprises with strong relations to CPC-members are almost impossible to enforce due to the omnipotence of the One Party State.
- Court orders made against persons or enterprises with strong relations to local court divisions of enforcement or the police are also very difficult to enforce due to conflict of interests.

The fact, that local courts and police departments are dependent on economic funding from the local government, can make it difficult to enforce court orders against major tax payers in the local community.

It must be noted, though, that the Supreme People's Court has realised this issue and has made tremendous efforts to improve enforcement in recent years, hence the situation has been improving.

##### 5. *Can I appeal a court decision?*

Yes. According to Chinese law, each case shall have at most two trials, which means that litigants to a case and their legal representatives, who challenge a judgment made by a local court in the trial of first instance, have the right to appeal the case to the next higher level court, but only once. In other words: A decision made by an Intermediate People's Court can be appealed to a Higher People's Court.

Once an appeal is filed, the next higher court must try the case again. The judgment of the second trial shall be final and cannot be appealed.

However, the parties to litigation may challenge the final decision or the effective decision through the trial supervision procedure

by appealing to the appellate court or the higher court. After reviewing the complaint, the president of the appellate or higher court may ask the Judicial Committee to make a decision to accept or reject the appeal. It must be noted, though, that under no circumstances does the retrial initiated by the trial supervision procedure suspend the enforcement of the effective judgment that is challenged.

# Useful links

## Help and advice when establishing a FIE in China

- [www.capitallaw.cc](http://www.capitallaw.cc)  
Capital Associates' website.
- [www.ncochina.com](http://www.ncochina.com)  
NCO China's website.

## Government and organizations

- <http://english.gov.cn/index.htm>  
The official website of the Chinese central government.
- [www.ebeijing.gov.cn](http://www.ebeijing.gov.cn)  
Official website of the Beijing Municipal Government.
- [www.shanghai.gov.cn](http://www.shanghai.gov.cn)  
Official website of the Shanghai Municipal People's Government.
- [www.china.org.cn](http://www.china.org.cn)  
Government portal site to China that offers broad access to news about China.
- [www.fdi.gov.cn](http://www.fdi.gov.cn)  
Website of the Chinese Ministry of Commerce directed to foreign investors. The site comprises government news and information about investment directions, economy, statistics and law.
- <http://english.mofcom.gov.cn/>  
Official website of the Chinese Ministry of Commerce.

- [www.chinainvest.com.cn](http://www.chinainvest.com.cn)  
China International Electronic Commerce Centre's website. Contains investment news and information about investment projects in China.
- [www.tdctrade.com](http://www.tdctrade.com)  
Hong Kong Trade Development Council's website. Provides information about CEPA.
- [www.tid.gov.hk/english/cepa/](http://www.tid.gov.hk/english/cepa/)  
Website of Hong Kong Trade and Industry Department. Provides full text documents on all CEPA agreements and annexes.
- [www.adb.org](http://www.adb.org)  
Website of the Asian Development Bank.

### **Other sources of information about China**

- [www.transparency.org](http://www.transparency.org)  
Website of Transparency International, a coalition against corruption.
- [www.hoover.org/publications/clm](http://www.hoover.org/publications/clm)  
Website of the Hoover Institution of Stanford University. Provides information about China's leadership politics and its foreign and domestic policies.
- [www.chinaeconomicreview.com](http://www.chinaeconomicreview.com)  
China Economic Review is a monthly magazine published in Hong Kong covering business, finance and economics in China.
- [www.worldbank.org/transitionnewsletter](http://www.worldbank.org/transitionnewsletter)  
World Bank newsletters on developing economies.

- [www.cia.gov/library/publications/the-world-factbook/](http://www.cia.gov/library/publications/the-world-factbook/)  
U.S. CIA World fact book.
- [www.expatsinchina.com](http://www.expatsinchina.com)  
A guide for foreigners living in China.

## **Logistics**

- [www.maps-of-china.com](http://www.maps-of-china.com)  
Maps of Chinese cities, provinces and regions in the principal areas of China.
- [www.primecargo.com](http://www.primecargo.com)  
Website of the international transportation and freight forwarding company Primecargo.
- [www.dsv.com](http://www.dsv.com)  
A transportation company that offers end-to-end transport and logistics solutions.

## **News in English**

- [www.chinadaily.cn](http://www.chinadaily.cn)  
Website of China Daily, the Chinese government's official mouthpiece.
- [www.scmp.com](http://www.scmp.com)  
Website of South China Morning Post, which is a little less censored than China Daily.
- [www.shanghaidaily.com](http://www.shanghaidaily.com)  
Website of the local Shanghai newspaper
- <http://english.peopledaily.com.cn>.

## **Chambers of commerce**

- [www.amcham-china.org.cn](http://www.amcham-china.org.cn)  
The American Chamber of Commerce in China.
- [www.europeanchamber.com.cn](http://www.europeanchamber.com.cn)  
The European Chamber of Commerce in China.
- [www.pek.britcham.org](http://www.pek.britcham.org)  
The British Chamber of Commerce in China.
- [www.ccifc.org/](http://www.ccifc.org/)  
The French Chamber of Commerce in China.
- [www.dccc.com.cn](http://www.dccc.com.cn)  
The Danish Chamber of Commerce in China.
- [www.swedishchamber.com.cn](http://www.swedishchamber.com.cn)  
The Swedish Chamber of Commerce in China.

## Abbreviations

AIC	Administration of Industry and Commerce
AMEA	Anti-Monopoly Law Enforcement Agency
ASBE	Accounting Standards for Business Enterprises
BLTB	Beijing Local Tax Bureau
CAS	Chinese Accounting Standards
CBRC	China Banking Regulatory Commission
CCPIT	China Council for the Promotion of International Trade
CEPA	Closer Economic Partnership Arrangement
CIETAC	China International Economic and Trade Arbitration Commission
CJV	Contractual or Cooperative Joint Venture
CO (CEPA)	Certificate of Hong Kong Origin (CEPA)
COFCOM	Commission of Commerce
CPA	Certified Public Accountant
CSRC	China Securities Regulatory Commission
DTT	Double Taxation Treaty
EJV	Equity Joint Venture
EPZ	Export Processing Zones
FESCO	Foreign Enterprise Service Corporation
FIE	Foreign Investment Entity
FIP	Foreign Invested Partnership
FR	Factory Registration with TID (CEPA)
HKTDC	Hong Kong Trade Development Council
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
LoI	Letter of Intent
MII	Ministry of Information Industries
MOFCOM	Ministry of Commerce
MOLSS	Ministry of Labour and Social Security
NDRC	National Development and Reform Commission
NPC	National People's Congress

PBOC	People's Bank of China
PRC	People's Republic of China
RMB	Renminbi
RO	Representative Office
ROOs	Rules of Origin (CEPA)
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SAR	Special Administrative Region (Hong Kong and Macau)
SAT	State Administration for Taxation
SIPO	State Intellectual Property Office of the PRC
TID	Hong Kong Trade and Industry Department
TRIPs	Trade-Related Aspects of Intellectual Property Rights (agreement under WTO)
WFOE	Wholly Foreign Owned Enterprise
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

## References

We have found inspiration for the handbook on the websites listed under “Useful links”. In addition, various materials from events and presentations together with “Danmarks Nationalbank, Quarterly Review 1, 2009” have been used.

Last, but not least, we have drawn on the long experience of Capital Associates and NCO China in advising clients.

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