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Practicing the Law of the World from New York

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PRACTICUM: FORM AND POLICY

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COMMENTARY

Professional Responsibility: Ethical Dilemmas Across Borders in a "Borderless World"

By James P. Duffy, III

(The following is an edited version of introductory remarks made by Mr. Duffy in conjunction with a discussion panel on ethical matters at the Fall Meeting of the International Law and Practice Section of the NYSBA held in Shanghai on 21 October 2006.)

In this panel, we are going to explore various facets of the "The Rule of Law," as it is known and understood by our panelists. In the process, we will explore and discuss the differences between the American and common law notions (as expressed in New York) of professional responsibility, attorney-client privilege, preservation of client confidences, and the like in contrast with the comparable obligations of major bars of Asia, particularly, the Shanghai Bar and Thailand.

Before we begin, I would like to set the stage, as it were, and give you a brief overview of how we are going to approach today's presentations.

First, I would like to emphasize that the Rule of Law is quite different from being "ruled by laws." It is important that we all understand this difference and what it means. For example, Nazi Germany was ruled by laws, but the Nazi regime did not observe the Rule of Law.

Under Nazi rule, it was never a crime to be Jewish in Nazi Germany. However, it was a crime to be Jewish and not prominently wear, when in public, a large yellow Star of David. Similarly, it was a crime for a Jewish person to be in a public place without proper documentation.

It was through laws such as these that the Nazi government was able to concentrate enormous power over its populace and achieve some of the most horrific consequences in history.

Typically, all dictatorships rule by law and never by the Rule of Law. This is because ruling by laws helps the dictator concentrate power in his hands at the expense of those the dictatorship governs. Ruling by laws helps the dictator maintain rigid control over those governed and prevents them from challenging the laws that rule them.

Previously in our meeting we have heard from three prominent speakers, one from the New York State Bar Association, one from the Chinese National Council for Social Security, and one from the Chinese Communist Party. Each speaker acknowledged the need for the Rule of Law and stressed its importance to them, to the constituencies they serve, and to the society in which they function. We also observed that, while each speaker invoked the Rule of Law, each speaker also sometimes gave different weight to the various components of the Rule of Law. This is not at all surprising, because the Rule of Law, like democracy, can mean different things to different people, even though there is a core of basic understanding.

In a recent address to the American Bar Association at its annual meeting in Hawaii on 5 August 2006, Mr. Justice Anthony M. Kennedy offered his views on the Rule of Law as follows:

> The Law is superior to, and thus binds, the government and all its officials.
>
> The Law must respect and preserve the dignity, equality, and human rights of all persons. To these ends, the Law must establish and safeguard the constitutional structures necessary to build a free society in which all citizens have a meaningful voice in shaping and enacting the rules that govern them.
>
> The Law must devise and maintain systems to advise all persons of their rights, and it must empower them to fulfill just expectations and seek redress of grievances without fear of penalty or retaliation.

Gilbert Keith Chesterton, who was an English lawyer, is best known as a prolific novelist and essayist in the late 1800s and early 1900s. He is also known for his so-called paradoxes. One of his paradoxes is very relevant to the discussion of the Rule of Law. Chesterton wrote: "Man is never so free as when he is governed by just laws." Chesterton's paradox is, of course, that Chesterton equates freedom with being governed, but with the qualifier of being governed by just laws. This is another workable definition of the Rule of Law.

The Rule of Law applies with equal force and effect to those who govern and those who are governed. The Rule of Law does not discriminate for or against government or the people who are governed. Among its other qualities, the Rule of Law protects:

- The strong and the weak
- The rich and the poor

- The popular and the unpopular
- The government and the governed

One could just as easily reverse the order of each pair above – e.g., the weak and the strong: The Rule of Law protects the weak and the strong. In any case, the Rule of Law is blind, just like the statue of Justice (the Greek goddess Themis), who is typically shown as blindfolded. The Rule of Law plays no favorites. Everyone is equal before the Law; everyone is bound by the Rule of Law.

The Rule of Law does not just happen. It comes about from conscious and deliberate decisions of an enlightened society that is committed to its establishment and preservation. All areas of society need to participate in the process. However, certain components are more effective than others. These components include a democratically elected legislature and an independent judiciary, among others.

The legal profession also plays an important and special role in protecting and preserving the Rule of Law. This is a fundamental duty of the lawyer, the legal profession, and the organized bar.

In promoting the Rule of Law in society, an independent bar is, in fact, a *sine qua non*. A united legal profession offers greater strength against, as well as independence from, government, business, clients, and corruption. As such, the organized bar helps prevent the concentration of power in government, business, and elsewhere in society, a concentration that normally has a corrosive effect on the Rule of Law.

While there are clearly other factors that are essential for the Rule of Law to flourish, such as a free press and uncorrupted legislators, we want to focus on the role of the profession in today's rapidly changing world.

An independent bar can only exist with strong and clearly defined core values. This then necessitates a closer look at what the core values are and should be. In taking that closer look during our discussion today, we will follow an outline that is closely based upon a publication of the European Union outlining the role of the lawyer in the European Union. I have chosen this as a model so that we do not necessarily have a bias toward the common law. The EU document divides the practice of law into seven main areas:

- Independence
- Trust and Personal Integrity
- Confidentiality
- Respect for the Rules of Other Bars and Law Societies
- Incompatible Occupations
- Personal Publicity
- The Client's Interests

In our discussion today, we will focus on these core values: what they are; why we have them; how they apply to the problems we encounter each day in our practices; and whether they need to change or be adapted as our world becomes increasingly more integrated and interdependent.

Independence. Independence is a value that should not be required of lawyers alone. Independence is important to be able to maintain objectivity and also to prevent an unhealthy concentration of power in any area of government or society. An independent bar is best able to prevent the concentration of power when there is an independent judiciary. Independence of the various elements of society assures a healthy competition among them and respect for them.

Trust and Integrity. Not too much need be said about this value, since it is rather self-explanatory. A lawyer must be trustworthy and have the highest degree of integrity, not only in his or her professional life but also in his or her personal life. If a lawyer does not have personal integrity and cannot be trusted in his or her personal life, it is highly unlikely he or she will have these attributes in his or her professional life.

Confidentiality. The preservation of client confidences is the essence of being a lawyer. Without the preservation of client confidences, it would be impossible for the lawyer to gain the information necessary to render proper and effective legal advice. While there are many different aspects to this value, such as the "attorney-client privilege" of common law and the obligation of "professional secrecy" of civil law, these are just varied devices for implementing the same value.

Respect for Rules. Lawyers must first and foremost uphold the law. They must also respect the needs and interests of other lawyers and not put them in jeopardy of violating their own rules, especially when they might be different. A lawyer is the servant of the law rather than its master.

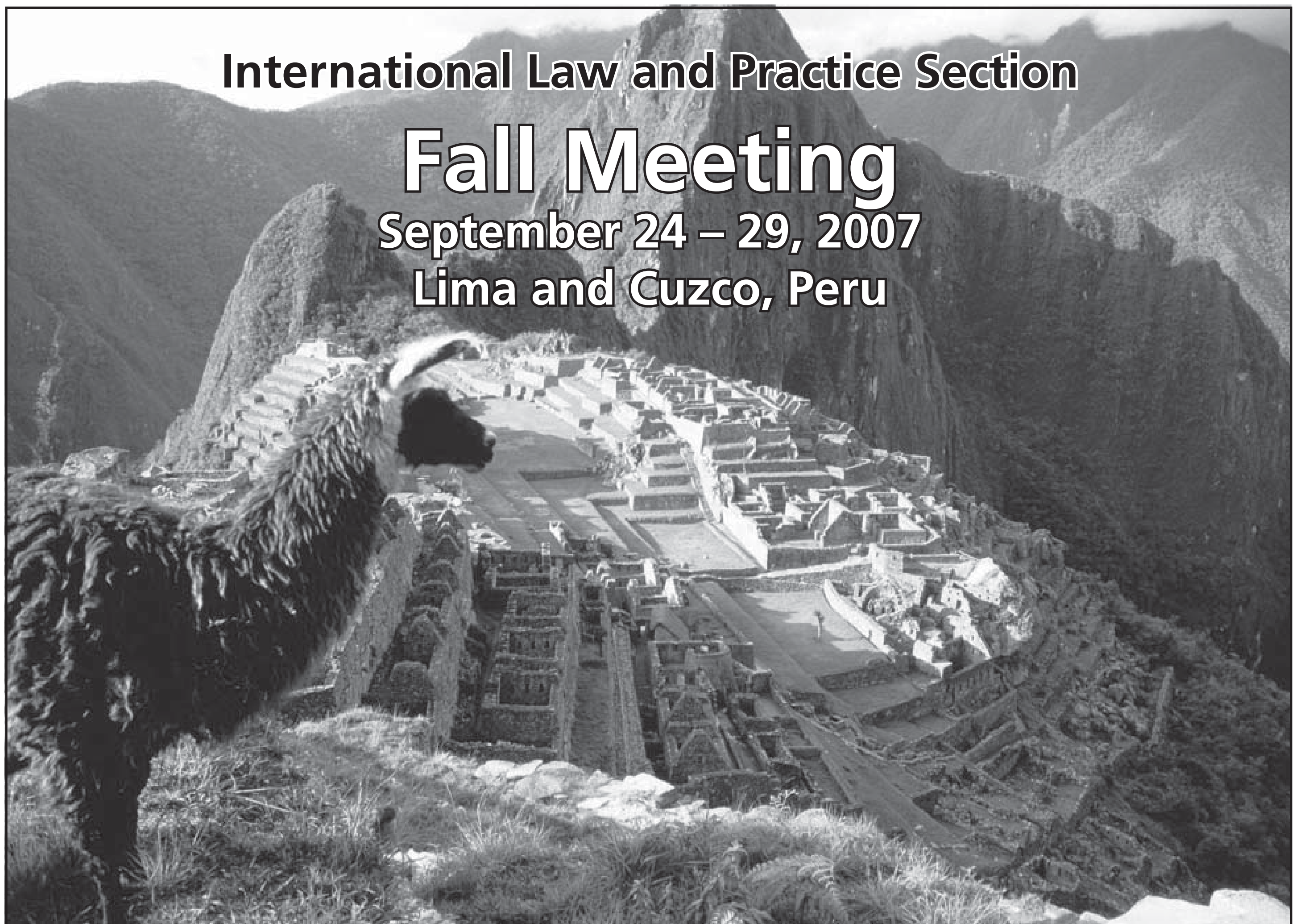
Incompatible Occupations. Certain activities are inconsistent with being a lawyer, and they must be avoided in dealings with clients, in order to ensure there are no direct or indirect conflicts between a lawyer's obligations as a lawyer and his or her obligations in another occupation. One good test for the propriety of lawyer activities with clients is to whom the lawyer owes a duty in the other activity. If the duty does not directly run to the client, the activity is ripe for a review.

Personal Publicity. Many jurisdictions do not permit lawyer advertising. Since the *Bates* case in 1972, lawyers in the US can advertise, subject to reasonable limitations on their right of free speech. Where advertising is permitted, it should be tasteful, professional, and above all truthful.

Client Interests. Every client is entitled to diligent, independent representation within the limits of the law from his or her lawyer. A lawyer must not allow a client to pursue frivolous or vexatious claims. A lawyer must not let a client mislead or deceive a court. A lawyer must make sure that the client knows and understands his or her obligations to the judicial process.

There is also another core value that The New York State Bar Association has emphasized as being especially important, namely, doing the public good, or *pro bono*. This is consistent with our profession's commitment to ensure equal access to procedural and substantive justice. Access to justice must involve both the procedures necessary to achieve it as well as the substantive provisions that establish its parameters.

Our panelists will now give us their prepared remarks.



Pictured above: Machu Picchu—an ancient Inca ruin

Please mark your calendars, as the New York State Bar Association's International Law and Practice Section returns to the Latin American region for its 2007 seasonal meeting, September 24 - 29, in Peru. Lawyers from around the world will gather in Lima from September 24 to 27, then ascend to Cuzco to conclude the meeting in high style.

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Estate Planning Considerations Under Philippine Law

By Ma. Gracia P. Tan

I. Estate Tax

The estate tax is alive in the Philippines, a legacy from the United States, whose Internal Revenue Code of 1939 was practically copied verbatim and enacted as the first internal revenue code of the Philippines.[1] In its present form, the estate tax is imposed on "taxable estate" at graduated rates, the lowest rate being 5% (a "taxable estate" is ₱200,000 - ₱500,000) and the top rate being ₱1,215,000 plus 20% of the "taxable estate" in excess of ₱10,000,000.00.[2]

The "taxable estate" is the difference between the "gross estate," on one hand, and "allowable deductions," on the other hand, adjusted by the net share of the surviving spouse therein, not as an heir but as a conjugal partner, if the property regime governing them is other than the system of complete separation of property or, if during the marriage, they obtained a court-approved separation of properties.[3]

For a *Filipino citizen* (whether resident of the Philippines or not at the time of death) or *resident alien*, the "gross estate" includes all property belonging to him or her at death, wherever situated, real or personal, tangible or intangible.[4] In respect of a *non-resident alien*, the "gross estate" is only that part of his entire estate which is situated in the Philippines.[5] Citizenship, residence, and location or situs of the properties are therefore at the core of the estate tax.

The "gross estate" includes the following:[6]

1. Transfers in contemplation of death, by trust or otherwise; or under which the decedent has retained the possession, enjoyment, or right to the fruits of the property so transferred until the decedent's death; or under which he or she had retained the right to designate the person who shall possess or enjoy the property or its fruits, or income;
2. Revocable transfers, by trust or otherwise;
3. Property passing under general power of appointment exercised by the decedent;
4. Proceeds of life insurance taken by the decedent on his own life and receivable by his estate or by a beneficiary whose designation is revocable;
5. Transfers for insufficient consideration, to the extent of the difference between the fair market value (at the time of death) of the property and the amount or value actually received therefor by the decedent.

The "allowable deductions" include the following:

1. In respect of citizens or resident aliens:[7]
    a. Certain expenses, losses, indebtedness and taxes, subject to conditions specified by law;
    b. Property previously taxed, or the so-called vanishing deductions;
    c. Transfers to or for the use of the Philippine government, or any political subdivision thereof, for exclusively public purposes;
    d. The value of the family home not exceeding ₱1,000,000.
    e. A standard deduction of ₱1,000,000.
2. In respect of non-resident alien decedents, the foregoing deductions are also allowed, except the family home and standard deductions.[8] However, it is a condition for deductibility that the value of the decedent's estate not situated in the Philippines be included in the estate tax return.[9]

In any case, a credit for estate taxes paid to a foreign country is allowed under certain conditions.[10]

Although the estate tax may not be as high as in other countries imposing a similar tax and although no tax is imposed on the heirs, devisees or legatees, other considerations would of course warrant transfers *inter vivos* of property or the making of an estate plan.

We have has a good selection of modes of transferring property *inter vivos* in the Philippines, but like other jurisdictions, we also have certain rules and legal systems that limit or circumscribe their application. Among these are the system of legitimary and forced heirship and the system of property relations among spouses. They bind Philippine citizens, though living abroad, since they are laws relating to family rights.[11]

In addition, a transfer of property, whether real or personal, owned by foreigners is subject to the laws of the Philippines if it is located, or is otherwise deemed to have legal situs, in the Philippines.[12] Moreover, the forms and solemnities of wills and other public instruments conveying property are governed by Philippine law if executed in the Philippines or before diplomatic or consular officials of the Philippines abroad.[13]

II. The System of Legitimary or Forced Heirship

A. Overview

The Philippines follows a system of partial reservation of hereditary property, where the inheritance is divided into the "legitime" (the reserved portion), and the "free portion." This system, along with our predominantly civil law tradition, is one of our most enduring legacies from Spain, which colonized the Philippines for almost four centuries. It is so well entrenched, and there is no indication at all that it may be changed, primarily because it reflects and promotes the

Filipino cardinal virtues of family centeredness, solidarity and continuity.

Our Civil Code expressly provides the following:

> [I]intestate and testamentary succession, both with respect to the order of succession and to the amount of successional rights and the intrinsic validity of testamentary provisions, shall be governed by the national law of the person whose succession is under consideration, whatever may be the nature of the property and regardless of the country where located.[14]

The capacity of certain heirs to succeed, and questions of preterition (omission of heirs), disinheritance, and collation are also governed by the national law of the decedent. Hence, our system of legitimary or forced heirship should be properly considered in estate planning if the decedent is a Filipino citizen.

"Legitime" is that part of a decedent's property which he cannot freely dispose of because the law has reserved it for his so-called "compulsory heirs."[15]

B. Compulsory Heirs

As specified by law,[16] the compulsory heirs are the following:

1. legitimate children and descendants of the deceased;
2. in the absence of the foregoing, the legitimate parents or ascendants;
3. the widow or widower;
4. recognized illegitimate children.

Legitimate children and descendants are *primary* compulsory heirs: they always succeed and are preferred. Legitimate parents and ascendants are *secondary* compulsory heirs: they succeed only if the decedent has no surviving primary compulsory heirs. On the other hand, the widow or widower and recognized illegitimate children are *concurring* compulsory heirs because they always succeed, either with the primary or secondary compulsory heirs, or with each other, or by themselves, as the case may be. In the ultimate analysis, compulsory or forced inheritance applies only to the surviving spouse and children, or the spouse and parents of the decedent.

Legitimate children are those conceived or born during the marriage,[17] even if the marriage is subsequently annulled, or declared void.[18] Illegitimate children, on the other hand, are those conceived and born "outside" a valid marriage.[19]

C. Amount of Legitime

The legitime of the primary compulsory heirs consists of one-half of the hereditary estate.[20] The children inherit in their own right, dividing the legitime in equal shares.[21] Grandchildren and other descendants inherit by right of representation.[22]

The legitime of the secondary compulsory heirs is also one-half of the estate,[23] which is divided equally; the nearer in relation excludes the farther.[24]

The legitime of any class of concurring compulsory heirs, if surviving alone to the exclusion of primary or secondary heirs, is also one-half of the hereditary estate.[25] If they concur with other classes of compulsory heirs, or with each other, their respective legitimes decrease.[26] In any case, the legitime of an illegitimate child, if concurring with a legitimate child, is always one-half of the legitimate child's.[27] If a spouse concurs with several legitimate children, her legitime is equal to the share of one legitimate child; if concurring with only one legitimate child, her legitime is one-quarter of the estate.[28]

D. Non-Impairment of Legitime

An individual cannot deprive his compulsory heirs of their legitime, even by will; nor can he or she impose any burden, encumbrance, condition, or substitution of any kind whatsoever.[29] In the interest of the family, however, a parent who desires to keep any agricultural, industrial or manufacturing enterprise may assign the same to a specific child, provided that the parent directs the legitime of the other children to be paid in cash.[30]

Still, no compulsory heir may be deprived of such heir's legal inheritance. The only way by which any compulsory heir may be so deprived is by disinheritance on the grounds and in the manner specified by law.[31]

A future legitime may not also be renounced or compromised,[32] because this is merely an expectancy. However, an heir may repudiate his or her inheritance once it is vested, and the heir is certain of the death of the decedent.[33] The effect of repudiation is retroactive to the moment of the decedents' death.[34]

E. Collation of Donations

Donations given to children, legitimate or illegitimate, are charged to their legitime,[35] and subject to collation,[36] unless the decedent-donor expressly provided otherwise, or if the donee-heir repudiates the inheritance.[37] Collation consists either in adding the value of the donation to the estate to determine the totality of the legitime or in actually restoring the donated asset to the estate in order to complete the legitime of other heirs who may have suffered impairment by reason of the donation. Hence, to the extent that a donation to a compulsory heir has exceeded that heir's legitime, the excess is charged against the "free portion" and may even be subject to reduction.[38] Testamentary dispositions that impair the legitime are also to be accordingly reduced.[39]

Donations to a spouse, except for occasional "moderate gifts," are prohibited by law and are null and void.[40] The

same rule applies to persons cohabiting as husband and wife without a valid marriage.

F. The "Free Portion"

The "free portion" is that part of the estate remaining after the legitimes of the surviving compulsory heirs are covered. At the most, it is 1/2 of the estate, e.g., in the case where only one kind or class of compulsory heirs survives. The legitime of the surviving spouse and/or illegitimate children, if concurring with each other or with the primary or secondary compulsory heirs, is always taken from the other half.

A person is able to devise and bequeath the free portion as he or she sees fit, but only through a valid will,[41] and provided that the heir, devisee or legatee is capacitated to inherit.[42] To safeguard against undue influence, certain persons cannot, however, inherit by will,[43] nor may those deemed "unworthy"[44] inherit by will.

Testamentary dispositions in favor of persons with whom the testator has had illicit relations, as well as dispositions in favor of public officers, their spouses, children or ascendants, by reason of the public office, are also void.[45]

III. Property Regimes Between Spouses

The property regime governing legally married spouses is primarily determined by their marriage settlements which, to be valid and enforceable, must be executed before the marriage.[46] And unless the spouses stipulated to the contrary, their property regime is governed by Philippine law, regardless of where the marriage is celebrated, or their residence, except as follows:

1. if both spouses are aliens;
2. as to the extrinsic validity of contracts affecting property not situated in the Philippines and executed in the country where the property is located; and
3. as to the extrinsic validity of contracts entered into in the Philippines but affecting property situated abroad whose laws require different formalities.[47]

In the absence of marriage settlements, or when the regime agreed upon is void, the system of absolute community of property governs.[48] The community generally consists of all property owned by each of the spouses at the time of the wedding or acquired thereafter.[49] The only properties excluded from the community, and thus remaining paraphernal or capital, as the case may be, are the following:

1. those acquired before the marriage by either spouse who has legitimate descendants by a former marriage;
2. those acquired during the marriage by gratuitous title, unless the donor, testator or grantor expressly provided otherwise; and
3. property for personal and exclusive use of either spouse, except jewelry (which forms part of community property).[50]

The administration and enjoyment of the community property belongs to both spouses *jointly*; in case of disagreement, however, the husband's decision prevails, subject to the wife's recourse to the courts for a proper remedy.[51] Only when one spouse is incapacitated may the other make powers of administration; however, any disposition or encumbrance of any property must be authorized by the court, or consented to by the incapacitated spouse.[52]

Either spouse may dispose by will of his or her interest in the property without the other's consent;[53] but neither spouse may donate community property without the consent of the other, except for moderate donations for charity or on the occasion of family celebrations or distress.[54] As stated earlier, every donation or grant of gratuitous advantage, direct or indirect, between the spouses during the marriage is also void, except for moderate gifts.[55] However, if the spouses agreed in their marriage settlements to a different regime, they may donate to each other not more than 1/5 of their present property.[56]

For unions without marriage, but where the parties are otherwise capacitated to marry each other, the property regime is generally that of co-ownership, and neither party can dispose of his or her share inter vivos during the cohabitation without the consent of the other.[57] If either party is, however, incapacitated to marry the other, the property regime is generally that of co-ownership pro-rata to their actual joint contribution of money, property, or industry.[58] If the incapacity is due to a valid and existing marriage to another, the share of the party concerned accrues to the community property of the valid marriage.[59]

IV. *Inter Vivos* Transfers

A. Introduction

Clearly, the Philippine system of forced heirship and absolute community of property relations between spouses greatly impacts the estate planning of Philippine citizens, especially in regard to providing for their children and spouse. Due care in selecting a particular mode of *inter vivos* transfer must therefore be taken in order that the plan may be fully given effect. To illustrate, some modes of *inter vivos* transfer are discussed below.

B. Donations

As earlier stated, a donation to any compulsory heir is charged to his legitime and subject to collation. In other words, it is an advance on his legitime. Any advantage that may be sought to be given to such an heir under the donation may therefore be defeated if such donation is found upon collation to have impaired the legitime of the other compulsory heirs. Moreover, there is not much difference between the rates of the donor's tax and the estate tax; in the former, the lowest rate is 2% (applicable to a dona-

tion value between ₱100,000 - ₱200,000) and the top rate is ₱1,004,000 for donations of ₱10 million and above, plus 15% of the value in excess of ₱10 million.[60]

However, if the donation is to a stranger, i.e., a person who is not the spouse, ancestor, lineal descendant, sibling, or relative by consanguinity within the fourth degree of the donor, the donation is subject to a flat rate of 30%,[61] which is considerably higher than the top rate of estate tax. Donations to such persons, not being compulsory heirs, are not subject to collation,[62] provided that the legitime of the compulsory heirs is not impaired thereby;[63] otherwise, they may also be reduced.

The term "donation" is here used in the sense of an act of liberality or generosity. If the impelling motive for the donation is the natural and moral duty of parents to support their children, the thing given to such compulsory heirs will not be subject to collation. Thus, expenses for support, education, medical attendance, even in extraordinary illness, or customary gifts, are not subject to collation. However, expenses incurred by parents in giving their children a professional, vocational or other career are brought to collation if the parents so provide or if they impair the legitime.[64] The reason for the distinction is that, while such expenses are important, they are not considered as necessary as expenses for general education.

The donor's tax is imposed on the donor, not the donee. Taxable donations include all property, tangible or intangible, wherever situated; however, in the case of a *non-resident alien*, the donor's tax is not imposed if the property donated is located outside the Philippines.[65] It should be noted, however, that the following intangible properties are deemed to be situated in the Philippines:[66]

1. franchise rights exercised in the Philippines;
2. shares, obligations or bonds issued by any company organized or constituted under Philippine law, or by a foreign corporation, 85% of the business of which is located in the Philippines;
3. shares, obligations or bonds issued by any foreign corporation if such shares have acquired a business situs in the Philippines; and
4. shares or rights in any partnership, business or industry established in the Philippines.

Nonetheless, no donor's tax is collected in respect of intangible property if the country of citizenship and residence of the non-resident alien donor does not impose, or allows a similar exemption from, a transfer tax of any character on donations of intangible property made by Filipinos not residing in that country.[67]

Donations made in favor of the Philippine government or any of its political subdivisions, or any non-profit entity created by any of its agencies, are exempt from the donor's tax, as are donations to educational, charitable, religious, cultural or social welfare institutions, and accredited NGOs, trust, philanthropic or research organizations, provided certain qualifying requirements are met.[68]

In any event, it must also be considered that a donation *mortis causa*, or one that takes effect after the death of the donor, partakes of the nature of a testamentary disposition and, therefore, is includible in the taxable estate,[69] unless exempt or excluded in the cases specified by law.

C. Trusts

Under Philippine law, a trust is essentially a relationship of fiduciary character. As such, there is no actual transfer by the trustor to the trustee of equitable ownership of the property. The trustee merely holds legal title while the trustor retains equitable ownership or title, which he has the right usually to continue exercising under a revocable trust or *inter vivos* trust or is passed on to the beneficiaries at the time specified in the trust. We "draw freely upon American precedents in determining the effects of trust, especially so because the trusts known to American and English equity jurisprudence are derived from the *fidei commissa* of the Roman Law and are based entirely upon civil law principles."[70]

We have seen however, that transfers to a revocable trust, or to one under which the trustor reserved certain rights in respect of the property or the designation of beneficiaries, will not effectively take the trust property away from the hereditary estate. A bequest of property put in trust is taxable in accordance with estate tax laws, even if stipulated to be delivered to the beneficiary long after the decedent's death.[71] Moreover, even if the trustor is incompetent and cannot legally exercise the power of revocation, mere possession at death of such power is sufficient to render such trust a revocable one; however, the transfer of properties to a revocable trust where the trustor, trustee and beneficiaries are one and the same person or interest, will not be subject to a donor's or capital gains tax, there being "no actual transfer of ownership" and the trustor continuing to hold all incidents of ownership.[72]

This is not to conclude, however, that if the trust is revocable, transfers of property to the trust will necessarily be exempt from the donor's tax, because the donor's tax applies, by express provision of law, "whether the transfer is in trust or otherwise, direct or indirect."[73] It is submitted that the donor's tax will not apply only if the beneficial ownership of the trust property continues to be enjoyed by the trustor, or if the power to revert title to the trust property in the trustor is vested in the trustor and/or any other person not having a substantial adverse interest in the disposition thereof or its income.[74]

Accordingly, transfers of trust property to an irrevocable trust may be subject to the donor's tax, since the intention is to distribute the same, including its fruits or income, to the designated beneficiaries at some future time or even after the death of the donor. This is effectively a donation *inter vivos*.[75] In the meantime, the income of the trust is sub-

ject to income tax in practically the same manner as is the income of individuals,[76] for which the trustee is obliged to render a return and pay the tax.[77] In addition, the trustee is required to file information returns regarding income payments made by it in the trustee's capacity as such.[78]

D. Sale or Other Disposition for Consideration

To be sure, title to property may be transferred by way of sale. Property so transferred is not subject to collation nor is it accounted for in the computation of legitime. This is because the alienator is deemed to have received in exchange an equivalent value in money or money's worth. It is therefore absolutely required that, for a transfer by way of sale to be fully respected, it must be for sufficient consideration. Otherwise, the property may still be includible in the taxable estate or be subject to the donor's tax to the extent of the difference between the fair market value of the property at the time of donation or death and the actual consideration received therefor by the donor or decedent.[79]

Income from the sale of property by an individual is generally subject to capital gains tax. *Resident citizens* are subject thereto irrespective of where the sale takes place or the location of the property;[80] *non-resident citizens* and *resident aliens* are subject thereto only with respect to gains from property considered as sourced from within the Philippines.[81] *A non-resident alien engaged in trade or business in the Philippines* is taxed in the same manner as a resident alien,[82] while a *non-resident alien not engaged in a trade or business* is subject to a flat rate of 25% on income derived from Philippine sources.[83] However, if the property sold consists of *real property* or *shares of stock of a Philippine company*, the capital gains tax payable is the same for all such classes of individual taxpayers: a flat rate of 6% of the gross selling price of real property,[84] or 10% of the net capital gain from sales of shares of stock.[85]

Gains on the disposition of real property located in the Philippines are always Philippine-sourced,[86] while those of personal property are generally Philippine-sourced if the sale is effected in the Philippines.[87] However, gains from the sale of shares of stock in a domestic (Philippine) corporation are always considered Philippine-sourced, even if sold abroad, such that the transfer of such shares cannot be made in the corporate books unless a tax clearance is issued by our Bureau of Internal Revenue.[88]

E. Life Insurance

We have also seen that the proceeds of life insurance under a policy taken by the deceased on his or her own life and payable to his or her estate or to a beneficiary whose designation is irrevocable is includible in the gross estate. However, they are not subject to income tax, whether payable in a lump sum or otherwise; but if they are subject to the payment of interest, the interest is subject to income tax.[89] Amounts received by the insured as a return of premiums paid by such insured under a life insurance policy, endowment or annuity, either during the term or at maturity, are also not subject to income tax.[90] However annuities and pensions are generally subject to income tax.[91]

F. Transfer to a Controlled Corporation

This is probably the most popular mode of *inter vivos* transfer in the Philippines that is part of an estate plan. Here, an individual is allowed to transfer property to a corporation in exchange for shares of stock of the latter without recognizing taxable income, provided the individual gains control of the transferee corporation as a result of such transfer.[92] "Control" is ownership of at least 51% of the total voting power of all classes of stock entitled to vote.[93]

This device, however, is ultimately a case of tax deferment, not tax exemption, because in a subsequent disposition of either the property or stock, the historical cost of the property transferred is deemed to be the basis for purposes of computing taxable gain or loss. Moreover, the shares of stock will eventually form part of the gross estate of the property transferor and be subject to the rules of forced heirship and the conjugal property regime as well.

V. Conclusion

There are, of course, other ways and devices by which to transfer property to intended beneficiaries of family wealth. Suffice it to state that, given the various restrictions and incidents of transferring property as illustrated by the foregoing, there cannot be a prescribed standard formula. Circumstances of nationality and residence, the location, situs, and character of the properties, the capacity and relationships of intended beneficiaries, must all be duly taken into account in carrying out the wishes of the client. Each of these factors could very well spring traps for the unwary.

Endnotes

1. National Internal Revenue Code, Commonwealth Act No. 466 (1939). The first inheritance tax law in the Philippines was Act 2601, also of U.S. origin, which took effect on 1 July 1916.
2. National Internal Revenue Code of 1997, Rep. Act No. 8424, as amended (hereinafter the "Tax Code") § 84.
3. *See* Family Code arts. 138, 137 and 134.
4. Tax Code § 85.
5. *Id*.
6. *Id*.
7. Tax Code § 86(A).
8. *Id*. § 86(B).
9. *Id*. § 86(D).
10. *Id*. § 86(E).
11. Civil Code art. 15. Laws relating to status, condition and legal capacity also bind Philippine citizens, wherever they are.
12. Civil Code art. 16.
13. *Id*. art. 17.
14. *Id*. art. 16.
15. *Id*. art. 886.
16. *Id*. art. 887, as modified by the Family Code.
17. Family Code art. 164.
18. *Id*. art. 54.

19. *Id.* art. 168.
20. Civil Code art. 888.
21. *Id.* art. 980.
22. *Id.* art. 962.
23. *Id.* art. 889.
24. *Id.* art. 890.
25. *Id.* arts. 894 and 901.
26. *See id.* arts. 893, 894, 895, 896 and 897, for instance.
27. Family Code art. 176.
28. Civil Code art. 895.
29. *Id.* art. 904.
30. *Id.* art.1080.
31. *Id.* art. 915. The grounds for disinheritance of children and descendants include maltreatment of the decedent by the heir; unjustified refusal to support the decedent; leading a "dishonorable or disgraceful life"; and conviction for an attempt on the life of the decedent, his or her spouse, descendants or ascendants. In respect of ascendants, the grounds include abandonment, inducing their daughters to live a corrupt or immoral life, loss of parental authority, unjustifiable refusal to give support, and attempt by one ascendant (parent) against the life of the other. In respect of a spouse, the grounds include giving cause for legal separation from the other or loss of parental authority, unjustifiable refusal to support the children, or conviction for an attempt on the life of the other, his or her descendants or ascendants. *See id.* art. 919, 920 and 921.
32. *Id.* art. 905.
33. *Id.* arts. 1041 and 1043.
34. *Id.* art. 1042.
35. *Id.* arts. 909 and 910; this is to be understood as being applicable to parents and ascendants as well.
36. *Id.* art. 1061.
37. *Id.* art. 1062.
38. *Id.* arts. 909 and 911.
39. *Id.* art. 907.
40. Family Code art. 87.
41. Civil Code art. 914. The requirements for the validity of a will are numerous and must be strictly complied with.
42. *Id.* art. 1024.
43. *Id.* art. 1027. These are the priest who heard the testator's last confession, or minister who extended spiritual aid during his last illness; relatives of such priest or minister within the fourth degree, and the order, church or community to which the priest or minister belongs; a guardian, with respect to his ward, if the disposition is made before approval of the guardian's accounts, unless the guardian is a descendant, ascendant, spouse, or sibling of the testator; the attesting witness to the will, his or her spouse, parents or children; and any physician, nurse or health worker who took care of the testator during his or her last illness.
44. *Id.* art. 1032. These are parents who have abandoned their children or induced their daughters to lead a corrupt or immoral life, or made attempts against their virtue; any person who has been convicted of an attempt against the life of the testator, his or her spouse, descendants or ascendants; any person who has brought groundless suit or testimony against the testator for a crime punishable by six years or imprisonment or more; any heir of age who, having knowledge of the violent death of the testator if that be the case, fails to report it to the authorities; any person convicted of adultery or concubinage with the spouse of the testator; any person who by fraud, violence, intimidation or undue influence causes the testator to make a will, change one already made, or forges a supposed will of the decedent.
45. *Id.* art. 1028, in relation to Civil Code art. 739.
46. *Id.* art. 74.
47. *Id.* art. 80.
48. *Id.* art. 75.
49. *Id.* art. 91.
50. *Id.*
51. *Id.* art. 96.
52. *Id.*
53. *Id.* art. 97.
54. *Id.* art. 98.
55. *Id.* art. 87.
56. *Id.* art. 84.
57. *Id.* art. 147.
58. *Id.* art. 148.
59. *Id.*
60. Tax Code § 99(A).
61. *Id.* § 99(B).
62. *See* Civil Code art. 1061.
63. *Id.* art. 909.
64. *Id.* art. 1068.
65. Tax Code § 104.
66. *Id.*
67. *Id.* The same rule applies in respect of the estate tax.
68. *Id.* § 101. A similar exemption is allowed for estate tax purposes as well. *See id.* § 87(D).
69. Civil Code art. 728; Tax Code § 85; Rev. Rul. No. 081-98.
70. *Miguel v. Court of Appeals,* 29 SCRA 760.
71. *Lorenzo v. Posadas,* 64 Phil. 353.
72. Rev. Rul. Nos. UN-041-1-20-95 and UN-042-1-20-95. *See also* Tax Code § 63, providing that the income from trust property under a revocable trust is included in computing the taxable income of the grantor or trustor.
73. Tax Code § 98.
74. *See* Rev. Rul. Nos. UN-042-1-20-95 and UN-041-1-20-95; Tax Code § 63.
75. Civil Code art. 729; *see Gibbs v. Commissioner*, 4 SCRA 1165.
76. Tax Code §§ 60 and 61.
77. *Id.* § 65.
78. *Id.* § 68.
79. *See id.* §§ 85 and 100.
80. *Id.* § 24(A).
81. *Id.* § 24(A)(1)(b) and (c), in relation to *id.* §§ 31 and 42.
82. *Id.* § 25(A)(1).
83. *Id.* § 25(B).
84. *Id.* §§ 24(D) and 25(B).
85. *Id.*
86. *Id.* § 42(A)(5).
87. *Id.* § 42(E).
88. *Id.*; a similar clearance is also required in transfers of real property by whatever mode.
89. *Id.* § 32(B)(1).
90. *Id.* § 32(B)(2).
91. *Id.* § 32(A)(8) and (10).
92. *Id.* § 40(C)(2).
93. *Id.* § 40(C)(6)(c).

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Canada: Employer Liability for Immigration Breaches Can Be Costly

By Sergio R. Karas

I. Introduction

The current labor shortages experienced by Canadian companies in many industries have heightened the need for qualified workers. Many Canadian companies are now hiring foreign workers to fill the gap left by retiring employees, an aging population, lack of qualified prospects in Canada, and opportunities for growth at home and abroad. Canadian employers who never before considered hiring foreign workers are now in the process of actively recruiting them. Stories of labor shortages in the construction, mining, petroleum and other industries are almost a daily feature in the national press. While Canadian employers are now feeling the need to look abroad for qualified skilled workers, a practice that has been commonplace for many years in the United States, caution is necessary.

II. The IRPA

A. Section 124 of the IRPA

The *Immigration and Refugee Protection Act* ("IRPA"), in force since 28 June 2002, contains a number of provisions dealing with misrepresentations made by foreign nationals or by other persons with respect to applications for immigration status. Employers should be particularly careful when hiring foreign workers to ensure that no misrepresentation is made to the authorities by any party to an application. The specter of potential liability is very real under the current immigration legislation.

Employers should pay special attention to the provisions of Section 124 of the IRPA, which states that:

> (1) Every person commits an offence who
>
> (a) contravenes a provision of this Act for which a penalty is not specifically provided or fails to comply with a condition or obligation imposed under this Act;
>
> (b) escapes or attempts to escape from lawful custody or detention under this Act; or
>
> (c) employs a foreign national in a capacity in which the foreign national is not authorized under this Act to be employed.
>
> (2) For the purposes of paragraph (1)(c), a person who fails to exercise due diligence to determine whether employment is authorized under this Act is deemed to know that it is not authorized.
>
> (3) A person referred to in subsection 148(1) shall not be found guilty of an offence under paragraph (1)(a) if it is established that they exercised all due diligence to prevent the commission of the offence.

Specifically, Section 124(1)(c) appears to be far reaching in its scope and may prove worrisome for employers. The words in the section that make it a contravention of the IRPA to *"employ a foreign national in a capacity in which the foreign national is not authorized under this Act to be employed"* are very broad and could be interpreted to cover any situation where there is a change in the employee's duties or in the terms of employment. For example, if a foreign worker receives a promotion during the course of employment in Canada, the conditions of his or her Work Permit may be violated and the employer could find itself in contravention of Section 124(1)(c) of the IRPA. Similarly, if an employer merges or is acquired by another company and this results in a change in the foreign worker's duties or reassignment to another location, the provisions of the IRPA could also be contravened by the employer.

B. The Danger of a Change in Circumstances

Generally speaking, when a foreign worker enters Canada, he or she receives a Work Permit. Such a Work Permit could be issued by Citizenship and Immigration Canada (CIC) pursuant to an exemption from the IRPA Regulations (as in the case of intra-company transferees or other exempt categories), or could be granted after the issuance of a Labor Market Opinion by the Foreign Worker Unit of Service Canada, when the employer has demonstrated that there are no Canadians available for the position, or there could be a transfer of skills to Canada, or to fill a labor shortage, or where other benefits could ensue. In each case, the entry of the foreign worker into the Canadian labor force is governed by the terms and conditions set out in the Work Permit or in the Labor Market Opinion.

For example, a senior manager or a specialized knowledge worker could enter Canada as intra-company transferees based on their status in the corporate structure, seniority, special skills, knowledge, and salary commensurate with the position. However, if there is a change in the corporate structure which results in a change in the

assignment of the foreign worker, a contravention of the IRPA could occur. Also, where a foreign worker is admitted to Canada to perform duties for an employer at a specific location, but the workplace is changed to another province, a contravention could also take place.

In cases where a Labor Market Opinion has been issued by Service Canada, a contravention of the IRPA could have serious ramifications. Labor Market Opinions set out in great detail the terms and conditions of employment, including salary, vacation, benefits, place of employment, and other significant factors pertaining to the engagement of the foreign worker. Labor Market Opinions are issued after a careful review by Service Canada of all the circumstances surrounding the employer and its request to hire a foreign worker and, in many instances, after extensive national advertising and a thorough search for local candidates. If the foreign worker's duties change due to reassignment or restructuring, those conditions may trigger a contravention. For example, where a company hires a foreign worker to discharge his duties as a Sales Manager and he or she is then promoted to the position of Marketing Director, the employer may be in contravention of the IRPA, since it is engaging the foreign worker in a different capacity to that intended when the Labor Market Opinion and the Work Permit were granted. Conversely, if the same Sales Manager is demoted to a non-managerial position, a similar difficulty would arise.

The problem of employing a foreign national in a capacity in which he or she is not authorized specifically by the Work Permit is compounded by the attribution of "deemed knowledge" to the employer by Section 124(2) of the IRPA. Under that section, a person who fails to exercise due diligence to determine whether the employment is authorized is "deemed to know that it is not authorized." The provision imposes an active duty on the employer to satisfy itself that a foreign national is authorized to work in a specific position, and to determine that a Work Permit is valid at all times during the employment. It is therefore extremely important that an employer keep track of all foreign workers in a systematic fashion, including the positions for which they are authorized to perform services, the duration of the Work Permits, and expiry dates.

When charged with a contravention, employers could rely on the defense of "due diligence" set out in Section 124(3) of the IRPA, if they can establish that they have exercised all reasonable care to prevent the commission of an offense. Again, this section places an active duty on the employer to monitor foreign workers in a very detailed manner, and to document their files as extensively as possible.

C. Consequences of Contravention

Contraventions of the IRPA carry serious penalties. Pursuant to Section 125, a person who commits an offense may face heavy fines or even imprisonment. Section 125 states:

> **125.** A person who commits an offence under subsection 124(1) is liable
>
> (a) on conviction on indictment, to a fine of not more than $50,000 or to imprisonment for a term of not more than two years, or to both; or
>
> (b) on summary conviction, to a fine of not more than $10,000 or to imprisonment for a term of not more than six months, or to both.

Although there have been, to date, no reported cases of employer prosecution, there is anecdotal evidence that some smaller subcontractors in the construction industry have been cited for contraventions of the IRPA. However, generally speaking, Citizenship and Immigration Canada (CIC) and Canada Border Services Agency (CBSA) have not actively pursued employers who employ unauthorized foreign workers. Contrast this with the U.S. situation, where large-scale employer prosecutions are common.

In one reported case, however, the authorities chose a different route to deal with the problem of unauthorized employment. In *Brar v. Canada (Minister of Citizenship and Immigration*), 2006 FC 1502, the applicants were citizens of India who applied for and received Work Permits to enable them to come to work in Canada. The Work Permits were for "Bombay Paradise Restaurant" in Calgary, owned by a numbered company. Their permits made it clear that the applicants were not authorized to work for any employer or in any location other than specifically stated in the permits. However, upon arrival in Canada, the applicants found out that the restaurant was under construction and far from being completed. The owner of the business placed them in another establishment known as "Bombay Sweethouse and Restaurant," which apparently was not under the same ownership, although paychecks issued to the workers were issued by the numbered company which was the owner of "Bombay Paradise Restaurant." The workers were cooks and candy makers at the second location, where they remained employed.

The authorities became aware that the applicants were working for an employer which was believed to be different from that stated in the Work Permit. As a result, an Exclusion Order was issued based on the determination that there was a violation of the IRPA. Specifically, the Exclusion Order relied upon Sections 41(a) and 29(2) of the IRPA, which state:

> 41(a) A person is inadmissible for failing to comply with this *Act* in the case of a foreign national, through an act or omission which contravenes, directly or indirectly, a provision of this *Act;*
> …

> 29(2) A temporary resident must comply with any conditions imposed under the regulations and with any requirements under this *Act,* must leave Canada by the end of the period authorized for their stay and may re-enter Canada only if their authorization provides for re-entry.

Upon hearing the matter, the Immigration Division held that the above noted provisions had been contravened by the workers and issued Exclusion Orders against them. At the hearing, the workers took the position that they were unsophisticated and not familiar with the laws in Canada. They contended that they were told that the "Bombay Paradise Restaurant" was not yet ready, but the owner had another establishment where they could work. However, the Immigration Division rejected that contention, and held that the applicants had an obligation to know what the requirements of admission to Canada were and that "ignorance of the law is never an excuse."

Upon judicial review, the Federal Court quashed the Exclusion Orders and held that, in this case, "Bombay Paradise Restaurant" was the employer which paid the applicants, and declined to accept the government's position that a person must interpret the terms of the Work Permit in light of the application upon which it was granted. The court held that the Work Permit should be readily understood on its own, without reference to other material, and should be understandable to all interested persons, not just to the worker or the government, on its face. The court held that the government has a responsibility to ensure that Work Permits are sufficiently clear and specific. The court likened the issuance of the Work Permit to the interpretation of the contract, and if there is ambiguity it should be construed against the party which prepared it. The court exhorted the government to make Work Permits clear to all parties, and found that the applicants had not breached the terms of their Work Permits.

While in the above-noted case the applicants escaped sanction, it should be considered in light of its specific circumstances. It remains debatable whether the stringent interpretation given by the court to the requirement for clarity necessary in a Work Permit could have the effect of relieving applicants from responsibility for making reasonable inquires concerning the nature of their employment. In the above case, it must be noted that the employer continued to pay the applicants, that the location of work was within the same geographical area, and there appears to have been some sort of arrangement between the two restaurants. However, matters could be very different if there is a slight variation in the factual context. Further, it remains to be seen whether a higher court would agree with this restrictive interpretation of the seemingly clear provisions of the legislation.

III. Conclusion

Employers must exercise the utmost care when hiring foreign workers. In particular, employers must adhere to the terms and conditions set out in the Work Permits and in Labor Market Opinions. Failure to do so may result in serious penalties. It is prudent for employers to seek appropriate legal advice before reassigning foreign workers to new positions, to avoid the potential for a contravention of the IRPA which can carry substantial penalties.

It is crucial that employers who intend to reassign foreign workers to different duties or positions within the organization obtain legal advice prior to doing so, and take active steps to file the appropriate documentation to obtain changes to the terms and conditions attached to the Work Permit or Labor Market Opinion, if one was obtained.

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Dispute Settlement in the World Trade Organization

By Marian Ladner and Ogbo Ossai

I. Introduction

The World Trade Organization (WTO), as the successor to the framework established by the General Agreement on Tariffs and Trade (GATT), is the only global international organization that deals with the rules of trade between nations. GATT, created in 1947, was the first step toward handling disputes using a multilateral system instead of merely unilateral measures. The GATT's dispute settlement procedure became more formalized after 1952, with disputes being referred to a panel of independent experts. The independent experts on the panel acted in their own capacity and not as representatives of member countries. The panels reviewed evidence submitted by the disputing parties and issued rulings and recommendations about policy actions to be taken to bring the offending policies into compliance with GATT rules. The panels were also empowered to recommend compensatory measures for restitution to a complainant. Many of the rules under GATT led to inadequate international progress. For instance, under the old GATT system, any party, including the defendant, could exercise veto power and thereby block the establishment of a panel to hear a case. This veto could also apply to a decision to adopt a panel report, because a consensus was required to adopt a panel report. In addition, there were no fixed timetables, so many cases would drag on inconclusively for years. These measures rendered the old GATT dispute settlement process inefficient and ineffective. As a result, many countries used unilateral measures to settle disputes.

The WTO was created during the Uruguay Round of Negotiations in 1995. The WTO is based on agreements negotiated and signed by a majority of the world's trading nations and ratified by their governments. The agreements have three main objectives: (i) to help the flow of trade, (ii) to achieve further liberalization through negotiations; and (iii) to set up an impartial means of dispute resolution. In the WTO, a dispute basically amounts to an allegation of a broken promise arising out of one country's adoption of a trade policy or action taken that is viewed by one or more members as a breach of the WTO agreements. WTO members ("Members") have agreed to use the multilateral system of settling disputes when they believe that fellow Members are violating trade rules. The Uruguay Round agreement introduced a more structured approach with clearly defined stages in the dispute settlement procedure. The agreement underscores that prompt settlement is essential for the WTO to function effectively. Typically, a case will run its full course in 12 to 15 months, inclusive of an appeal. However, there is flexibility built into the agreed timeframes, so that urgent cases such as perishable goods can be dealt with in a timely manner.

II. Process for Settling Disputes

A. Consultation

The first stage in the process of settling disputes is called "consultation." Consultation is the process in which the disputing countries are given the opportunity to attempt to settle the dispute by themselves. The consultation process can take up to 60 days.[1] If consultation fails, the disputing parties may request that the WTO director-general mediate or that the Dispute Settlement Body (DSB) establish a panel. The WTO director-general is also available to mediate at any other stage of the process.

B. Panel

If the disputing parties are unable to resolve the dispute either through consultation or mediation, the second stage begins by the complaining party requesting the appointment of a panel. The DSB, which has the responsibility of settling disputes, also has the sole authority to establish panels of experts.[2] The DSB has up to 45 days to appoint the panel. Unless the parties agree otherwise, the panel shall within 20 days of its appointment examine the relevant provisions in the agreement(s) cited by the parties in the dispute and make findings that will assist the DSB in making recommendations or in issuing rulings. The panel members are selected such that they are independent, diverse and with a wide spectrum of experience. The panel will typically be composed of three members unless the disputing parties agree to a five-member panel. The parties are required to present their case in writing before the panel's first hearing. At the first hearing, the complaining party or parties, the responding party and any other country that has expressed an interest in the dispute will make their case. At the second hearing, the countries involved submit their written rebuttals and present oral arguments. If one raises scientific or technical matters, then the panel may consult with an expert in that area or appoint an expert review board who will then present an advisory report to the panel. After consideration of the written rebuttals and the oral argument, the panel issues a draft of the descriptive section of its report to the disputing parties. This descriptive section contains only the facts and the arguments. This first draft does not include any findings or conclusions. The two sides are given two weeks to comment on the panel's first draft. Upon expiration of the time allowed for the disputing parties to com-

ment, the panel will consider any comments received and subsequently issue an interim draft of its report containing the descriptive sections and the findings and conclusions. The parties are given one week to ask for a review. The period of review may not exceed two weeks and during that period the panel may hold additional meetings with both sides of the dispute. A final report is submitted to both sides and the findings in the final report shall include a discussion of the arguments made during the interim review stage. The final report is then circulated to all the Members. If the panel determines that the disputed trade measure violates a WTO agreement or an obligation, then the panel will recommend that the measure be made to conform to the WTO rules. The panel may also suggest ways in which this can be accomplished. Within 60 days after the date of circulation of the panel's final report to the Members, the report is adopted by the DSB as a ruling or recommendation unless a party notifies the DSB of its decision to appeal or a consensus of the DSB decides not to adopt.[3]

C. Appeal

Either or both sides can appeal the report to the "Appellate Body" before it becomes a ruling. Appeals are limited to points of law such as legal interpretations covered in the panel's report. The DSB appoints individuals to serve on the Appellate Body for a four-year term. The Appellate Body is composed of individuals of recognized standing in the field of law, international trade and the subject matter of covered agreements. The Appellate Body is composed of seven members, three of whom serve on any one case. The members of the Appellate Body are not affiliated with any government. The Appellate Body may uphold, modify or reverse the panel's legal findings and conclusions. As a general rule, the appeal process should not last more than 60 days, but in no case may the proceedings exceed 90 days. Within 30 days of the circulation of the Appellate Body's report to the Members, the DSB adopts the Appellate Body report unless rejected by a consensus of the Members.[4]

D. Implementation

After a case has been decided, the priority is for the losing party to bring its policy in line with the ruling or recommendation. However, if the verdict favors the defendant, the case typically ends. The dispute settlement agreement emphasizes that "[p]rompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefits of all Members."[5] If the Member that is the target of the complaint loses, it must follow the recommendations of the panel or the Appellate Body. It must state its intention to do so at a DSB meeting held within 30 days after the adoption of the panel or Appellate Body report. If immediate compliance with the recommendation and ruling is impractical, the Member will be given a reasonable period of time in which to do so. If the Member concerned fails to act within the reasonable period of time as determined, then the Member must, if requested, enter into negotiations with the complaining side in order to determine mutually acceptable compensation. If no satisfactory compensation has been agreed within 20 days of the expiration of the reasonable period of time, the complaining side may ask the DSB for permission to impose limited trade sanctions. The DSB must grant such request within 30 days of the expiration of the reasonable period of time unless there is a consensus against the request. The sanction should be imposed in the same sector as the dispute; however, if this is not practical or if it would not be effective, then the sanction can be imposed in a different sector of the same agreement. Here, the objective is to reduce the chances of the sanctions spilling over into unrelated sectors while at the same time allowing the sanctions to be effective.

E. Case Studies[6]

The following are some examples of how disputes have been resolved at the WTO.

1. United States—Standards for Reformulated and Conventional Gasoline[7]

On 24 January 1995, Venezuela requested consultations with the United States and on 10 April 1995, Brazil also lodged its own complaint. The complainants alleged that a U.S. gasoline regulation discriminated against complainants' gasoline in violation of GATT Articles I and III, and Article 2 of the Agreement on Technical Barriers to Trade. At Venezuela's request, the DSB established a panel on 10 April 1995. The DSB, at Brazil's request, also established a panel on 26 April 1995. However, on 31 May 1995, in accordance with Article 9 of the Dispute Settlement Understanding (DSU), it was agreed that a single panel would consider the complaints of Venezuela and Brazil. The report of the panel was circulated to Members on 29 January 1996. The report found the U.S. regulation to be inconsistent with GATT Article III:4 and not to benefit from an Article XX exception. The U.S. appealed on 21 February 1996. The Appellate Body issued its report on 22 April 1996, modifying the panel report on the interpretation of GATT Article XX(g), but concluding that Article XX(g) was not applicable in this case. The DSB adopted the Appellate Body report and the panel report modified by the Appellate Body on 20 May 1996. The U.S. agreed to amend its regulation within the 15-month period, and on 26 August 1997 reported to the DSB that a new regulation had been signed on 19 August 1997.

2. United States—Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada[8]

Canada requested consultation with the U.S. on 3 May 2002. The request concerned the U.S. Department of Commerce's (USDOC) final countervailing duty determination with respect to certain softwood lumber from

Canada. Canada challenged the initiation and conduct of the investigation, the final determination, provision of expedited reviews, and other matters related to these measures. It contended that these measures were inconsistent and violated the U.S.'s obligations under Articles 1, 2, 10, 11, 12, 14, 15, 19, 22 and 32 of the SCM Agreement and Articles VI:3 and X:3 of GATT 1994. Consultations were held on 18 June 2002, and a panel was established on 1 October 2002. On 29 August 2003, the panel report was circulated to Members. The panel found that the USDOC acted consistently with the SCM Agreement and GATT 1944 in determining that the programs at issue provided a financial contribution and those programs were "specific" within the meaning of the SCM. The panel also determined that the USDOC acted inconsistently with the SCM Agreement when it rejected private timber prices in Canada as the benchmark in determining whether and to what extent Canada was subsidizing lumber companies by providing low-cost timber. The USDOC used U.S. prices as the basis for the benchmark. Finally, the panel found that the USDOC had improperly failed to conduct a "pass-through" analysis to determine whether subsidies granted to one producer were passed through to other producers. The U.S. appealed to the Appellate Body on 21 October 2003, and on 19 January 2004 the Appellate Body report was circulated to the Members. The Appellate Body upheld the panel's finding that the Canadian provincial governments' provision of low-cost timber to lumber producers constituted a "financial contribution" pursuant to the SCM Agreement. The Appellate Body reversed the panel's findings, rejecting Canadian prices as a benchmark. It also reversed the panel's finding that the USDOC should have conducted a "pass-through" analysis to determine whether subsidies granted to one lumber producer were passed through to other lumber producers. The Appellate Body's only finding against the U.S. was that the USDOC should have conducted a pass-through analysis with respect to the sales of lumber from sawmills to unrelated lumber remanufacturers, because the primary and remanufactured lumbers were products subject to the USDOC's aggregate investigation.

The DSB adopted the Appellate Body report and the panel report as modified by the Appellate Body on 17 February 2004. The U.S. stated its intention to implement the DSB recommendations and rulings on 5 March 2004 and requested a reasonable period of time to implement. On 17 December 2004, the U.S. informed the DSB that USDOC had revised its Countervailing Duty (CVD) order, thereby implementing DSB's recommendations and rulings. On 30 December 2004, Canada requested the establishment of a panel under Article 21.5 of the DSU, claiming that the measures taken by the U.S. to comply with DSB's recommendations and rulings were inconsistent with U.S.'s obligation under Articles 10 and 32.1 of the SCM Agreement and Article VI:3 of GATT 1994. On 1 August 2005, the compliance panel report was circulated to the Members and the panel found deficiencies in USDOC's implementation. On 6 September 2005, the U.S. appealed to the Appellate Body. The Appellate Body upheld the panel's finding. On 20 December 2005, the DSB adopted the Article 21.5 Appellate Body report and the panel report as upheld by the Appellate Body.

3. Egypt—Measures Affecting Import of Textile and Apparel Products[9]

The U.S. requested consultations with Egypt on 23 December 2003. The consultation concerned tariffs applied by Egypt to certain textile and apparel products and the decree of the President of Egypt No. 469 of the year 2001 ("Decree No. 469") and any amendments, related regulations, and other implementing measures. The U.S. alleged that, in the Uruguay Round, Egypt agreed that (i) it would remove a general prohibition on apparel and made-up textile by 1 January 2002; (ii) it would bind its duties under HS Chapters 61 (articles of apparel and clothing, knitted and crocheted) and 62 (articles of apparel and clothing, not knitted or crocheted) at an *ad valorem* rate of forty-six percent in 2003, forty-three percent in 2004 and forty percent thereafter; and (iii) it would bind its duties under HS Chapter 63 (other made-up textile articles; sets; worn clothing) at an *ad valorem* rate of forty-one percent in 2003, thirty-eight percent in 2004 and thirty-five percent thereafter. The U.S. alleged that Decree No. 469 amended customs duties applicable to a number of imported articles, including articles that enter under HS Chapters 61, 62 and 63, and imposed specific duties (i.e., in Egyptian pounds per piece of clothing) rather than *ad valorem* duties. The U.S. alleged that the specific duties greatly exceeded the rate of duty that Egypt had agreed to. The U.S. indicated that these tariffs, Decree No. 469 and related measures were inconsistent with Egypt's obligation under Article II of the GATT 1994 and Article 7 of the Agreement on Textiles and Clothing. Egypt and the U.S. informed the DSB on 20 May 2005, that they had reached a mutually agreed upon solution pursuant to Article 3.6 of the DSU.

4. Mexico—Tax Measures on Soft Drinks and Other Beverages[10]

On 16 March 2004, the U.S. requested consultations with Mexico concerning certain tax measures imposed by Mexico on soft drinks and other beverages that use sweeteners other than cane sugar that were not imposed on beverages using cane sugar. The tax measures concerned included (i) a 20-percent tax on soft drinks and other beverages that use any sweetener other than cane sugar (the "beverage tax"); and (ii) a 20-percent tax on the commissioning, mediation, agency, representation, brokerage, consignment and distribution of soft drinks and other beverages that use any sweetener other than cane sugar (the "distribution tax"). The U.S. considered

that these taxes were inconsistent with Article III of GATT 1994, specifically, Article III:2, first and second sentences, and Article III:4 thereof. Canada requested to join the consultations on 26 March 2004 and Mexico informed the DSB of its acceptance of Canada's request on 14 May 2004. The U.S. requested the establishment of a panel on 10 June 2004. The DSB deferred the establishment of a panel at its meeting on 22 June 2004. The DSB established a panel on 6 July 2004 after a second request by the U.S. Canada, China, the European Communities, Japan and Pakistan reserved third-party rights, however, Pakistan withdrew on 20 August 2004. A panel was composed on 18 August 2004. The report of the panel was circulated to Members on 7 October 2004. The panel found that the soft drink tax and the distribution tax, as imposed on imported sweeteners, imported soft drinks and the associated bookkeeping requirements, were inconsistent with Articles III:2 and III:4 of GATT 1994. The panel also found that the measures were not justified by Article XX(d) of GATT 1994. Mexico notified the DSB of its decision to appeal on 6 December 2005. On 6 March 2006, the Appellate Body report was circulated to Members. The Appellate Body upheld, for different reasons, the panel's finding that Mexico's measures did not constitute measures to secure compliance with laws or regulations within the meaning of Article XX(d) of GATT 1994. This was because the provision did not permit WTO Members to take measures to seek to secure compliance by another Member of that other Member's international obligation. On 24 March 2006, the DSB adopted the Appellate Body report and the panel report, as modified by the Appellate Body report. Mexico stated its intention to implement the DSB recommendations and rulings on 21 April 2006 and requested a reasonable period of time to implement. On 22 June 2006, the U.S. informed the DSB that a reasonable period of time for Mexico to comply could not be agreed upon between the parties. The U.S. then requested that the reasonable period of time be established through binding arbitration pursuant to Article 21.3(c) of the DSU. Mexico and the U.S. informed the DSB on 3 July 2006 that they had mutually agreed that the reasonable period of time would be nine months and eight days, expiring on 1 January 2007. However, if the Mexican Congress enacted legislation between 1 December and 31 December 2006, then the reasonable period of time would be ten months and seven days, expiring on 31 January 2007. The U.S. withdrew its request for arbitration as a result of this agreement.

5. China—Value-Added Tax on Integrated Circuits[11]

The U.S. requested consultations with China on 18 March 2004 concerning China's preferential value-added tax (VAT) for domestically produced or designed integrated circuits (IC). The U.S. alleged that, although China provides for a 17 percent VAT on ICs, enterprises in China are entitled to a partial refund of the VAT on ICs that they have produced, resulting in a lower VAT rate on their products. The U.S. indicated that China appeared to be subjecting imported ICs to higher taxes than those applied to ICs domestically produced in China, thereby according less favorable treatment to imported ICs. The U.S. considered these measures to be inconsistent with China's obligation pursuant to Articles I and III of GATT 1994, the Protocol on the Accession of the People's Republic of China, and Article XVII of the GATT. China and the U.S. notified the DSB on 26 March 2004 that they had reached an agreement during the consultations. China agreed to amend or revoke the measures at issue to eliminate the availability of VAT refunds on ICs produced and sold in China. On 5 October 2005, China and the U.S. notified the DSB that the terms of the agreement had been successfully implemented, and thus they both agreed that a mutually satisfactory solution had been reached in the matter.

6. United States—Measures Relating to Shrimp from Thailand[12]

On 24 April 2006, Thailand requested consultations with the U.S. concerning anti-dumping measures on imports of frozen warm-water shrimp from Thailand. The consultations request related to a practice known as "zeroing" negative dumping margins, and the consequent imposition of definitive anti-dumping duty measures on imports of frozen warm-water shrimp from Thailand. Thailand believes that through its use of "zeroing," the U.S. has failed to make a fair comparison between the export price and the normal value, and, therefore, calculated distorted margins of dumping in violation of its obligation under Articles 1, 2.1, 2.4, 2.4.2, 3.1, 3.2, 3.3, 3.4, 3.5, 5.8, 9.2 and 9.3 of the Anti-Dumping Agreement, and Articles II, III, VI:1, and VI:2 of GATT 1994. Thailand also requested consultations on the U.S. continuous bond requirement and on its application to imports of frozen warm-water shrimp. India, Japan, Brazil and China have all requested to join the consultations. Thailand requested the establishment of a panel on 15 September 2006. The DSB established a panel at its meeting on 26 October 2006. Brazil, Chile, China, the European Communities, India, Japan, Korea and Mexico have all reserved their third-party rights. This dispute was still pending as of the writing of this article.

III. Conclusion

The case studies presented above demonstrate that the dispute resolution process at the WTO is utilized by many countries in their efforts to resolve trade disputes efficiently and effectively, with cases proceeding in a timely manner. Members are gaining confidence in the dispute resolution process, as demonstrated by the increasing number of cases being brought to the DSB for resolution. So far, there has not been any overt defiance of the DSB's rulings, unlike what transpired with the rulings of WTO's predecessor, GATT. This compliance with DSB rulings is yet another indicator of country satisfaction with the process.

Endnotes

1. *See* World Trade Organization, Uruguay Round Agreement, Annex 2: *Understanding on Rules and Procedures Governing the Settlement Dispute*, art. 4, at 355-57, http://www.wto.org/english/docs_e/legal_e/28-dsu.pdf.
2. *Id.* art. 6, at 358.
3. *Id.* art. 16, at 363.
4. *Id.* art. 17, at 365.
5. *Id.* art. 21, at 366.
6. Some of the disputes are still in progress; the summaries presented herein are current as of 5 January 2007.
7. *See* World Trade Organization, Dispute Settlement: Dispute DS2 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds2_e.htm
8. *See* World Trade Organization, Dispute Settlement: Dispute DS257 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds343_e.htm; *see also* U.S. Trade Representative Monitoring and Enforcement, Dispute Settlement Update (15 Nov. 2005), at http://www.ustr.gov/assets/Trade_Agreements/Monitoring_Enforcement/Dispute_Settlement/asset_upload_file343_5697.pdf
9. *See* World Trade Organization, Dispute Settlement: Dispute DS305 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds305_e.htm.
10. *See* World Trade Organization, Dispute Settlement: Dispute DS308 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds308_e.htm.
11. *See* World Trade Organization, Dispute Settlement: Dispute DS309 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds309_e.htm.
12. *See* World Trade Organization, Dispute Settlement: Dispute DS343 at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds343_e.htm.

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The WTO Doha Development Round: The Development Dilemma and Other Competing Interests

By Andrea Ewart

I. Introduction

A. Scope of Article

This article presents an overview of the World Trade Organization (WTO) Doha negotiations and its current state of play. Incorporating the perspective of African and Caribbean WTO members, this analysis discusses the varied interests that will need to be reconciled to arrive at a successful conclusion to the round. The article concludes that a successfully negotiated round is in everyone's interest and ends with some speculative comments by the author about the way forward.

B. Overview of WTO Doha Negotiations

December 2006 has come and gone, and with it the extended deadline for conclusion of the Doha negotiating round of the World Trade Organization (WTO). In November of 2001, at a ministerial conference[1] held in Doha, the capital of Qatar, WTO members agreed to initiate the Doha Development Round. The name given to the round implied a focus on addressing the needs and concerns of developing countries. Nevertheless, because the round's primary goal remains trade liberalization, i.e., a reduction in barriers to the international movement of goods and services, a tension has developed between the stated development goals and the expectations of the intended beneficiaries of this development focus.

The United States and most developed countries promote the view that developing countries stand to benefit most from the elimination of tariffs, particularly their own.[2] This position relies on a 2002 World Bank study stating that tariff elimination would create developing country income gains of US $500 billion and lift more than 300 million people out of poverty by 2015.[3] Developing countries, on the other hand, believe that they have yet to see the touted benefits of the liberalization effected as a result of the Uruguay Round. Reportedly, some developing countries saw a "Development Round" as a "free round" which would focus on the delivery of increased market access by developed countries without any need for developing countries to address their own market deficiencies.[4] More pressing is the reality that many developing countries are still struggling to implement the commitments made during the Uruguay Round. These capacity issues have limited their expected gains from existing trade liberalization agreements and commitments and make them reluctant to assume new obligations. Developing countries also complain that the failure of developed countries to reduce their programs of agricultural supports has continued to disadvantage many developing country products.

Reform of agricultural markets is perhaps the most contentious issue facing both developed and developing countries during this round. Of particular interest is the reduction or elimination of various forms of agricultural subsidies, i.e., the practice by which countries provide support, such as payments or guarantees of artificially high prices, to their farmers. This issue was not addressed during the Uruguay Round because of its complexity. First, there is the extent to which European Union (EU), U.S., and Japanese farmers—the primary recipients of these programs—depend on the subsidies. The subsidizing countries, while they would like to continue these programs for their own farmers, are not at all complacent about similar programs offered by other countries. The United States has proposed a fairly ambitious reform program, but there is skepticism about its ability to deliver on this proposal, particularly in light of the extension of its domestic subsidies by the 2002 Farm Bill.[5] Meanwhile, the steps taken in 2003 by the European Union to reform its Common Agricultural Policy (CAP) have been deemed insufficient by the United States and other negotiating parties.[6] Nevertheless, the European Union has insisted that it has no intention of making additional reforms prior to its internal deadline of 2013. To further complicate this issue, the EU's subsidy programs have benefited developing countries from the African-Caribbean-Pacific (ACP) group through duty-free quotas for their agricultural products which are then exported from the EU at subsidized rates. Thus, there are many entrenched interests that are almost guaranteed to be unhappy at the prospect of any serious reform to agricultural trade.

These difficult and contentious issues have impeded the progress of negotiations during this round. In fact, the concerns of developing countries aborted an earlier attempt to launch a new round when the ministerial conference convened in 1999 in the U.S. city of Seattle. And the first ministerial conference held after the launch of the round in the Mexican city of Cancun in September of 2003 ended unsuccessfully because developing countries believed that the commitment made at Doha to focus on their needs was not being met and members were unable to agree on how to reform trade in agriculture.

The next movement forward occurred almost one year later at the July 2004 meeting of the WTO General Council.[7] The meeting produced what was referred to as the "July Agreement," which temporarily revived the negotiations by (i) providing that all agricultural subsidies that distort trade (i.e., that result in prices and production higher or lower than levels that would usually exist in a competitive market) are to be eliminated or reduced; and

(ii) narrowing the range of areas in which countries will have to commit to new trade-liberalizing rules. The July Agreement outlined the framework for negotiating new trade liberalizing rules and allowed for some incremental decisions to be made at the December 2005 ministerial conference in Hong Kong.

II. What Has Been Decided to Date

A. Negotiating New Rules on Agriculture

The program of agricultural reform to be negotiated as part of the Doha Development Round will focus on three "pillars": domestic subsidies, export subsidies, and tariffs. Members have so far committed to do the following:

(1) Substantially reduce trade-distorting domestic subsidies, with developed countries making the deepest cuts.

(2) Eliminate agricultural export subsidies by 2013. This date just happens to be the EU's internal deadline for revisiting its own agricultural subsidy programs. Members are to negotiate the set of rules by which they can continue to offer programs to support exporting industries.

(3) Reduce tariffs on agricultural products, starting from existing bound rates, i.e., the tariff rates to which each country already committed during the Uruguay Round. The deepest cuts are to be made on those products with the highest tariff rates, but members *may* propose that some types of products be designated "sensitive" and excluded from any commitment to deep tariff reductions.

(4) Permit developing countries to receive special and differential treatment, i.e., exemptions from WTO rules that will include longer transition periods, including the following: the temporary ability to continue subsidies to reduce the costs of marketing exports of agricultural products; continued exemption from the commitment to reduce domestic support for government assistance and investment programs that encourage agricultural and rural development; and the ability to designate items as "Special Products" and therefore be eligible for more flexible treatment of those products that a country considers important to its food security, livelihood and rural development needs.

B. Negotiating Market Access for Industrial Goods

Members have committed to do the following in the area of non-agricultural market access (NAMA):

(1) Reduce tariffs on all manufactured products, with the deepest cuts expected on those products with the highest tariff rates. As a general goal, Members committed to focus on reducing or eliminating high tariffs, tariff peaks (tariffs of 15% or above), tariff escalation (higher import duties on semi-processed and finished products than on raw materials), and non-tariff barriers on those products that developing countries are particularly interested in exporting.

(2) Allow developing countries to receive special and differential treatment through longer implementation periods for tariff cuts, and being able to commit to smaller tariff reductions than those made by developed countries.

Countries are encouraged to request or to make offers, i.e. specific proposals, on the non-tariff barriers they would like to be eliminated.

C. Negotiating Services

Members have agreed to the following general principles:

(1) All sectors are open to liberalization.

(2) Members are to make their offers (i.e., specific proposals on how they would liberalize their service markets) and requests (i.e., the access they would like to members' markets) by the deadline (which has been repeatedly pushed back because so few offers or requests have been made).

(3) Individual developing country members may be allowed to open fewer sectors and to liberalize fewer types of transactions.

(4) Negotiations may be also pursued on a plurilateral basis, allowing countries to make an offer or request of more than one country with respect to specific sectors or modes of supplying the service.

D. Negotiating Trade Facilitation Rules

Members have agreed to the following:

(1) New rules will be developed to streamline countries' trade and customs procedures in order to further expedite the movement, release, and clearance of goods, including goods in transit.

(2) Special and differential treatment provisions will include the usual transition periods for implementing commitments, but will also include consideration of countries' actual implementing capacities; an understanding that countries are not to be required to undertake investments in infrastructure projects beyond their means; and means of addressing the cost implications of proposed measures.

(3) Members will also discuss how to improve technical assistance and capacity building for developing countries, and establish provisions for effective cooperation between countries' customs agencies.

E. Addressing the Concerns of Developing Countries

In addition to providing special and differential treatment with respect to new rules to be developed, the following issues were raised to address the outstanding concerns of developing countries:

(1) The General Council was charged with (i) reviewing all special and differential treatment provisions in WTO Agreements that are intended to benefit developing countries but which have been difficult to implement and (ii) making recommendations on how to make them more effective and operational. The review has since been completed but no concrete proposals have been accepted on how to make the provisions more effective.

(2) Members also recognized two potentially negative effects of tariff reductions that reduce (i) the revenues available to support a country's budget; and (ii) the benefits developing countries receive from duty-free access into developed-country markets. No specifics have been developed on how to address these concerns.

(3) Developed country members have also committed to implement duty and quota-free access for products originating in the 40 least developed countries (LDCs). Members have further agreed to establish a "Trade for Aid" program to assist all developing countries with the supply-side capacity and trade-related infrastructure they need to implement and benefit from the WTO Agreements and to expand trade.

The above agreements provide only a framework. Most negotiating countries have yet to provide the specific numbers or language around which concrete negotiations can actually take place. As late as November 2006, the WTO Director-General, Pascal Lamy, said that full negotiations could start only when Members were ready to put numbers to the key issues that they have already discussed in general terms.[8] For example:

(1) Most countries have yet to propose actual numbers by which they would be willing to cut tariffs on agricultural and industrial goods;

(2) No agreement has been reached on the formula to be used to apply tariff cuts on agricultural and industrial goods;

(3) Most countries still need to provide specifics on the agricultural subsidies they would eliminate;

(4) Members have not yet proposed the products and/or programs they would like to exempt from the new rules to be established under this round. The battle over which agricultural products may be deemed "sensitive" and therefore exempt from tariff cuts has yet to take place.

(5) No specifics have been agreed to about Special and Differential Treatment provisions for developing countries. For example, over what time period would they be allowed to phase in tariff cuts and to continue to subsidize the costs of marketing exports of agricultural products; and which agricultural products could be exempted from the rules as "Special Products" because of their importance for the country's rural development goals?

Where these numbers have been proposed, the difference in positions remains vast. To illustrate, while Brazil has offered to cap NAMA tariffs at 30%, the EU and other developed nations are insisting on a cap of no higher than 15%. And the deadlines for countries to provide these specifics have repeatedly come and gone without result. In sum, the above framework is all that exists five years after the launch of the round and after the expiration of an already extended deadline. Although it is still possible to conclude a successful negotiating round, the various competing interests that have combined to make this round so intractable will need to be reconciled.

III. Current Obstacles and Competing Interests to Concluding a Successful Round

The first factor hindering the concluding of a successful round is the continued failure to bridge the wide divergence in interests of the primary players, namely, the United States, the European Union, and the block of emerging market economies led by Brazil, China, and India. The United States needs business support and congressional approval for a trade deal that promises a sufficient increase in exports for U.S. companies to offset the anticipated losses from increasing imports into the U.S. market. This means a trade agreement that promises to provide (i) increased access to the EU agricultural market through EU removal of additional domestic and export subsidies; (ii) big increases in market access through tariff reductions on manufacturing goods, particularly in the emerging markets of Brazil, China, and India; and (iii) increased access to services, particularly in the telecommunications, financial, computer, and express delivery sectors.

The European Union, on the other hand, needs to be able to show improved access to industrial and service markets, particularly in the large emerging markets such as Brazil and India, to convince its constituents that it makes sense to speed up the reform of the EU agricultural subsidy programs. EU members, France in particular, have been extremely vocal in refusing to give EU negotiators any leeway to move from the EU's internal timetable for reforms. Meanwhile, Brazil and India have been insisting that the EU offer additional cuts to its program of agricultural subsidies before they make substantial offers in the areas of interest to the EU.

Led by Brazil, the Group of 20 (G-20) comprises twenty WTO developing country members that share

a common negotiating position focused on winning elimination and/or reduction of agricultural subsidies and tariffs by both the United States and the European Union. Their position is that neither the U.S. nor the EU has gone far enough in this area. These G-20 members are also the developing country members whose markets are of primary interest to developed countries and who are under pressure to in turn open up their industrial and services markets. To this the G-20 repeatedly responds, "You first."

In short, as Pascal Lamy has said, listing the requirements for a successful deal, the United States must make deeper cuts on its domestic supports; the EU must offer increased agricultural market access; and the developing countries must offer more in respect of industrialized tariffs.[9]

Negotiators and commentators have noted a second factor in the lack of leadership by the United States and the European Union.[10] Long-time WTO observers acknowledge that a strong and unified push by U.S. and EU political leaders has been indispensable to progress on past WTO trade rounds. This time, however, they note, the U.S. and the EU have been engaged in a series of trade wars over their mutual subsidies for their airbus industries. The speculation is that the past reluctance to negotiate on the issue may have spilled over into a lack of focus on acting together to move the round forward.

Indeed, when they have been engaged in bilateral discussions, their energies have focused on managing and minimizing their numerous trade disputes. A 20 June 2005 EU-U.S. summit addressed the wide spectrum of U.S.-EU relations. In the area of trade, the focus was on developing mechanisms to allow for early discussions about pending legislation and regulation on either side of the Atlantic that could trigger more trade disputes. The U.S. and the EU each have actively used the WTO dispute settlement system to bring cases against the other, and each has fared badly, through adverse rulings, in these cases. Arguably, their energies have been too focused on repairing their trade relationship to permit consensus at the moment on how to lead the current round of trade liberalization.

Domestically, both the U.S. and the EU also face pockets of strong political resistance to further liberalization. In the United States, the agricultural, steel, and textile sectors are heavily protectionist, with strong support from powerful members of the U.S. Congress. Resistance exists in general to the prospect of more trade agreements, and WTO decisions that have forced changes to domestic policy and legislation generate much rancor among some members of the U.S. Congress. In 2004 alone, there were four WTO cases that revolved around the ability and willingness of the U.S. Congress to repeal or to rewrite laws that had been deemed WTO-inconsistent and in 2005 two of those cases remain unresolved.[11] The EU, for its part, is currently facing the ire of its agricultural sector as it introduces reforms, the latest being to its heavily protected sugar sector. These changes, too, are being spurred on by adverse WTO decisions that have deemed components of the EU's Common Agricultural Policy (CAP) illegal under WTO rules.[12]

These internal battles, it is felt, have detracted from the ability of the U.S. and the EU to provide political leadership in the multilateral negotiations. Furthermore, there is concern that the U.S. administration has been focusing on its bilateral trade agenda to the detriment of the multilateral negotiations. Since the 2001 launch of the Doha Round, the United States has negotiated bilateral free-trade agreements (FTAs) with Australia, Bahrain, Chile, each of the five Central American countries that comprise the Central American Free Trade Agreement (CAFTA) and the Dominican Republic,[13] Colombia, Morocco, Oman, Panama, Peru, and Singapore. Negotiations have also been launched with five South African countries in an unsuccessful attempt to create a U.S.-South African Customs Union FTA, and are ongoing with Malaysia.

There are also suggestions that the U.S. and EU business communities, both of which played a leading and very vocal role in the Uruguay Round, are still absorbing the changes from that round. Reportedly, some businesses are at the moment quite comfortable with the incremental changes that result from bilateral negotiations and private agreements with countries' regulators. Furthermore, while they can achieve greater results from agreements with 150 countries, it is so much harder to do!

Finally, there is the reality that, both as a result of a "weakened appetite" for liberalization as well as in response to the capacity concerns of developing countries, expectations for the round have been considerably reduced. The ambitious agenda that aimed at increased liberalization of the service sector and at developing rules on trade and investment, competition policy, government procurement and transparency, and trade facilitation—the so-called Singapore Issues that were rejected by developing countries at the Cancun Ministerial Conference—has been scaled back to focus on two primary issues: (i) agricultural market access, including reform of trade in agriculture; and (ii) market access for industrial goods. Although trade facilitation remains on the agenda, negotiations on trade in services have been seriously stalled. Indeed, the EU's struggles to liberalize trade in services within its borders provide some insight into just how difficult this issue is likely to be in the WTO. A "watered-down" round has created the paradoxical situation in which those industrialized countries that had originally pushed the more ambitious agenda have much less to gain from the current Doha agenda.

There are those who look to the WTO's structure to find the reasons for the impasse. The EU's Pascal Lamy has called the process "medieval." Former U.S. Trade

Representative Robert Zoellick has said that the structure is cumbersome and the governing issues challenging. These statements refer to the consensus rule that governs ministerial conferences, the WTO's decision-making body. A rule that gives one country the authority to veto decisions made by the majority of members appears dysfunctional in an organization of almost 150 countries.

In this author's opinion, however, the biggest institutional weakness is the decision to proceed with negotiations before addressing the capacity issues that afflict its developing country members. The capacity issues are a very serious threat to the organization. Many developing countries do not have the resources to participate effectively in the negotiating process. Their small teams are incapable of successfully covering all of the sessions conducted at ministerial conferences and general council meetings, many of which are conducted simultaneously. Neither are they able, in real time, to respond to changes in the negotiating positions of other members. Understandably, this limitation has a dampening effect at a forum where an original position is expected to be just that, and on a process that is expected to consist of members' give and take. At past negotiating forums, developing countries have accepted on faith the statements of the developed world that they would be better off if they just signed on to the commitments. They no longer believe this. They are no longer willing to rubber-stamp agreements that they did not negotiate and may not understand. Given these realities, it is not surprising that they viewed as a success the unified exercise of their veto authority at the Cancun Ministerial Conference to stop the negotiation on issues other than the ones they came prepared to discuss.

IV. Discerning the Interests of Developing Countries

At the outset, it might be instructive to take some time to define more precisely the concept of "developing countries" in the WTO. This term refers to a self-defined group of countries, mostly former colonies in Africa, Asia, Latin America, and the Caribbean. Consequently, this grouping includes countries with very disparate economic realities and needs. They include the larger emerging market economies, among which are Brazil, China, India, Indonesia, Mexico, Argentina, South Africa, and South Korea.[14]

At the bottom of the grouping are 50 least developed countries (LDCs), located primarily in sub-Saharan Africa, of which 32 are WTO members. The LDC category is more defined and uses a United Nations classification that is based on three objective criteria: (i) a GDP per capita of less than US $750; (ii) low indicators in nutrition, health, education, and adult literacy; and (iii) economic vulnerability (e.g., instability of agricultural production, exports of goods and services, and the like).

The other countries fall somewhere in the middle and include a new grouping whose concerns were recognized at the Hong Kong Ministerial Conference: small vulnerable economies (SVEs).[15] SVEs are typically small, island states that share the following characteristics: smallness, physical isolation from markets, dispersion of small pockets of population, and a small and highly specialized human and physical resource base. These inherited and inherent characteristics result in high operating costs which have forced many to rely upon the export trade of products or services related either to short-term extractive activities or niche markets, or upon trade preferences and tax concessions.[16] The authors of the study on SVEs state that no other grouping of countries, including LDCs, has been required to undertake such wide-ranging adjustments over the last decade of globalization and as a result, SVEs face particular problems which include the following: (i) loss of preferences; (ii) application of rules that do not recognize their inherent characteristics; and (iii) implementation of complex and burdensome WTO obligations, many of which are outside the countries' administrative capabilities.[17] The islands of the Caribbean meet many if not all of these characteristics and have assumed a leading role within this group.

This diverse grouping poses the question, does it make sense to have a one-size-fits-all prescription toward enabling development through trade and economic growth? One must also query whether reliance on the alleged benefits of tariff cuts pays sufficient attention to the round's development goals. In March 2006, the Carnegie Endowment released a study entitled *Winners and Losers: Impact of the Doha Round on Developing Countries*.[18] Using computer models to measure the impact on countries of concluding a Doha Agreement based on current guidelines for negotiating new rules on manufacturing and agricultural trade, the study's conclusions contradicted several commonly held ideas about the value of the round to developing countries. The study concludes, for example, the following:

(1) The proposals would actually increase the gaps between the rich and poor among and within WTO members.

(2) Most developing countries would receive limited benefits or even lose from liberalization of trade in agriculture, primarily because the products of subsistence farmers are generally not competitive globally.

(3) The poorest countries, LDCs, would be net losers of trade liberalization.

(4) The low-income countries just above LDC status would be hurt by the special assistance extended to the LDCs.

These findings are not conclusive, and the study has been criticized for relying on a static model that does not

take into account the cumulative effect of ongoing trade liberalization.[19] Nevertheless, it highlights the need to go beyond tariff cuts and to adopt a more nuanced approach toward the connection between trade and development.

An additional factor is the reality that many developing countries already benefit from very generous preferential market access programs that grant duty-free entry to U.S. and EU markets for a wide range of products. At the same time, this preferential margin is being eroded as the liberalization process leads to lower or zero tariffs for an increasing number of countries' products. What then, do these countries have to gain from a round that focuses on tariff cuts as the primary benefit to them? At the same time, with the tariff barrier to entry in developed country markets removed or minimized, technical, sanitary and phyto-sanitary (SPS), health, and safety requirements for entry create non-tariff barriers (NTBs) that are sometimes insurmountable. Yet, the SPS and Technical Barriers to Trade (TBT) agreements negotiated during the Uruguay Round are not open for renegotiation during the Doha Round. Countries are being encouraged to submit requests and offers to address existing NTBs, but many of these issues are being shelved for discussion at the bilateral and regional levels.[20] This removes one possible benefit from the round for developing countries and yet another incentive for developing countries to participate effectively.

V. The Way Forward

Although bilateral and regional free trade arrangements are being touted as an alternative to a WTO agreement, there is no doubt that countries would prefer to conclude a WTO agreement in which several interests and goals can be pursued simultaneously. The proliferation of trade deals has resulted in confusing and sometimes conflicting rules under which products are allowed to enter a country. WTO multilateral trade negotiations allow for wider consensus and clarity about the rules of trade. And most conclusively, a multilateral arena such as the WTO talks provides the sole opportunity to bring together the major players to agree on the rules for reforming trade in agriculture.[21]

Resolution of the stalemates on the path to successful conclusion of the round will require time. December 2006 was considered to be an "artificial" deadline, pushed primarily by the expected expiration in June 2007 of the U.S. President's Trade Promotion Authority (TPA) rather than by any estimation of how long it would take to arrive at a competent solution to the range of issues being addressed by the round. The Uruguay Round was initiated in 1986 and concluded in 1994. It is not surprising that the Doha Round, which must address a range of the more intractable issues left unaddressed by the previous round, may require longer than the scheduled four- or five-year time frame. So this author's response to the question, "When if not 2006?" is, "As long as it takes."

Nevertheless, the way forward must include some calculation of the necessary components for an agreement to win passage in the U.S. Congress. TPA currently requires that Congress either approve or reject unchanged negotiated trade agreements so long as the document meets goals predetermined with the U.S. Congress. Without TPA, an agreement presented to Congress may either not be passed in its entirety, have conditions placed on the passage of specific provisions, or sit in limbo because of insufficient votes to ensure passage of the enabling legislation. Without TPA, the United States is not considered a credible negotiating partner. At the same time, in the absence of credible progress on the negotiations, there is little incentive to push for an extension of TPA. Therefore, TPA may have to lapse, as indeed it has before. Perhaps the surest way to get sufficient congressional votes to renew TPA is to negotiate an agreement that generates sufficient benefits for a variety of interests that will be willing to lobby hard for its passage. This will take time.

Indeed, reports of a possible breakthrough in the impasse on agricultural negotiations between the United States and the European Union may encourage the U.S. Congress to renew TPA before it expires. The January 2007 World Economic Forum, held in Davos, Switzerland, has reportedly provided an opportunity for a breakthrough in the U.S.-EU impasse on agricultural negotiations and for new life to the Doha process. It is reported that the two members are close to a deal that would have the European Union improve its offer to cut farm tariffs to bring average tariffs closer to the level desired by the United States. In turn, the United States would offer to lower its subsidies.[22] These are positive signs of the start of greater cooperation between the two trade partners. At the same time, a deal between the two must face challenging internal and external tests. Inside the European Union, the deal must win the approval of its members, most noticeably France. A U.S. commitment to reduce subsidies must be vetted by the U.S. Congress and the very powerful farm lobby. Externally, the question is whether the large emerging economies, i.e., Brazil and India, will consider the U.S. and EU concessions significant enough for them, in turn, to increase their offers to improve access to their goods and services markets. In sum, a U.S.-EU agricultural deal is only the tip of the iceberg and leaves many other interests and issues on the negotiating table.

Among the interests that still need to be addressed is the link between trade and development. Conversations in the corridors of Washington indicate a genuine desire by developed economies to find solutions to the development dilemma. There is also genuine bewilderment as to the means by which this might be accomplished, particularly because political (and other) realities mean that they are unwilling and perhaps unable to consider solutions that come at their expense.

For this reason and, more important, because they can best articulate their self-interests, developing countries need to take the lead in this endeavor. They need to do so, not by looking backwards at what used to be, but by looking forward. They need to determine what they want their economies to look like in 2050, for example, and what it would take to get there. But they too need time to be able to identify, articulate, and present negotiating positions based on these goals. They can then proceed full steam ahead with trade liberalization, using goal-oriented and time-specific special and differential treatment provisions in the context of those long-term development goals.

Finally, building the capacity of the developing country members will allow them to arrive at the table better prepared and able to negotiate. Keeping the agenda manageable, and giving sufficient lead time for analysis of members' proposal will ensure better participation at the meetings. There will be less need for countries to fall back on the veto if they are truly part of the process. Failure to address this basic issue will exclude from effective participation at the table the only parties able successfully to address the development dilemma in the Doha negotiations.

Endnotes

1. The ministerial conference is the WTO's top decision-making body comprising a representative, usually the top governmental official on trade or foreign affairs, from each member country and meets at least once every two years.
2. *See, e.g.,* World Trade Organization, "Market Access for Non-Agricultural Products: Revenue Implications of Trade Liberalization," Communication from the United States, TN/MA/W/18/Add.2.
3. *Id.*, citing to World Bank, Global Economic Prospects (2002).
4. *See* discussion by Jeffrey Schott, *Unlocking the Benefits of World Trade*, Special Report in THE ECONOMIST, 1 Nov. 2003, available at http://www.iie.com/publications/papers/paper.cfm?ResearchID=271 (visited 28 Dec. 2006).
5. *See, e.g.,* Tassos Haniotis, "The New U.S. Farm Bill From an EU Perspective," available at http://ec.europa.eu/agriculture/external/wto/usfarmbill/tassos.pdf (visited 28 Dec. 2006). Mr. Haniotis was a member of the cabinet of the then EU Commissioner on Agriculture.
6. *See, e.g.,* Senator Chuck Grassley (R-IA), "Goals for the WTO ministerial conference in Hong Kong, China, December 2005," available at http://www.senate.gov/~finance/press/Gpress/2005/prg120905.pdf (visited 28 Dec. 2006).
7. The general council is a permanent body of representatives from each member country that meets several times a year in the organization's Geneva headquarters and is the primary decision-making body when the ministerial conference has not been convened.
8. International Center for Trade and Sustainable Development (ICTSD), *APEC, Others Want Doha Talks to Restart But Make No Offers*, BRIDGES WEEKLY TRADE NEWS DIGEST, Vol. 10, No. 39, 22 Nov. 2006, available at http://www.ictsd.org/weekly/06-11-22/story3.htm (visited 28 Dec. 2006).
9. ICTSD, Vol. 10, Special Edition, 3 July 2006, available at http://www.ictsd.org/weekly/06-07-03/story1.htm (visited 28 Dec. 2006).
10. Many of the following insights have been gained from comments heard by the author at off-the-record events in Washington, D.C.
11. *See* discussion in Matthew S. Dunne et al., "International Trade," in *International Legal Developments in Review: 2004*, THE INTERNATIONAL LAWYER, Vol. 39, No. 2, 209, 219-220 (2005); and Kristy L. Balsanek et al., "International Trade," in *International Legal Developments in Review: 2005*, THE INTERNATIONAL LAWYER, Vol. 40, No. 2, 217, 231-2 (2006).
12. The latest WTO ruling on this issue came in *European Communities—Export Subsidies on Sugar*, WT/DS265, WT/DS266, and WT/DS283.
13. The CAFTA-DR negotiations were conducted separately with the five CAFTA members (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) and with the Dominican Republic.
14. Chuan Li, "What are Emerging Markets?" University of Iowa, Center for International Finance and Development, available at http://www.uiowa.edu/ifdebook/faq/faq_docs/emerging_markets.shtml (last visited 7. Oct. 2006).
15. Hong Kong Ministerial Declaration, para. 21.
16. Roman Grynberg and Jan Yves Remy, "Small Vulnerable Economy Issues and the WTO," Paper presented at the 24th Commonwealth Parliamentary Conference of Members from Small Countries, Quebec, Canada (2004).
17. *Id.* at 4.
18. Available at http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=18083&prog=zgp&proj=zted (visited 27 Dec. 2006).
19. *See, e.g.,* "EU Welcomes Carnegie Research on Development in Doha Talks," available at http://ec.europa.eu/trade/issues/newround/doha_da/pr170306_en.htm (visited 28 Dec. 2006).
20. Hong Kong Ministerial Declaration, para. 22.
21. *See* Kristy L. Balsanek et al., "International Trade," in *International Legal Developments in Review: 2005*, THE INTERNATIONAL LAWYER, Vol. 40, No. 2, 217, 222, n. 12 (2006) (lack of progress in Doha agriculture negotiations has hindered discussion in other regional and bilateral free trade initiatives.)
22. *See, e.g., Ministers Inject Fresh Life into Doha Trade Talks*, FINANCIAL TIMES, 29 Jan. 2007, at 3.

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Current Economic, Legal and Political Developments in Bolivia and Their Impact on China and Bolivia Trade and Investment

By Fernando Aguirre B.

I. Introduction

This article is intended as a general overview of the Bolivian trade and investment situation, incorporating a brief analysis of the current political and legal environment in the context of important changes that are taking place in Bolivia, with particular emphasis on the relations between China and Bolivia.

II. China and Latin America

A. China's Needs

In his book on China and Latin America,[1] D. Ion de la Riva highlights the importance of China in the world today by reminding the reader that China might have the second largest economy in the world by 2020 and the largest by 2050, primarily as a result of China joining the World Trade Organization, the growth of internal consumption, and China's commercial relations with most of the Latin American countries, which have substantially increased during the last two years. De la Riva also notes that during 2003 China was the largest importer of raw materials in the world, many of which (copper, gold, soybean and oil) came from Latin America. Chilean exports to China already exceed nine percent of the total; those from Argentina, eight and a half percent; from Peru, eight percent; and Brazil, six percent. In 2003 exports to China from the Latin American countries exceeded US $10.2 billion.

Another commentator, Sergio M. Cesarini, notes that, "Chinese priorities for the decade accentuate its need for the supply of raw materials and sources of energy: it is here that Latin America acquires renewed importance as a receiver of investments within the framework of complementary productions."

B. Bolivia's External Economic Integration

Bolivia has participated in various economic integration efforts in Latin America over the years. An important one has been the Andean Community, which is currently attempting to overcome certain critical internal issues.

Trade between the Andean Community and China during the past ten years has been increasing, growing at an accumulated annual average rate of twenty-one percent. China acquired special relevance in 2004, since during the first eight months of that year, trade as compared with the same period of the previous year increased by forty-five percent. Main exports from the Andean Community to China comprised a list of fifteen main products, namely, fish flour, copper minerals, lead minerals, copper cathodes, nickel ferrous, copper waste, aluminum waste, ferrous products, iron minerals, aluminum oxide, zinc minerals, non refined copper, iron laminated products, and bananas. Main imports from China included recorders, videos, walkie-talkies, radios, shoes, toys, machinery parts, data processing machines, printers, TV sets, motorcycles, Christmas products, dolls and kidney beans. Bolivia's exports to China have grown at an accumulated average annual rate of fifty-two percent, although still small in absolute numbers (US $11 million in 2003, but already US $28 million in 2004). Out of the total exports from the Andean Community those from Bolivia represent only one percent. From total imports of the Community, those to Bolivia represented only four percent. The five main Bolivian products exported to China have been tin minerals and concentrates, leathers, zinc minerals and concentrates, silver minerals and concentrates, and aluminum waste. Imports from China included polyester fabrics, shoes, tires, herbicides and related products, and toys. The balance of trade has been unfavorable to Bolivia.[2]

After inauguration of the new Bolivian administration in January 2006, as a result of general elections held in December 2005, the Bolivian Government faced a critical situation as a result of the decision of the Government of Venezuela to withdraw from the Andean Community. Venezuela withdrew on the allegations that the Andean community was in crisis because of the negotiation/execution of Free Trade Agreements between two of its members, Colombia and Peru, with the United States,[3] since those treaties would ostensibly affect internal trade in the Andean Community. Bolivia, a relative ally of Venezuela, joined the criticism, but decided to continue as a member, and the presidency of the Andean Community is now exercised by Bolivia. A specific claim by Bolivia was against the Free Trade Agreement between Colombia and the U.S., since it will affect Bolivian exports of soybean products to Colombia, one of its traditional markets. An understanding between the US, Colombia and Bolivia to meet in order to consider the situation has so far not been implemented. Situations like this highlight the tension that exists between opening trade relations with third countries via free trade agreements on the one hand and the integration programs in Latin America on the other hand. Bolivia had been an observer during the process of collective negotiations between the U.S. with the Andean coun-

tries, excluding Venezuela. During the Mesa government (2004–2005) there was an attempt to organize a working group to initiate formal negotiations with the U.S., but this did not find significant support. At the time there was strong opposition from MAS and social movements.

The new Bolivian administration, of a nationalistic and socialist orientation, is proposing new parameters for its international trade relationships. It has signed trade and economic cooperation agreements with Cuba and Venezuela. It continues to maintain relationships with the MERCOSUR, although its final participation is still pending. A difficult relationship is that with the United States of America, for a number of reasons. The Andean Community countries had received from the U.S. a special arrangement for preferential customs duties treatment for imports into the U.S. as part of a policy of cooperation in the areas of eradication of cocoa growth and the struggle against corruption. This arrangement concluded in December of 2006. As part of the negotiations with the U.S., the Andean Community countries agreed that the arrangement would be replaced by more complete free trade agreements, and this was the reason for the negotiations with Colombia, Peru and Ecuador.

In the case of Bolivia, the new administration rejects the concept of a "free trade agreement" and is promoting the negotiation of a new type of commercial cooperation agreement. In the meantime, however, it has officially requested from the US the extension of the current special arrangement, apart from the probable incorporation in a system of generalized preferences. Conversations held between the two governments have made little progress so far, and is unlikely that Bolivia will succeed in its request—at least in the near future. This creates a difficult internal situation for a good number of Bolivian exporters to the US, which will lose their current preferential treatment, although the government has offered exporters special loans to finance the equivalent amount of customs duties they would have to pay to the US. Because of the probable loss of markets, the new administration has been talking with other countries, including China. President Evo Morales visited China and discussed, amongst other things, the possibility of exports of soybean products. However, given the size of the Bolivian economy, it might find it difficult to cover the demands of China. Similar efforts are being pursued with other countries.

The Bolivian economist, Horst Grebe L, President of the Bolivian Foundation "Prisma," a think tank for the promotion of public policies, considers Bolivia to be running the risk of isolation because of its nationalistic policies and tendencies. Thus Bolivia faces the possibility of a continued crisis in the Andean Community and the need to join efforts with very strong South American trade partners, such as Brazil and Argentina, who are active members of MERCOSUR. Its current conversations with Brazil and Petrobras, the largest investor in Bolivia in the oil and gas industry, made difficult by Bolivia's "nationalization" policies in regard to hydrocarbons, pose difficult questions for the future for this fundamental industry in the Bolivian economy.

Latin America in general is subject to the centrifugal forces in the global economy, and is being forced to look more to other regions than to its own. This explains, among other things, the numerous free trade agreements between Latin American countries and the U.S. and, to a lesser extent, with others outside the region. This also partly explains the loss of weight which Latin America has been experiencing in the international political arena and puts in question whether there is any sort of Latin American identity to be recovered.

The recent political developments of Latin America show three tendencies: (i) populist left as in Argentina, Venezuela and Bolivia; (ii) social democracy left as in Brazil, Chile, Peru and Uruguay; and (iii) center right as in Colombia and Mexico. The so-called "Washington Consensus," which was the basis for the liberalization policies of the 1980s and 1990s, is being abandoned. Venezuela and Brazil dispute hegemonic power in the region.

The world tendencies have also changed: there have been changes in the priorities of the US after 11 September 2001; there are problems in the WTO negotiations; and there are other critical issues that have a global impact, including Islamic fundamentalism, the emergence of China and India as world economic powers, the new economic configuration in the Pacific Basin, the increasing introversion of Europe, and the precious situation of certain multilateral institutions.

Apart from China and India, there are also other emerging important economies, such as those of Russia, Brazil, and South Africa. Latin America's transitional growth rates is greater than the world average but less than the growth rate in Asia, Africa and certain economies in East and Central Europe. The GDP growth rate is greater in Asia than in Latin America. Foreign investment is more oriented to Asia, Western Europe and Eastern and Central Europe. Worrying signs in Latin America include the continued unfair distribution of income and wealth and renewed policies of various Latin American states to purchase armaments. Venezuela is among the leaders in this new arm's race. Various regional conflicts are yet unresolved.

C. China and Bolivia

Diplomatic relations were established between the People's Republic of China and Bolivia in 1985. Over the years China and Bolivia have signed around seventy cooperation and other agreements. Many of them have been for specific projects and activities, by way of donations

or preferential credits from China, especially within the general framework of the 1994 Agreement for Economic and Technical Cooperation. Bilateral working groups and committees have dealt with a number of issues, including the possibilities of Chinese investments in Bolivia. Cultural and educational programs have been agreed upon. Consular relations are subject to special agreements. Other agreements deal with military cooperation.

In May of 1992 China and Bolivia signed an Agreement for the reciprocal promotion and protection of foreign investments, a BIT similar to others which Bolivia, as many other countries around the globe, have signed. As is common with BITs, the agreement provides for recognition of fair and equitable treatment and protection of their respective investments. It includes a most-favored-nation treatment, although excluding as triggers privileges under customs union, free trade zone, economic union agreements and agreements to avoid double taxation or to facilitate trade within borders.

The parties have further agreed not to expropriate, nationalize or adopt similar measures against investments unless made (i) for public interest, (ii) in accordance with internal legal procedures, (iii) without discrimination, and (iv) with convertible and freely transferable compensation which is to be equivalent to the value of the expropriated investment at the time of expropriation. Payment of such compensation is to be made without delay.

Under the China-Bolivia BIT, in the event of controversies between the contracting parties, they are to be settled by diplomatic means, failing which they may be referred to ad hoc arbitration following the rules of the treaty. Controversies between an investor and one of the contracting parties are to be settled amicably, failing which, within a period of six months, any of the parties has the right to submit the controversy to a competent municipal court of the receiving country, should the laws of the State so allow. On the other hand, however, failing agreement within six months, the controversy is to be settled, at the request of either party, by ad hoc arbitration, unless the party has filed a claim before the municipal court. The agreement establishes the rules for ad hoc arbitration: if the Arbitration Tribunal has not been established within four months, any of the parties may invite the Secretary General of ICSID to make the appointments. The tribunal is to resolve the controversy based upon the laws of the recipient party of the investment, the provisions of the agreement, and generally recognized principles of public international law.

On the occasion of the celebration of the fifty-seventh anniversary of the establishment of the People's Republic of China, the Chinese Embassy in La Paz reported on progress in the relationships between both countries, noting that there is great potential in different areas. It mentions that between 1985 and 1995, i.e., the first decade of diplomatic relations, the annual volume of bilateral trade was between US$3 million to US$5 million, mostly composed of import into Bolivia. But in the period 2004-2005 the volume of trade had risen to US$53.1 million in 2004 and US$81.63 million in 2005, the latter being a record. During 2006, the volume of trade during the first six months has reached US$53.79 million, with a substantial increase in exports from Bolivia. Machinery and textiles from China and mineral products, wood and hydrocarbon products from Bolivia are the types of goods with the most potential for access to the other's markets.

Many Chinese corporations are focusing on the investment market of Bolivia, amongst them MINMETAL (Corporation for Metals, Minerals and Non-Ferrous Metals) and ZIJIN for the development of the mining sector, while Hua Wei and ZTE are involved in the telecommunications sector. Companies from China are seeking business opportunities in areas such as wood, agriculture, leather and others. Prospects for investment from China to Bolivia look positive, based on the complementary nature of their economies. The visit of President Evo Morales to China has represented a new direction for the two countries' bilateral relationship: In the past two years there have been more formal delegations on both sides visiting China and Bolivia. The current Mining Minister headed an important delegation with members of Bolivian mining cooperatives to learn more about China's progress and needs in the mining area.

III. Political and Legal Environment

The so-called "Gas War" of 2003 concluded with the resignation of the then President Sánchez de Lozada, under pressure from "social movements" demanding radical changes in Bolivia's hydrocarbons policy and in the "neo-liberal" model of the economy. Strong criticisms of privatization policies were raised, especially in respect of the then active state oil company. A strong demand for a Constitutional Assembly to pass a new Constitution formed part of this social and political movement.

Vice President Carlos Mesa took over power, with the undertaking to call for a National Referendum on a new hydrocarbons policy and to pass reforms to the Constitution, enabling a call for a Constitutional Assembly. The Hydrocarbons Referendum was held, based on which Congress passed a new Hydrocarbons Law in May of 2005. Reforms to the Constitution were also passed, opening up the possibility of a Constitutional Assembly.

The new Hydrocarbons Law affected the contractual rights of foreign oil companies operating since the 1990s. The Law provided for new contracts to be signed and created additional taxes. Foreign companies protected by BITs gave notice of a "controversy" to the government—opening periods of negotiation not yet concluded. Petrobras, the largest foreign investor in oil and gas not

protected directly by a BIT, also expressed opposition and announced its probable recourse to arbitration.

Vice President Mesa was forced to resign due to political pressures, and the President of the Supreme Court assumed power and called for general elections and elections for a Constitutional Assembly in December 2005. The left wing party, MAS, with strong support by social movements and indigenous peoples, won the general election. President Evo Morales, the former leader of the coca growers, took power in January of 2006, announcing a "nationalistic" policy. In regard to foreign investment, his favorite phrase was, "We wish partners, not owners."

In May of 2005 the government passed a decree for "nationalization" of hydrocarbons, in an attempt to implement the new Hydrocarbons Law. Foreign companies voiced their opposition and concerns, and a new period of negotiation was opened. Petrobras took a hard line in the negotiations and presented various demands. The possibility of arbitration continued, whether before the ICSID or elsewhere.

That same month the Government announced a new Economic Plan for five years, which included various "nationalization" measures affecting other sectors. A nationalistic approach, giving to the state the main role in mining and other national resources activities, was included. The debate over the role of private investment, particularly of a foreign origin and of the BITs, became even more open and stronger. The general focus of the Plan was to foster local industrialization of raw materials and products more than the mere export of raw materials, especially in oil and gas, mining and forestry. The contract with Jindal of India on the Mutún iron deposits followed this philosophy.

The Constitutional Assembly was elected and inaugurated in August 2006, with majority control by the MAS party and its allies. One key debate continues: the state policies on natural resources. Some radical proposals of full control by the state have been made. The indigenous people movements propose reverting domain and title over non-renewable and renewable natural resources to the indigenous people community organizations. At this time the Constitutional Assembly is still discussing its internal regulations, because of a disagreement over the majorities required to approve each individual article and the full text of the Constitution. There is a strong division between the MAS party and its allied social movements and a part of the minority opposition, which includes various regional civic movements. The eastern and western regions are in conflict over the issue and there have been fears of a serious social and political division.

Since the 1980s Bolivia has signed and ratified around twenty Bilateral Investment Treaties (BITs), most but not all of which provide for ICSID arbitration for disputes based on expropriation and related claims. As mentioned above, protected oil companies have filed notices of disagreement in respect of the new Hydrocarbons Law and the Decree of Nationalization. Negotiations are under way. Other negotiations are to take place with foreign companies operating in other areas (electricity, telecommunications, transport, refineries and forestry) as a result of the new Economic Plan, which includes the announced intention of the state to obtain a majority equity participation in previously privatized companies. Land tenure has become another complex but separate debate.

In December of 2005 a recourse was filed with the Constitutional Court, demanding that the Bolivian laws ratifying the Washington Convention (ICSID) and various chapters and articles in BITs dealing with international commercial arbitration be declared contrary to the Constitution. The Court denied the demand and ruled that the ratifications of the treaties were constitutional, quoting, among other things, Article 27 of the Vienna Convention on the Law of Treaties. The Constitutional Court adhered to the doctrine that courts cannot review the constitutionality of treaties once they have been ratified. In this way it confirmed the concept that there is constitutional control of treaties only before they are ratified: once consent is given by ratification, the treaty relationship is, as between the contracting states, subject to international law.

Other recourses were filed with the Constitutional Court demanding judgments that certain provisions in a number of laws be declared contrary to the Constitution. One of them was against articles of the Mining Code which considered mining concessions to be real property which could be disposed of and mortgaged as any other real property, with some conditions. The Court found those articles to be contrary to the Constitution, based on the Court's interpretation of "public domain" over natural resources. The Court ordered new substitute legislation to be passed by Congress within a maximum period of two years. Otherwise, as a consequence of the ruling, those articles would be automatically derogated upon expiration of such term. This ruling coincided with a long debate over the need for new mining legislation. The Constitutional Assembly is therefore to deal with the issues of "public domain" and treatment of natural resources, and a new Mining Code is to be passed which will be based either on the Court's ruling or on the new Constitution. A "nationalistic" approach of some kind is expected. In any event, there is uncertainty over ownership rights and role of private national and foreign investment.

In August of 2006, after complex negotiations, the large so-called Mutún Iron Ore's project was finally awarded by the new Government to Jindal, the Indian iron and steel company. The award has been confirmed, but final contractual terms are still being negotiated. This would be a US$ 2.1 billion investment, and the

Government has announced that this will be a "model" to follow in contracts with foreign investments in terms of a new method of granting legal certainty for investments under new policies. But the stability clause is still being negotiated, and the other terms are not known. There is also the question whether it will contain an international arbitration clause, since Bolivia has no BIT signed with India.

Currently there is only one Bolivian claim pending resolution before the ICSID: it was filed against the Bolivian Government by a Chilean company for expropriation compensation under the Chile-Bolivia BIT, based on a policy action by the Government of President Mesa in 2005, by which the company's mining concessions reverted to the state, again because of social pressure. The case has been recently registered and is just now starting.

Another case was filed in 2001, claiming compensation for expropriation of investments under the Netherlands' BIT as a consequence of the Government's decision to rescind in 2000 a water concession contract with Aguas del Tunari S.A., which was eighty-percent owned by foreign investors. The request for arbitration was made in November 2001, and compensation claimed was US $25 million. After constitution of the Arbitration Tribunal, the Bolivian Government filed jurisdictional issues and defenses of lack of consent and of lack of control under the treaty. The Arbitration Court denied both by an award rendered in October 2005. The case was thereafter settled between the parties.

In the current political environment there are important challenges ahead. For example, can the Constitutional Court's ruling on the Mining Code be treated as an expropriatory rule of law under BITs? Initially it depends on new legislation to be passed, either as part of the new Constitution and/or a new Mining Code to be enacted. But because of the deferred effect of the Court's ruling absent new legislation, should it not have retroactive effect? In any event, it is quite possible that the Court's ruling itself could be considered a legal rule which triggers protection under BITs.

Another legal question is whether the new Bolivian Constitution, once it is passed, could give rise to a claim under applicable BITs if the Constitution adversely affects rights granted under a BIT: would the Constitution itself be a rule of law under the BIT's definitions, triggering the right to a claim? This appears to be possible, despite the inherent complex political implications.

Endnotes

1. *China y America Latina. Nuevos Enfoques sobre Cooperación y Desarrollo. Una segunda Ruta de la Seda?* (2005).
2. Statistical Document, General Secretariat, Andean Community, Commercial Trade of the Andean Community and China, 1994–2004 (January 2005).
3. Ecuador suspended a similar negotiating process.

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China and Peru Trade and Investment

By Guillermo Ferrero

I. Introduction

This article reviews and explains past trends in trade (in the context of both exports and imports) between China and Peru, as well as recent foreign direct investment undertaken by Chinese investors in Peru, the legal and regulatory framework applicable to bilateral trade and investments between both countries, and the author's views regarding the future of the commercial relationship between China and Peru.

II. Background of the Peruvian Economy

A. General Overview

The main objective of the current Peruvian Government is to achieve high and sustained economic growth, along with lower inflation rates and sufficient international reserves to support the sustainability of external accounts. The results of these efforts in 2005 were very favorable: As to the real sector, the GDP grew by 6.7% over 2004, and as of December 2005, fifty-four months of consecutive economic growth has been registered, which placed Peru among the most dynamic and consistent countries in the Latin American region.

Meanwhile, Central Bank figures show that total exports reached US $17.2 billion in 2005, 36.7% higher than the year before. With imports totaling on average US $1 billion monthly, the trade balance surplus accrued to US $5.2 billion in 2005.

Moreover, financial stability accounts for Peru's large foreign currency reserves position at the Central Bank, which constituted fourteen months of Peruvian imports as of December 2005. By the end of 2005, foreign currency reserves held at the Central Bank had reached US $14.097 billion.

B. Export Growth

After a remarkable 39.6% growth in 2004, exports continued to grow, and in 2005 they increased by 37% in nominal terms when compared with the year before. Various factors contributed to the growth in exports, including an expanding international demand, higher commodity prices stemming from rising Chinese market demand, and the US Andean Trade Promotion and Drug Eradication Act (ATPDEA), which provides for duty free entry of many Peruvian products into the US market.

With a 30.4% market share of total exports and a 39.5% growth in 2005, the United States was once again Peru's largest destination for exports, as reported by Peru's Exports Promotion Board, Prompex, followed by China with a 10.9% market share, which is a 49.5% increase over a year ago.

Growth basically came from traditional exports (42.2% increase), although non-traditional exports also rose significantly (22.9%) in 2005. Fishmeal and fish oil foreign sales grew 18%. Oil and oil by-products also grew 129%, mainly through greater sales of gas liquids from the Camisea gas fields, and rising international crude prices. Mining, which accounts for 56.4% of all Peruvian exports, benefited from higher international metal prices and jumped 39.9%. Exports of textiles and apparel were the most important non-traditional exports, totaling almost US $1.2 billion in 2005, a 16.6% growth over a year ago.

C. Country Risk

As reported by the Peruvian Ministry of Foreign Affairs, a prudent economic program has contributed to preserving Peru's sovereign risk rating as among the lowest in the Latin American region. As of 29 September 2006, Peru's country risk registered 1.35, a new historical low, as recorded by EMBI+ Peru and prepared by JP Morgan investment bankers.

D. Investment Attraction

In brief, as indicated by Peru's Ministry of Foreign Affairs, Peru offers the following advantages:

- A stable macroeconomic climate.
- Less country-risk than other countries in the region.
- Investment opportunities in infrastructure, utilities and private sector projects.
- ATPDEA and other integration incentives (such as with China).
- A close opportunity to sign a Free Trade Agreement with the United States of America (ratification by United States Congress is pending).
- A stable political outlook.

Peru offers investors several sectors with clear comparative advantages, such as mining, with world-class ores that largely explain the investments received by this sector the past years; agriculture that enables counter-season crops; fishing and aquaculture offering a huge diversity of sustainable resources; production of textile and apparel specialized in great quality plain knit; and tourism with different archeological, culture and natural sites.

The main investors in Peru are Spain, with a 33.1% share of the foreign direct investment, followed by the USA and UK with 15.8% and 15.6%, respectively.

II. China and Peru

A. Reasons for the Bilateral Relationship between China and Peru

The bilateral relations between China and Peru are defined principally by three factors.

First, there is the strategic economic convergence that stems from the geographical position of Peru as a bridge between Northeastern Asia and South America and the Atlantic Ocean. Second, there is the ability of Peru to project itself as an important factor in extended sub-regional markets, such as the Andean Community and the United States market (given the likely execution of a free trade agreement with the USA). Third, there is the fact that Peru has a very favorable legal system oriented toward attracting foreign investment and promoting international trade. Indeed, Peru offers foreign investors access, without restriction, to the majority of its economic sectors, with (i) free transfer of capital; (ii) free competition; (iii) guarantee of private property; (iv) access of nationals and foreigners to national and foreign credit; and (v) freedom to distribute dividends and other forms of returns abroad.

Moreover, the Chinese interest in increasing economic relations with Latin America generally rests on the following characteristics of the countries in the region:

- The Latin American countries are in the course of economic development.
- The Latin American countries are meaningful markets for consumer goods and capital assets.
- The Latin American countries have an abundance of raw materials, which could constitute an important source of supply for the modernization plans of China.

B. Legal Framework of the Bilateral Relations between China and Peru

The People's Republic of China and the Republic of Peru established diplomatic relations on 2 November 1971. Since then, bilateral cooperation in trade has increased gradually. Most recently, in January 2005, China and Peru entered into the following agreements, which will strengthen trade, investment and business links between both nations:

- Agreement for mutual judicial assistance in criminal matters.
- Protocols for the access of Peruvian table grapes to the Chinese market.
- Protocols for the access of Chinese apples to the Peruvian market.
- Three memoranda of understanding which cover the following topics:
  - Memorandum for cooperation in the promotion of investments.
  - Memorandum for cooperation in the exploration and exploitation of oil and natural gas and petrochemicals.
  - Memorandum for the recognition of Peru as an official destination for Chinese tourists.
- Agreements for cooperation between the Chinese Council for the Promotion of International Commerce (CAPIT) and the Agency of Promotion for Private Investment of Peru (Proinversión), with an aim at developing cooperation for the promotion of investments of Chinese companies in Peru and Peruvian companies in China.
- Agreements for technological cooperation.

C. Volume of Bilateral Trade

In the last ten years, the trade between China and Peru has increased at a very rapid pace.

Imports of Peru from China have grown from US $188 million in 1996 to US $1.061 billion in 2005. Twenty products represented thirty-three percent of the overall imports from China in 2005.

Likewise, the exports of Peru towards China grew from US $419 million in 1996 to US $1.826 billion in 2005, which represents approximately a four hundred fifty percent growth during that period. Twenty products represented ninety-nine percent of the total exports towards China. The principal export products were flour, powder and "pellets" of fish.

As reported by the Andean Community, the chart set forth on Appendix 1 indicates the rate of imports and exports among China and the countries of the Andean Community (which includes Peru):

D. Bilateral Trade–Main Products

1. Principal exports from Peru to China

(a) Mining

Peru possesses mineral resources that China needs for its Tenth Program of Five-Year Development, such as copper, lead, zinc and iron, among others. These mining products represent the most significant exports from Peru to China, considering the overall value in U.S. dollars.

(b) Fishing

Peru exports frozen products (hake, anguila, jurel, shells) and dry fishing products (fins of shark and sea cucumbers, among others). Moreover, besides flour and oil from fish, Peru has comparative advantages in eel, squid, prawns, fish tape, mackerel, and shellfish, all of which may be exported in a frozen condition. The high freight costs can be compensated by a preferential treatment of

duties on fishing products. The principal export products were flour, powder and "pellets" of fish. The foregoing fishing products represent the second most significant exports from Peru to China, considering overall value in U.S. dollars.

(c) Farming

The principal Peruvian farming products with potential interest for the Chinese market are grapes, mango, citrus fruits, purple corn, brown peanuts, and beans, among others.

(d) Textiles

The main textiles that Peru exports to China are alpaca and wool.

2. Principal exports from China to Peru

The main products that Peru imports from China are machinery and equipment, oil and its derivatives, plastics, optical and medical equipment, organic chemicals, iron and steel, domestic appliances, and machines for the processing of information.

Moreover, the most important companies exporting products from Peru to China belong to the mining and fishing industries, while the largest importers of Chinese products belong to the wholesale and electronic sectors.

III. Investments

A. General Overview

An Agreement for the Promotion and Reciprocal Protection of Investments between Peru and China became effective as of 1 February 1995.

China is ranked as the eleventh largest foreign direct investor in Peru. By December 2001, the sum of Chinese investments officially registered before Proinversión amounted to US $122 million, which basically reflected the investment made by the Shougang Company in the privatization of "Hierro Peru."

In recent years, China has increased the sum of investments to an amount totaling US $280 million, basically through the projects Shougang Hierro Peru, the petroleum company Sapet Peru, and Bruce Diversión.

B. Important Investments / Transactions

1. Mineral and Electricity Industries: Shougang Hierro Peru S.A.A.

Shougang Hierro Peru S.A.A., which is a company dedicated to the extraction and processing of iron, has received the largest foreign direct investment by Chinese interests in Peru. Shougang Hierro Peru S.A.A. is a subsidiary of Shougang Corporation, of Beijing, China. Shougang Hierro Peru's metallurgical operations in Peru are located in the Ica Region, south of Lima. Moreover, Shougang has a subsidiary in Peru dedicated to the generation and distribution of electricity in Peru, named Generación Eléctrica S.A.A.

As reported by Peru's Congress, in February of 1992, Peru began the privatization of Iron Perú S.A.A. The company was privatized in the middle of serious political instability, social unrest and terrorist activity. In fact, at that time Peru was considered a high-risk country for foreign investments. Therefore, the initial price set by the Peruvian Government was US $22 million, which included a discount of approximately thirty percent, given the aforementioned reasons. Notwithstanding the foregoing, the company was acquired through a process in which the Chinese Consortium Shougang paid approximately US $120 million, which is US$ 98 million in excess of the base price of US $22 million.

Once the acquisition was completed, the Peruvian Government, then lead by Mr. Alberto Fujimori, issued three Decrees through which the Peruvian State decided to capitalize credits for more than S/. 800 million Nuevos Soles, which as of today date would amount to approximately US $246 million.

Moreover, Peru's Congress reported that, after the acquisition and the capitalization of credits undertaken by the Peruvian Government, Shougang failed to meet its commitments, as agreed in the privatization contract. Indeed, while Shougang promised to invest US $150 million during the period from 1992 to 1995, the Company failed to meet such obligation and had to pay a fine of US $12 million to the Government.

The breach by Shougang in meeting its investment commitments has generated serious social problems in both the company and the city of Marcona. According to analysts, working conditions have not improved, given the absence of technological renovation. Finally, it is important to stress the ecological damage that the area of Marcona has suffered as a result of the re-wash of chemical residues that are being released into the sea adjacent to Marcona, causing pollution of the bay.

Although Shougang's investment in Peru turned out to be a negative example to follow, it is expected that current and future Chinese investments in Peru will bring benefits to the Peruvian economy, as explained below.

2. Fishing Industry and Infrastructure

(a) Fishery Group Limited Company

A very important new Chinese investment is underway in the fishing business. Indeed, the board of directors of China Fishery Group Limited Company has announced that its indirect wholly owned Peruvian subsidiary, CFG Investment S.A.C ("CFG Peru"), has entered into a share purchase agreement, as of 12 June 2006, to acquire certain Peruvian fishing companies.

(b) Luneng Shandong Group

Another important future transaction could be led by the Chinese Luneng Shandong Group. With approximately US$30 billion in capital, the Group has shown its intent to invest in the construction of a port with three wharves in the littoral of Tacna Department that could allow the entrance and exit of ships. The mega-port would require an investment of US $2 billion.

The mega-port would be constructed in the Sama valley (Tacna), south of Lima and next to Chile. The mega-port would occupy a strategic position in Latin America, due to the fact that the site is located in the center of the western side of South America. It would represent the most proximate geographical point between China and South America. This site would also constitute an entrance and exit to and from the Republic of Bolivia and the western and southern states of Brazil, which would therefore facilitate international business for them.

IV. The Future

The commercial relationship between China and Peru looks very promising. On the one hand, bilateral trade has grown systematically during the last ten years. That trend is expected to continue during the coming years, mainly because of the high prices of commodities, such as minerals. On the other hand, although past Chinese investments in Peru have not delivered the benefits the Government was expecting, future major investments are foreseen principally for the fishing and infrastructure sectors.

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APPENDIX

Exports and Imports from the Andean Community Countries with China (Millions of US Dollars)

Country/Year	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05
EXPORTS FOB										
Andean Community	510	663	297	326	569	574	756	901	1674	2292
Bolivia	0	0	0	4	6	5	8	11	23	19
Colombia	7	13	9	15	29	20	30	81	133	237
Ecuador	77	157	52	83	58	29	14	13	49	7
Peru	**419**	**490**	**233**	**215**	**439**	**424**	**614**	**630**	**1189**	**1826**
Venezuela	6	3	3	10	32	96	91	165	277	203
IMPORTS CIF										
Andean Community	358	461	547	599	981	1480	1632	2073	3160	4508
Bolivia	12	9	15	30	63	70	96	84	108	136
Colombia	130	183	226	228	354	474	532	682	1068	1552
Ecuador	28	52	65	47	78	223	338	482	722	621
Peru	**188**	**215**	**213**	**222**	**289**	**353**	**463**	**642**	**769**	**1061**
Venezuela	0	0	28	72	199	360	203	183	493	1138
TRADE BALANCE										
Andean Community	151	202	-250	-273	-418	-906	-876	-1172	-1489	-2217
Bolivia	-12	-9	-14	-27	-57	-65	-88	-73	-84	-117
Colombia	-123	-171	-217	-213	-324	-455	-502	-601	-935	-1316
Ecuador	49	105	-13	36	-20	-194	-324	-468	-674	-614
Peru	**231**	**275**	**20**	**-6**	**150**	**71**	**150**	**-13**	**420**	**765**
Venezuela	6	3	-25	-62	-167	-264	-111	-18	-216	-935

Adoption of Trade Regulations in China: Scope and Effect

By Dr. Olaf Christiansen

I. Introduction

First of all I want to thank the New York Bar Association for the opportunity to participate in this program in Shanghai. I want to focus my remarks on merger control issues and will try to share some experiences from transactions involving merger control in several jurisdictions. Since I come from Europe—namely, from Germany—my comparisons will principally reflect my European experiences.

II. Chinese Merger Control Proposal

I have been provided with a copy of the draft Anti-Monopoly Law of the People's Republic of China of June 22, 2006 (the "Draft"). In Chapter IV of the Draft, comprising Articles 16 through 25, a regime of how to handle "concentrations of undertakings" is established. The proposed Chinese merger control regime resembles regimes of other countries and there are some familiar elements even from the German perspective.

Key elements of the Draft include the following:

(a) **Article 16**: **Definition of "Concentration**." A "concentration of undertakings" is defined as referring to the following situations:

  (1) an actual merger of companies;

  (2) the acquisition by a company of the shares or assets of other companies "to an adequate extent";

  (3) the acquisition of control of other companies or the capability of imposing determinative effects on other companies by contract or other means.

(b) **Article 17**: **Turnover thresholds**. Premerger notification is required if (i) all parties participating in a concentration had worldwide sales in the previous year of more than RMB 12 billion and (ii) one of the parties had total sales in China in the previous year of more than RMB 800 million. If the premerger notification process is triggered, the parties may not proceed with the merger until they have received clearance to do so from the Anti-Monopoly Authority.

(c) **Articles 21 and 22**: Review procedure.

  (1) **First phase: maximum of thirty days**. The Anti-Monopoly Authority is to conduct a preliminary review and decide whether to initiate further review within thirty days from the date of receipt of the documentation submitted in connection with the premerger notification. If the Authority decides not to undertake a further review or makes no decision within the thirty-day period, the merger may proceed.

  (2) **Second phase: maximum of ninety days**. If the Anti-Monopoly Authority decides to conduct a further review, it must complete the review within ninety days after its decision. It must then decide whether to prohibit the merger.

  (3) **Extension of review period: maximum of sixty days**. The Anti-Monopoly Authority may extend the ninety-day review period by up to sixty days if any of the following applies:

    (i) the parties agree to the time extension;

    (ii) the documentation submitted by the parties is inaccurate and needs verification; or

    (iii) the relevant circumstances have significantly changed after the premerger notification occurred.

(d) **Article 24**: **Prohibition standard**. The Anti-Monopoly Authority must prohibit the merger if it has or may have the effect of eliminating or restricting competition. If, however, the parties can prove that the merger can improve competitive conditions, that the positive elements clearly outweigh the negative ones, or that the merger is in the public interest, the Authority may decide not to prohibit the merger. Moreover, the Authority may impose conditions on the implementation of the merger.

(e) **Article 14**: **Presumption of dominant market position**. Entities that meet any of the following conditions can be conclusively found to hold a dominant market position:

  (1) A company has a market share of more than one-half.

  (2) The joint market share of two companies is more than two-thirds.

  (3) The joint market share of three companies is more than three-quarters.

III. Comparison with Other Jurisdictions and Practical Impact of the Proposal

A. Applicability of Chinese Merger Control Laws

At the outset, it should be mentioned that, according to the standards of international law, Chinese merger control laws can apply only when a transaction has an appreciable effect within the territory of the People's Republic of China.

The Chinese Merger Control Proposal contains several elements that are standard components of the merger control regimes of other jurisdictions. In particular, the definition of a "concentration" and the application of thresholds to define what transactions are subject to the premerger notification requirement follow common principles established all over the world and afford the parties transparency as to what they will have to comply with.

The definition of a "concentration" in the Draft seems fairly clearly to state what constitutes a merger of undertakings and the acquisition of control. However, there is some ambiguity with respect to the acquisition of voting shares or assets to an "adequate extent." The Draft states that the detailed standard for this is to be provided by the Anti-Monopoly Authority in some sort of a guideline. In light of the purpose of merger control, it should be made clear that *de minimis* acquisitions of shares or voting rights will not be subject to merger control. Thus, for example, acquisitions of less than twenty-five percent of the shares and/or voting rights of a company should not be subject to the merger control regime. The same is true with respect to the "capability of imposing determinative effects" on another company. In that regard, it needs to be clarified what is actually meant by "determinative effects" since such definition of a concentration is otherwise vague and gives the Anti-Monopoly Authority almost always an argument in favor of its exercise of jurisdiction. A clear-cut definition issued by the Anti-Monopoly Authority would give the companies more legal certainty. Here too, in order to ensure the effectiveness of the merger control regime, the concept of decisive influence should not be construed too widely.

Finally, Article 17 of the Draft opens the door for alternative notification and material investigation standards for several industries, namely, banking, insurance and "other special industries or sectors." The hope remains that in particular the term "special industries or sectors" will not be interpreted in a way that overly extends the regulatory burden for companies. Experience from other jurisdictions teaches that sector-specific regulation is best handled by the same authority (thereby providing one-stop-shopping) and within the same timeframes as apply to other sectors.

B. Procedural Issues

The thresholds and the timetable provided in the Draft are clear. With regard to timeframes, it appears clear that "days" means "business days," not "calendar days." Moreover, the potential for extending the proceeding for an additional sixty days should be treated as an absolute exception. Even though the parties need to agree to the extension, the Anti-Monopoly Authority should be organized efficiently enough in its practice and investigations that such time extensions would normally not be required. Otherwise, the parties would feel pressured to agree to an extension as a matter of course, which would make regular proceedings last for almost six months.

The Draft provides that transactions are deemed not prohibited if the Anti-Monopoly Authority does not issue a decision within the procedural time periods. This is in line with the system in other jurisdictions and beneficial for the parties.

The prohibition against implementing a transaction prior to clearance is also fairly common. It is worth mentioning again that such a prohibition would be applicable only to the extent the transaction had an effect within the territory of the People's Republic of China.

C. Substantive Issues

The prohibition standard of the Draft is based on the potential of a proposed transaction for eliminating or restricting competition. This standard maneuvers between standards commonly found elsewhere. In particular, the wording in the Draft only refers to a restriction of competition and does not require the restriction to be appreciable or significant.

While in several jurisdictions the "dominance test" (i.e., a test as to whether there is the creation or strengthening of a dominant position) applies, the U.S. test refers to a significant lessening of competition ("SLC"). In 2004 the European Union's Merger Control Regulation[1] was reformed. The previously applied dominance test was abolished, since, it was argued, the dominance test would not cover cases involving unilateral effects issues. Instead, the new Merger Regulation refers to a "significant impediment of effective competition" ("SIEC") and specifically states that the creation or strengthening of a dominant position is a key element of the SIEC test.

Article 23 of the Draft lists key factors that are to be analyzed in a merger control proceeding in China. It specifically draws attention to the market shares of the companies, the controlling power of the companies over the market, the degree of concentration in the market, and the possibility of the companies to eliminate or restrict competition. Moreover, other factors, like market access, technology improvement, the effect on consumers and economic development are also to be taken into account.

The Anti-Monopoly Authority has the burden of proof regarding the elimination or restriction of competition, while the parties to the transaction have the burden of proof to show that the positive effects of the transaction outweigh its negative effects. In particular, the parties have the burden of proof regarding the factors mentioned above (e.g., market access, technology improvement, the effect on consumers and economic development). However, as briefly described in Part II above, Article 14 of the Draft, which is not part of the statutory chapter on merger control, provides for presumptions of dominant positions. In Article 12, the Draft defines a dominant market position as a controlling market position that is capable of controlling the price or quantity of products or other trading conditions in the relevant market or restricting or affecting other companies to entering into the relevant market.

To begin with, it is not clear whether the presumptions are applicable in the context of the merger control provisions. However, there is certain likelihood that this will be the case. In practice the Anti-Monopoly Authority could argue that the creation or strengthening of a dominant position per se would be regarded as an elimination or restriction of competition allowing it to prohibit a transaction. If the presumptions are applicable, this would in effect mean that the burden of proof regarding the elimination or restriction of competition shifts to the parties.

In other jurisdictions, in particular in Germany, competition laws also provide for presumptions of dominant positions. These presumptions also have in practice a significant negative impact on merger control proceedings. The competition authorities are in a comfortable position in cases where the presumptions apply. However, irrespective of the fact that the economic correctness of these presumptions has never been proven, competition authorities have to bear in mind, that merger control laws and, in particular, prohibition decisions interfere with the affected companies' entrepreneurial freedom. In the light of this, the burden of proof regarding the competitively negative effects of a transaction should always lie with the competition authority. Ideally, the presumptions of dominant positions should be completely deleted from the Draft.

IV. Concluding Observations

In summary, it is worth noting that in China a merger control regime is to be established. Companies wanting to do business in China require legal certainty and there needs to be transparency with respect to the regimes companies need to comply with.

As mentioned above, the merger control laws need to afford companies clarity as to which transactions are subject to premerger notification provisions. The Chinese competition authority should issue clear statements on its interpretation of certain terms of the law.

Moreover, it is of utmost importance that the competition authorities efficiently investigate transactions. The competition authorities need to do their work in a timely manner to ensure that companies are not unnecessarily delayed in consummating investments.

Finally, it should be assured that companies do not have to carry the burden of proof regarding the non-existence of negative effects of a transaction. The positive existence of those effects should always need to be proven by the competition authority. In addition, the competition authority needs to establish an efficient system to protect business secrets of the parties.

We look forward to seeing a prospective merger control system established in China.

Endnote

1. Council Regulation 139/2004, 2004 O.J. (L24) 1.

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Adoption of Trade Regulations in China, Scope and Effect: An American's View

By the Hon. Pamela Jones Harbour

I. Introduction

Once again, I am delighted to have the opportunity to contribute to the *Practicum* and to provide some thoughts on the development of China's draft Anti-Monopoly Law. My remarks today reflect my personal views and not necessarily those of the Federal Trade Commission, any of its other Commissioners, or the government of the United States.

The draft Anti-monopoly Law represents a ten-year effort to formulate a comprehensive competition law that is expected to bring some cohesion to the existing Chinese competition law regime. I appreciate the resources that the Chinese government has devoted to crafting a competition law that has the potential to contribute to the growth of the Chinese economy and the welfare of its people. The transparency of the drafting process and the willingness of the Chinese government to seek advice from foreign competition officials and experts are especially commendable. U.S. government officials, including those from my agency and the Department of Justice ("DoJ"), have been active for years in providing advice to government officials in many countries that were drafting competition laws, some for the first time. Officials from my agency, the Federal Trade Commission ("FTC" or "Commission"), and DoJ have attended numerous meetings and seminars over the past few years. They have commented on approaches and issues under consideration in drafting the new Chinese law and have shared their views of sound competition law principles and best practices, based on the United States's long experience with antitrust enforcement.

These comments have emphasized certain key principles of U.S. antitrust law: protecting the competitive process, rather than individual competitors; focusing on effects on consumer welfare, rather than on producer welfare; using competition law to promote competition, rather than other social and economic objectives; promoting efficiency even if some competitors do not survive; treating all firms equally without regard to nationality; and protecting legitimate intellectual property rights. They have stressed that a competition law grounded in sound legal and economic principles is an important element of a dynamic, well-functioning economy, and that economic growth and consumer welfare benefit from robust competitive domestic markets.

China faces a particular challenge in making the transition to a market economy from a long-standing, centrally planned economy with a large state sector. I strongly endorse the provisions of the draft law that could be used to prohibit public restraints on competition imposed by government entities or pursuant to government regulation. Without such authority, the new competition agency may not be able effectively to address a major, durable source of anticompetitive conduct that could harm the Chinese economy and consumers. Government enterprises should be subject to the competition law. Exempting them from competition law coverage solely because of their status as government-owned or -controlled enterprises would likely harm both competition and consumers.

Although successive drafts of the Anti-Monopoly Law that the Chinese government has shared with us indicate that the drafters have benefited from external advice, there are still provisions that would benefit from further modification. Today, I would like to focus my remarks initially on some important substantive concerns, particularly those relating to abuse of dominant position, premerger notification thresholds, exemptions, and the relationship between intellectual property rights and the Anti-Monopoly Law. In doing so, I will point out differences in approach between the draft Anti-Monopoly Law and U.S. antitrust law and international law and practice. I will then discuss the relationship between U.S. competition laws and intellectual property rights in the standard-setting process.

II. Abuse of Dominant Market Position

A. Overview

United States law does not specifically address "abuse of dominant market position." Section 2 of the Sherman Antitrust Act prohibits the closely related concept of monopolization. The essential elements of the offense of monopolization are (1) the possession of monopoly power in a relevant market, and (2) the use of exclusionary conduct to acquire, preserve or expand monopoly power, as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[1]

The treatment of unilateral conduct by monopolists or firms with dominant positions is the most challenging area of competition policy because it is the area where it can be difficult to distinguish between beneficial hard-nosed competition and harmful exclusionary conduct. Competitive conduct frequently looks like exclusionary conduct because aggressive competition may harm less efficient firms. These less efficient firms may in turn complain to competition authorities to seek government

protection from legitimate competitive pressures. But the goal of competition law should be the protection of the competitive process rather than individual firms. U.S. law does not protect less efficient firms from legitimate, vigorous competition from another firm, even if that firm holds a dominant or monopoly position. Determining whether a competitor is competing aggressively or acting anti-competitively is a challenge that is best met by the application of objective, economically based, and transparent standards.

We want businesses—all businesses, including firms with dominant positions—to compete vigorously, day in and day out. We want them to continue to invest in research and development that may generate new or enhanced products and services. In the long run, these practices tend to foster innovation and promote economic growth and well-being. But if some firms perceive that their routine, day-to-day decisions are being second-guessed by enforcers—just because their companies may hold a dominant position—we should not be surprised to see them competing less vigorously or taking fewer research and development risks. As a result, competition may be suppressed, not enhanced, by treating dominant firm conduct as automatically suspect.

B. Determination of Dominant Market Position

The draft Anti-Monopoly Law presumes a dominant market position based on the market share of a single firm or the combined market shares of two or three firms. Without further analysis, such presumptions can yield an erroneous conclusion because high market share by itself is not inevitably a reliable indicator that a firm has market power in any particular market.

Under the laws of the United States and many other jurisdictions, market shares are only the starting point for detailed economic analysis of factors relevant to an assessment of a firm's market power. Under U.S. antitrust law, durable market power is the ability to profitably maintain price over competitive levels for a significant period of time. In making this determination, we first define the relevant product and geographic market and then determine the firm's market share in the relevant market. We then carefully analyze the structure and competitive dynamics of the relevant market, examining the presence or absence of barriers to entry, such as government limitations on new entrants or proprietary technology that is unavailable to potential competitors. Other relevant factors include the pace and nature of technological change and innovation in the relevant market, market trends, such as whether the market is expanding or contracting, the existence of excess capacity that can be used to increase output in the event of a price increase, and key customers whose size or attributes create an ability to resist a price increase. An analysis of these factors is essential to determining the significance of market shares in the evaluation of market power. I note that several of these factors are listed elsewhere in the draft Anti-Monopoly Law's provisions on abuse of a market dominant position.

The very nature of U. S. antitrust analysis, therefore, argues against using conclusive presumptions of dominant market position based on market shares alone. Market share presumptions for establishing joint dominance are even less appropriate. Aggregation of market shares of competitors to find joint dominance makes little legal or economic sense absent some agreement among those firms to exercise their market power jointly. Furthermore, if there is such an agreement, the better approach is to address it under provisions prohibiting anti-competitive agreements among competitors.

Accordingly, the legal standards for market dominance should clearly indicate that the determination is based on the establishment of durable market power: the ability to maintain price over competitive levels for a significant period of time. The determination will be based on an economic analysis of the range of factors generally considered in analyzing market power. Alternatively, if some presumptions based on market shares are deemed necessary, they should be rebuttable presumptions. A rebuttable presumption provides an opportunity for a firm to offer proof either that it does not possess market power or that any market power it does possess is not durable.

Before leaving this topic, I should add that it may be appropriate and helpful to the business community for the Anti-Monopoly Law or implementing regulations to establish a safe harbor, that is, a market share below which there will not be a finding of a market dominant position. In the United States, we do not bring enforcement actions challenging unlawful monopolization if the market share of a firm is less than fifty percent because a firm with a market share below this level is unlikely to have durable market power.

C. Prohibited Conduct

The draft Anti-Monopoly Law prohibits a firm with a dominant market position from engaging in certain specified conduct. Each example of abusive conduct is a type of conduct that will usually constitute legitimate competitive behavior. Some of the prohibited conduct can be anticompetitive under particular circumstances. These provisions of the draft Anti-Monopoly Law are deficient because they fail to distinguish clearly legitimate competitive conduct from that which injures competition. Without careful economic analysis of competitive effects, these prohibitions pose a significant risk of interfering with pro-competitive conduct by, for instance, undermining a firm's ability or willingness to provide product innovations or to adopt more efficient production or distribution methods.

An example of prohibited conduct in the draft law that raises these concerns is the prohibition of "unfair" high pricing. U.S. competition law does not limit the price that a monopolist is permitted to charge—a monopolist may charge as high a price as the market will tolerate. Risky investments in innovation are often undertaken only because of the prospect of receiving a large return from a major technological breakthrough or a popular new consumer product. As our Supreme Court has observed:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth.[2]

Unless the monopolist sells its product in a market characterized by barriers to entry, high prices normally will attract firms to enter the market—especially when the new entrant can offer a lower price, a better product, or enhanced services. New entry can restore the competitive equilibrium, tending to drive prices back toward competitive levels without the need for government intervention. Allowing market forces to work rather than resorting to enforcement to control supra-competitive prices avoids burdening competition officials with the difficult and unnecessary task of monitoring prices and evaluating whether they are "unfair" or "excessive." In the United States, the FTC or DoJ are not asked to set "fair" prices because it is beyond the agencies' core competence and a diversion of their limited enforcement resources.

The draft law also prohibits selling below cost without valid reasons. U.S. competition agencies and courts are particularly cautious when evaluating claims that predatory or low pricing is likely to lead to the acquisition or maintenance of a monopoly. Aggressive price-cutting looks precisely the same as legitimate competition. Mistakes regarding predatory pricing can be very costly: prohibiting price reductions deprives consumers of the very benefits competition laws are intended to promote. Therefore, U.S. competition law treats predatory pricing as illegal only in the unique and unlikely situation where a firm can reduce its prices below cost long enough to drive the competition out of the market and then raise prices high enough for a sufficiently long time to recoup the lost profits from the earlier below-cost sales.[3] If the firm cannot recoup its losses, the below-cost sales are unlikely to injure competition.

To avoid discouraging legitimate, aggressive discounting, the draft law or implementing regulations should specify the circumstances in which a violation will be found. That is: the prices must be below an appropriate measure of cost; and the firm must be likely to recoup its losses in the future.

There are other examples of abusive conduct covered in the draft law which require carefully focused analysis. Refusals to trade, exclusive dealing, tying and price discrimination may, in any given case, be either beneficial or harmful to competition. Such conduct or agreements can be competitively neutral or pro-competitive, especially when they align the interests of manufacturers and distributors, encourage better service, or otherwise stimulate competition. Conversely, these same practices in other circumstances can be misused to restrict or limit competition unreasonably.

Distinguishing the good from the bad invariably requires careful, indeed usually rigorous, analysis of actual or likely market effects. To that end, U.S. competition authorities apply a "rule of reason" analysis, assessing the pro-competitive and anticompetitive effects to determine if any conduct or agreement unreasonably and substantially limits competition before initiating enforcement actions in these areas. The draft law or implementing regulations should clearly state that these types of conduct and agreements are prohibited only where they (1) have no reasonable or legitimate business justification and (2) exclude or substantially limit competition so as to create, strengthen or maintain a dominant market position.

III. Notification Thresholds for Concentrations

The proliferation of competition laws that include premerger notification requirements and an increase in transnational merger and acquisition transactions have resulted in the more frequent occurrence of multiple reviews of the same transaction by the competition authorities of several nations. Requiring notification of mergers that do not meet an appropriate standard of materiality as to the level of "local nexus" imposes unnecessary transaction costs and delays and diverts scarce resources of reviewing competition authorities from more important enforcement priorities without any corresponding enforcement benefit. Recognizing this, the International Competition Network ("ICN"), a network of ninety-nine competition agencies devoted to promoting convergence on sound competition principles, developed a set of Recommended Practices for Merger Notification Procedures that represents international consensus on principles and best practices for premerger notification systems.[4]

The ICN's Recommended Practices provide that each jurisdiction's merger review rules should seek to screen out transactions that do not have an appreciable effect on competition within the jurisdiction. Notification of a transaction should not be required unless the transaction is likely to have a significant, direct, and immediate

economic effect in the jurisdiction concerned. The ICN recommends that notification thresholds require that at least two parties to a transaction have significant local activities or that if local nexus requirements are based on a single party's domestic contacts, the thresholds should focus on the local activities of the acquired business and use thresholds that are sufficiently high to avoid notification of transactions without potential material effect on the local economy. The ICN Recommended Practices specifically state that the most suitable thresholds are based on significant local sales or asset levels within the jurisdiction.

U.S. premerger notification thresholds provide that the parties must have combined U.S. sales or assets exceeding $113.4 million and the acquired party must have assets or sales in or into the U.S. exceeding $56.7 million. In addition, the U.S. ensures that foreign transactions have an adequate nexus with the U.S. by exempting certain foreign transactions from notification obligations. For example, the U.S. exempts acquisitions of foreign assets where those assets generate less than about $57 million in annual sales in the U.S., and acquisitions of stock in a foreign company when the acquired company has less than about $57 million in assets in the U.S. or less than $57 million of annual sales in or into the U.S. These thresholds are adjusted annually based on changes in the gross national product of the United States.

The premerger notification thresholds in the draft Anti-Monopoly Law appear to be inconsistent with the ICN Recommended Practice concerning local nexus to the reviewing jurisdiction because they would require reporting of merger and other transactions that do not have an appreciable effect on competition within China. The inconsistency stems from the notification requirement in the draft law that is based on one of the parties having a certain level of total turnover in China. Notification then would be required even if only the acquiring firm's total turnover in China meets or exceeds the prescribed level. The ICN Recommended Practices specifically discourage notification thresholds that can be satisfied based solely on the acquiring firm's local activities, irrespective of any local activity by the firm to be acquired because of the unnecessary transactional burdens and lack of any significant effect on the local economy.

IV. Exemptions

I will now turn to the provisions of the draft Anti-Monopoly Law relating to exemptions. All countries have some exemptions from the coverage of their competition laws. The key is to keep the exemptions as narrow and as clear as possible. This will help reduce uncertainty as to the basic goals of the competition law and facilitate its enforcement.

The U.S. competition authorities do not have the power to grant an exemption from our antitrust laws. Exemptions from U.S. laws have been created largely by statutes enacted by Congress, and sometimes by our courts. If Congress decides that other policy considerations should take priority over our antitrust laws, it enacts specific legislation for that purpose. We do not believe that it is in the best interest of our economy for competition officials to try to balance competition policy with other objectives, such as industrial policy, economic development, or employment, in making their enforcement decisions. Factors other than competition do not readily lend themselves to objective economic analysis and tend to undermine the predictability and consistency of a competition agency's enforcement decisions. Furthermore, limiting a competition agency's evaluation to competition issues enables the agency to focus on its core area of expertise, promotes public confidence in the economic basis of competition law, and avoids confusion.

The draft law should clarify that only conduct that is specifically authorized by law will be exempt. The draft law currently authorizes the competition authority to grant specific exemptions for monopoly agreements and lists specific factors to be considered in making the decision. Any exemption decision by the agency should be based solely on competition factors. In addition, the draft should make clear, as it does with bid-rigging, that hardcore cartel conduct, such as price-fixing or market division among competitors, will not qualify for exemption.

V. The Interface of Intellectual Property Rights and Competition Law

A. In General

I would now like to turn to the provision in the draft Anti-Monopoly Law relating to intellectual property rights. The draft law would apply only to conduct that abuses intellectual property rights and restricts and eliminates competition. We support this narrow application of the draft law to intellectual property rights. However, the law is silent about the relationship, if any, of this provision with other provisions of the draft law, such as those on abuse of dominant market position. We remain very interested in the manner in which the Anti-Monopoly Law will ultimately be implemented with respect to intellectual property rights. Both intellectual property rights (specifically, patents) and competition play an important, complementary role in promoting innovation, economic growth and consumer welfare. Achieving the proper balance between competition law and intellectual property rights is critical to facilitating, rather than impeding, innovation. This issue of the proper balance is particularly important at this juncture for the Chinese economy. It is timely and appropriate, therefore, for me to focus my remaining remarks on the topic of intellectual property rights, and more specifically on two aspects of them: how they affect standard setting, and how these rights fit in with the overall competition enforcement policy.

Regarding the latter, economists have long known that innovation is a principal factor in fostering a dynamic, growing economy. Innovation promotes consumer welfare and economic efficiency in a number of ways. It drives down costs through the development of more efficient production and distribution techniques. It stimulates economic growth by bringing desirable new products into the market. It also may limit the creation and exercise of market power by fostering the development of new technologies that permit entrants to leapfrog the advantages of and the entry barriers enjoyed by entrenched dominant firms. One of the cornerstones of innovation is intellectual property because it is both a key input into and a byproduct of successful innovation. Intellectual property, therefore, is a highly valued asset in every economy, and it has been granted substantial legal protection by most nations of the world, including the United States, in order to preserve that value.

Additionally, there is a close relationship between intellectual property rights and standard setting, and both are affected by competition policy. A sound evaluation of their interrelationship requires that business, economic, and legal principles be considered in combination in order to maximize economic progress and the economic welfare of our citizens. Properly understood and applied, intellectual property rights and antitrust law are complementary, not conflicting, legal systems that should be employed harmoniously to promote a vibrant, healthy economy. Both systems can, and should, be applied to standard setting activities in such a manner as to maximize innovation and consumer welfare.

B. Scope of Protection for Intellectual Property Rights

Given the importance of intellectual property in fostering economic progress, one might wonder whether the world's economies might progress even faster if intellectual property were more freely available for others to use and build upon, i.e., treated more like a public good than private property. While that idea has some simple appeal, an erosion of intellectual property rights would be extremely shortsighted. There is an international consensus today that a strong intellectual property regime is needed to provide an incentive to undertake costly and risky investment in innovative activities.

It can be very expensive to conduct the research and development that is necessary to come up with new products and technologies. It is quite common for there to be many failures before a successful innovation is achieved. There would be little incentive for firms to make such a risky investment in research and development if others could freely copy or use a successful innovation and prevent the inventor from realizing well-earned rewards. Effective intellectual property rights are one of the most important means for providing those incentives. In the United States, intellectual property rights laws give innovators the right to exclude others from using their inventions for a specified period, and thus guarantee the innovators an opportunity to realize a return commensurate with the value of the invention and the risk that was undertaken. Protecting intellectual property rights is one of the major challenges—and obligations—of a global economy.

Certain elements are necessary in any intellectual property system in order to provide meaningful protection to the holders of those rights. Consider an inventor who holds a valid patent that covers a particular invention. Three propositions regarding the rights of the inventor merit emphasis.

First, the inventor has a legal right to exclude others from using that invention for an appropriate period of time. As a necessary corollary, antitrust liability for unilateral, unconditional refusals to license patents should not play a meaningful role in the interface between intellectual property rights and antitrust protections.

Second, whether the inventor chooses to commercialize the invention or license it to others, the inventor may unilaterally set the price or license fee at whatever level he or she chooses. Indeed, the prospect of potentially high profit is a major incentive for undertaking risky and costly innovative endeavors, and the entire thrust of the intellectual property laws is to use that incentive to encourage innovation. The United States Supreme Court recently noted that the opportunity to charge high prices "induces risk taking that produces innovation and economic growth."[5] Accordingly, there is no violation under U.S. antitrust law for unilaterally pricing an intellectual property license "too high."

Third, there should not be a presumption that a patent or other form of intellectual property by itself creates market power. Although a patent creates an exclusive right to the invention, there may be substitutes that can accomplish the same function as the invention. Therefore, a careful market analysis is needed to determine the scope of the relevant market and whether the patented invention has market power. The FTC and the DoJ, in their joint Intellectual Property Guidelines,[6] have long held that intellectual property rights cannot be presumed to create market power. The U.S. Supreme Court unanimously endorsed this position last year.[7]

There can be situations where intellectual property rights will confer market power, as when a patented invention dominates a relevant market. That outcome, without more, does not violate U.S. intellectual property or antitrust law. Indeed, the possibility of such an outcome is a major incentive to engage in innovative activities, and the intellectual property laws use that incentive to encourage innovation. A violation of U.S. antitrust law requires an element of anticompetitive conduct, i.e., conduct that is not competition on the merits or efficiency-enhancing,

that tends to exclude competitors or potential competitors from the market, and that enables the intellectual property rights holder to create, maintain, or extend its market power.

So far I have been discussing unilateral conduct by an intellectual property rights holder. Joint conduct, particularly with a competitor, raises the possibility of anticompetitive collusion or exclusion and must be examined with those possibilities in mind. Even so, U.S. antitrust law recognizes that many forms of collaborative conduct can be efficiency-enhancing, and so most forms of collaboration are analyzed under a standard, known as the rule of reason, that balances potential anticompetitive losses against pro-competitive gains. One of the most important areas in which collaborative conduct can promote competition involves joint efforts to set standards.

C. Intellectual Property Rights and Standard Setting

Intellectual property rights increasingly are implicated in standard setting and licensing arrangements. For example, standards that enable the interoperability of products or services, such as the telecommunications network of a mobile phone system, may incorporate multiple technologies protected by intellectual property rights, often held by more than one person or entity. The licensing of intellectual property rights may substantially influence the way in which new technologies are disseminated and, in turn, affect the introduction of new products and services in the marketplace. Intellectual property rights licensing arrangements frequently are associated with the introduction of standards. In short, standard setting and intellectual property licensing policies may greatly affect the development of new goods and services, future innovation, and the competitiveness of markets.

Standard setting is increasingly important as a way of reducing transaction costs, and standards have a particularly important role in ensuring compatibility and interconnectivity of products and services. Standards may be particularly important in markets with "network effects" (where the utility of the network rises as parties are added to it) and complex technologies such as information technology and telecommunications. The technological revolution that we are experiencing in these markets has benefitted from, and resulted in, significant standard setting activity.[8] Standards may prove important in "low tech" industry settings as well, and in global trade.

D. The Standard-Setting Process: Key Characteristics

1. In General

Standards can be defined succinctly as "any set of technical specifications that either provides or is intended to provide a common design for a product or process."[9] As economies become more complex, the need for standards grows. They affect almost every aspect of our lives, from the food we eat, our health care, the vehicles we travel in, our information technology systems, and numerous aspects of our entertainment. They are promulgated by governments[10] or private groups or arise from their spontaneous acceptance by the marketplace.

In the United States, standard setting is largely done by private entities. This private standard-setting process enhances competition in most instances. It offers the greatest likelihood that an efficient standard will emerge—perhaps through consensus standard setting, through competition between standards, or through some combination of both processes. A market economy is based on the premise that competition is more likely than other forms of economic organization to maximize economic progress and produce the optimal outcome for consumers with respect to product price, quality, and innovation. That premise should be valid regardless of the degree of standardization that is appropriate in an industry. Consensus acceptance of a standard within a market indicates that there is more than one way of providing an element of a product or service that consumers want, but the market would be better served by use of a common method.

That does not mean that competition in the technology that is being standardized is no longer important. At the standard-setting stage there is competition among alternative technologies to be included in the standard. There is no reason that competition to be included in a standard should be any less market driven than competition in the downstream market for products or services that incorporate the standard. Given the basic premise of a market economy, we can expect market participants in a competitive system to select the technology that is most likely to meet consumer needs and desires in an efficient manner. After a standard is established, however, competition for that standard does not end. There always will be competition to improve upon the standard and, perhaps, to supersede it. Here again, the preference of the market is an excellent arbiter of which technology prevails.

2. Antitrust Implications of Standard Setting

Standard setting normally is an efficiency-enhancing activity and, as such, usually does not raise significant antitrust concerns. On the contrary, standard setting usually is considered to be pro-competitive. However, under exceptional circumstances, antitrust concerns can and do arise. The standard-setting process may raise such concerns if it involves unreasonably exclusionary conduct or anticompetitive collusion. For example, in one case,[11] makers of steel conduit were found liable for "packing" a standard setting organization ("SSO") meeting with its agents and thereby improperly obtaining an SSO decision that limited the standard to steel conduit, thereby excluding a perfectly viable alternative product (i.e., a plastic conduit) from being used in the building industry. This is an example of an artificial restraint on entry, resulting in unreasonable exclusion from the market.

There are also examples of unilateral exclusionary conduct in the standard-setting context. In particular, an intellectual property rights holder that takes part in standards setting may have an incentive to improperly obtain or increase the market power of its intellectual property rights. Such a strategy may involve the intellectual property holder: misleading a standards-setting body regarding its intellectual property interests, leading to the adoption of a standard that "reads on" the holder's intellectual property, and then subsequently exercising that new market power by demanding unexpected licensing royalties after a standard has been set and producers have incurred costs that "lock them in" to the standard. The FTC recently brought two cases involving that sort of conduct, one involving a governmentally set standard and another involving private standard setting.

The FTC charged that the Union Oil Company of California ("Unocal") misrepresented to a California state environmental regulator that certain information was non-proprietary, in connection with the regulator's promulgation of a regulatory "clean air" standard for refining reformulated gasoline.[12] The regulator allegedly relied on those misrepresentations in promulgating the standard, and refiners expended billions of dollars to "lock themselves in" to the standard. After lock-in, Unocal began enforcing its patent rights against refiners producing gasoline according to the standard, thereby allegedly imposing more than $500 million of additional costs each year on California consumers. The case was settled with a consent agreement under which Unocal agreed to stop enforcing the relevant reformulated gasoline patents, and to release all relevant gasoline patents to the public, potentially saving consumers billions of dollars.

In the private SSO case, the FTC charged a computer technology firm, Rambus, Inc., with deceptive and misleading conduct in connection with a private standard-setting process for technologies used in the computer memory chips found in a wide variety of products. The Commission found that the private SSO unwittingly adopted standards encumbered with Rambus's patents. Rambus sought to enforce its patents worldwide against companies manufacturing memory products in compliance with the standards. The Commission found that, through its course of deceptive conduct, Rambus was able to distort a critical standard setting process and engage in an anticompetitive hold-up of the computer memory industry, and that this conduct constituted exclusionary conduct under Section 2 of the Sherman Act. The Commission reserved judgment on the issue of remedy and ordered further briefing on that issue.[13]

Neither the *Unocal* nor the *Rambus* case found liability based on the mere acquisition of market power. It is the acquisition of market power through anticompetitive conduct that is condemned by the U.S. antitrust laws, and such condemnation is entirely consistent with the effective protection of intellectual property rights.

3. Respecting Intellectual Property Rights in the Standard-Setting Context

It is readily apparent that there is much at stake in how intellectual property rights are treated in a standard-setting context. An intellectual property rights holder has a legitimate expectation of being rewarded for a successful innovation that is knowingly incorporated into a standard. The use of proprietary intellectual property in the standard can substantially increase the value of that intellectual property and may increase the cost of using that standard. Thus, an intellectual property rights holder may have an incentive to improperly use the standard setting process to obtain or increase the market power of its intellectual property.

The danger of competitive abuse of intellectual property rights during a standard-setting process does not mean it would be acceptable to override intellectual property rights in the interest of dispersing more broadly the benefits of a standardized technology. Regardless of what short-term benefits may accrue for customers in the affected markets, there would be serious longer-term costs. As I noted earlier, intellectual property rights provide a critically important incentive to invest in costly and risky research and development. Failing to provide adequate protection for intellectual property rights could result in significantly less incentive to make investments in research and development, and the pace of innovation could be reduced and the rate of economic progress could well slacken. The derogation of intellectual property rights by standards organizations also could make intellectual property owners more reluctant to participate in standard setting. We would thus lose some of the benefits of standardization, and the standards adopted likely would be less efficient. Finally, the weakening of intellectual property rights is likely to have a negative impact on technology transfers and foreign investment.

This issue arises in the context of compulsory or mandatory royalty-free licensing of intellectual property rights, particularly patents. Compulsory licensing has been advocated by some Chinese officials. Under U.S. law, a firm's unilateral and unconditional refusal to license its intellectual property, standing alone, has not been an antitrust violation. U.S. antitrust officials from both the DoJ and FTC have commented on the lack of antitrust liability for the refusal to license intellectual property.[14] Having found that an antitrust violation has occurred, however, the U.S. antitrust agencies may invoke compulsory licensing as a means of remedying the anticompetitive harm flowing from the violation. The most important criticism of compulsory licensing is that such requirements would be tantamount to requiring the intellectual property owner to create competition in its own technology. That might lessen private initiative and incentive to innovate.[15] Even when antitrust liability has been established, some commentators point to formidable

"theoretical and practical problems"[16] with compulsory licensing and caution that "this remedy should be avoided where another, simpler remedy is available."[17] Most important among the difficulties cited in crafting an efficient compulsory licensing remedy is that it requires courts to act as administrators and price regulators.[18] Additionally, as the U.S. Supreme Court noted in *Trinko*,[19] "compelling negotiation between competitors may facilitate the supreme evil of antitrust: collusion."

At the other end of the spectrum, it also would not be prudent automatically to rule out the use of proprietary technologies in a standard, even if viable non-proprietary alternatives are available. The proprietary technology may prove superior and provide substantial benefits that would outweigh the potential costs. A blanket refusal to incorporate proprietary technologies could also inhibit innovation.

Given those considerations, an SSO's rejection of proprietary technologies would require careful scrutiny under U.S. antitrust law. In a 1985 case against the American Society of Sanitary Engineering ("ASSE"),[20] the FTC challenged ASSE's policy of refusing to develop a standard for a product that is patented or manufactured by only one manufacturer, regardless of its merits. The case was settled with the issuance of a consent order that prohibited such blanket exclusions.

At the same time, SSO members may have legitimate concerns that the cost of utilizing a standard may be excessively high (and its commercial utility may be undermined) if patent rights unexpectedly are invoked after the standard has been adopted and implemented. Joint *ex ante* royalty negotiations among SSO members and patentees prior to adoption of a standard may be an effective way of dealing with this problem. Such negotiations could facilitate informed consideration of the comparative costs of alternative technologies that may be implicated by a standard. As such, *ex ante* negotiations should be assessed under the antitrust rule of reason, with full weight being given to the efficiencies they may engender as well as any potential anticompetitive aspects. In a speech last year, FTC Chairman Majoras noted that joint *ex ante* royalty negotiations can be a way of preventing the "hold up" problem and "can increase competition among rival technologies striving for incorporation into the standard," thus warranting rule-of-reason treatment.[21]

The interests of intellectual property rights holders and the standards community can best be mediated in a market-driven process in which the participants can make informed assessments of the costs and benefits of incorporating proprietary technology in a standard. Prospective users of a standard have an understandable interest in knowing in advance what it might cost to use a standard. Likewise, standards organizations should be in a position to make informed decisions about the cost effectiveness of alternative standards. Accordingly, some standards organizations have a policy of requiring participants to disclose their intellectual property rights, even including applications for such rights, in technology being considered for inclusion in a standard. That may be a prudent policy as a contractual matter between a standards organization and its participants. It protects against the "hold-up" situation that is mentioned above in Part V.D.2. It should be up to each SSO, however, to determine what particular rules or policies best advance its interests. As long as those rules or policies are not anticompetitive, government should avoid second-guessing an SSO's decisions.

VI. Summary and Conclusion

In sum, intellectual property plays a vital role in furthering economic progress and consumer welfare, and it is important to protect the incentives that promote the creation of intellectual property, namely, intellectual property rights. Intellectual property rights in the standard-setting context are an increasingly important topic because of the rapid expansion of intellectual property and the fact that many standards can only be practiced with licenses for intellectual property from one or more firms.

The relationships among intellectual property rights, standard setting, and the enforcement of competition laws are complex. Standard setting, often succeeded by intellectual property licensing, may raise the value of intellectual property. This may, in turn, promote economic growth by enhancing the rights holders' incentive to innovate. Every use of standard setting, however, may not be pro-competitive. For instance, an intellectual property rights holder may use exclusionary conduct in an SSO to acquire, preserve or expand monopoly power. Proper application of the antitrust laws can counteract this competitive concern without undermining legitimate protection for intellectual property rights or deterring legitimate, pro-competitive standards-setting activity.

In short, the interests of intellectual property rights holders, affected producers, and consumers are often best mediated through a competitive, market-driven standard-setting process characterized by transparency, arms'-length negotiations, informed decision making, efficient licensing practices, and appropriate law enforcement. Such a market-driven process is most likely to produce an efficient standard that will both protect the legitimate rights of intellectual property rights holders and promote the interests of consumers.

Endnotes

1. *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966).
2. *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).
3. *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222-224 (1993).
4. The Recommended Practices are available at: http://www.interntionalcompetitonnetwork.org/notification.html.
5. *Trinko*, 540 U.S. at 407.
6. U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* § 2.2 (Apr. 6, 1995), *at* http://www.ftc.gov/bc/0558.pdf.
7. *Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 547 U.S. ___, 126 S. Ct. 1281 (2006).
8. *See* Janice M. Mueller, *SYMPOSIUM: PATENT SYSTEM REFORM: Patent Misuse Through the Capture of Industry Standards*, 17 Berkeley Tech. L.J. 623, 631-32 (2003); Marc Hansen *et al*, *Disclosure and Negotiation of Licensing Terms Prior to Adoption of Industry Standards: Preventing another Patent Ambush?*, Eur. Competition L. Rev. (Dec. 2003); Robert A. Skitol, *Concerted Buying Power: Its Potential for Addressing the Patent Holdup Problem in Standard Setting*, 72 Antitrust L. J. No. 2, 727, 730 (2005) (explaining that the patent hold-up problem "arises from the interaction of (1) proliferating patents generally and (2) proliferating needs for standards to enable interoperability among both competing and complementary products seeking to exploit new technologies").
9. Mark A. Lemley, *Intellectual Property Rights and Standard Setting Organizations*, 90 Cal. L. Rev. 1889, 1896 (2002).
10. Governments may develop their own standards or endorse and adopt private standards through the passage of laws or regulations.
11. *Allied Tube & Conduit Corp. v. Indian Head*, 486 U.S. 492 (1988).
12. *See* FTC Press Release, *Dual Consent Orders Resolve Competitive Concerns About Chevron's $18 Billion Purchase of Unocal, FTC's 2003 Complaint Against Unocal* (June 10, 2005), available at http://www.ftc.gov/opa/2005/06/chevronunocal.htm. *See also In re Union Oil Co. of Calif.*, Docket No. 9305 (June 10, 2005) (Agreement Containing Consent Order), *at* http://www.ftc.gov/os/adjpro/d9305/050610agreement9305.pdf.
13. *In re Rambus, Inc.*, Dkt. No. 9302 (Aug. 2, 2006) (Commission decision), *at* http://www.ftc.gov/os/adjpro/d9302/060802commissionopinion.pdf.
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15. *See Delrahim*, note 14 *supra*, at 5 (concern with stifling innovation).
16. Phillip Areeda, Louis Kaplan, Aaron Edlin, Antitrust Analysis ¶ 286 at 353 (6th ed. 2004).
17. *Delrahim*, note 14 *supra*, at 8.
18. *See* Carl Shapiro, *The Strategic Use of Licensing: Is There Cause for Concern about Unilateral Refusals to Deal?*, Written Statement Submitted to the U.S. Department of Justice and Federal Trade Commission Hearings on Intellectual Property and Antitrust (May 1, 2002), *at* http://www.ftc.gov/opp/intellect/020501xscript.pdf.
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20. *In re Am. Soc'y of Sanitary Eng'g*, Dkt. C-3169, 106 F.T.C. 324 (1985). The members of the ASSE include plumbing equipment manufacturers and designers.
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An EU Perspective on the Draft Chinese Anti-Monopoly Law

By Frank Fine

I. Introduction: EC Influence

The Chinese Government has accepted a great deal of input from various antitrust agencies and ad hoc groups in formulating its draft Anti-Monopoly Law (the "Draft Law"). Although the American Bar Association's Antitrust Section is widely known to have been in discussions with the Chinese Government, the European Commission was evidently in contact with the Government as well. U.S. antitrust lawyers may be surprised to learn that the current Draft Law is much more influenced by EC competition law than by U.S. antitrust law. In the mid-1990s, a similar phenomenon occurred in the steps leading up to the South African Competition Act of 1998. One may opine that, among Chinese officials (as in many developing countries), the EU model is perceived as providing greater enforcement powers to the Chinese Anti-Monopoly Enforcement Authority. At least on paper, the Chinese Government seems determined to use antitrust law to curb the excesses of state-owned monopolies and perhaps to break them up.

II. Specific Instances of EC Influence

A. Dominant Position

The influence of European thinking is no more apparent than in the provisions of the Draft Law regarding the abuse of dominant position. Here, one finds, for example, in Article 15(1) a prohibition on excessive or unfairly low prices. The latter, which is distinguished from predatory pricing (Article 15(2)), is apparently intended to address loyalty rebates and discounts and possibly profit margin squeezes, all of which are prohibited by Article 82 of the EC Treaty. One also finds in Article 15, with regard a number of the listed types of infringements, a defense of "valid reasons." This would seem more akin to the EU defense of "objective justification" pursuant to Article 82 than to a defense based on the rule of reason. If this interpretation is correct, the "valid reasons" defense to Article 15 infringements (when it is available) probably would be based on very limited grounds. For example, one may posit that predatory pricing under Article 15(2) might be justified if it is in response to a price war. Likewise, refusals to trade under Article 15(3) might succeed where the dominant firm is able to assert, for example, that its trading partner is a bad credit risk.

B. Abuse of IP Rights

Article 54 of the Draft Law, which is apparently new to the present text, provides redress for the abuse of intellectual property rights. This provision is doctrinally parallel to the "existence/exercise" distinction made under Article 82 of the EC Treaty, under which the exercise of IP rights may, in "exceptional circumstances" (to quote from the ECJ *Magill* judgment of 1995) constitute an abuse of dominant position (and therefore justify a compulsory license), such as when the IP in question protects subject matter constituting a de facto industry standard, access to which is considered essential for market entrants seeking to introduce a "new product." The Draft Law apparently contemplates that future case law will provide the elements constituting an abuse of IP rights. It is not unreasonable to posit that *Magill* and its progeny will be closely examined for their relevance to the Chinese situation. This prospect may be unpleasant to U.S. antitrust lawyers and companies who consider the EU to have exceeded reasonable bounds in this field. However, others will consider such rules as providing a valuable check on the abusive exercise of IP rights.

It is also plausible to consider that Article 54 may provide sanctions against companies that withhold disclosure of their IP in order to influence standard-setting in favor of a standard that requires access to the withholder's IP, with subsequent patent litigation against users of such IP constituting an abusive exercise of patent rights.

C. Fines

Article 46 of the Draft Law further provides for a maximum fine of ten percent of the parties' turnover in the preceding financial year. This limit comports exactly with the ceiling imposable by the European Commission under Regulation 1/2003.

III. Unanswered Questions

However, the Draft Law leaves a number of questions unanswered, and there is no indication of what the Chinese Government will be referring to by way of third country benchmarks.

A. "Notifiable" Agreements

For example, it is not clear from the Draft Law whether questionable commercial agreements will be "notifiable" (as was the previous practice of the European Commission) to the Anti-Monopoly Enforcement Authority for clearance purposes, or whether, instead, the Chinese Government will leap directly to a self-assessment system, by which the parties must determine for themselves the legitimacy of their contemplated commer-

cial arrangements. Given the Chinese Government's apparent comfort with the EU approach, it might consider, at a minimum, voluntary notification during the initial years, and the publication of its clearance decisions. This would enable companies to obtain legal certainty concerning their own arrangements, while providing valuable guidance to other companies contemplating their own dealings. Notifiability, at least during the early years of enforcement, would be consistent with the EU's historical approach.

B. Complaint Mechanisms and Guidelines

The Draft Law is also silent as to the mechanisms/formalities in making complaints, the relevant time limits for the Anti-Monopoly Enforcement Authority to act, and grounds for the rejection of complaints, as well as the pre-conditions for the Committee to act on its own volition. Nor does the Draft Law provide rules governing investigations, discovery, rights of defense—including access to the file, business secrets and attorney-client privilege.

Sooner rather than later, the Government will need to address the above issues in implementing legislation and guidelines. Moreover, if indeed the Government is considering the direct implementation of a self-assessment system, it will need to promulgate guidelines for horizontal and vertical agreements, and on the abuse of dominant position, in order to provide companies with transparent rules of conduct.

There are also open issues relating to the transparency of the investigative process, the rights of defense and other due process-related safeguards. The following are just some of questions that arise:

- If a formal investigation were to be initiated, would defendants have a right of access to the evidence being used against them? Would they even have a right to a hearing?
- If corporate premises were to be raided in a Chinese cartel investigation (pursuant to Article 36(1)), would the defendants have a right to counsel? What are the proposed limits on Chinese police power?
- Would complainants and defendants have a broad choice of legal representation, or would they be obliged to engage an attorney licensed in China? In a related vein, what are the proposed rules on attorney-client privilege, and will these be protectionist in character?
- What are the rights of appeal from decisions of the Anti-Monopoly Committee? There are none specified in the Draft Law.

C. Criminal Liability

Most disturbingly for U.S. companies, there are indications that substantive breaches of the Draft Law (Article 49), as well as the obstruction of investigations (Article 51), may give rise to criminal liability. The Draft Law does not state the types of conduct that may result in criminal penalties, nor the nature and extent of the penalties, but potential imprisonment might well be foreseen. Criminal sanctions for procedural breaches would seem to be particularly harsh, especially when these breaches are committed by low- to mid-level employees who may not have received any company training whatsoever as to how to conduct themselves during an antitrust investigation.

It is suggested that a developing country such as China, with a short history of liberal economic policy, virtually no experience with antitrust enforcement, and a hotly disputed record on human rights, would engender greater public confidence by withholding criminal penalties until a "competition culture" has been established, and until it has convinced Western governments that adequate safeguards for due process have been instituted.

In this latter regard, a comparison with the EU's penalties for competition law infringements is not appropriate, because the EU does not possess any police powers. However, it will be recalled that it took the EU some forty-five years to obtain sufficient confidence in the existence of a European competition culture to entrust companies with the "self-assessment" of their commercial agreements.

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Acquisitions of Oil and Gas Resources by Chinese Companies

By Libin Zhang

I. Overview

As the fastest growing in the world, the economy of the People's Republic of China ("PRC" or "China") continues to grow at a high annual rate. With such growth, China's need for energy is also increasing rapidly. For example, China consumes 6.5 million barrels of oil every day, accounting for 8% of the world's consumption. Since 2004, China has been the world's second-largest oil consumer, just behind the United States. China is forced to import from abroad more than forty percent of its oil needs. As a result, China, together with the U.S., has been pushing global demand for the past few years.

Traditionally, China has relied on coal as its major source of energy. Despite its large natural reserve of coal resources, China's constant reliance on coal resources as a supply of energy for fueling its economy growth is subject to certain restrictions. One restriction is that coal resources in the long run are non-renewable resources. The other restriction is that the use of coal has caused serious environmental problems and will generate external costs for its society. Moreover, China cannot rely on its own oil and gas resources. China's domestic accessible oil and gas resources are very limited. Due to depleting reserves and domestic output, China's oil and gas imports will likely, by 2020, be in the range between fifty percent and seventy-five percent of China's needs. This is a bleak situation in terms of energy supply which China's economy has to face in both the short and the long run. To solve this problem, China has adopted a "going abroad" (*zou chu qu*) strategy.

II. China's Strategy of "Going Abroad"

Since the 1980s, China has opened up its internal oil and gas upstream sectors for foreign oil companies, although such access is not without limitations. While the inbound acquisition by foreign investors of companies or assets in mainland China still continues, the big new development is the emergence of Chinese companies as acquirers of oil and gas resources outside China. The leading players have been China's state-owned national oil companies (Chinese NOCs), which have acquired oil fields, refineries, petrochemical facilities and mines throughout the developing countries.

Chinese NOCs each have their own oil and gas-related service companies, which are intended to provide services to affiliates within their respective group. Despite the fact that Chinese oil and gas-related service companies are facing competition from foreign service providers, these Chinese companies have started to go abroad for projects.

The wave of outbound acquisitions by Chinese NOCs reflects China's strategy of "going abroad." Such strategy is more the result of a forced decision rather than an active proposal based on self-initiative. Due to the urgent need and pressure to find oil overseas, Chinese NOCs have adopted an opportunist approach. By accepting higher degrees of political risk in those developing countries which the established international oil companies (IOCs) will shy away from, Chinese NOCs tend to avoid direct competition with IOCs and have gained access to some attractive upstream asset portfolios.

To reduce the risks, especially the political risks associated with investment overseas, China's government has been trying its best to help Chinese NOCs through foreign diplomacy. For instance, Chinese NOCs' campaign to obtain energy resources from the former Soviet Republics of central Asia, Africa, the Middle East and Central and South America has occurred in the context of Beijing's diplomatic efforts to secure and expand Chinese influence in these regions. In June 2006, Chinese Premier Wen Jiabao visited seven African countries, as oil prices climbed to record highs, in an effort to boost the business activities of Chinese NOCs in these countries. Many memoranda of understandings were entered into between China and African countries. China's cooperation with African countries is coupled with China's investments in infrastructure projects in the host countries.

III. Advantages and Disadvantages of Chinese NOCs in "Going Abroad"

Chinese NOCs have both advantages and disadvantages for their overseas mergers and acquisitions ("M&A") activities. One advantage is that they are fully backed by the support of the PRC government, as reflected in China's recent "oil diplomacy." China has always enjoyed good relationships with countries in Asia, Africa and South America. The other advantage is that Chinese NOCs are cash-rich and staffed with young and educated people. China National Offshore Oil Corporation (CNOOC) has rich experience in dealing with western IOCs.

Notwithstanding the above, there exists quite a number of disadvantages or difficulties for Chinese NOCs in implementing the "going abroad" strategy.

First, there are very few opportunities for Chinese NOCs to squeeze into the established oil and gas production regions such as the Gulf of Mexico and the North Sea. Thus, Chinese NOCs are forced to turn elsewhere.

Second, the political stability of some host countries has always been a big concern and a factor affecting NOCs' operations in these countries.

Third, back in the PRC jurisdiction, all Chinese NOCs are subject to some sort of "red tape" or a set of rules before they are permitted to invest abroad. Furthermore, any change to the laws and regulations in China will also affect Chinese NOCs' operations in their home jurisdiction, which will indirectly affect their ability to formulate and implement a long-term strategy for going abroad. At present, China is in the process of drafting its own energy laws. Issues relating to monopoly, antitrust, price caps for downstream products, and the like, are still open for discussion. There is uncertainty as to how the law will address and resolve such issues. With the current price caps for downstream products, China National Petroleum Corp. (CNPC) and China Petroleum Chemical Corporation (SINOPEC) are burdened with negative margins in their domestic refining operations.

Fourth, Chinese NOCs still need to improve their corporate governance. SINOPEC and CNPC and their subsidiaries are still being operated much like a government agency rather than commercial enterprises.

Finally, Chinese NOCs are still in their M&A learning curve. Closing a deal does not necessarily mean the successful completion of an acquisition. Integration with the local corporate culture, and the like, still remain big post-closing challenges.

IV. China's Major Players

There are three major Chinese NOCs, namely, CNPC, SINOPEC and CNOOC. Before the reform of China's oil and gas sector in 1998, CNPC was specialized in the upstream, SINOPEC was the only major player for downstream and petrochemical business, while CNOOC was a developer of China's offshore resources. By the reform in 1998, some upstream and downstream operations were liberalized among the Chinese NOCs, as a result of which CNPC was allowed to engage in downstream business and SINOPEC was permitted to go upstream.

The first is CNPC. Its overseas arm, China National Oil and Gas Exploration and Development Corp. is charged with a role for overseas oil and gas expansion. CNPC has a listed company, PetroChina. CNPC group now has oil and gas assets in 22 countries.

Another major player is SINOPEC. It is China's second-largest oil producer and the country's leading downstream and petrochemicals manufacturer. It has fewer financial resources than CNPC/PetroChina and is currently burdened with negative margins in its domestic refining operations. SINOPEC's international expansion moves have to date included a bias towards exploration. Significant acreage positions have been acquired in Kazakhstan, Yemen, Saudi Arabia, Myanmar (Burma) and Brazil. Exploration will continue to be an important theme in SINOPEC's future expansion strategy.

The third major player is CNOOC, China's offshore oil producer. It was established in the late 1970s for the express purpose of working with IOCs for joint development of China's offshore oil and gas projects. It holds a first-mover advantage in the development of liquefied natural gas (LNG) import terminals in southern China. CNOOC made a string of overseas acquisitions in countries including Indonesia and Australia. Then in the summer of 2005 it lost out, partly due to U.S. government intervention, to the U.S. giant Chevron in a US $18.5 billion cash bid for Unocal. This failed attempt revealed the scale of its ambitions in the M&A market. It is expected that another acquisition attempt on the similar scale of Unocal is unlikely in the near term due to strong competition from IOCs, political opposition in the U.S., and the fear of another high profile failure. CNOOC is likely to return its focus to asset and smaller corporate acquisitions that complement its existing business. The Asia-Pacific, Africa and Central Asia are likely to be the main areas of its attention, and further deals on the scale of the recent US $2.3 billion Nigeria deepwater acquisition can be expected.

V. Where Chinese NOCs Invest

China draws the majority of its overseas oil from the Middle East and southwest Asia. Its efforts to secure new foreign sources of petroleum are global in scope. Driven by the need to access natural resources, particularly oil and gas, Chinese NOCs have invested in the oil industry of scores of countries, which include Angola, Indonesia, Iran, Iraq, Kazakhstan, Sudan, Venezuela, Argentina, Brazil, Peru, Yemen, Canada, Colombia, Malaysia, Mexico, Mongolia, Papua New Guinea, and the United States, and the list expands almost daily. The M&A projects of China's NOCs mostly took place in the developing countries, particularly certain African countries.

These projects are augmented by proposed pipelines with or in Russia, Turkmenistan, Thailand and possibly Pakistan, Afghanistan and Burma. CNPC is to build two 12-billion Yuan (US $1.48 billion) pipelines to provide oil and gas from Russia and Kazakhstan to the center of China.

At present, bilateral relationships between China and Arab countries are the best in history, and Arab countries are important trade partners for China. In 2005, China im-

ported US $5.37 billion of oil and gas products from Arab countries and 55% of China's imported LNG is from Arab countries. CNPC and SINOPEC have cooperated with Arab countries to a substantial degree. CNPC has had oil projects in seventeen Arab countries, with total investment worth as much as US $6 billion by the end of 2005 (according to CNPC).

The pressure to look for oil has forced Chinese NOCs to turn to controversial countries, such as the Sudan and Iran, for possible M&A activities. Sudan is increasingly important as a source of China's oil. CNPC is the largest foreign investor there. The decision of the United States to cut ties with the Sudan in the mid-1990s pressured western IOCs to withdraw but opened up an opportunity for China. SINOPEC was talking with Iran on the onshore Yadavaran oil field in Iran, despite political uncertainty in Tehran.

VI. Business Models

Chinese NOCs' offshore M&A activities usually take the form of an acquisition of an interest in projects/blocks or of equity in project companies. In some cases, such acquisitions may be financed by Chinese government credit lines. In other cases, Chinese NOCs' acquisitions in the upstream sector may be coupled with infrastructure projects in host countries or with a package arrangement relating to oil and LNG trading transactions, thereby avoiding competition with other NOCs and IOCs in the M&A market in the upstream.

In all these cases, we see comprehensive and flexible tactics in implementing the "going abroad" strategy. To some industrial analysts, Chinese NOCs seem to have given unusual offers in bidding and private negotiations, but other analysts say that this can be justified due to China's urgent need for oil and gas resources based on long-term considerations.

VII. PRC's Legal Requirements for Investment Overseas

China does not have a uniform energy law. Pieces of administrative legislation were issued by the National People's Congress, the State Council and relevant ministries. The PRC energy law system is fragmented. Many issues were left unregulated and subject to uncertainty as China's energy law system is being built. Relevant energy laws include the following:

(1) PRC Regulations on Sino-Foreign Joint Development of Offshore Petroleum Resources;[1] PRC Regulations on Sino-Foreign Development of Onshore Petroleum Resources,[2] which set up the framework for Chinese NOCs to cooperate with foreign oil companies in developing China's offshore and onshore petroleum resources.

(2) Regulations on Protection of Oil and Gas Pipelines,[3] which apply to both onshore and offshore oil and gas pipelines.

(3) PRC Energy Saving Law,[4] which encourages conservation of energy and development of new energies.

In addition, there are numerous administrative laws and decrees and documents issued by relevant ministries, which more or less relate to development of oil and gas resources.

The PRC government has been steadily liberalizing the regulatory regime applicable to investments abroad by Chinese companies. Under the applicable regulations, technically, a prospective acquirer would have to go through a variety of verification and approval procedures before completing an overseas acquisition.

According to the Interim Measures on the Review of Overseas Investment Projects of the National Development and Reform Commission (NDRC), effective October 2004, project verification is required for all types of investment transactions outside mainland China by PRC legal persons and their controlled overseas subsidiaries. Verification and approval of overseas investment by PRC enterprises are also required pursuant to the Ministry of Commerce's Regulations Regarding Approval Matters on Investment and Establishment of Enterprises Abroad, effective October 2004. State Administration of Foreign Exchange (SAFE) review is required if the PRC acquirers need to purchase foreign exchange funds, or use foreign exchange held by it in China, for the acquisition.

VIII. Future Trends

While practically every country is trying to develop substitute energy products for strategic reasons and energy security, M&A activities will continue to be a hot area in the international scene. Going forward, the international upstream M&A market is likely to remain extremely active. If oil prices drop sharply, the financially more secure and larger players will move to acquire the most attractive of the second-tier companies.

On the scene of future M&A activities, state-owned oil companies in the developing countries (including Chinese NOCs) will become the major players to compete with the big western oil companies. IOCs will come face to face with state-owned oil companies from developing countries more often, not only as customers, partners, and custodians in developing a host country's resources, but also as commercial competitors on the world stage. Cooperation between state-owned oil companies of the developing countries (e.g., by taking part in a joint bid) has focused more on long-term relationships. For instance, state-owned oil companies from India and China

are basically competing with each other and have the same needs. However, they do cooperate with each other in some projects. By working together, acquisition costs will come down, while bargaining power goes up. For instance, along with CNPC and SINOPEC respectively, ONGC Videsh Limited (OVL) from India has acquired two key projects, one in Syria and the other in Columbia.

The cooperation between state-owned oil companies of the developing countries and the western IOCs is evolving. On one hand, there is more competition and on the other hand, there will be opportunities for cooperation on a project basis. State-owned oil companies of the developing countries would seek technology, expertise and capabilities that the western IOCs offer with regard to LNG, gas to liquids, secondary recovery, unconventional oil and ultra-deep water activities. Whether in the form of cooperation or competition, state-owned oil companies of the developing countries, especially Chinese NOCs, will surely play a more active role in the international scene of M&A in the energy sector.

Endnotes

1. Promulgated by the State Council on 30 January 1982, and amended on 23 September 2001.
2. Promulgated by the State Council on 7 October 1993.
3. Promulgated by the State Council on 2 August 2001.
4. Promulgated on 1 November 1997 by the National People's Congress.

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Progress in Environmental Impact Assessment in China: The 2002 Environmental Impact Assessment Law

By Hu Yuan

I. Background

Since 1979, the People's Republic of China (PRC) has employed the concept of environmental impact assessment (EIA) in its basic environmental protection law, as well as in many specialized environmental statutes. The first EIA regulation, promulgated in 1986, focused on construction projects and was replaced by the Regulation on Construction Project Environmental Protection Administration of 1998, which is currently undergoing revision.

In addition to the lack of some crucial mechanisms, such as public participation and follow-up supervision, the previous regulation, with its focus on "construction projects," had included within its scope governmentally funded projects and private projects but made no consideration for governmental decision-making action. What is more, because it was issued by the State Council, the regulation had a relatively small impact, when compared with the overall importance of EIA.

The Environmental Impact Assessment Law of PRC (the "EIA LAW") was hence enacted by the Standing Committee of the National People's Congress (NPC) in 2002 and took effect on 1 September 2003. The law contains many new rules and serves as an EIA milestone for China.

II. Summary of Key Components of the Law

The EIA Law consists of five chapters and 38 articles. It is the type of very general law that only provides an EIA framework and EIA guidelines.

A. Classes of Activities Subject to EIA

1. EIAs Regarding Governmental Planning

One of the most important improvements made by the EIA Law is the fact that governmental planning is required to undergo an EIA although other kinds of governmental decision-making actions, such as policy making and legislation, are still not subject to the EIA process. It should be noted that not all governmental planning requires an EIA. Only governmental planning related to the economy and having an environmental impact are subject to the EIA process. Such planning includes the following two types:

(a) *Guidance planning*. Guidance planning is more comprehensive planning that serves as a directive for special planning. It refers to plans regarding land use, as well as plans regarding exploration, utilization and development in areas, river basins and sea areas that are drafted by relevant departments of the State Council, local people's governments at or above the level of municipality (having districts) and their relevant departments.[1]

(b) *Special planning*. Special planning refers to plans concerning industry, agriculture, pasturage, forestry, energy, water conservancy, communications, urban construction, tourism and exploration of natural resources that are drafted by the relevant departments of the State Council, local people's governments at or above the level of municipality (having districts) and their relevant departments.[2]

2. EIAs Regarding Construction Projects

There is no definition in the law of what a construction project is. Although, in a notice promulgated by the State Environmental Protection Administration (SEPA), a "project" is defined to include all kinds of development and construction activities carried out with the means of fixed assets investment which may be funded by the nation, collective economy, joint venture, stock association, foreign capital, capital from Hong Kong, Macao, Taiwan and individual business. Construction projects can be divided into four types: capital constructions, technical rebuilding, real estate development and others. Service trades, such as the restaurant and entertainment sectors, which may have environmental impact, are also within the jurisdiction of the regulation (i.e., they are regarded as construction projects).[3] The law divides construction projects into the following three categories:

(a) Construction projects which have significant potential environmental impacts must prepare an EIA report.[4]

(b) Construction projects which have minor potential environmental impact must prepare an EIA report form.[5]

(c) Construction projects which have very little potential environmental impact and do not need to carry out an environmental impact assessment must complete an EIA registration form.[6]

The Catalogue of Construction Project Environmental Protection Administration Classifications[7] enumerates the specific project types.

Unlike the National Environmental Policy Act (NEPA), the PRC law does not provide for a first-stage environmental assessment to determine whether an EIA will actually be required. The types of plans and projects requiring an EIA are stipulated in the law and its implementing regulations.

B. Timing of EIA

1. EIAs Regarding Governmental Planning

With respect to guidance planning, the relevant departments of the State Council, local people's governments at or above the level of municipality (having districts) and their relevant departments are to conduct environmental impact assessment during the course of the drafting of comprehensive plans.[8]

With respect to special planning, the relevant departments of the State Council, local people's governments at or above level of municipalities (having districts), and their relevant departments shall organize and conduct environmental impact assessments of relevant special plans prepared by them before the drafts of such special plans are submitted for examination and approval. Generally the EIA can start to be prepared when the initial draft is prepared: the earlier, the better.[9]

2. EIAs Regarding Construction Projects

The EIA is to be made at the feasibility-analysis stage of projects. For those construction projects that do not require feasibility analysis, all EIA documents are to be submitted before the start of construction.[10]

C. Content of the EIA

1. EIAs Regarding Governmental Planning

With respect to guidance planning, the relevant departments are simultaneously to prepare an EIA when drafting plans by including as part of the plans a description of the environmental impact of the plans. The portions of such a plan that deal with environmental impact must provide analysis, forecasts and an assessment regarding potential environmental impact after plan implementation and must set forth countermeasures and means that would prevent or alleviate adverse environmental impact.[11]

With respect to special planning, the relevant departments are to submit environmental impact reports to the authority responsible for examining and approving such special plans. Environmental impact reports for special plans must include the following contents:[12]

(a) analysis, forecast and assessment regarding the potential environmental impact after implementation of the plans;

(b) measures and countermeasures to prevent or alleviate adverse environmental impact; and

(c) environmental impact assessment conclusions.

2. EIAs Regarding Construction Projects

For construction projects that have significant potential environmental impacts, an EIA report comprehensively assessing the resulting environmental impact must be prepared. The environmental impact report for construction projects must include the following:[13]

(a) overview of the construction project;

(b) status quo of the surrounding environment of the construction project;

(c) analysis, forecast and assessment of the potential environmental impact of the construction project;

(d) measures taken by the construction project for environmental protection as well as technical and economic demonstrations;

(e) analysis of economic gains and losses relating to the construction project's environmental impact;

(f) recommendations for implementing environmental monitoring of the construction projects;

(g) conclusions of the environmental impact assessment.

Construction projects that have minor potential environmental impact are to prepare an EIA report form in which an analysis or special assessment of resulting environmental impact is to be conducted. SEPA is responsible for determining the content and format of the environmental impact report forms.[14]

Construction projects that have a very small potential environmental impact must complete an EIA registration form. SEPA is responsible for determining the content and format of the environmental impact report forms.[15]

The fact that the EIA Law does not require that an EIA include consideration of alternatives (including the alternative of "no action") makes China's EIA system less efficient, although officials may consider alternatives in their decision-making process.

E. Persons Responsible for Preparing EIA Documents

1. EIAs Regarding Governmental Planning

In connection with guidance planning, the relevant departments are simultaneously to prepare an EIA when drafting plans by including as part of the plans them-

selves a description of the environmental impact of the plans. The departments responsible for drafting the plans are responsible for preparing the assessment.[16]

With regard to special planning, the special planning drafting departments are to conduct the EIA separately from the process of making special plans, as follows:[17]

(a) The departments can prepare environmental impact reports by themselves, by organizing experts from related departments and agencies, or by finding special qualified EIA institutions (which are not government-affiliated institutions).[18]

(b) For special plans that may cause adverse environmental impact and directly affect the public, the departments drafting the special plan must, before the drafts of such plans are submitted for examination and approval, hold symposiums or hearings or otherwise solicit opinions on the environmental impact reports from relevant units, experts and the public. But cases in which secrecy is required by state regulations are excepted. The departments drafting special plans must conscientiously consider the opinions of the public and must attach the explanations of its acceptance or non-acceptance of such opinions to the environmental impact report submitted for examination.[19]

2. EIAs Regarding Construction Projects

For a construction project that requires an EIA report, the report is to be prepared by a specialized institution with corresponding environmental impact assessment qualifications, engaged by the construction entity to provide technical services.[20]

Except in conditions where secrecy is required by state stipulations, for construction projects that may have a major impact on the environment, the construction entity must, prior to the submission of the construction project EIA report for approval, hold symposiums or hearings or adopt other forms of soliciting the opinions of relevant entities, experts and the public. Explanations for the adoption or rejection of these opinions must be attached to the environmental impact report submitted by the construction entity for approval.[21]

For a construction project that requires only an EIA report form, the same applies as set out immediately above, that is, the construction entity must engage a qualified special EIA institution to prepare the report form, but in this case there is no requirement for public participation.[22]

For a construction project that requires only an EIA registration form, the construction entity is to complete the registration form, and there is no requirement for public participation.

F. Examination and Approval of EIA Documents

1. EIAs Involving Governmental Planning

With respect to guidance planning, the examination and approval authority will not examine or approve any draft plans that do not include an assessment of their environmental impact.[23]

With respect to special planning, the departments drafting the special plan must, when submitting the draft of the plan for approval, attach the environmental impact report and send it to the authority for examination. The authority may not approve a draft plan without an attached environmental impact report.[24]

Before the local people's government at or above the municipality (having districts) level reviews the draft of a special plan and makes a decision, it must first direct the environmental protection department or other department to assemble experts and representatives of the relevant departments to form an examination group to conduct an examination of the environmental impact report. The examination group is to provide a written opinion.[25]

If the draft special plans are approved by the relevant departments of the people's governments at or above provincial level, the approving authority is to send the EIA report relating to the special plan to the environmental protection administration at the same level to examine the report as well. The two departments are to assemble experts and representatives of the relevant departments to form an examination group to conduct an examination of the environmental impact report. The examination group is to provide a written opinion.[26]

When examining and approving a draft special plans, the relevant department is to take into account the conclusion of the environmental impact report and the examination opinion as an important basis for decision-making. In the event that the relevant authority does not adopt the conclusion and examination opinions, it must provide an explanation and record it for future reference.[27]

After the implementation of a plan having a major impact on the environment, the drafting authority is to promptly organize a follow-up assessment of the environmental impact and report the assessment result to the examination and approval authority. If an obvious adverse impact on the environment is discovered, measures for improvement must be put forward in due course.[28]

2. EIAs Regarding Construction Projects

The construction entity must submit the EIA documents relating to a construction project to the administrative environmental protection department having authority in accordance with relevant regulations.[29]

If there is a sector administrative department with jurisdiction over the construction project, the construction entity must submit the environmental impact report or report form to the corresponding administrative environmental protection department after it has been subjected to preliminary examination by the sector administrative department. An EIA registration form, however, is not subject to such a requirement.[30]

The authority is to make an examination and approval decision and give written notice to the construction entity within 60 days after receipt of an EIA report, within 30 days after receipt of an EIA report form, or within 15 days after receipt of an EIA registration form, respectively.[31]

If any major changes occur after the approval of the EIA documents or if the start of construction occurs more than five years after the date when the EIA documents are approved, the construction entity must re-submit the EIA documents.[32]

If construction project EIA documents are not examined by the administrative environmental protection department stipulated by law or are not approved after examination, the project approval authority may not approve its construction, and the entity may not start construction.[33]

In the course of construction, the construction entity must simultaneously implement the countermeasures for environmental protection raised in the EIA report, the EIA report form and the opinions of the approval authority.[34]

In the course of the construction and operation of a project, if the circumstances surrounding the project become inconsistent with approved EIA documents, the construction entity must organize a post-assessment of the environmental impact, adopt corrective measures, and file a report with the original EIA documents examination authority and project approval authority. The original EIA documents examination authority may also ask the unit to prepare a post-assessment of environmental impact and take corrective measures.[35]

III. Issues in Implementing the EIA Law

A. Compliance

1. Relatively High Rate of Violations

Many construction entities begin construction projects without an EIA or without the approval of EIA documents. For instance, administrative environmental protection departments across the entire country inspected 388 power station projects in 2005 and found that 139 of them started construction or operation without an EIA.[36]

Some local environmental protection bureaus illegally approve EIA documents, thereby violating the law. In Jiangxi Province, for example, many small paper mills and small cement factories were found to have had no EIA approval at all in 2004. However, in the inspection of more than ten small paper mills in 2005, almost all were found to have obtained the approvals of EIA documents although they are serious polluters.[37]

2. Reasons for Noncompliance

China's economy always appears overheating. The traditional concept of "economic development first" still strongly affects decision-making. What is more, until now the achievements of local officials in their posts are basically evaluated by increases in GDP, which makes local governments too concerned about economic development while neglecting the environment. Moreover, local administrative environmental protection departments may fail to fulfill their duty because of institutional and financial constraints. Regardless of the causes of environment degradation, both local governments and construction entities do not pay attention to EIA procedure even if it is required by law.

The penalty for violating the law is very low. In the event that a construction entity fails to submit the construction project EIA documents for approval and begins construction without authorization, the administrative environmental protection department which has approval authority over the construction project can only instruct the unit to stop construction and to carry out supplemental formalities within a limited time. If the time limit is exceeded without handling the supplemental formalities, only a fine of RMB 50,000 to 200,000 can be imposed.[38] Such penalties are too weak to serve as adequate incentives for entities to comply with the law. Even if found to have begun construction without EIA approval, a construction entity need only supplement EIA procedure. Moreover, for those big projects, the maximum fine of RMB 200,000 (US $24,000) is far cheaper than the time-consuming and costly EIA process.

B. EIA Quality

The provisions relating to the EIA for governmental planning have been the most difficult of the provisions of the 2002 EIA Law to be fully implemented. Most departments have no idea how to prepare an EIA regarding governmental planning. Only few governmental plans have conducted meaningful EIAs.[39]

EIA documents for construction projects are not yet prepared in a professional manner nor are they effective. Some special environmental assessment institutions are irresponsible in their preparation of construction projects documents and may even fake an assessment.[40]

The reviews and examinations conducted in the approval process are often inadequate. Many local environmental protection departments, especially those depart-

ments at a low level, do not seriously examine the EIA documents, thereby making the EIA a mere formality.[41]

A lack of technical expertise is one of the reasons for poor EIA quality. Determining the effects of human activities on the environment can be complicated. The current shortage of professional personnel and technical expertise contributes to the poor quality of EIAs in China, especially of EIAs relating to governmental planning.

The EIA Law is very general. Before a set of detailed procedures can be developed, there will be much flexibility and uncertainty in the enforcement of the law. Although improvement is underway, rules have yet to be set for many matters, such as the management of the special, qualified EIA institutions. Some special, qualified EIA institutions may engage in dissembling or other deceptive practices in an effort to gain more customers, including unqualified construction entities.

The dependence of local environmental protection departments on local government for financing and staffing tends to make these departments lower their standards and view the EIA as no more than a routine procedure.

C. SEPA's Efforts to Strengthen the EIA System

1. "Environmental Protection Storm"

On 18 January 2005, SEPA issued an edict ordering a halt to a total of 30 large construction projects. Breaches of environmental requirements were the main reason for the ban. Construction of these projects in 13 different provinces, mostly in the power sector, had all begun without submitting an EIA. Three of the largest projects, namely, Xiluodu Hydropower Station on the upper Yangtze River, the underground power station at the Three Gorges Dam, and the Three Gorges project power supply station, stopped by SEPA are being built by the Three Gorges Project Development Corp. Until February 2005, all the projects had stopped construction and supplemented the EIA process or been fined. This event was later called the "Environmental Protection Storm."[42]

The "Storm" marked the fist time that violations of the EIA Law were made known to the public since its implementation in 2003. The halt marked a major victory for the environmental protection administration in its fight against major environmental law violators, including powerful state-owned enterprises. It not only taught those violators a lesson, but what is more important, enhanced the awareness of all of Chinese society about the necessity for the EIA process. Since the Storm, other violations of the EIA Law have often been made public on the Internet from time to time.

2. SEPA's Efforts to Promote Public Participation

In 2005, SEPA held a public hearing on the Yuanmingyuan (a heritage park in Beijing, which was formerly an imperial garden) project to cover its lake beds with impermeable covers, presumably to conserve water. It was the first public hearing.[43]

Although there are some articles providing for public involvement in the EIA Law, they are very ambiguous and not practical. In February of 2006, SEPA enacted Provisional Measures on Public Participation in Environmental Impact Assessment. These measures represent the first regulation on public participation and aim at strengthening public surveillance to help the government improve its policy-making and credibility. According to SEPA, the Provisional Measures are the first step; an environmental information disclosure system will also be established to ensure transparency in decision-making and the efficacy of public participation.[44]

3. Other Efforts

Other efforts to make the EIA Law more practical and effective include a series of regulations that have been promulgated, including the following:

(a) Provisions on Special Planning Environmental Impact Report Examination, SEPA, 2003;

(b) Administrative Measures on Managing Expert Databases for Environmental Impact Evaluations, SEPA, 2003;

(c) Provisional Measures on Holding Hearings for Administrative Licenses Relating to Environmental Protection, SEPA, 2004;

(d) Technical Guidelines for Environmental Risk Assessment on Projects RI/T169-2004, SEPA, 2004;

(e) Provisional Measures on Registering and Managing EIA Engineer Professional Competence, SEPA, 2005;

(f) Construction Project Environmental Protection Management Regulation (draft of amendment), SEPA, 2005;

(g) Administrative Measures on the Qualification of Environment Impact Assessment Institutions, SEPA, 2005; and

(h) Provisional Measures on Public Participation in Environmental Impact Assessment, SEPA, 2006.

It is said that the environmental protection appearances of the local officials will be taken into account when evaluating their achievements in post in 2007. This may fundamentally change the current compliance situation, especially for those violations of local governments.

All the previous show a tendency—that the law will be more strictly implemented in the future.

Endnotes

1. *See* EIA Law art. 7, ch. 2. There are generally three different types of municipalities in China. On the highest level are municipalities directly under the central government. Their status is the same as provinces, and they are divided into districts. At the middle level are municipalities that are also further divided into districts; these are usually capital cities in the provinces. At the lowest level are municipalities that have no districts; they are on about the same level as the districts within the middle-level municipalities and have county-level status. Planning by municipalities at the lowest level is not regulated by the EIA Law.
2. *See id.* art. 8, ch. 2.
3. *See* Notice on Some Problems in Carrying Out the Regulation on Construction Project Environmental Protection Administration, SEPA, No.107 (1999).
4. *See* EIA Law art. 16, ch. 3.
5. *Id.*
6. *Id.*
7. SEPA, Order 14, eff. 1 Jan. 2003.
8. *See* EIA Law art. 7, ch. 2.
9. *See id.* art. 8, ch. 2.
10. *See* Construction Project Environmental Protection Management Regulation art. 9, ch. 2.
11. *See* EIA Law art. 7, ch. 2.
12. *See id.* art. 10, ch. 2.
13. *See id.* art. 16 and art.17, ch. 3.
14. *See id.*
15. *See id.*
16. *See id.* art. 7, ch. 2.
17. *See id.* art. 8, ch. 2.
18. *See* Interpretation and Practice Guideline of the 2002 EIA Law, written by the Commission of Legislative Affairs of the NPC Standing Committee.
19. *See* EIA Law art. 8, ch. 2.
20. *See id.* art. 20, ch. 3.
21. *See id.* art. 21, ch. 3.
22. *See id.* art. 20, ch. 3.
23. *See id.* art. 7, ch. 2.
24. *See id.* art. 12, ch. 2.
25. *See id.* art. 13, ch. 2.
26. *See id.* arts. 4 and 5; Provisions on Special Planning Environmental Impact Report Examination, SEPA, Order 3 12003.
27. *See* EIA Law art. 14, ch. 2.
28. *See id.* art. 15, ch. 2.
29. *See id.* art. 22, ch. 3.
30. *See id.* art. 22, ch. 3.
31. *See id.*
32. *See id.* art. 24, ch. 3.
33. *See id.* art. 25, ch. 3.
34. *See id.* art. 26, ch. 3.
35. *See id.* art. 27, ch. 3.
36. *See* http://www.china-eia.com/indexcontent/tzgg/panyue-tb-hpzf.htm.
37. *See* http://env.people.com.cn/GB/1072/4845684.html.
38. *See* EIA Law art. 31, ch. 4.
39. *See* http://news.xinhuanet.com/politics/2006-01/06/content_4016445.htm.
40. *See* Notice on Strengthening the Management of Environmental Impact Assessment, SEPA, No.51, 2006.
41. *See* http://env.people.com.cn/GB/1072/4845684.html.
42. *See* http://info.water.hc360.com/list/zt-hbfb.shtml.
43. *See* China Daily, 23 Feb. 2006, p. 2, available at http://www.chinadaily.com.cn/english/doc/2006-02/23/content_523214.htm.
44. *See* http://www.h2o-china.com/lianmeng/necw/viewnews.asp?id=36947.

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Chinese Employment and Labor Law: Current Status and Future Developments

By Junlu Jiang

I. Introduction

This article gives an overview of the current labor laws in the People's Republic of China and provides a brief analysis of the latest developments. The article consists of two parts: The first part deals with legal regulations and policies currently in force; the second part introduces the proposed legislation on employment contract law, where some comments are also put forward for discussion.

II. Status Quo

The Labor Law of the People's Republic of China (hereinafter referred as the "Labor Law"),[1] adopted by the Standing Committee of the National People's Congress in 1994, serves now as the basic system of rules in the area of employment and labor law. Its position and stipulations on some important issues are summarized below.

A. Termination of Employment Contracts

In China it is difficult for an employer to terminate an employment contract before expiry. Under the Labor Law, an employer may terminate an employment contract before its expiry in the following four situations:

- **Article 24:** An employment contract may be terminated upon agreement of parties concerned through consultation.
- **Article 25:** An employer may terminate an employment contract if one of the following cases occurs: 1) a worker is proved to be not up to the employment standards within the probationary period; 2) an employee has seriously violated labor discipline or the rules and regulations laid down by the employer; 3) an employee is in serious dereliction of duty or has resorted to deception for personal gains and caused serious losses to the interests of the employer; 4) an employee has been affixed with criminal responsibility.
- **Article 26:** In one of the following cases, an employer may terminate an employment contract, but must give a written notice to the employee thirty days in advance: 1) an employee, after a treatment of disease or non-job-related injuries, is unable to do the job assigned by the employer; 2) an employee is not competent for the job assigned to him and still falls short of the standards even after being trained or given other jobs; 3) an employment contract can no longer be performed due to major changes in the objective conditions of the employer and a revision cannot be reached through consultation by both parties.
- **Article 27:** When an employer needs to cut employment due to near bankruptcy and in a period of legal rectification or due to difficulties in its production or business operations, the trade union or all the workers are to be informed of the true situation, with their opinions heard and conveyed by the employer to the labor administration department. If an employer who has cut employment according to the provisions of this article recruits workers again within six months, priority is to be given to the employees who were formerly discharged.

However, the right of the employer to dismiss an employee under certain of the above provisions is restricted under the following circumstances. Thus, according to Article 29 of the Labor Law, the employer is prohibited from terminating the employment contract in accordance with Articles 26 and 27 where any one of the following circumstances arises: 1) an employee has been confirmed to have lost totally or partially the capability to work due to occupational disease or a job-related injury; 2) an employee is in the period of treatment for diseases or injuries; 3) a woman employee is in the pregnancy, lying-in or breast-feeding period; 4) certain other cases as provided for by law or administrative decrees.

Of course a resignation by an employee can as a matter of law be accepted.

B. Overtime and Work Hours

1. Standard Working Hours

The term "standard working hours" refers to the working hour system implemented by employers under normal conditions, as stipulated by the laws and regulations, and is divided into daily and weekly working hours. "Standard daily working hours," also called a working day, are the working hours arranged by an employer for each 24-hour period, from morning to evening. "Standard weekly working hours," also called a working week, are the working hours arranged by an employer for each seven-day week. According to the standards for working hours currently implemented by the Chinese Government, a working day consists of eight hours and a working week consists of forty hours over a five-day week.

An employer that cannot satisfy the above requirements mandated by Articles 36 and 38 of the Labor Law

because of special production circumstances may implement other measures for work and rest time in accordance with the requirements of Article 39 of the Labor Law and with the approval from the labor administration department. For example, it may adopt flexible measures for arranging work and rest time. More specifically, an enterprise may implement a system of non-fixed working hours or a system of comprehensive calculation of working hours according to the enterprise's special production circumstances, the special nature of the work involved, or the individual employee's position.

Note that a "non-fixed working hour system" is a system whereby working hours are not calculated according to a fixed-length working day. Following approval from the labor administration department of the People's Government, employers which adopt a non-fixed working hour system will not be subject to the restrictions set out in Article 41 of the Labor Law relating to extended standard daily working hours and extended standard monthly working hours. However, such an employer must adopt flexible working hours and other suitable work and rest time options so as to guarantee the right of its employees to take rest and holidays as well as fulfill their production and work assignments.

An enterprise may implement a system of non-fixed working hours for any of the following employees:[2]

- Senior managerial personnel, field personnel, sales personnel, some shift employees and other employees of an enterprise whose standard working hours cannot be assessed owing to the nature of their work.
- Long-distance transport personnel of an enterprise, taxi drivers, some railroad, port and warehouse personnel engaged in loading and unloading of cargo, and other employees who are required to work on an ad hoc basis due to the special nature of their work.
- Other employees for whom the system of non-fixed working hours is suitable due to the special circumstances of production, special work requirements, or the scope of their job duties.

2. Extension of Working Hours

The term "extension of working hours" is referred to in Article 41 of the Labor Law and includes overtime worked during normal working days and also overtime worked on rest days and legal holidays. Specifically, the total amount of overtime worked on normal weekdays, rest days and legal holidays is not to exceed thirty-six hours per month. Until such time as the legislative arm of the PRC enacts legislation providing further interpretation of this regulation, it is to be enforced accordingly.

According to Article 44 of the Labor Law, when arranging the overtime pay for a worker's overtime, the enterprise is to pay not less than one hundred fifty percent of the normal wage. When arranging for employees to work overtime during rest days, the employer should first consider making arrangements for employees to take alternative rest days, but when such alternative rest days cannot be arranged, the employer is to pay such employees no less than two hundred percent of their normal wage. Alternative rest time should be provided in the same time period as the overworked time. When arranging for employees to work during a legal holiday, the employer should pay no less than three hundred percent of their normal wage, and in general alternative rest days may not be used to substitute legal holidays.

C. Vacation and Holidays

1. Holidays

According to the stipulations of the Labor Law and the *Measure Regarding National Standards for Annual and Commemorative Holidays* (revised by the State Council on 18 September 1999), employees are entitled to two days of rest per work week. Each employee is entitled to a total of ten legal holidays every year as follows:

- New Year's Day (1 January)—one day
- Chinese New Year/Spring Festival (the first, second and third days of the first month of the lunar calendar)—three days
- Labor Day (1, 2 and 3 May)—three days
- National Day (1, 2 and 3 October)—three days

In addition to the above, there are certain holidays which are eligible for certain employees, but not all. For example, there is Women's Day (8 March), which is a half-day off for all female employees. And there are those traditional holidays observed in accordance with the customs of ethnic minorities that are stipulated as holidays by the People's Government at the provincial level of the relevant ethnic minority regions.

Should any of the above national holidays fall on weekends (i.e., Saturday or Sunday), employees are eligible for additional day(s) off on the following work day(s). Those holidays which are observed by certain group of ethnic minorities, but not all, which are not stipulated by the People's Government, are not to be carried over and taken on the next workday, should they fall on a weekend.

2. Leave

(i) Annual Leave

Employees who have worked for longer than one year continuously are entitled to annual leave with pay.

Specifically, Article 45 of the Labor Law stipulates that:

> The State shall implement a system of paid annual leave. Employees who have worked continuously for at least one year are entitled to annual leave, the detailed measures for which shall be stipulated by the State Council.

However, the State Council has not promulgated the detailed measures. Until the State Council promulgates those measures, enterprises should continue to adhere to the Notice on Issues concerning Employees' Annual Leave, jointly promulgated on 15 June 1991 by the Central Committee of the Chinese Communist Party and the State Council. This notice stipulates that:

> When determining the amount of annual leave to be given to employees, the enterprise shall differentiate among various factors, such as the work obligations, qualifications and work experience and position of the different types of employees as well as other factors. However, in any event, annual leave may not exceed two weeks.

Therefore, although employees are entitled to annual leave, the management personnel of the enterprise has the discretion to grant the appropriate amount of time for annual leave to employees according to their qualifications, work experience and position in the enterprise, subject to the legally mandated two-week limit.

(ii) Family Leave (Covering Employees in State-Owned Enterprises)

According to the Regulations Regarding Family Leave for Employees,[3] an employee who has worked for more than one year, who does not live with his or her spouse, and who is unable to visit the spouse on public rest days (weekends), is entitled to take leave in order to visit his or her spouse. An employee who has worked for more than one year, and does not live with his or her parents and is unable to visit the parents on public rest days (weekends), is entitled to take leave in order to visit the parents.

The term "parents" here includes the adults who raised the employee as a child and relatives whom the employee is currently supporting. It does not, however, include parents-in-law. The family leave regulations for married and unmarried employees are as follows:

- Married employees are given one thirty-day period per annum to visit their spouses.
- Married employees are given one twenty-day period for every four years to visit their parents.
- Unmarried employees should, in principle, be given one twenty-day period per annum to visit their parents. If, due to work requirements, the employer is unable to give family leave, or if the employee agrees to do so, family leave may be taken as one forty-five-day period every two years.

The period of family leave consists of the time for the employee visiting his or her spouse or parents and, in addition, the time period of leave granted for traveling, as the actual circumstances require. The aforementioned leave periods all include public legal holidays and legally stipulated holidays within the period granted.

D. Social Insurances

In China social insurances are regulated by the Labor Law, which covers pension, medical care, work injury and unemployment as well as maternity.

1. Basic Pension

Pursuant to the Labor Law, both employer and employee are required to pay basic pension insurance premiums, and should make full payment on time. Where premiums are not paid in full and on time, the corresponding amounts will not be credited to the employees' individual accounts, and the pension fund will not cover the cost of such retired employees. The employer has the duty to withhold such payments from the employee's salary.

2. Enterprise Supplementary Pension Insurance

The term "enterprise supplementary pension insurance" refers to a type of social insurance provided in addition to basic pension insurance, which the Chinese Government encourages enterprises to establish on behalf of their employees, in accordance with the financial status of the enterprise, after basic pension contributions have been promptly made in full. It is a second "tier" of the pension insurance system and plays a complementary role to the basic pension insurance: Employers often provide supplementary pension insurance to their key or outstanding employees as an incentive, in order to retain such employees and increase morale.

Social insurance and commercial insurance are different from each other. The social insurance is implemented by the state in accordance with the laws and administrative regulations and is therefore mandatory: Such social insurance aims to provide fair and reasonable welfare and basic protection for the livelihood of employees and is not intended to make a profit. On the other hand, commercial insurance establishes a relationship on the principles of mutual consent and fairness between the insurance company, whose intention is to make profit, and the insured.

E. Medical and Maternity Leave

1. Medical Leave Period for Enterprise Employees for Illness or Non-Work-Related Injuries

According to the *Regulations for the Medical Leave Period for Enterprise Employees for Illness or Non-*

Work-Related Injuries, when an enterprise's employees must stop work due to illness or non-work-related injuries and must undergo medical treatment, a medical leave period of between three and twenty-four months is to be provided for the employee, according to the employee's actual number of years of employment with the prior employer and the number of years of employment with the current employer.

Employees who have actually worked for fewer than ten years in total, including prior employment, and fewer than five years with the current employer, are eligible for up to three months of medical leave, and those who have worked for more than five years with the current employer are eligible for up to six months of medical leave.

Employees who have actually worked for more than ten years in total, including prior employment, but fewer than five years with the current employer, are eligible for up to six months of medical leave, and those who have worked for more than five years with the current employer are eligible for up to nine months of medical leave. Those who have worked with the current employer for between ten and fifteen years are to be given twelve months of medical leave, those who have worked with the current employer for between fifteen and twenty years are to be given 18 months of medical leave. Finally, those who have worked with the current employer for more than twenty years are to be given twenty-four months medical leave.

The foregoing is set out in the following chart.

Entitlement to medical leave period		
Total years worked	**Employment with the enterprise**	**Medical treatment period (months)**
Fewer than 10 years	Fewer than 5years	3
	More than 5years	6
More than 10 years	Fewer than 5 years	6
	5-10 years	9
	10-15 years	12
	15-20 years	18
	More than 20 years	24

Employees entitled to three months of medical leave are allowed to take a total period of six months medical leave; those entitled to six months are allowed to take a total period of twelve months medical leave; those entitled to nine months are allowed to take a total of fifteen months medical leave; those entitled to twelve months are allowed take a total of eighteen months of medical leave; those entitled to eighteen months are allowed to take a total of twenty-four months medical leave; those entitled to 24 months are allowed to take a total of thirty months medical leave.

Medical leave period (months)	Total period allowed for medical leave (months)
3	6
6	12
9	15
12	18
18	24
24	30

During an employee's medical leave period, the employees' sick pay, illness relief funds and medical treatment will be implemented in accordance with the relevant regulations.

In addition, employees who have serious illness (such as cancer, mental illness or paralysis) and fail to recover within twenty-four months are entitled to extend the medical treatment period upon approval by the enterprise and the supervisory labor department.[4]

2. Maternity Leave

Female employees who have not violated the relevant state regulations on family planning are entitled to the following maternity leave.[5]

- Female employees are eligible for no fewer than ninety days of maternity leave, including fifteen days before childbirth and seventy-five days afterward.
- For female employees who experience a difficult childbirth, fifteen extra days may be added. If the female employee gives birth to more than one child, fifteen extra days may be added for each additional child in one delivery.
- For female employees who have a miscarriage, the enterprise is to grant maternity leave based upon documentation from the medical department. Female employees are entitled to fifteen to thirty days of maternity leave after a miscarriage in the first four months of pregnancy and forty days maternity leave for a miscarriage after four months of pregnancy.

F. Work Injury Benefits

All types of enterprise and individual industrial and commercial business operators who hire workers in the PRC are to participate and purchase work injury insurance stipulated in the *Regulation for Work Injury Insurance* and pay premiums for work-related injury insurance for all staff and workers hired.

An employee who suffers a work-related injury or from an occupational disease and requires temporary absence from work in order to receive treatment during the

paid medical leave period will receive the original salary and benefit and be paid by the employer monthly.

An employee who suffers from a work-related injury may request termination of the employment relationship with the employer, and the employer will make a one-time payment of a medical subsidy for the work-related injury and an employment subsidy for the injured employee. The specific amount will be determined by the appropriate governmental authority of the province, autonomous region or centrally-administered municipality.

The benefits available for employees injured in the course of work in Beijing are prescribed in accordance with Article 15 and Article 18 of the *Regulation for Work Injury Insurance for People Working for Enterprises in Beijing*.

G. Retirement / Pension Benefits

Article 73 of the Labor Law stipulates that employees are to receive the following social insurance benefits in accordance with the law:

- Pension benefits following retirement (male employees who have reached the age of sixty or female employees who have reached the age of fifty (blue collar workers) or the age of fifty-five (while collar workers) whose continuous time worked totals ten years.
- Medical treatment benefits for persons suffering from an illness or non-work-related injury.
- Work-related injury benefits for persons who are disabled as a result of a work-related injury or who suffer from an occupational disease.
- Unemployment benefits for persons who are unemployed.
- Maternity benefits for females who give birth to children.

Employers should provide social insurance for their employees through the local insurance organizations, in accordance with the type of social insurance and contribution standards stipulated in the Labor Law and other laws. Enterprises should promptly make contributions in full payment to the corresponding insurance funds.

H. Housing Allowance

The development of housing funds has been beneficial to managers and employees of FIEs (Foreign Invested Enterprises) in a number of ways. By contributing a relatively small amount, the employer can participate in the housing fund system without penalty.

Foreign enterprises and their employees in Beijing are to contribute to the social insurance funds and the Housing Fund as follows:

Contribution Rates in Beijing

Fund \ Contributor	Employer	Employee (Percentage of individual wage)
Basic Pension	19%	7%
Basic Medical Insurance	9%	1%
Unemployment Insurance	1.5% of total payroll	0.5%
Work-related Injury Insurance	0.2%-1.9% of total payroll	Does not contribute
Maternity Insurance	Not Applicable	
Housing Fund	10% employee's actual wage	10%

I. Restrictions on Confidentiality Agreements and Non-Compete Agreements

A "trade secret" refers to proprietary technical information and business information relating to production, sales and operations that is unknown to the public, is of economic benefit to employer, has a practical application, and for which reasonable protective measures have been adopted by the employer (regardless of the type of medium on which the trade secret is stored or recorded). If the above information has fallen into the public domain, the company cannot list them as its own secret information.

Under Chinese Law, the term of the non-compete obligation may not exceed three years and the company must pay the employee the agreed-upon amount of monetary compensation in consideration of his/her performance of the non-compete obligations, failing which the employee can not be legally obligated to adhere to such obligation.

III. Proposed Developments

In November 2005, the proposed draft Employment Contract Law was approved by the State Council for submission to the NPC Standing Committee for its ratification. The first deliberation has already been finished, and the second began in October 2006. As another principal law in this area, it is expected to promote greatly the development of Chinese labor law. This part of this article deals with some problems emerging in the course of the discussions concerning the draft. The answers set forth below to these questions represent only personal opinions and may deviate from the official Employment Contract Law finally promulgated.

A. Enterprises that Fail to Sign Employment Contracts with their Employees

China's current Labor Law requires an employer to enter into a written employment contract with each employee when an employment relationship is established between the two. The legitimacy of oral employment contracts is generally not recognized by law, unless the employer and the employee have no disagreement on the content of the contract. In normal cases, the supervisory body[6] of the Ministry of Labor and Social Security will impose an administrative penalty on the entities or individuals who fail to sign an employment contract with their employees upon the establishment of an employment relationship.

The Employment Contract Law draft also stipulates the duration of employment contracts and imposes heavier legal obligations on employers who fail to sign employment contracts with their employees. Where the employer fails to sign a contract with the employee, the duration of the employment relationship is deemed to be for an indefinite period, or a long-term employment contract. (Some academics recommended that it should default into a three-year contract.) Considering the strict restrictions of the current Labor Law on the termination of employment contracts, such long-term contracts are likely to impose substantial pressure on employers in terms of the flexibility of their recruitment.

Enterprises should pay great attention to the concern and attitude of the Employment Contract Law draft toward enterprises that fail to enter into employment contracts with their employees. They should enter into fixed-term employment contracts with their employees according their actual needs.

B. Employers' Obligation to Compensate Employees upon the Termination of Employment Contracts

China's current Labor Law does not require employers to compensate their employees when an employment contract is terminated upon expiration. However, some provinces or municipalities, such as Fujian province, have local regulations or rules that require employers to do so.

Compensation refers to money received by the employee from the former employer for purposes of the employee's living and job hunting expenses after the contract termination. This is remuneration paid in another form to reward the employee for his or her contribution to the employer. Under the current Labor Law, employees whose employment contracts are terminated due to their incompetence may still receive compensation. However, the employees whose contracts are terminated upon the expiration the contract (where no mistakes are made) are not entitled to such compensation. Such a practice has been considered inequitable. More importantly, the fact that employees are not entitled to compensation upon the expiration of the employment contract has resulted in the prevalence of short-term employment contracts, and the tendency of employers to favor shortening the contract duration. This phenomenon has attracted the attention of the whole society.

Since China's Labor Law sets stringent restrictions on the rescission of employment relationships but overlooks the imposition of restrictions on the termination of employment contracts, a large number of enterprises choose to sign one-year contracts with their employees to get around the labor law's restriction on prematurely rescinding employment contracts.

In the discussions about the draft Employment Contract Law, the issue of appropriate measures to combat the tendency of shortening employment contract durations attracted a lot of attention. One suggested measure is to require enterprises to deem employment contracts automatically renewed twice as long-term contracts; another is to require enterprises to compensate their employees upon the expiration of the contract. For each year the employee served in the organization, the employee should receive one or two months' pay as compensation. The latter measure has received more widespread support.

Pursuant to these views, it is crucial for enterprises to make adjustments to their human resources policies and systems and to decide on the duration of employment contracts, modify staff handbooks, establish or revise performance appraisals and punishment criteria according their situation and needs. This way, enterprises can keep the people they need and let go of the ones they don't need.

C. Statutory Requirements on Enterprises' Internal Labor Rules

The concept of "internal labor rules" of an enterprise refers to the system of day-to-day human resources management, including documents setting forth the specific rights and obligations of the employees. Enterprises may manage their staff according to their internal labor rules, but, thus far, the law is silent on such internal labor rules. The draft Employment Contract Law sets forth various provisions to fill this gap.

The draft requires employers to create internal labor rules in areas such as security and hygiene, workplace discipline, leave and vacation, and employment contract management. This is done to provide security to the employees' rights and certainty in regard to obligations of employment.

The draft provides that employers are to solicit the opinions of their employees' union when drafting and

modifying their internal labor rules. Where no employees' union has been established in the enterprise, the employer is to hold hearings among the employees.

The draft also stipulates that the internal labor rules created by employers are to be effective on the day that employees are officially given notice and are to be binding on both the employer and the employee. Internal labor rules may be invalidated by the Ministry of Labor and Social Security, the Labor Dispute Arbitration Commission, and the courts.

When a dispute arises between an employer and employee where an employee claims an internal labor rule to be invalid, the employer is to bear the burden of producing evidence to show that the relevant internal rule(s) complies with the requirements of the draft Employment Contract Law. If the employer fails to meet its burden, the penalty that the employer has imposed on the employee pursuant to such rule(s) may be revoked. In practice, an employer's most effective way of providing notice is still to ask the employees to sign a written confirmation. Employers should be very wary about notifying employees via email.

D. Employees of "Labor Dispatch Agencies"

The hiring of workers from so-called "labor dispatch agencies" has attracted considerable attention. The draft Employment Contract Law is especially concerned about the potential detrimental effects such a phenomenon may have on workers' rights.

Labor dispatch agencies differ from employment agencies and headhunting firms. The former employ and enter into employment contracts with the laborers themselves, dispatching the laborers to enterprises in need of the laborers. The enterprises where the laborers actually work (the so-called "end employer") only need to pay the labor dispatch agency a commission and do not have an obligation to pay the laborers' wages, or contribute to the laborers' social security or housing funds. Rather, these obligations are fulfilled by the labor dispatch agencies themselves. Employment agencies and headhunting firms do not establish contractual labor relations with the referred employees, nor do they contribute to laborers' social security or housing funds.

The draft confirms the legitimacy of labor dispatch agencies, but requires that such companies obtain certification before conducting business and entering into the employment contract with the employee. In addition, the draft requires labor dispatch agencies to enter into a labor dispatch agreement with the "end-employer" enterprise where the employee will be working. Such agreement must specify the following terms:

- the name of the dispatched laborer;
- the role of the dispatched laborer;
- the place of work;
- the duration of dispatch;
- the end-employer's detailed expectations of the laborer; and
- the breakdown regarding which obligations to the laborer are to be fulfilled by the labor dispatch agency and which are to be performed by the end-employer. (The laborer is to be informed of the content of such agreement.)

The draft also requires the end-employer to refrain from using the laborer in a manner not contemplated by the labor dispatch agreement and prohibits such an entity from dispatching the laborer to other entities.

The draft further provides that, if the dispatch agency seeks to alter or terminate the employment contract, the laborer can communicate directly with the end-employer. In such an event, the end-employer bears the obligation of facilitating the negotiations between the laborer and labor dispatch agency.

The draft stipulates that the end-employer is responsible for ensuring that the labor dispatch agency does not take any illegal actions, such as docking the laborers' wages. The end-employer is jointly and severally liable for such acts.

The latest news is that, because of strong disagreement from the labor dispatch companies, the draft eliminates the restriction on a maximum one-year dispatched period.

E. The Representative Offices of Foreign Companies

At present, the representative offices of foreign companies in China do not have the right to hire employees directly and may only recruit staff through foreign enterprise service institutions that enter into employment contracts with personnel. Such an arrangement is irreconcilable with the labor reforms contemplated by the Employment Contract Law and is likely to complicate labor relations if left standing.

The draft leans towards permitting representative offices to enter into contractual labor relationships as employers and deems that the Employment Contract Law be applicable to such situations.

F. Specific Provisions on Non-Compete Clauses

The operation of non-compete clauses was a hotly debated issue during the drafting deliberations of the Employment Contract Law. The current labor law does not include provisions regulating non-compete clauses, despite the fact that such clauses are widely employed in certain industries, including IT for example. How the Employment Contract Law should deal with non-compete clauses was an issue that drew a lot of attention.

The draft Employment Contract Law permits employers to include non-compete clauses in their employment contracts vis-à-vis employees with knowledge of trade secrets or to sign separate non-compete agreements with such employees. Pursuant to such an agreement, the subject employee is prohibited from working for other employers that manufacture the same type of products or operate the same kind of business as the employer, and from starting his or her own business that manufactures similar products, or provides similar services that may be in competition with the employer, for a certain period after the termination or rescission of the employment contract. In the event of breach, the employee is liable to the employer for damages. The draft also requires non-compete clauses to include a provision obligating the employer to compensate the employee for such restrictions upon the termination or rescission of the contract. The compensation for a non-compete clause/agreement is to be no less than the annual pay that the employee would receive from the employer under the employment contract, regardless of the duration of the restriction. Some experts oppose the implementation of such a requirement on the ground that the amount of compensation given should relate to the duration of the non-compete restriction. They propose that the compensation should be one-third of the pay that the employee would receive from the employer during the non-compete period. The damages imposed for breach of a non-compete clause are to be no more than twice the compensation the employer must pay the employee in consideration for such restriction.

The draft provides that the geographic scope of non-compete clause/agreements must be limited to cover only regions where the actual competition with the employer may occur. The duration of non-compete clause/agreement may not be longer than two years, which is one year shorter than the current duration of such clauses /agreements in practice.

In addition, the draft provides that non-compete clauses will be held invalid in the following situations:

- Where the trade secrets of the employer have already been published or no longer have an impact on the employer's interests.
- Where the employer fails to compensate the employee for the non-compete clause/agreement as agreed upon after the termination or rescission of the employment contract.

G. The Principle of Employee Protection

Although the principle of employee protection was not expressly included in the draft Employment Contract Law, that principle is embodied in specific clauses.

For instance, where the employee and the employer dispute the interpretation of the clauses of the employment contract, the draft provides that such clauses are to be interpreted in a way that is favorable to the employee. This follows the principle of *contra proferentum*, in that the language of an employment contract is normally drafted by the employer.

In terms of the renewal of employment contracts, the draft requires employers to perform employment renewal formalities before the expiration of the contract. If an employee continues to work for the employer after the expiration of the employment contract, the contract will be deemed automatically renewed if the employer failed to negotiate a new contract.

The draft also requires employers to remunerate employees for work already performed where the employment contract is invalidated or rescinded, except in circumstances where the employee is engaged in malicious collusion or such remuneration would impair the public policy interests of the nation, collectives or third parties. The amount of the remuneration may be negotiated by the employer and the employee. If such negotiation fails, the remuneration of employees recruited by the enterprise in similar roles may be used as a benchmark.

Where the employment contract conflicts with collective contracts or state regulations, the employer and employee may renegotiate if (i) the remuneration or labor conditions, etc. agreed upon in the employment contract fail to comport with the minimums set by the state or the relevant collective contract; or (ii) if the existence of an employment contract is ambiguous and the labor dispute arises from the failure to use a written contract. If such negotiations fail, the relevant provisions in the collective contract will be applied, but if no relevant provisions are available in the collective contract, the relevant state regulations will be applied, and if relevant provisions are available in both the collective contract and the state regulation, those that are more favorable to the employee will be applied.

The principle of employee protection will be widely adopted in arbitral and judicial practice.

IV. Conclusion

As embodied in the draft discussed above, the forthcoming Employment Contract Law may cause extensive changes to labor relations. Consequently, corporate human resources management must adapt to the requirements of the new law. HR managers must amend their letters of appointment, employment contracts, internal labor rules, and various other documentations in order to satisfy the requirements of the Employment Contract Law.

Endnotes

1. It was adopted at the Eighth Session of the Standing Committee of the Eighth National People's Congress on 5 July 1994 and became effective from 1 January 1995.
2. According to the stipulations of Article 4 of the *Measures for Examination and Approval of the Implementation of the System of Non-fixed Working Hours and Comprehensive Calculation of Working Hours by Enterprises,* promulgated by the Ministry of Labor on 14 December 1994 and effective on 1 January 1995 ("Examination and Approval Measure").
3. It was adopted by the 17th Session of the Standing Committee of the 5th National People's Congress on 6 March 1981 and promulgated by the State Council on 14 March 1981.
4. *See* Article 2 of the *Notice for Implementing the Regulations for the Medical Leave Period for Enterprise Employees for Illness or Non-Work-Related Injuries*, promulgated on 23 May 1995.
5. *See Regulations of People's Republic of China for the Protection of Female Employees*, promulgated on 21 July 1988 and implemented on 1 September 1988 by the State Council; the *Response to Questions Regarding the Regulations for the Protection of Female Workers*, promulgated by the Ministry of Labor on 20 January 1989; and the *Notice Regarding Several Questions on Maternity Leave for Female Employees,* promulgated on 4 September 1988 and effective from 1 September 1988.
6. The labor supervisory bodies are established at all administrative levels of the labor and social security ministries and are in charge of the administrative supervision and management of the labor law.

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Trust Law and Trust Business in the People's Republic of China

By Hao Wang

I. Introduction

The trust, regarded by Lepaulle as "the guardian angel of the Anglo-Saxon," spread its wings to China in 2001. How is it being regarded in the "Forbidden City"? How is it being used? Is it being used to its fullest extent? Set forth below is a short discussion of these points.

II. Introduction of 2001 Trust Law

Beneficiaries' rights under a country's trust law may be very extensive, so that they have proprietary interests that bind many third parties, or less extensive, so that they only have protected preferential rights in respect of the "ring-fenced" trust property in the hands of the trustee.

A. "Special Contract" Concept

To introduce a trust concept into a civil law system, it makes sense to begin with the use of the less extensive type of trust. Thus, the 2001 Trust Law of the People's Republic treats the settlor, the trustee and the beneficiaries as if they were parties to a special contract. Under that "special contract" concept the settlor has detailed special rights, which are then extended to the beneficiaries also, and under which the trustee cannot resign without the consent of the beneficiaries and of the settlor, so the trustee cannot unilaterally replace itself with a new trustee. The trustee manages the trust property in the trustee's own name in accordance with the wishes of the settlor as expressed in the trust document and in the best interests of the beneficiaries, of whom at least one must be in existence at the creation of the trust. The key duty of the trustee is to keep the trust property separate from privately owned property and to keep separate accounts for the trust property.

Another aspect of the fact that this is treated as a special kind of contract is that the settlor, like the position in English law, has the right to receive information from the trustee about the trust and, in some cases, to remove the trustee. More controversially, and unlike the position in English law, when one trustee retires and another trustee takes over, the new trustee inherits not only the rights of the trustee as trustee, but *also* his obligations, at any rate those in respect of third parties. It is not entirely clear whether this takeover of liability extends to private contracts entered into by the first trustee in handling trust affairs.

B. Rights of Beneficiaries

However, the proprietary aspect of a trust mainly arises because the beneficiaries have rights in relation to the things that are the subject of the trust, which persist even though the things themselves have been transferred to third parties. This is the characteristic of the property idea. In the Chinese trust law, however, there is no such simple statement of the beneficiary's rights against third parties. Instead, the idea is that the beneficiaries of a Chinese trust have the right to make a claim before the court for an order that the third party to whom the assets had been wrongfully transferred should retransfer the assets to the trustees, so that they can then be administered in accordance with the terms of the trust itself. This is a property right, of a sort, but a much more restricted one than the right of the beneficiary under a common law trust.

C. Items Not Addressed

The Trust Law does not expressly deal with a number of areas which are important in English trust law. For instance, there are no provisions on perpetuities, or on how long a Chinese trust may last, or on how long income may be accumulated. There are no provisions dealing with the area of English trust law known as dishonest assistance in a breach of trust.

D. Developments Since 2001

It is fair to say that almost all trusts created under the 2001 Trust Law are commercial in scope rather than familial. Most Chinese who have the money to settle in a trust would either prefer not to use the trust mechanism at all, or, if they are persuaded of the merits of using one, then they would normally invest via trustees in another jurisdiction, particularly if it were a jurisdiction where Chinese is spoken, such as Singapore.

However, it is not always the case that the money or capital can be taken outside China (at any rate lawfully) and hence the Chinese may well resort to the creation of a trust under this law even for familial purposes. Or there may be some family trusts created in China with funds from abroad, or so-called "cross-border" trusts, where some beneficiaries are in China and some are not. However, where Chinese residents can benefit from or control an overseas company or trust, they may be obliged to report this to the Foreign Exchange authority, by virtue of Circular 75 of the State Administration of Foreign Exchange, issued on 21 October 2005.

In any event, the vast majority of trusts created under this law are going to be for commercial purposes. Chinese trusts will commonly be used for purposes such as a so-called capital trust, combining the investment capital of many investors so that one large asset can be purchased.

III. Opportunities for Foreign Trust Companies

The China Banking Regulatory Committee ("CBRC"), the direct supervisor of trust industry in China, favors tight control over trustees doing business in China. Although the 2001 PRC Trust Law requires a trustee to be a natural person or legal person with full civil capacity, the Trust Law nevertheless provides that, if other laws or administrative regulations contain other trusteeship conditions, such provisions of the other laws or regulations prevail. Articles 4 and 12 of the Regulation of Management and Business of Trust and Investment Companies, issued by the CBRC, stipulate that only a trust and investment company ("TIC") licensed by the CBRC can act as a trustee to conduct trust business in China, i.e., act as a trustee in the course of business for profit. Therefore, it is necessary for a foreign trust company to become a stakeholder of an existing TIC or set up a TIC with a Chinese Partner, since a wholly foreign-owned TIC is still currently in the restricted foreign investment areas.

In January 2005, senior officials from the CBRC mentioned in a high-profile circular that Sino-foreign equity joint venture TICs will be greatly encouraged in order to improve the corporate governance of the domestic TICs and to help domestic TICs to diversify their businesses. As of December 2004, there were fifty-nine TICs licensed by the PRC. There are about ten old TICs that failed to renew their licenses last time and are currently preparing to apply for new licenses. The CBRC sensibly announced that, among other new requirements, the applicant is required to have a foreign strategic shareholder in order to get the license to become the "authorized person."

A twenty-percent share is the maximum that a single foreign party can hold in a Sino-foreign equity joint venture TIC. However, a recent case indicates that the CBRC is willing to accept more than the maximum limit to encourage the establishment of Sino-foreign equity joint venture TICs. CBRC has primarily agreed to allow a Hong Kong group to acquire indirectly 46.6% of a Shanghai-based TIC, which might become the first Sino-foreign equity joint venture TIC in China. It has been said that both Barclays and Ashmore are seeking to obtain approvals to get a substantial equity holding in two TICs now.

Chinese TICs mainly involve themselves in so-called collective capital trust schemes, where a TIC promotes a capital trust scheme to the public (like an English unit trust), but lends all the trust capital to a project of a company, like a real estate developer that needs financing. Other business TICs involve leasing projects, holding shares for clients in Management Buy Outs, employee shareholding plans, and being a custodian for a private or public company. TICs also try to do securitization with state-owned banks to dispose of distressed assets. Under the current legal framework of the PRC, there are many obstacles to establishing a company to act as a Special Purpose Vehicle (SPV) in terms of true sales and the insolvency ring-fence. Thus, it is desirable and feasible to establish a trust as the SPV, where a bank is the settlor and beneficiary and the TIC acts as a trustee. The bank then transfers its beneficiary rights to the investors. For an English trust company, the business of a Chinese TIC is merely a custodianship coupled with an investment service, which is not a real trusteeship. It is anticipated that the foreign stakeholders will bring more ideas about trusteeship. Currently, the proposed amendments for both the Regulation of Management and Business of Trust and Investment Companies and the Regulation of Capital Trust Schemes have been finished, and may be issued in the early spring of 2007. These regulations will direct TICs to excel at real trust services and investment services.

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