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ART LAW IN TRANSACTIONAL PRACTICE

Jeff W. Slattery†

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services to local artists and arts organizations.
INTRODUCTION

Artists are increasingly important players in the economic, social, and cultural development of communities throughout the United States. Unfortunately, a lack of adequate funding and appreciation of their legal needs often means artists do not seek or receive transactional legal assistance when it would be beneficial. Attorneys, meanwhile, may perceive the needs of artists as very specialized, and thereby well beyond the scope of services the attorney can provide. For these reasons, artists may find themselves without legal assistance, to the detriment of their business, their creative output, and their community. This article seeks to demystify a number of the transactional issues faced by visual artists working in communities across the country, suggesting how attorneys versed in other industries and a variety of doctrinal areas might be able to assist.¹ By helping local artists, attorneys can foster community development in economic, social, and cultural terms. In the interest of brevity, this article will focus on transactional issues commonly encountered by relatively unknown artists creating works in the present day, selling those works for profit, and earning a modest living from their efforts. On the practitioner side, it will focus on attorneys working in a solo or small firm environment.

¹ For “[a]rt law, simply put, is a body of law, involving numerous disciplines, that protects, regulates and facilitates the creation, use and marketing of art. Art law is not a separate jurisprudence or unified legal doctrine that applies to all of the issues confronting those in the art world. Those involved in the practice of art law look to a variety of disciplines, such as intellectual property, contract, constitutional, tort, tax, commercial and international law to protect the interests of their clients. Some of these legal principles are national in scope, while others vary according to the development of state law.” ROBERT C. LIND, ROBERT M. JARVIS & MARILYN E. PHelan, ART AND MUSEUM LAW 3 (2002).
I. The Value of Visual Artists

Throughout human history and around the globe, visual artists have played an important role in the development of society, culture, and community.² Drawings, paintings, sculpture, and other forms of art have served to record historical events, forge identities, and express the views of people, both individually and in groups.³ From prehistoric pictographs and carvings adorning caves and temples to digital creations making rounds of the Internet, visual art has long influenced human development.

Today, community-focused leaders, planners, developers, and scholars acknowledge the important role artists play in community development on a number of levels. Cities and towns across the United States and around the world are increasingly working to develop “creative economies,” that is, economies built around creative people and their work product, ranging from paintings and sculpture to graphic and industrial design.⁴ Even where a creative economy is not the goal of a particular community, artists and their work can enhance the desirability of living in or visiting that community, indirectly facilitating economic development.⁵

When viewed broadly, there are many artistic parts and players in a thriving, creative community, including individual artists, collectives of multiple artists, arts organizations (such as theatre and dance companies), performance and exhibition spaces (such as galleries, museums, halls, and theaters), and educational institutions. While these individuals and entities have certain legal needs in common, their specific needs are diverse enough to warrant a focused approach in this article. With visual artists working independently as painters, photographers, sculptors, and the like in cities and towns throughout the country, their transactional needs provide that focus.

⁵ See Maria Rosario Jackson, Art and Cultural Participation, in UNDERSTANDING THE ARTS AND CREATIVE SECTOR IN THE UNITED STATES, supra note 2, at 94-95.
II. THE TRANSACTIONAL NEEDS OF VISUAL ARTISTS

Generally speaking, the transactional needs of individual, working, visual artists are much the same as those of any small business. Each must focus on revenue, bringing in money to continue developing, marketing, and selling their products and services. The particular circumstances may warrant formation of a partnership, corporation, or limited liability company. Written contracts should be used to memorialize the rights and responsibilities in their business arrangements. Permits and licenses are often required to provide their goods and services. Artists are sometimes employees, but more often create their works independently, doing so under their own name.

Of course, artists also have concerns involving areas of the law not necessarily shared by other businesspeople. Their creative output often involves copyright, moral rights, publicity rights, the First Amendment, and may, in some parts of the country, require a certificate of authenticity.\(^6\) Each of these areas, both common and particular, will be discussed in turn.

A. Legal Concerns Common to Creative and Other Industries

1. Business Entity Formation and Operation

Visual artists who provide goods or services to others at a price are businesspeople. The solo artist who paints, photographs, or sculpts the world or their vision into a work of art, and subsequently sells that work, is most often operating as a sole proprietor. Insofar as there are neither partners involved nor assets to protect, such artists may need little more from their attorney than an explanation of the benefits and detriments of operating as a sole proprietor versus forming a corporation or limited liability company. Asking the client about income, expenses, profits, and losses, and encouraging the creation of a business plan can foster a focus on the financial realities of their enterprise, however large or small. Connecting the client with an accountant or small business services organization\(^7\) can add to the

---

\(^6\)E.g., CAL. CIV. CODE §§ 1742, 1744 (West 2012); N.Y. ARTS & CULT. AFF. §§ 15.01, 15.03 (McKinney 2012).

\(^7\)E.g., SCORE (the Service Corps of Retired Executives) is a nationwide, non-profit association dedicated to helping small businesses get started, grow, and achieve their goals through education and mentorship. SCORE is supported by the U.S. Small Business Administration, and with a network of more than 13,000 volunteer mentors working in 364 chapters across the country, the association is able to deliver services at low or no cost. See SCORE, http://www.score.org (last visited May 15, 2012).
client’s knowledge and further hone their business acumen. While these discussions and referrals do not necessarily result in immediately billable time for the attorney, they make longevity of the client’s enterprise far more likely, benefiting the client, attorney, other professionals, and the community at large. If all goes well, the client’s income will grow, perhaps resulting in business expansion, an increase in assets, and a commensurately greater need for limited liability protection. Should the client opt for a limited liability entity, articles will probably need to be filed with the Secretary of State, and the usual startup documents drafted.\(^8\)

Attorneys with experience forming entities for clients not involved in the arts are well prepared to do so for artists. The majority of concerns that artists have and the provisions used to address those concerns are common to many other industries. The most notable additions will tend to focus on the ownership of artwork created during the life of the entity, and what happens to such works in the event of dissolution.\(^9\) The ownership question is often answered in one of two ways: either the artist holds title to the works and licenses their use to the entity, or the entity holds title to the works.\(^10\) From a legal perspective, ownership of copyright may be influenced by the question of liability, after examining the likelihood of a lawsuit.\(^11\) There are also financial considerations that an accountant can be helpful in addressing, such as the viability of licensing the use of works to the entity, resulting in royalty or flat-fee payments to the artist, whether in addition to or in lieu of other compensation.

2. Regulatory

As people variously engaged in providing services and selling

\(^8\) For corporations, such documents typically include bylaws, initial shareholder and board meeting notices and minutes, and perhaps a shareholder buy-sell agreement; limited liability companies typically entail an operating agreement and minutes of an initial member meeting, together with relevant notices or waivers of notice, and the like.

\(^9\) A common provision is that copyright in all works reverts to the author of the work upon dissolution of the entity.

\(^10\) In situations where the entity owns all copyrights, the question becomes whether such ownership is from inception of the work (as a work made for hire), or after their completion (as the subject of a copyright transfer agreement). Copyright ownership is discussed more fully in a separate section of this article. See discussion infra Part II.B.1.c.

\(^11\) For example, visual artists whose work integrates, borrows from, or is heavily influenced by the work of others are more likely to find themselves defending a complaint than artists who create works that are entirely original. In the former situation, ownership of copyright by a separate entity may be desirable.
goods, artists must often comply with the same regulations as many other businesses. Transactional attorneys can help artists interpret the applicable regulatory requirements, and secure permits and licenses as needed.

Common regulations at the local level involve zoning and business permits. As to zoning, artists who conduct their work in or from a personal residence, whether leased or owned, should be sure the creation and sale of their work takes place in geographic areas where such activities are allowed.\footnote{Zoning Laws for Home Based Businesses, U.S. SMALL BUSINESS ADMINISTRATION, http://www.sba.gov/content/zoning-laws-home-based-businesses (last visited May 25, 2012).} Looking at creation, the concerns are often greatest for sculptors, whose work may involve tools and materials that local government feel are better suited to an industrial rather than residential neighborhood.\footnote{\textit{Such as cutting, grinding, or welding equipment, a kiln or furnace, and molten glass or metal.}}

Sales of an artist’s work might also involve permits at the local and state level.\footnote{\textit{See infra Part II.B.4, discussing seller’s permits more fully in the section on First Amendment Concerns.}} Most cities and counties require individuals or entities that provide goods or services to hold the relevant permits and licenses, and pay any associated fees or taxes.\footnote{\textit{E.g., SAN DIEGO, CAL. MUN. CODE § 31.0121 (2004) (“No person shall engage in any business, trade, calling or occupation required to be taxed under the provisions of this Article until a certificate of payment is obtained.”) Such a certificate is available to anyone who pays the relevant fee.); S.F., CAL. POLICE CODE art. 13, § 869 (1982) (“[I]t shall be unlawful for any person to peddle goods, wares or merchandise, or any article, material or substance, of whatsoever kind . . . on the public streets or sidewalks of the City and County of San Francisco without first having obtained a permit from the Chief of Police and having paid the fees and been granted a license as required by law.”).}} One example is local registration of a fictitious business name, though artists will often be exempt from this requirement, as they conduct business under their actual name. Regardless of the name an artist does business under, the sale of goods will often require a business license, seller’s permit, or the like. Such documents may also be required at the state level.\footnote{\textit{See, e.g., CAL. REV. & TAX. CODE § 6226 (West 2012) (“Every retailer selling tangible personal property for storage, use, or other consumption in this State shall register with the board . . . .”).}}

3. \textit{Contracts}

Written agreements of all sorts are important for artists, just as they are for other businesspeople. Examples of agreements commonly

\begin{itemize}
\item \textit{\footnote{\textit{Such as cutting, grinding, or welding equipment, a kiln or furnace, and molten glass or metal.}}}
\item \textit{\footnote{\textit{See infra Part II.B.4, discussing seller’s permits more fully in the section on First Amendment Concerns.}}}
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\item \textit{\footnote{\textit{See, e.g., CAL. REV. & TAX. CODE § 6226 (West 2012) (“Every retailer selling tangible personal property for storage, use, or other consumption in this State shall register with the board . . . .”).}}}
\end{itemize}
needed by artists include those between the artist and individual customers, galleries, dealers, and others interested in purchasing, displaying, or further exploiting their work, such as coffee houses, bars, restaurants, hotels, creators of merchandise, and the like.

Attorneys can help artists by reviewing contracts already entered into, in addition to negotiating and drafting contracts to memorialize deals made in the future, just as they do with other clients. The sort of help an attorney can provide with contract interpretation, negotiation, and drafting is primarily based on knowledge of contract law in their jurisdiction, as applied to particular industries.

There are particular sorts of contracts unique to arts-oriented clientele, at least by name. Examples include gallery or dealer consignment agreements, art sales and leasing agreements, and art commission agreements. While these agreements are somewhat specialized, an attorney experienced with similar agreements in other industries will find the fundamentals to be largely the same. For such practitioners, adapting existing forms to the world of visual art is a straightforward matter, involving the use of readily available forms and practice guides.\(^\text{17}\)

For example, in a typical consignment arrangement, an artist provides a gallery or dealer with one or more works of art, on the understanding that the gallery or dealer will try to sell the works, splitting the proceeds with the artist. While the client will have likely thought through the issues of selling price and payment percentages, their attorney should highlight additional issues to consider, such as the duration of the consignment, responsibility for the cost of advertising and promoting the work for sale, whether such efforts will require making reproductions of the work in print or digital media.\(^\text{18}\)

\(^{17}\) See, e.g., 6 ALEXANDER LINDEY & ARTHUR LANDAU, LINDEY ON ENTERTAINMENT, PUBLISHING AND THE ARTS: AGREEMENTS AND THE LAW §§ 16.4–.23 (3d ed. 2012), available at Westlaw LINDEY3D (discussing the elements of art work contracts); 5-28 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 28.02 (2012), [hereinafter, NIMMER] (discussing the sale of art, including a form bill of sale); 1 RALPH E. LERNER & JUDITH BRESLER, ART LAW: THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS, AND ARTISTS Appendix 1-1 (3d ed. 2005), available at Westlaw PLIERF-ART (artist consignment with security agreement); TAD CRAWFORD, BUSINESS AND LEGAL FORMS FOR FINE ARTISTS (3d ed. 2005) (includes CD-ROM with forms); SUSAN M. BIELSTEIN, PERMISSIONS, A SURVIVAL GUIDE: BLUNT TALK ABOUT ART AS INTELLECTUAL PROPERTY (2005) (includes forms and sample permission log).

\(^{18}\) If so, the agreement may need to include a limited copyright license allowing reproduction and distribution of copies under 17 U.S.C. § 106 (2006). Copyright will be discussed more fully in a separate section of this article. See discussion infra Part II.B.1.
attribution of the work to the artist,\textsuperscript{19} the particular means of display,\textsuperscript{20} transportation, and insurance for loss or damage. Similar agreements can also be used with retail shops, bars, restaurants, hotels, and other places where an artist’s work might be displayed with an accompanying price tag.

In an art sale or leasing agreement, an artist either sells their work outright, or lends it to another for a fixed term and price, respectively. Here again, such agreements will be largely the same as sales or leasing agreements for other sorts of personal property,\textsuperscript{21} with additional provisions relating to copyright and moral rights.\textsuperscript{22}

In an art commission agreement, an artist creates a work at the behest of a particular customer, whether an individual collector, a local business, a branch of the government, or the like. Practitioners familiar with independent contractor agreements in other industries will have little difficulty adapting an existing form to an art commission agreement because the fundamentals are similar,\textsuperscript{23} with copyright and moral rights again figuring in as important, additional concerns.

Most contracts involving works of art will speak to the ownership of copyright in the relevant works, and permitted uses invoking copyright or moral rights, which stand to apply long after the work is sold.\textsuperscript{24} The particular needs depend largely on the scope of the agreement, and while copyright and moral rights can be very nuanced, the majority of arts-related contracts will involve a handful of fundamentals, as discussed elsewhere in this article. Still, there are areas where more specialized issues will arise, and practitioners should be aware of them.\textsuperscript{25}

\textsuperscript{19} As may be required by 17 U.S.C. § 106A(a)(1) (2006).
\textsuperscript{20} Id. § 106A(a)(2).
\textsuperscript{21} Typical clauses for sales agreements include payment amount and method, delivery, representations and warranties, and conditions to be met; leasing agreements often also include stipulations of the lease duration, renewal options, maintenance and repair provisions, insurance requirements, and a purchase option.
\textsuperscript{22} See infra Parts II.B.1-2 (discussing copyright and moral rights more fully in their respective sections).
\textsuperscript{23} Typical clauses for commission agreements include identifying the parties, defining the scope of services, setting the price and payment terms, specifying a delivery date, clarifying that the artist will provide all materials and tools, will work according to their own schedule, can hire assistants, will pay their own taxes, obtain their own insurance, and the like.
\textsuperscript{24} 17 U.S.C. § 106A(d)(1) (moral rights apply for the life of the author); id. § 302(a) (the term of copyright for works created after January 1, 1978 is the life of the author plus 70 years); id. § 202 (copyrights are distinct from title in the physical work itself, and are not automatically transferred when the physical work is sold).
\textsuperscript{25} See, e.g., id. § 106A(a)(3)(d) (discussing the rights of artists to prevent continued...
When it comes to particular agreements and provisions, including those briefly discussed above, there are numerous resources available for attorneys to consult, including treatises, practice guides, annotated forms, checklists, and guidelines.26

4. Landlord / Tenant

Like most other people who provide goods and services to others, artists need space to conduct their business. When starting out, many artists will create their work at home, then sell that work at street festivals and art fairs, in local shops, or on the Internet.27 For artists creating works in a rented home, language in the lease agreement explicitly allowing them to do so is often advisable. Likewise, artists who seek to sell their works from home should ensure the lease allows for such activity. While artists may feel it wise to conceal their business from their landlord, doing so could well violate provisions common in many residential lease agreements.28

As their business grows, artists may seek out commercial space to create or sell their works. Here again, the lease agreements will be very similar to those used with clientele in other industries.

5. Employment Status

Transactional attorneys can help artists address employment concerns by discussing the differences between working as an employee and an independent contractor, perhaps reviewing, negotiating, and drafting relevant agreements. In practice, most artists conduct their business as independent contractors: they control the manner and means of their work, provide their own facilities and materials, work for numerous clients at any given time, and set aside money for income tax purposes. Attorneys who have worked with independent contractors in other industries will already understand the majority of relevant issues. Of course, there are issues that will require specific knowledge of a particular client’s industry and particular laws not applicable in other industries, though that is the

26 See generally sources cited supra note 17.
28 See, e.g., Residential Lease Agreement, LEGAL FORMS, http://www.legalforms.name/lease-agreement-forms/residential-lease-agreement.pdf (last visited May 21, 2012) (“[t]enants shall use the premises for residential purposes only and for no other purpose . . . .”).
circumstance with clients working in many different fields. For attorneys working with visual artists, the top industry-specific concerns are likely to be copyright and moral rights. Each of those areas will be discussed more fully in a later section of this article, and here again, there are numerous resources that practitioners may rely upon for guidance.\textsuperscript{29}

6. Trademark

Transactional attorneys can help artists protect their trademark rights by explaining trademark rights generally, preparing and filing applications to register those rights with the United States Patent and Trademark Office,\textsuperscript{30} and maintaining registrations once issued.\textsuperscript{31} With a trademark registration in hand, artists can prevent others from providing similar goods and services under a confusingly similar name.\textsuperscript{32}

Artists generally create and sell their works under their personal name, which is capable of federal trademark protection.\textsuperscript{33} One potential wrinkle is that many artists sign their works using only their surname, and the use of a surname alone requires a showing that it is

\textsuperscript{29} See generally sources cited supra note 17.

\textsuperscript{30} Most states also provide trademark registrations on a statewide basis. See 3 THOMAS J. MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 22:10 (4th ed. 2012), available at Westlaw MCCARTHY (featuring a table showing each state affording trademark protection). This article will focus solely on the standards for federal registration, because in most states, registration does little more than establish that a given person was using a particular mark as of a certain date. \textit{Id.} § 22:1. In addition, “[i]n most states, courts have held that the state trademark common law and statutes on trademark law are to be given the same meaning and interpretation as the mainstream principles of common law and federal trademark law.” \textit{Id.}

\textsuperscript{31} Maintenance of a federal registration entails filing affidavits of continued use in the sixth and every tenth year. \textit{See} 15 U.S.C. § 1058(a) (2006); an application for renewal of the registration is also required every tenth year. \textit{See} 15 U.S.C. § 1059(a).

\textsuperscript{32} \textit{Id.} § 1125.

\textsuperscript{33} Federal trademark law provides that where a personal name identifying a particular person is used as a trademark, the consent of that person is required. \textit{See} id. § 1052(c). Attorneys filing an application to register trademark rights on behalf of an artist must be sure to obtain the consent of the applicant in order to secure a registration. \textit{See} TMEP § 1206.04(b) (8th ed. Oct. 2011) (stating that “[c]onsent may be presumed only where the individual whose name or likeness appears in the mark personally signs the application. If the application is signed by an authorized signatory, consent to register the name or likeness must be obtained from the individual. This is true even where the name or likeness that appears in the mark is that of the individual applicant.”

\textsuperscript{29} See generally sources cited supra note 17.
At common law, trademark rights apply to personal names when the name has been used long enough to develop what is known in trademark parlance as “secondary meaning.” In sum, the public must come to recognize the name as indicating the sole source of particular goods or services.

As a general rule, the United States Patent and Trademark Office will presume secondary meaning on a showing that a personal name has been used in connection with offering particular goods or services for five years. Additional evidence of secondary meaning is often helpful, and can include: direct consumer testimony; consumer surveys; exclusivity, length, and manner of using the mark; the amount and manner of advertising; the amount of sales and number of customers; an established place in the market; and proof of intentional copying.

However, as noted above, the user of a surname alone must also show that the name is not “primarily merely a surname,” so the focus is on the primary significance of the name to the purchasing public, not the secondary significance. Government attorneys examining an application for trademark registration in the United States Patent and Trademark Office rely on the following five factors in making this determination: (1) whether the surname is rare; (2) whether the term is the surname of anyone connected with the applicant; (3) whether the term has any recognized meaning other than as a surname; (4) whether it has the "look and feel" of a surname; and (5) whether the stylization of lettering is distinctive enough to create a separate commercial impression.

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35 McCarthy, supra note 30, § 13:1 (“The basic rules pertaining to the protection of personal names as marks are these: (1) Proof of secondary meaning is required for protection. (2) Even where a likelihood of confusion is shown, the junior user who uses his own personal name as a mark will receive preferential judicial treatment in the framing of an injunction.”) (citations omitted).
36 Id. at § 13:2 (“Personal names are one of the classes of marks that do not have the status of a protectable mark upon mere adoption and use. They acquire legally protectable status only after they have had such an impact upon a substantial part of the buying public as to have acquired ‘secondary meaning.’ That is, the public has come to recognize the personal name as a symbol that identifies and distinguishes the goods or services of only one seller.”) (citation omitted).
38 Echo Travel, Inc. v. Travel Assocs, Inc., 870 F.2d 1264, 1267 (7th Cir. 1989) (citations omitted).
40 TMEP § 1211.01 (8th ed. 2011).
41 Id. (citations omitted).
Another caveat with regard to using a personal name as a trademark is that courts will often make allowances for another individual who shares and conducts business under the same name.\textsuperscript{42} That is, even where a likelihood of confusion is established, the courts may give preferential treatment to the newcomer when crafting an injunction.\textsuperscript{43}

\section*{B. Legal Concerns More Particular to Creative Clientele}

\subsection*{1. Copyright}

Transactional attorneys can help artists understand copyright law as applied to the business of creating and selling works of art, with an emphasis on registration of rights and drafting contractual provisions. In addressing these topics, it will be helpful to first explain how a few copyright fundamentals apply to visual artists and their work.

\subsubsection*{a. Subject Matter of Copyright}

Works created by visual artists are most often within the subject matter of federal copyright law, as “pictorial, graphic, and sculptural works.”\textsuperscript{44}

To qualify for copyright protection, such works must be (1) original and (2) fixed in a tangible medium of expression.\textsuperscript{45} First, a work is “original” when it is the product of a person’s own intellect and creative efforts, as opposed to being copied from another, already existing work.\textsuperscript{46} Second, a work is fixed in a tangible medium of expression when it is “sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration.”\textsuperscript{47}

Where a visual artist sets about drawing, painting, photographing, or sculpting something from their mind or the world, without reference to another, similar work already created by someone else, the result will typically satisfy the originality and fixation requirements for copyright protection. The average still life or landscape painting, for

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{42} \cite{McCarthy, supra note 30, § 13:2.}
\item\textsuperscript{43} Id.
\item\textsuperscript{44} 17 U.S.C. § 101 (2006) (defining “pictorial, graphic, and sculptural works” as including “two-dimensional and three-dimensional works of fine, graphic, and applied art, photographs, prints and art reproductions, maps, globes, charts, diagrams, models, and technical drawings, including architectural plans.”).
\item\textsuperscript{45} Id. § 102.
\item\textsuperscript{47} 17 U.S.C. § 101.
\end{enumerate}
\end{footnotesize}
example, is the product of the artist’s perception and hand, making it an original work. When assessing creativity, the courts look for a bare minimum, and will steer clear of making any determinations based on aesthetic beauty or lack thereof.\(^{48}\) Thus, and by example, it does not matter how well or poorly executed a given painting is. Finally, the fact that such a painting is on paper, board, canvas, or some other substrate will constitute being “fixed in a tangible medium,” as it can be perceived (e.g., by looking at it), reproduced (e.g., by photographing or scanning it), or otherwise communicated (e.g., by showing it to others with a webcam).

The originality analysis becomes more complicated when works borrow from or combine existing, copyrighted works. In this context, permissions from the authors of existing works are strongly advised: the defense of fair use,\(^{49}\) while tempting when viewed from the ivory tower, involves a complicated,\(^{50}\) ad hoc analysis,\(^{51}\) and is expensive to assert.\(^{52}\)

The key questions involve the purpose and character of the use, the nature of the original work, the amount and substantiality of what was borrowed, and the impact on the market for the original.\(^{53}\) From a

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\(^{48}\) See Bleistein v. Donaldson Lithographing Co., 188 U.S. 220, 251–252 (1903) (“It would be a dangerous undertaking for persons trained only to the law to constitute themselves final judges of the worth of pictorial illustrations, outside of the narrowest and most obvious limits. At the one extreme some works of genius would be sure to miss appreciation. Their very novelty would make them repulsive until the public had learned the new language in which their author spoke. It may be more than doubted, for instance, whether the etchings of Goya or the paintings of Manet would have been sure of protection when seen for the first time. At the other end, copyright would be denied to pictures which appealed to a public less educated than the judge. Yet if they command the interest of any public, they have a commercial value – it would be bold to say that they have not an aesthetic and educational value – and the taste of any public is not to be treated with contempt. It is an ultimate fact for the moment, whatever may be out hopes for a change.”).


\(^{50}\) See NIMMER, supra note 17 at § 13.05 (“One case calls this obscure doctrine of fair use ‘the most troublesome in the whole law of copyright.’ [citing Dellar v. Samuel Goldwyn, Inc., 104 F.2d 661 (2d Cir. 1939) (per curiam)]. Another notes that the ‘doctrine is entirely equitable and is so flexible as virtually to defy definition.’ [citing Time, Inc. v. Bernard Geis Assocs., 293 F. Supp. 130 (S.D.N.Y. 1968)].”).

\(^{51}\) See Campbell v. Acuff-Rose Music, 510 U.S. 569, 581 (1994) (clarifying that every fair use claim “has to work its way through the relevant factors, and be judged case by case, in light of the ends of the copyright law.”).

\(^{52}\) Informal inquiries of copyright practitioners in 2012 ranged between $200,000 and $500,000 to litigate such a defense in a complex case, and $25,000 to $50,000 in a simple one.

transactional perspective, artists can be counseled to entirely avoid the difficulty and expense of a fair use analysis by obtaining written permission to use a pre-existing work. Such permissions involve a copyright license, discussed in more detail below.

b. Rights and Registration

The owner of copyright in a given work has the exclusive rights to reproduce, distribute, display, and prepare derivatives of that work. Any or all of these rights may be licensed or transferred to a third party, as discussed more fully in the next section.

It is important to understand that while copyright law requires fixation for protection, the rights described above are afforded to the owner of the intangible, underlying work, not the person who owns a particular, physical embodiment of that work. Thus, where a visual artist creates and sells a painting or sculpture, the purchaser of the physical piece does not own any copyright interest by virtue of having purchased the piece. That said, purchasing a physical piece of artwork does limit the reach of copyright in a couple of important ways.

The most salient limitations on an artist’s copyright stem from the so-called “first sale doctrine.” The first limitation goes to the right of distribution, as the owner of a lawfully acquired physical copy of a work of visual art is allowed to lend, lease, or resell that particular copy of the work to another person.

The second limitation goes to the right of display, as the owner of a lawfully acquired piece of art, whether a painting, photograph, sculpture, or the like, is entitled to publicly display that piece of art without permission from the copyright owner. This public display limitation is itself limited, however, to the physical purchased piece or a single projection of it, and only to people who are present where the

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53 Id. § 106(1), (2), (3), (5).
54 Id. (stating that the owner of copyright has the exclusive right “to authorize” reproduction, distribution, display, or the creation of derivative works).
55 Id. § 201(d).
56 Id. § 102.
57 Id. § 202 (stating that “Ownership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied.”).
58 Id. (stating that “Transfer of ownership of any material object . . . does not of itself convey any rights in the copyrighted work embodied in the object . . . “).
59 See id. § 109(a).
60 Id. § 109(c).
purchased, physical piece is located.\textsuperscript{61} These limitations serve to resolve natural tensions between copyright law and traditional property rights. Without them, purchasers of art would not be able to do things they are used to being able to do with other purchased goods, which could impact the market for sales of art. Such an impact could, in turn, result in fewer works of art being created, which would be counter to the core purpose of copyright law: encouraging the proliferation of creative works in order to facilitate a culturally rich society.\textsuperscript{62}

Transactional attorneys can help artists a great deal by drafting language to include in receipts for the sale of their works, clarifying the rights of the purchaser and those retained by the artist.

As to copyright registration, works created after January 1, 1978 need not be registered with the Copyright Office to have copyright protection,\textsuperscript{63} but registration does have significant benefits. In sum, registration puts the public on notice that the artist is claiming copyright in their work, allows access to federal courts in the event of infringement,\textsuperscript{64} creates a rebuttable presumption of ownership and validity,\textsuperscript{65} and if done within three months after making the work widely available to the public, allows relief in the form of statutory damages and attorneys fees.\textsuperscript{66}

Copyright registration should be applied for as soon as a work is created, and if possible, no later than three months after the work is made available to the public. While such immediate registration is not

\begin{itemize}
\item \textsuperscript{61} Id.
\item \textsuperscript{62} See Twentieth Century Music Corp., v. Aiken, 422 U.S. 151, 156 (1975) (stating that “Creative work is to be encouraged and rewarded, but private motivation must ultimately serve the cause of promoting broad public availability to literature, music, and the other arts. The immediate effect of our copyright law is to secure a fair return for an ‘author’s’ creative labor. But the ultimate aim is, by this incentive, to stimulate artistic creativity for the general public good.”).
\item \textsuperscript{63} 17 U.S.C. § 408(a).
\item \textsuperscript{64} Id. § 411(a).
\item \textsuperscript{65} Id. § 410(c) (“In any judicial proceedings the certificate of a registration made before or within five years after first publication of the work shall constitute prima facie evidence of the validity of the copyright and of the facts stated in the certificate. The evidentiary weight to be accorded the certificate of a registration made thereafter shall be within the discretion of the court.”). The courts may, in their discretion, extend the presumption beyond the five year period set forth in the Copyright Act, or reduce it. See NIMMER, supra note 17, at § 12.11(A)(1).
\item \textsuperscript{66} 17 U.S.C. § 412. On the issue of damages, plaintiffs who have applied for registration within three months after making the work widely available to the public are entitled to claim either their losses and defendant’s profits, or statutory damages. Id. § 504(a). As losses and profits are often nominal, plaintiffs frequently opt for statutory damages, which range from $200 to $150,000 per infringed article, depending largely on the knowledge and intent of the defendant. See id. § 504(c).
\end{itemize}
required for access to federal courts, registering more than three months after making the work available to the public means the artist cannot claim statutory damages or attorneys fees in an infringement action. Finally, civil actions for copyright infringement are subject to the relevant statute of limitations, currently set at three years after a claim accrues.

Applying for copyright registration is very straightforward and relatively inexpensive. There is a printable form for works of visual art available on the Copyright Office website, and an online system for electronic filing. For entirely original works by a living artist, the information required includes: the name of the artist, year of birth, country of citizenship, title of the work, artistic medium, contact information for the copyright owner (if different than the artist), contact information for a correspondent the Copyright Office may contact, and an address where a resulting certificate of registration should be sent. The applicant will also need to include two copies of the work in question and pay the requisite application processing fee, which should be no more than $35 in most circumstances.

In addition, for artists who have created a large number of works, it is possible to register any number of unpublished works as a collection, all for a single application processing fee.

As previously discussed, artists who create works based upon or incorporating the works of others need to be particularly aware of copyright laws, as they may need to seek permission for such use.

c. Ownership of Copyright

Assuming the work of a given visual artist falls within the subject

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67 Id. § 411(a).
68 Id. § 412.
69 Id. § 507(b).
72 See, e.g., supra note 70.
matter of copyright, the artist will typically be the copyright owner from the moment of creation, though it is possible to have joint ownership where another person is involved in creating the work, or ownership entirely by a third party, where the work is “made for hire.”

For jointly owned works, each owner shares equally in the resulting copyright. Further, joint owners cannot be liable to one another for infringement, and so are equally entitled to independently use the work themselves, or license the work to third parties on a non-exclusive basis, though any profits earned must be apportioned among all joint owners. In addition, each joint owner is entitled to transfer their ownership interest in the copyright, without consent of the other joint owner. Consent of all joint owners is, however, required for the grant of an exclusive license to a third party.

Transactional attorneys can encourage joint owners to have an administration agreement, whereby the consent of all joint authors for any sort of license or transfer may be required, depending on their preference. Such an agreement is a particularly good idea for exclusive licensing of jointly owned works, and may be insisted upon by a third party licensee.

Rather than being owned by an artist, copyright in a work of art may be owned entirely by a third party from the moment of creation, where the work is “made for hire.” Under the Copyright Act, there are two ways a work is made for hire: first, where the work is created by an employee, within the scope of their employment; or second, where the work has been specially ordered or commissioned for use as a contribution to a collective work, as a part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer material for a test, or as an atlas, but only if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire. Importantly, though, the parties in either

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76 Id. Joint works involve more than one author, each having the intent to merge their creative efforts into a single work. Id. § 101.
77 Id. § 201(b).
78 See id. § 201(a); Richlin v. Metro-Goldwyn-Mayer Pictures, Inc., 531 F.3d 962, 968 (9th Cir. 2008).
79 Oddo v. Ries, 743 F.2d 630, 633 (9th Cir. 1984).
80 Davis v. Blige, 505 F.3d 90, 98 (2d Cir. 2007).
81 Id. at 100 n.10.
82 17 U.S.C. § 201(b).
83 Id. § 101.
circumstance may agree in writing to another form of ownership.  

Looking first at employment, the courts typically use multi-factor tests from agency law to determine whether an artist is working as an employee or an independent contractor, and if found to be an employee, to determine whether the work was within the scope of employment. Keeping these tests in mind will assist a transactional attorney asked to negotiate or draft an agreement for a visual artist working for a third party. By drafting contractual provisions that speak directly to control, supervision, tools, materials, taxation, and the like, the attorney can help ensure that a statement of copyright ownership elsewhere in the agreement is properly supported.

Turning to agreements for the creation of works to become a part of a statutory category set out above, transactional attorneys can again help ensure the wishes of the parties are supported by an appropriate description of the works and statement of copyright ownership.

In every contract involving the creation of copyrightable subject matter, it is crucial to clearly identify the owner of copyright and the basis for their ownership. Identifying the basis for copyright ownership will help to prevent problems, including a potentially overreaching use of the work made for hire doctrine. In particular, practitioners negotiating a work made for hire agreement should ensure that the artist’s working relationship will satisfy the relevant agency test factors, or that the work falls within one of the nine statutory categories.

Finally, attorneys should be sure to research applicable state laws, as there may be additional rights and responsibilities that flow from

84 Id. § 201(b).
85 Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 751-52 (1989) ("Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party . . . [n]o one of these factors is determinative.") (citations omitted); but see infra note 88 (identifying state laws defining "employee" and "employer" for purposes of the work made for hire doctrine).
86 Reid, 490 U.S. at 740; City of Newark v. Beasley, 883 F. Supp. 3, 7 (D.N.J. 1995) (quoting the KESTATEMENT (SECOND) OF AGENCY § 228 (1958) for the proposition that a work is within the scope of employment where: it is of the kind of work the employee is employed to perform; creation of the work occurs substantially within authorized work hours and space; and such creation is actuated, at least in part, by a purpose to serve the employer).
reliance on a work made for hire provision to establish third party copyright ownership.\textsuperscript{87}

d. Transfer and License

The rights to reproduce, distribute, adapt, or display a particular work may be transferred\textsuperscript{88} or licensed\textsuperscript{89} to others. Any transfer of copyrights must be in a signed writing,\textsuperscript{90} though a license may be oral. Nevertheless, artists are well advised to memorialize all transactions involving their copyrights and third parties in writing.

With an understanding of the particular copyrights at issue (such as reproduction, distribution, display, or the creation of derivative works), basic contract drafting principles, and relevant industry practices, copyright transfer and license agreements are a straightforward staple for transactional attorneys representing visual artists. A typical transfer agreement will identify the parties, the work, the particular rights being transferred or licensed, and the payment amount and terms. A license agreement should also delineate the scope of media and technology allowed, license duration and territory, and clarify issues of ownership, exclusivity,\textsuperscript{91} and revocability.

\textsuperscript{87} E.g., CAL. LAB. CODE § 3351.5(c) (West 2012) (defining an “employee” as: “[a]ny person while engaged by contract for the creation of a specially ordered or commissioned work of authorship in which the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire, as defined in Section 101 of Title 17 of the United States Code, and the ordering or commissioning party obtains ownership of all the rights comprised in the copyright in the work.”); CAL. UNEMP. INS. CODE § 686 (defining an “employer” as “any person contracting for the creation of a specially ordered or commissioned work of authorship when the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire, as defined in Section 101 of Title 17 of the United States Code, and the ordering or commissioning party obtains ownership of all of the rights comprised in the copyright in the work. The ordering or commissioning party shall be the employer of the author of the work for the purposes of this part.”). Thus, reliance on the work made for hire language to establish copyright ownership by the commissioning party in an independent contractor agreement can automatically render the commissioned party an employee for purposes of unemployment insurance and other privileges of employment under California law.

\textsuperscript{88} 17 U.S.C. § 201(d)(1).

\textsuperscript{89} See id. § 106 (“[T]he owner of copyright under this title has the exclusive rights . . . to authorize any of the following . . . .”) (emphasis added).

\textsuperscript{90} Id. § 204(a).

\textsuperscript{91} Notably, an exclusive copyright license is considered a transfer of ownership. Id. § 101 (“A ‘transfer of copyright ownership’ is an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license.”)

\textit{continued . . .}
Whether a transfer or license, the attorney may also include provisions common in other agreements.\textsuperscript{92}

In order to avoid pitfalls, practitioners with experience drafting contracts in other industries would be well served to review some of the numerous treatises or practice guides devoted to copyright law\textsuperscript{93} or the visual arts.\textsuperscript{94}

2. Moral Rights

Codified within the Copyright Act is the Visual Artists Rights Act of 1990 (known as “VARA”), providing the additional rights of attribution and integrity to visual artists.\textsuperscript{95} While several states promulgated similar legislation prior to VARA,\textsuperscript{96} this article will focus solely on federal law.

Only paintings, drawings, prints, sculptures, and still photographic images can receive protection under VARA.\textsuperscript{97} To receive protection, such a work must exist in fewer than 200 copies, each of which is consecutively numbered and signed by the artist.\textsuperscript{98} Finally, if the work in question is a photograph, it must also have been created for exhibition purposes.\textsuperscript{99}

Assuming the statutory definition is met, the artist who created the relevant work holds the rights of attribution and integrity.\textsuperscript{100} Put

\begin{itemize}
\item (emphasis added).
\end{itemize}

\textsuperscript{92} E.g., representations and warranties, indemnification, assignment, insurance, remedies for breach, integration, severability, choice of venue, and dispute resolution.
\textsuperscript{93} E.g., Lindey & Landau, supra note 17.
\textsuperscript{94} E.g., Lerner & Bresler, supra note 17.
\textsuperscript{95} 17 U.S.C. § 106A.
\textsuperscript{96} States with statutory moral rights for artists include: California, Connecticut, Georgia, Louisiana, Maine, Massachusetts, Montana, Nevada, New Jersey, New Mexico, New York, Pennsylvania, Rhode Island, and Utah.
\textsuperscript{97} 17 U.S.C. § 101. The statute further clarifies that “[a] work of visual art does not include—
\begin{itemize}
\item (A)(i) any poster, map, globe, chart, technical drawing, diagram, model, applied art, motion picture or other audiovisual work, book, magazine, newspaper, periodical, data base, electronic information service, electronic publication, or similar publication;
\item (ii) any merchandising item or advertising, promotional, descriptive, covering, or packaging material or container;
\item (iii) any portion or part of any item described in clause (i) or (ii);
\item (B) any work made for hire; or
\item (C) any work not subject to copyright protection under this title.”
\end{itemize}
\textsuperscript{98} Id.
\textsuperscript{99} Id.
\textsuperscript{100} Id. § 106A.
plainly, the right of attribution gives an artist the right to claim authorship of works they created,\textsuperscript{101} and to prevent the use of their name in connection with any works the artist did not create.\textsuperscript{102} In addition, the artist has the right to prevent the use of their name in connection with their work “in the event of a distortion, mutilation, or other modification of the work which would be prejudicial to his or her honor or reputation . . . .”\textsuperscript{103}

The right of integrity allows an artist to prevent the intentional distortion, mutilation, or other modification of his or her work.\textsuperscript{104} It further allows an artist to prevent the destruction of their works, when such works have achieved “recognized stature,”\textsuperscript{105} presumably without regard to the artist’s honor or reputation.

The rights of attribution and integrity are called “moral rights,” in homage to their origins under the body of French law known as “droit moral.”\textsuperscript{106} These rights are particular to the artist, not the copyright holder.\textsuperscript{107} Thus, they remain with an artist after the sale or license of their work—or any related copyrights—to a third party.\textsuperscript{108}

While moral rights provide protection beyond traditional copyright, they are subject to exceptions. For example, the right of integrity does not extend to changes in the work resulting from the passage of time, the nature of the medium or materials, conservation efforts, or public presentation.\textsuperscript{109} Furthermore, when a work of visual art is incorporated into or made a part of a building, and the work can be removed without alteration or harm, it may be removed by the building owner only after providing the artist with 90 days notice and opportunity to remove the work themselves.\textsuperscript{110}

Importantly, the rights of attribution and integrity may be waived in a written agreement.\textsuperscript{111} This helps resolve tension between the expectations of those who purchase property, whether tangible or intellectual, and rights that are otherwise personal to the artist. Transactional attorneys can help artists understand their moral rights, and may wish to include language in sales receipts, license and transfer agreements, and other documents, making the artist’s

\textsuperscript{101} Id. § 106A(a)(1)(A).
\textsuperscript{102} Id. § 106A(a)(1)(B).
\textsuperscript{103} Id. § 106A(a)(2).
\textsuperscript{104} Id. § 106A(a)(3)(A).
\textsuperscript{105} Id. § 106A(a)(3)(B).
\textsuperscript{106} Carter v. Helmsley-Spear, Inc., 71 F.3d 77, 81 (2d Cir. 1995).
\textsuperscript{108} Id. § 106A(e)(2).
\textsuperscript{109} Id. § 106A(c).
\textsuperscript{110} Id. § 113(d)(2)(B).
\textsuperscript{111} Id. §§ 113(d)(1)(B), 106A(e)(1)-(2).
customers and clients aware of the applicable rights and responsibilities.

3. Privacy and Publicity Rights

Rights of privacy and publicity are creatures of state law, and though many have been codified, treatment of them is inconsistent enough to warrant calls from scholars for a federal standard. As they stand, however, these state rights typically protect individuals from the use of their name, image, or likeness in certain circumstances. In some states, such rights pass to the heirs of an individual after death. Artists need to be aware of privacy and publicity rights when creating works that involve the name, image, likeness, or voice of an actual person, as the artist may be liable for damages or injunctive relief.

While there are statutory exceptions for certain uses, and the First Amendment may provide a defense, transactional attorneys can help artists avoid the hassle and expense of litigation by drafting model releases for signature by people featured in works of art, or the heirs of such people.

4. First Amendment

Works of visual art are natural candidates for First Amendment protection and often constitute protectable expression. As a result, courts have found the First Amendment broadly applicable to visual art, though not in all forms or circumstances. In particular,

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transactional attorneys can help visual artists address First Amendment concerns in the context of certain public displays and sales of visual art.

First, the removal of publicly displayed visual art has resulted in First Amendment claims, even where the display occurred under an appropriate permit or agreement. In each case, it was not until the work was unveiled for the public that removal was sought. Transactional attorneys advising visual artists can help reduce the likelihood of such a dispute by encouraging their clients to provide draft versions of the proposed artwork before committing to a final piece. To formalize that approach, provisions may be drafted into commission agreements giving approval rights to the commissioning party.

Second, artists who seek to sell their work in public may have a First Amendment right to do so without a permit, depending on whether and to what extent the work is expressive, the wording of the permitting requirement, and the process by which permits are issued. In short, the analysis of each prong is ad hoc, and idea or concept to those who view it, and as such are entitled to full First Amendment protection” while “the crafts of the jeweler, the potter and the silversmith . . . may at times have expressive content.”); Mastrovincenzo v. City of N.Y., 435 F.3d 78, 85 (2d Cir. 2006) (noting that “the Bery Court foreclosed the categorical placement of ‘all visual expression’ outside the reach of the First Amendment . . . .”); Roth v. U.S., 354 U.S. 476, 483 (1957) (reaffirming that neither obscenity nor libel are protected under the First Amendment). Specific to obscenity, the law has changed much over time, with courts and a number of state legislatures variously enlarging and contracting the scope of protection for visual art over time. See Lerner & Bresler, supra note 17, at 971-90.


122 The relevant governmental authorities may variously require a permit, license, or business tax certificate for sales within their jurisdiction. For brevity, this article will refer to each as a “permit.”

123 Mastrovincenzo, 435 F.3d at 95 (differentiating “a small set of presumptively expressive items - such as paintings, photographs, prints and sculpture - from other, potentially expressive items [the court] characterized as ‘crafts’ - such as those of the jeweler, the potter, and the silversmith” on the basis of the “dominant purpose” served by a particular item). Insofar as the item has a utilitarian purpose, that will be weighed against expressive characteristics. See id.

124 Bery, 97 F.3d at 698-99 (concluding that a city license requirement for the sale of visual art was an unconstitutional infringement of the artist’s First Amendment rights, in part because the sale of written material, such as newspapers, books, and other written matter, did not require such a license).

125 White v. City of Sparks, 341 F. Supp. 2d 1129, 1143-1144 (D. Nev. 2004) (concluding that a city license requirement for the sale of visual art was an
transactional attorneys should be prepared to conduct a brief analysis when counseling visual artists on the question of whether to obtain a permit to sell their work in public. Assuming a given artist’s work is entirely expressive, any permitting scheme controlling the time, place, and manner of selling that work must not be based on the content of the work, must be narrowly tailored to serve a significant governmental interest, and must leave open ample alternatives for communication.\textsuperscript{127} Of course, city attorneys across the country are well aware of these requirements, and draft all-encompassing permit requirements for selling goods in public places that should easily survive a First Amendment challenge.\textsuperscript{128} As a result, attorneys will often counsel artists to apply for the relevant permit or license before selling their work in public.

5. \textit{Certificates of Authenticity}

California and New York require a certificate of authenticity when art dealers sell a work of fine art that has been produced in multiples.\textsuperscript{129} The relevant California statute also extends that requirement to artists.\textsuperscript{130} Both states entail the disclosure of certain information to the purchaser, such as the name of the artist and title of the work, the artistic medium or process, the number of multiples in the edition, the existence of other editions, the date of creation, unconstitutional infringement of the artist’s First Amendment rights, in part because works of art intended for sale required the approval of a three-member panel, who would determine whether the works to be sold conveyed “a religious, political, philosophical or ideological ‘message.’”\textsuperscript{126}

\textsuperscript{126} See, e.g., \textit{Mastrovincenzo}, 435 F.3d at 95-96 (asserting “confidence that district courts will prove capable of making such determinations in much the same way that we distinguished between categories of goods in \textit{Bery}, and in the way that courts have dealt on a case-by-case basis with difficult line-drawing problems in other First Amendment contexts.”).


\textsuperscript{128} E.g., \textit{SAN DIEGO, CAL. MUN. CODE} § 31.0121 (“No person shall engage in any business, trade, calling or occupation required to be taxed under the provisions of this Article until a certificate of payment is obtained.”) Such a certificate is available to anyone who pays the relevant fee.); S.F., \textit{CAL. POLICE CODE} art. 13, § 869 (“[I]t shall be unlawful for any person to peddle goods, wares or merchandise, or any article, material or substance, of whatsoever kind . . . on the public streets and sidewalks of the City and County of San Francisco without first having obtained a permit from the Chief of Police and having paid the fees and been granted a license as required by law.”).

\textsuperscript{129} \textit{CAL. CIV. CODE} § 1742 (West 2012); \textit{N.Y. ART & CULT. AFF.} § 11.01-13.01 (McKinney 2012).

\textsuperscript{130} \textit{CAL. CIV. CODE} § 1742(e).
whether the master has been destroyed, whether the artist is deceased, and the like.\textsuperscript{131}

While not required in every state, certificates of authenticity can be helpful for artists across the country. Purchasers of art may view such certificates as both legitimizing their purchase and maintaining the value of it by limiting future reproductions. If an artist who is not required to provide a certificate of authenticity perceives value in having such a document, their transactional attorney can easily help draft one. The relevant statutes are easy to follow or use as a guide, and examples are widely available on the Internet.\textsuperscript{132}

III. ARTISTS AND ATTORNEYS: WORKING TOGETHER

Artists are some of the most interesting clients an attorney can have. Artists are invariably focused on their creative process and output, actively contributing to the richness of our lives in a very tangible sense. That energy can be infectious, and attorneys will doubtless find parallels between their clients’ approach to their work, and the attorney’s own approach to the art of lawyering. Meanwhile, artists can learn a great deal about being a businessperson from working with their attorney.

Many artists simply wind up being businesspeople, as their hobby becomes their means of earning a living. They often view their work product as the core of their success, and rightfully so. Their business acumen develops with time and experience, just as with any other client. In working with an attorney, artists may be forming one of their first professional relationships. Taking the time to educate artists on how to be clients can help them build solid relationships with agents, dealers, accountants, investors, bank managers, and other professionals.

From a monetary perspective, artists often have little in the way of financial resources, especially early in their careers. As a result, they simply lack the means to hire professionals to manage their business and legal affairs. From an attorney’s perspective, this is particularly problematic in light of the relatively large number of legal issues and potential pitfalls an artist faces. The good news is that most transactional attorneys can begin representing artists in an efficient, cost-effective manner. Assuming the attorney has a background in

\textsuperscript{131} CAL. CIV. CODE § 1744; N.Y. ART & CULT. AFF. § 15.03 (for works other than sculpture); see also N.Y. CLS ART & CULT. AFF. § 15.10 (for works of sculpture).

transactional practice and a collection of forms developed while representing clients from other industries, access to just a few of the many art-specific legal resources available today should be all that is necessary to achieve the requisite competence for effective representation.

Once competent, there are many ways attorneys can help economically disadvantaged artists receive the legal assistance they need. For example, attorneys can offer free consultations and lower billing rates for artists, whether on an hourly or flat-fee basis. Attorneys can also present workshops and seminars at local art schools and arts-focused non-profit organizations, write articles for publication in newsletters and blogs read by artists, join attorney referral services that specifically target visual artists, and mentor students providing assistance in arts-focused law school clinics.

IV. CONCLUSION

Whether they know it or not, visual artists living and working in communities across the country face a number of legal issues, and transactional attorneys with existing practices can help. By thinking

133 Such forms include corporate bylaws, limited liability operating agreements, sales and leasing agreements, independent contractor agreements, and the like.
134 See supra note 17.
creatively about the relationship, attorneys can help artists address their needs, facilitating the development of not only the artist’s business, but the attorney’s own practice, and the communities they live and work within.
TAking Down Trademark Bullying: Sketching the Contours of a Trademark Notice and Takedown Statute

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I. INTRODUCTION

“We have removed or disabled access to the following content that you have posted on Facebook because we received a notice from a third party that the content infringes or otherwise violates their rights: [insert your Facebook page name here].” For many college or high school students, such a message might result in social angst at losing access to a primary means of communication. In an increasingly socially-interconnected business world, however, a business receiving such a message stands to lose much more: “friends,” “likes,” connections, customers, reputation, and ultimately, revenue. The means by which access to a business’s online content may be curtailed by online intermediaries (“OIs”)1 vary immensely, but often arise out of an alleged breach of a third party’s copyrights or trademarks.2 While the Digital Millennium Copyright Act (“DMCA”) 3 provides for uniform, non-litigation mechanisms for pursuit and defense of claims of copyright infringement on the internet through a structured “notice and takedown” system (“NTS”), no such mechanism exists for trademark infringement. Businesses attempting to enforce trademarks or defend against alleged infringement are left at the whim of OIs’ varying policies and procedures in a “race to the bottom” whereby OIs seek (perhaps arbitrarily) to protect themselves from being construed as trademark infringers or being held liable on a contributory basis for user infringement,4 all without regard for the merits (or lack thereof) underlying the assertion or defense of trademark rights by users and third parties.

The following four fictional scenarios (based on actual events) demonstrate the wide-ranging effects of OIs’ responses to trademark disputes on the Internet:

1 By “online intermediaries,” we mean internet service providers (ISPs) and other providers/hosts of websites ranging from social media (e.g., Facebook) to auction (e.g., eBay) to search engines (e.g., Google) and others.

2 “Trademark” as used in this Essay means any trademark, service mark, trade dress, or other logo, symbol, etc. used as an indicator of the source of goods and/or services.


1. Oakley notices that counterfeit sunglasses bearing the OAKLEY logo are being sold by an eBay reseller. Oakley notifies eBay of the infringement and eBay, applying its policies, shuts down the reseller’s site selling the counterfeit sunglasses, disabling the reseller’s user account.\(^5\)

2. Small Business 1 (“SB1”), which holds a service mark registration for GREEN in connection with services described as “garden design,” competes with Small Business 2 (“SB2”), which holds a trademark registration for GREENBOX in connection with goods described as “raised garden planters.” SB1 notifies SB2’s ISP that SB2’s use of GREENBOX infringes upon SB1’s service mark. The ISP, applying its policies, shuts down SB2’s webpage.\(^6\)

3. Joe Smith, upset about buying an iPhone 4S for full price on the eve of the launch of the iPhone 5, frivolously and falsely notifies Facebook that Apple’s Facebook page is infringing his non-existent trademarks. Facebook, applying its policies, shuts down Apple’s Facebook page, disabling its user account, and deleting all connections to “friends” and users who “like” Apple.\(^7\)

4. High Fashion Designer (“HFD”) notices that a high number of its handbags bearing its trademarks are being legitimately resold in the secondary market by resellers. HFD, in order to curtail such resale and augment direct sales, notifies eBay, and eBay, applying its policies, shuts down each reseller’s site, disabling each of their user accounts.\(^8\)

This Essay uses the above scenarios to illustrate the breadth of potential disputes that should be mediated by an effective trademark NTS. In addition, an examination of several threshold points

\(^5\) See generally Tiffany Inc. v. eBay, Inc., 600 F.3d 93 (2d Cir. 2010) (describing the counterfeit sale of jewelry on eBay).


\(^7\) See Brad Sams, Neowin’s Facebook Page Taken Offline—We’re Back! (Again), NEOWIN.NET (Apr. 20, 2011, 3:10 PM), http://www.neowin.net/news/neowin039s-facebook-page-taken-offline-by-bogus-complaint.

\(^8\) See, e.g., Tiffany, 600 F.3d at 98 (discussing allegations that one of Tiffany’s goals in pursuing litigation was to “shut down the legitimate secondary market in authentic Tiffany goods”).
regarding the scenarios is instructive. First, the Oakley, Apple, and HFD disputes above elicit a normative response applying trademark laws—Oakley “should” be able to shut down counterfeiters, Apple “should not” be affected by frivolous trademark assertions, and HFD “should not” be able to assert its trademarks as “trademark bullying” against legitimate secondary market sellers. However, it is only in the Oakley example that the OI’s action of shutting down the site results in a normative outcome.9 If the OIs’ default policies instead were to “do nothing,”10 then the Apple and HFD examples would result in normative outcomes, and the Oakley example would result in an incorrect outcome. Second, regardless of the default action by the OI, the Small Business dispute may require a context-specific analysis to achieve a normative result consistent with the application of trademark laws. Trademark NTS structures should be designed to achieve the normative result as frequently and consistently as possible across a broad spectrum of potential disputes without undue effort by OIs.

As discussed further below, others have recognized the need for a uniform, non-litigation trademark NTS, generally offering proposals that, like the DMCA, establish a “safe harbor” for OIs as long as they follow certain steps in response to a notice of infringement. This is a critical underlying incentive that ensures widespread adoption and consistency, but designing a trademark NTS around the needs of OIs, or any other single constituency or normative goal of trademark law, misses the subtle distinctions inherent in online trademark disputes. In this Essay, we propose a broadly applicable framework (for which our four scenarios serve as archetypical examples) with which to evaluate proposed trademark NTSs and then briefly apply that framework to several existing proposals. Before introducing our framework, however, we briefly highlight the existing laws in the area of trademark takedown and contrast them with the DMCA.11

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9 A full assessment of the normative goals of trademark law is outside the scope of this Essay. For further discussion and elaboration on this topic, see, for example, Andrew Griffiths, A Law-and-Economic Perspective on Trade Marks, in TRADE MARKS AND BRANDS–AN INTERDISCIPLINARY CRITIQUE 241 (Lionel Bently et al. eds. 2008); Ralph S. Brown, Jr., Advertising and the Public Interest: Legal Protection of Trade Symbols, 108 YALE L.J. 1619 (1999); Martin R.F. Senftleben, An Uneasy Case for Notice and Takedown: Context-Specific Trademark Rights (Vrije Universiteit for Law & Governance), available at http://ssrn.com/abstract=2025075.

10 See, e.g., Louis Vuitton Malletier, S.A. v. Akanoc Solutions, Inc., 658 F.3d 936, 936 (9th Cir. 2011) (noting that if an OI took such a posture, it could be construed as a trademark infringer or held liable for contributory infringement).

11 An exhaustive review and comparison of such laws is outside the scope of this Essay.
II. PROSECUTING & DEFENDING CLAIMS OF ONLINE TRADEMARK INFRINGEMENT

Unfortunately, the law provides no uniform, non-litigation recourse for those who want to prosecute or defend claims of trademark infringement on the internet. Instead, disputes regarding alleged online trademark infringement are governed by one or more of the following sources, none of which is comprehensive, broadly applicable, or drafted to address the unique issues present in online trademark infringement.

The Common Law and the Lanham Act. Trademark owners can pursue common law trademark infringement claims in state court under state law, regardless of whether the mark at issue is federally registered. However, owners of federally registered marks also can pursue federal trademark infringement claims in federal court under Section 32 of the Lanham Act. Although owners of unregistered marks cannot bring federal infringement claims, the federal courts are not completely closed to them. Regardless of the basis or venue, however, litigation is expensive and time-consuming, making it undesirable and simply out of reach for many parties.

Moreover, although the Lanham Act has a provision specifically directed to online trademark use, its scope is limited to the use of a

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13 See, e.g., Frequently Asked Questions About Trademarks, USPTO.GOV, http://www.uspto.gov/faq/trademarks.jsp#.Toc275426681 (last modified Mar. 9, 2012, 11:02 AM) (“Federal registration is not required to establish rights in a trademark. Common law rights arise from actual use of a mark and may allow the common law user to successfully challenge a registration or application.”); see also, N.C. GEN. STAT. § 80-13 (2003) (“Nothing herein shall adversely affect the rights or the enforcement of rights in marks acquired in good faith at any time at common law.”).
15 See, e.g., Frequently Asked Questions About Trademarks, supra note 13 (listing “[t]he ability to bring an action concerning the mark in federal court” as one of “the benefits of federal trademark registration”).
16 See 15 U.S.C. § 1125 (2006). This section, which prohibits the use in commerce of “any word, term, name, symbol, or device, or any combination thereof” that “is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of [the user] with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person,” has been interpreted by the federal courts as providing a federal cause of action for claims of infringement of unregistered marks that have acquired distinctiveness—i.e., secondary meaning—in the relevant marketplace. See J. Thomas McCarthy, Lanham Act § 43(a): The Sleeping Giant Is Now Wide Awake, 59 LAW & CONTEMP. PROBS. 45, 45-46 (1996).
domain name that is identical or confusingly similar to, or, in the case of a famous mark, dilutive of, another person’s mark. Mark owners also have made extensive use of dilution claims under Lanham Act Section 43(c) against persons using their mark, or a variation of it, as a domain name. Unfortunately, neither of these provisions is useful in the context of other potentially infringing online trademark uses.

**ICANN.** The Internet Corporation for Assigned Names and Numbers (“ICANN”), which administers the internet name and address system on a global level, has an alternative dispute resolution policy, the Uniform Domain-Name Dispute Resolution Policy (“UDRP”), that governs domain name conflicts. Like the Lanham Act provisions discussed in the preceding paragraph, however, the ICANN dispute resolution policy does not address all forms of online trademark infringement.

**Website Terms and Conditions and Other Policies.** In the absence of regulation, many OIs have terms and conditions and other policies that generally prohibit their users from infringing the intellectual property rights of others and provide for removal of infringing content. Sometimes, these terms and conditions prescribe procedures for mark owners to send notice of such infringement and for alleged infringers to challenge the notice. While these policies help fill the void left by the other sources discussed above, they also often create the opportunity for a “self-help end-around” of court proceedings.

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19 Indeed, the legislative history of the Federal Dilution Act, which added subsection (c) to Section 43 of the Lanham Act, suggests that the legislation was intended to apply to domain names and provide a remedy for the situation in which one entity registers a domain name consisting of someone else’s famous mark. See 141 CONG. REC. S19311-01 (daily ed. Dec. 29, 1995) (statement of Sen. Patrick Leahy) (“[I]t is my hope that this antidilution statute can help stem the use of deceptive Internet addresses taken by those who are choosing marks that are associated with the products and reputations of others.”).
21 See FACEBOOK, http://www.facebook.com/#!/legal/terms (last updated Apr. 26, 2011) (Facebook’s terms, entitled “Statement of Rights and Responsibilities,” link to pages entitled “How to Report Claims of Intellectual Property Infringement” and “How to Appeal Claims of Copyright Infringement”); see also EBAY, http://pages.ebay.com/help/policies/questions/vero-ended-item.html (last visited May 16, 2012) (eBay’s Verified Rights Owner (“VeRO”) Program was developed to provide a procedure for intellectual property rights owners to ask eBay to remove certain listings that offer infringing items or contain infringing materials).
22 If, for example, in the Small Business scenario, SB1 and SB2 were involved in a trademark opposition case, SB1’s actions to take down SB2’s webpage could achieve SB1’s desired result much more quickly and efficiently than through the

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continued . . .
Conspicuously absent from the above list is the DMCA and its NTS.\textsuperscript{23} As its name would imply, however, the DMCA applies only to instances of alleged copyright infringement.\textsuperscript{24} There is no statutory equivalent in the Lanham Act.\textsuperscript{25} Thus, trademark owners who seek to protect their marks from infringement, and parties who have been accused of online infringement, are left to fend for themselves and fashion a remedy using one of the blunt instruments described above, or even attempt to shoe-horn their claims into the DMCA’s NTS. As described above, this uncertainty and lack of uniformity encourages trademark bullying and other sub-optimal results because OIs receiving takedown notices regarding infringing content are inclined simply to protect themselves by removing the content indefinitely and leaving the involved parties to resolve their dispute.\textsuperscript{26} This amounts to a pro-plaintiff legal regime where the party who shoots first wins,\textsuperscript{27} especially in cases in which an innocent party does not have the resources to hire counsel to challenge false accusations of trademark infringement.

### III. The Digital Millennium Copyright Act

Congress enacted the DMCA in part to “provide certainty for copyright owners and Internet service providers with respect to court process, but this should not be allowed. Such self-help dynamics alter the statutorily intended function of court resolution of difficult trademark issues and dramatically corrupt the parties’ incentives.\textsuperscript{23} 17 U.S.C. § 512(c) (2006) (“A service provider shall not be liable for . . . infringement of copyright by reason of the storage at the direction of a user of material that resides on a system or network controlled or operated by or for the service provider, if the service provider” meets certain criteria) (emphasis added).\textsuperscript{24} Id.


\textsuperscript{26} See Ken Fisher, \textit{Facebook Shoots First, Ignores Questions Later}, ARS TECHNICA, (Apr. 28, 2011, 2:37 PM), http://arstechnica.com/business/news/2011/04/facebook-shoots-first-ignores-questions-later-account-lock-out-attack-works.ars (commenting on how easy it is “to file a malicious claim and take down an entire brand’s page” and observing that “it seems the only way to resolve the issue [when Facebook disables a page due to a claim of infringement] is to get the original complainant [sic] to retract the claim”). While this article speaks of alleged copyright infringement, the discussion is equally applicable to trademark infringement.

\textsuperscript{27} To illustrate, consider the long-running debate over whether Han Solo or Greedo shoots first in the cantina scene of the first Star Wars movie: regardless of who shot first, Greedo is still dead.
copyright infringement liability online” by “clarify[ing] the liability faced by service providers who transmit potentially infringing material over their networks.”

Accordingly, the DMCA has two main components. First, it provides a “safe harbor” for an OI whose service hosts or transmits infringing work, but only if the OI meets certain statutory requirements.

Second, the DMCA provides a mechanism by which a copyright owner can give an OI notice that it is hosting infringing material. Upon receipt of such a notice, the OI must “respond[] expeditiously to remove, or disable access to, the material that is claimed to be infringing or to be the subject of infringing activity.” The OI then must take “reasonable steps” to notify the owner of the allegedly infringing content that the content has been removed or rendered inaccessible.

Unlike the procedures typically followed by many OIs in cases of alleged trademark infringement, the DMCA gives the accused infringer an opportunity to “counter notify” the OI if it believes the removal of its content is in error. The DMCA also, however, provides a ten-to-fourteen business day period in which the content will not be restored in anticipation of the accuser instituting legal action. Accordingly, commentators have criticized the DMCA for being pro-accuser. This lack of attention to the competing interests of the accuser and the accused is perhaps unsurprising given the pro-OI policy underpinnings of the DMCA.

Equally unsurprising is the fact that legal scholars and other commentators have put forth suggested statutory schemes governing

29 See 17 U.S.C. § 512(c) (2006); see also ALS Scan, Inc. v. Remarq Cmty., Inc., 239 F.3d 619, 625 (4th Cir. 2001) (stating that the service provider must be “innocent” and lack knowledge of the ongoing infringement).
33 See Fisher, supra note 26 (observing that “it seems the only way to resolve the issue [when Facebook disables a page due to a claim of infringement] is to get the original complainant [sic] to retract the claim”).
36 See, e.g., Tim Bukher, The Dumbest Examples of Online Copyright Law Enforcement, BUS. INSIDER (Nov. 23, 2011), http://articles.businessinsider.com/2011-11-23/tech/30432335_1_dmca-claims-of-trademark-infringement-content (discussing three cases in which “the innocent parties were ultimately successful in getting their content back online but only after having had their content down for, at minimum, the two week period that the DMCA sets out for takedown counter-notices” and noting that “[i]n the realm of internet business, where memes and popularity swell and fade like flash floods, two weeks can seriously hurt a business”).
allegations of online trademark infringement modeled on the DMCA. Because these proposals, like the DMCA, focus on providing a “safe harbor” for OIs, their proponents, like the 105th Congress that passed the DMCA, often stop short of fully analyzing how the system will affect the broad spectrum of potential accusers and accused.

IV. EVALUATING PROPOSED TRADEMARK NOTICE-AND-TAKEDOWN STATUTES

In order to effectively evaluate proposals regarding a trademark NTS, we suggest the following analytical framework, which begins by defining a broad spectrum of constituencies who potentially may assert or infringe trademark rights:

<table>
<thead>
<tr>
<th>Potential Asserters of Trademark Rights</th>
<th>Purported Infringers of Trademark Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holds registered “Famous Mark” (“FM”), clear basis for trademark (“TM”) claim</td>
<td>Seller of counterfeit goods</td>
</tr>
<tr>
<td>Holds registered trademark, clear basis for TM claim</td>
<td>Other infringer, clear infringing action</td>
</tr>
<tr>
<td>Holds registered “Famous Mark” (“FM”), unclear basis for TM claim</td>
<td>Other infringer, unclear infringing action</td>
</tr>
<tr>
<td>Holds registered trademark, unclear basis for TM claim</td>
<td>Potentially similar mark, same class of use</td>
</tr>
<tr>
<td>Holds common law trademark only</td>
<td>Similar mark, different class of use</td>
</tr>
<tr>
<td>Holds no trademark</td>
<td>Fair use users</td>
</tr>
<tr>
<td>Spurious/frivolous holder of trademark</td>
<td>Legitimate seller of authentic goods</td>
</tr>
</tbody>
</table>

Because a trademark NTS mediates disputes amongst parties, it is useful to evaluate such system’s application to disputes between various combinations of the above constituencies. The below matrix illustrates anticipated normative outcomes resulting from any such combination:

37 “Registered” means federal registration under the Lanham Act.
38 “Unclear basis for TM claim” means a potential assertion where a likelihood-of-confusion analysis (for which a court is best suited) may be required.
In the above matrix, the dark region corresponds to the clearest cases in which the normative result is an infringement determination, and a trademark NTS should establish an easy path to enable the potential asserter to curtail infringing activity. The un-shaded and dotted regions of the matrix correspond to the clearest cases in which the normative result is a determination of no infringement, and a trademark NTS should establish an easy path to enable the purported infringer to successfully counter and defend against infringement allegations. There are two general types of such cases: frivolous assertions by those holding no trademark rights whatsoever (unshaded region), and the blatant form of “trademark bullying” where legitimate holders assert their trademarks against fair use or legitimate sales (dotted region). Finally, the gray region corresponds to the difficult, context-specific cases where the normative result is unclear and would warrant further analysis or court resolution. These are the cases where unclear case law, variations between not only the marks, but also the associated goods and services, and distinctions between uses all complicate the analysis; a trademark NTS may merely establish a mechanism for identifying (rather than resolving) such cases. The scenarios presented in Part I are numbered in the matrix above, serving as archetypical examples of disputes in each of these regions, although as noted previously, with non-normative outcomes in certain instances. Clearly, the range of potential scenarios is far broader than our four examples, but we have selected each of them for the purpose of providing straightforward, yet varied, points of application for evaluating proposed trademark NTs.39

39 A more fulsome evaluation of any trademark NTS might benefit from an extrusion of our four examples to the full parameters of the matrix (likely including continued . . .
To demonstrate application of our framework, the following two sub-parts present two proposals, and the third sub-part evaluates the proposals against each of the four scenarios.

A. The “Safe Harbor for Trademark Infringement”

In a 2009 Note in the Berkeley Technology Law Journal, Elizabeth K. Levin proposes a safe harbor within trademark law in line with the DMCA’s goals of preserving strong incentives for OIs and trademark holders to address online infringement and limit OIs’ exposure to suit.40 The resulting proposal is aimed at protecting online auction sites, and would incorporate the DMCA’s prerequisites for safe harbor protection found in 17 U.S.C. § 512(c)(1)(A)-(C),41 as well as eliminate any requirement that the sites “track users in a particular way or affirmatively police users for evidence of repeat infringement.”42 Additionally, the proposal would incorporate procedures for notification and counter-notification based on the DMCA.43 The proposal would not, however, require the service provider to wait ten to fourteen business days to restore access to the allegedly infringing material after receipt of a counter-notice.44 Rather it would “require the auction site to repost the listing within a slightly shorter period of time in order to encourage ISPs to repost legitimate content quickly, especially where the complaint is frivolous.” 45

B. The “Expedited Dispute Resolution Proceeding”

Frederick W. Mostert and Martin B. Schwimmer propose a two
part, expedited dispute resolution proceeding to filter and address online trademark disputes as efficiently as possible.\textsuperscript{46} The Mostert and Schwimmer proposal and article, however, primarily focus on disputes similar to the Oakley scenario—namely enforcement by a famous mark holder against counterfeiters in an online auction/marketplace forum.\textsuperscript{47} As noted above, we believe this category of disputes to be the clearest case where the normative result is an infringement determination—the sale of counterfeit goods strikes at fundamental goals of trademark law to provide certainty of origin and reliability of quality—and the primary question in such a case is a factual one, namely whether a good is or is not counterfeit.\textsuperscript{48} The other difficult context-specific questions might not arise in this category.

The first phase of the proposed proceeding is a mandatory notice and takedown/safe harbor procedure resembling the DMCA and eBay’s VeRO system, followed by an arbitration phase.\textsuperscript{49} Notice and takedown is initiated by a trademark owner filing a short notice to an agent of the OI stating its good faith belief that a website is “offering goods that infringe its rights.”\textsuperscript{50} Notice also includes certain information regarding the owner’s rights in the trademark, basis for takedown, and other elements including the owner’s verifiable contact information and a declaration under penalty of perjury.\textsuperscript{51} The OI notifies the purported infringer, but does not immediately remove the content unless the OI has no verifiable contact information (in which case removal is automatic).\textsuperscript{52} If the purported infringer fails to

\textsuperscript{46} Frederick W. Mostert & Martin B. Schwimmer, Notice and Takedown for Trademarks, 101 TRADEMARK REP. 249 (2011).
\textsuperscript{47} Id. at 255-56.
\textsuperscript{48} Id. at 261-62 (“It is of interest that a trademark owner can have items in its possession and still not be able definitively to conclude whether an item is legitimate.”). Query whether the inability to identify legitimate goods might undercut certain goals of trademark law—if in fact the inherent value of a good (i.e., quality, functionality, fitness for particular purpose) diverges from the subjective value of a good (based on its trademark and the societal/cultural implications of ownership thereof), there seems to be something more going on that might not be properly addressed by the parameters of trademark law. In fact, the use of a trademark could in some cases add value to a good where such value was not already inherently there in the first place. Unfortunately, further assessment of this issue is outside the scope of this Essay.
\textsuperscript{49} Id. at 271-72.
\textsuperscript{50} Id. at 272.
\textsuperscript{51} Id. at 274-75.
\textsuperscript{52} Id. at 277-78. We agree with Mostert and Schwimmer’s assertion that there is little to no public policy argument in favor of the right to conduct commerce anonymously, especially if such party is conducting commerce under the auspices of a trademark, which is designed to provide a critical identification and origin function. Identification and origin from “anonymous” carries no value supportable
respond or responds inadequately, the infringing content is removed. The purported infringer may respond with a counter-notice, which must contain verifiable contact information, in which event the parties can enter into discussions or select an abbreviated arbitration proceeding. If such a counter-notice is filed, the purportedly infringing content remains online until the dispute is otherwise resolved. The system also incorporates a check against “bad faith” assertions, but looks to Rule 11 of the Federal Rules of Civil Procedure as a starting point, rather than a difficult-to-prove subjective “bad faith” standard.53

C. Evaluation of Proposals

1. Scenario 1: The Oakley Dispute

In the Oakley scenario, the owner of a registered trademark discovers blatant infringement—the offering for sale of counterfeit goods online. Here, both of the foregoing proposals would minimize the time, effort, and, therefore, money the trademark owner would expend in figuring out an initial, non-litigation remedy. Thus, it might encourage more trademark owners to take steps to protect their trademark rights in the face of the type of clear-cut infringement that trademark laws seek to combat. In particular, a framework in line with the Mostert and Schwimmer proposal might resolve many cases at the default stage, either because of lack of verifiable contact information for the purported infringer, failure to respond, or inadequate counter-notice. In the unlikely circumstance that a seller of truly counterfeit goods provided an adequate counter-notice, Oakley would have the capacity to seek more traditional legal remedies in order to achieve its desired outcome.

Note, however, that the timing of the actual takedown of the purportedly infringing content differs between the two proposals; Levin’s proposal would immediately result in removed content, whereas there could be a delay (at least until default or failure to properly respond) under the Mostert and Schwimmer proposal. In the context of sales of infringing goods, especially by means of time-limited auctions, even a several day delay could result in unimpeded sales of infringing goods, and provide infringers with the ability to close up shop and reopen under another name before a takedown is successful. Accordingly, although outside the scope of this Essay, it

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53 See id. at 278-79 (explaining that bad faith rarely has, if ever, been proven in a case under the comparable provision of the DMCA).
might be worth considering context-specific takedown timing. For example, for purportedly infringing sales of counterfeit goods in an online auction site or marketplace, content removal could be immediate, but for other categories of infringement or other OIs (such as Facebook or an ISP with respect to an owned website), a delay until default or inadequate counter-notice might be more appropriate. Alternatively, there might be other mechanisms whereby OIs could manage and disincentivize users who show a repeated pattern of receiving takedown notices and closing up shop only to reopen under another guise.

2. Scenario 2: The Small Business Dispute

In the Small Business scenario, the owner of a registered trademark (SB1) discovers what might be infringement under a likelihood-of-confusion analysis. As in Scenario 1 above, because each proposal would minimize the time, effort, and money SB1 would have to expend in figuring out an initial, non-litigation remedy, both proposals might encourage more trademark owners to take steps to protect their trademark rights. Conversely, because liability is not clear-cut in this scenario, each proposal’s counter-notice provision would provide a means for an accused infringer, like SB2, to protect its rights and restore content, thereby discouraging abuse by trademark bullies seeking to take down competitors indefinitely. However, because Levin’s proposal does not clearly define the amount of time that an OI must wait before restoring the content, and also does not state whether the allegedly infringing material must stay off the internet during the pendency of litigation, it is difficult to evaluate whether Levin’s proposal does enough to discourage abuse. Moreover, it likewise is difficult to evaluate whether the proposed periods of downtime would be so long as to have a potentially devastating effect on SB2’s business. The Mostert and Schwimmer proposal, however, would keep the content online in the event of an adequate counter-notice, preserving the status quo and enabling the parties to pursue traditional resolution methods of negotiation, arbitration or litigation.

In each of these proposals, however, there does not appear to be a mechanism that accounts for pre-existing litigation between parties involved in an online notice-and-takedown dispute, especially when the self-help takedown attempts to circumvent the impartial litigation process designed to resolve the underlying dispute.\(^{54}\) Accordingly, it

\(^{54}\) See supra note 22.
might be worth considering adding a layer to the form of counter-notice, where the purported infringer can indicate that the parties are involved in pre-existing litigation or trademark opposition proceedings, which will effectively bar a takedown from occurring, absent a resolution in the litigation or opposition proceeding to the contrary.

Finally, in scenarios comparable to this Small Business scenario, we would not expect a trademark NTS to quickly and easily resolve disputes. Instead, these often will require the context-specific analyses for which court mechanisms are best suited. The role of a trademark NTS with respect to disputes of this type is primarily one of identification and filtering to ensure that the easy cases are handled via the NTS, and only the more context-specific and difficult cases reach court (assuming they do not settle on the way to the courthouse).

3. Scenario 3: The Apple Dispute

In the Apple scenario, Joe Smith makes a fraudulent claim of trademark infringement that results in Facebook disabling Apple’s user account. Each of the proposals would incorporate a notice procedure that includes verifiable contact information for the infringer and a declaration under penalty of perjury. Provisions such as these could prove useful in deterring would-be accusers such as Joe Smith. Additionally, Levin’s proposal would afford Apple with a chance to send a counter-notice that could trigger Facebook’s obligation to restore the account if no legal action is commenced. However, as noted in the analysis of Scenario 2 above, Levin’s proposal does not identify the duration for which content is rendered inaccessible or whether such duration would effectively prevent trademark bullies, large and small, from achieving the desired effect of harming a business. The Mostert and Schwimmer proposal, on the other hand, would not have removed Apple’s content in the first place.

Although remedies for a “bad faith” assertion (as might be implicit in Levin’s proposal or covered by reference to Rule 11 of the Federal Rules of Civil Procedure in the Mostert and Schwimmer proposal) exist, it is not entirely clear whether such remedies offer a significant enough disincentive for frivolous accusers. It might be worth considering in this case, as in the analysis of Scenario 1 above, context-specific takedown timing with respect to accusers alleging infringement by holders of famous marks, which could provide a thumb on the scale in order to ensure that a likely frivolous accusation does not result in an automatic takedown of a “famous mark”-related website. Alternatively, filtering mechanisms could weed out frivolous assertions, if directed towards verification of a potential asserter’s
identity or verification of existing trademark rights, certain of which could be automated or centralized.\textsuperscript{55}

4. Scenario 4: The High Fashion Designer Dispute

In the High Fashion Designer scenario, the owner of a registered trademark discovers a fair use of its mark in connection with resales online, but attempts to curtail such fair use in order to strengthen its direct sales of goods. Here, Levin’s proposal would require the service provider to keep the allegedly infringing content off the internet for some period of time, even in the face of a fraudulent notice. In the case of a small reseller, this is potentially devastating.\textsuperscript{56} The Mostert and Schwimmer proposal, however, would not have removed the content in the first place, and the content would remain online assuming the reseller provides adequate counter-notice. The Mostert and Schwimmer proposal would then effectively shift the burden back upon HFD to exert pressure upon the reseller, where the existence of negotiation, litigation, and arbitration remedies are more effective at ferreting out legitimate claims by HFD against unauthorized resales, and discourage continued pursuit of illegitimate claims by HFD against fair use resales of goods.

\textsuperscript{55} Given the relatively clean slate in this arena, it is at least worth considering the establishment of a centralized system and mechanism that facilitates and maximizes efficiencies in the notice-and-takedown process, rather than relying upon decentralized OIs to review, process, and respond to notices and counter-notices on a case-by-case basis. For example, any OI who wishes to avail itself of a safe harbor with respect to direct or contributory trademark infringement could register with a Centralized Trademark Registration and Notice System (“CTRNS”), designating an employee as the point person to communicate with CTRNS. Notice and takedown instructions on participating OI websites would direct (or re-direct) potential asserters to file a takedown notice that would be processed by CTRNS, which will review it for conformity, conduct automated filtering directed towards verifying identity, verify existing trademark rights, verify jurisdiction, and otherwise ensure the quality of takedown notices that are ultimately transmitted by CTRNS to the participating OI point person. The OI then would re-direct the processed/filtered notice to the purported infringer, and any default or counter-notice would be re-transmitted to CTRNS for similar centralized processing, verifying identity, verifying existing disputes between the parties, etc. Such a centralized system could improve the quality, consistency, and predictability of trademark takedown disputes, helping filter out the frivolous, and perhaps ultimately devising further heuristics to characterize patterns of infringing behavior or trademark bullying that can be strategically addressed by further systemic modifications or regulation.

\textsuperscript{56} See Bukher, supra note 36 (“In the realm of internet business, where memes and popularity swell and fade like flash floods, two weeks can seriously hurt a business.”).
V. Conclusion

Within the parameters of this brief “Practitioner’s Essay” we have commented upon a practical problem that lawyers and their clients face on a frequent basis, and for which the available remedies are ill-fitting for a potential asserter of trademark rights and for parties wrongfully accused of infringement. Although much of the potential for analysis of this issue is outside the scope of this Essay and forum, it is our desire for this Essay to at least scratch the surface of this issue in a unique way that furthers analysis and commentary on the wide-ranging implications of and considerations related to trademark takedown notices and trademark bullying. While we and numerous others before us have expended efforts to devise, categorize, and identify the “best” trademark notice-and-takedown system possible (perhaps magnified by criticisms and perceived faults in the DMCA), it is our firm conviction that in this arena, even an imperfect solution is better than nothing.
PLEASE, STEAL MY ART: DOES INTELLECTUAL PROPERTY LAW HINDER CREATIVITY? OR, CAN WE STOP TALKING ABOUT INTELLECTUAL PROPERTY LAW AND TALK ABOUT CREATIVE PRACTICE RIGHTS?

Woodrow Hood†

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I. INTRODUCTION

“He who receives an idea from me, receives instruction himself without lessening mine; as he who lights his taper at mine, receives light without darkening me.”

Thomas Jefferson

In the performing arts, there is a saying: “Mediocre artists borrow; Great artists steal.” This bold statement does not mean the best artists steal. It is not a comment about product, but a comment about process. Artists steal ideas, stories, and even components, both large and small. This article is about the necessity of maintaining an artist's ability to steal and the clear and present danger of losing that freedom. The notion that freedom is a valuable part of creativity and innovation is deeply rooted in ideas about intellectual property and aesthetic evolution. If an artist steals an idea, finds an innovative solution to a problem or devises a new way of seeing an old thing, in the process of implementing that idea or shaping that thing into something new, the new work has the potential of bettering and improving upon the original. When it becomes something new, the original is transformed. And, along a long lineage of influences and ideas, humans better themselves through these innovations. We need these chains of influence—the evolution of ideas and new configurations—in service of a larger need: the progress, if possible, of our species.

II. THE CONSTITUTIONAL BASIS FOR COPYRIGHTS AND THEIR INCARNATION AS PROPERTY RIGHTS

The idea of creative freedom is not unheard of. As a matter of fact, this idea manifests itself in intellectual property laws. For instance, copyright, despite extension after extension, has a termination date. This notion was codified within the Constitution of the United States in order to secure to authors exclusive rights for a limited time. The authors of the Constitution ranked the importance of this idea in the same section and alongside the right to declare war,

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3 U.S. CONST. art. I, § 8, cl. 8.
to coin money, and to collect taxes. Therefore, because of this “limited time” phrase, drug companies lose their patents after a time period and (eventually) authors lose their copyright. It is easy to see that it is for the public good that ideas and things eventually move into a public domain—owned by the culture and not an individual or corporation.

However, in today’s cultural conversations and court decisions about copyright and ownership, producing artists ought to be concerned that they have pushed too far to the side of production at the expense of process. Artists argue about property rights, not creative rights. If the purpose of copyright is to make incentives for people to create or innovate, then copyright by its very nature should only last while the creators exist; that is, while they are still alive. However, today a person can own his or her works not only while he or she is alive, but for a full seventy years after death.

For corporate authors, copyright has extended from fourteen to ninety-five years. As the entertaining YouTube video *Copyright: Forever Less One Day* points out, George Lucas has control over his *Star Wars* properties until the year 2072. Thus, clearly copyright is no longer about private incentive but rather corporate ownership and profiteering.

Many understand that corporate health is important to the nation's economy, and for many a significant part of their retirement benefits are bound up in these corporations’ success or failure. These men and women need them to prosper so that they may as well. But in copyright’s massive shift away from functioning to serve the public good and towards private and corporate ownership and profiteering, whatever Americans may be gaining in control they may be losing in inventiveness and innovation. In the trajectories of the rise and fall of nations, one can see a move away from creative vibrancy (as we see in China and India, nations with a fairly loose sense of copyright) to stagnancy and ossification (as we see in Japan and some Euro-zone nations). Those who create lose their ability to use the tools and components of that very act of creation.

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4 See id.
6 See id. § 302(c); but see Lawrence Lessig, *Free Culture: How Big Media Uses Technology and the Law to Lock Down Culture and Control Creativity* 292 (2004) (proposing a shorter term).
III. TRANSFORMING THE OLD INTO THE NEW

Artists steal and, in the process, tend to make something entirely new. How many symphonies have been inspired by paintings, or folk dances, or even earlier pieces of music? How many films and plays tell an old story in a new way? Shakespeare, arguably the greatest writer in the English language, seemingly stole plots and ideas as a daily practice. The films 10 Things I Hate About You (1999) and O (2001) are Shakespeare's The Taming of the Shrew and Othello, respectively. Of course, West Side Story would not exist without Romeo and Juliet. Beyond Shakespeare, the 1995 hit film Clueless, with Alicia Silverstone, introduced an entire new generation to Jane Austen by updating her story Emma. Because the originals are in the public domain, artists of today are free to use them. For instance, nobody had to pay for the rights to Beowulf for the 2007 film.

Many artists create great work out of pre-existing ideas and works, recycling them over and over. That idea, in itself, is an important part of the creative process. We are unable to imagine somebody reworking the plot to Gone With the Wind or Citizen Kane today without some threat of legal action. So, borrowing from Shakespeare is creative but drawing from Margaret Mitchell (apparently one of the most protected estates outside of Disney, Michael Jackson, and The Beatles), is infringement.

Not only may ideas and plots be stolen, but also parts or small components. What new text is written without using the same words that previous authors used over and over, innumerable times, often using full phrases from originals? No musician creates music from notes never before played. In music there is the phenomenon that has become known as the “pop-punk chord progression.” In musical terms an example would be, for a song in the key of C major, the progression of: C-G-Am-F. You can hear this chord progression in a host of pop songs by Lady Gaga, The Beatles, Green Day, The Offspring, Journey, the Rolling Stones, and dozens of other modern artists. Or, rearrange those same chords to Am-F-C-G/B and one finds the “sensitive female chord progression” seen in Lilith Fair music festival performers. Pop comedy group The Axis of Awesome demonstrate this phenomenon most exactly in their performance “4 Chords,” in which they jump through thirty-six songs, using just these four chords, in six and one

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half minutes. No artists own those chords or the arrangement of those four chords; it is only the slightest variations in the songs that make them distinct enough to be deemed intellectual property.

Artists throughout the ages use the same media and materials over and over—not just ideas but also bits, pieces, and parts. Thus, the value placed upon a piece is determined by how original the particular arrangement of the piece seems to be and not the components themselves. Embedded in this acceptance is the acknowledgement that nothing is completely original. As Shakespeare said, “[i]f there be nothing new, but that which is [h]ath been before,”\textsuperscript{10} from Sonnet 59 which he took from The Bible:

“\begin{quote}
What has been will be again, \\
what has been done will be done again; \\
there is nothing new under the sun.\end{quote}”\textsuperscript{11}

This stealing is sometimes called “permissible borrowing.” The question often then becomes, “where is the line between permissible and non-permissible” or “do you have permission?” It is this question that sends the courts into a maelstrom of conflicting or confusing decisions and opinions.

**IV. FAIR USE AND ITS ROLE IN “PERMISSIBLE BORROWING”**

The more appropriate legal definition of “stealing” or “permissible borrowing” is called fair use—one of the most abused, confused and misunderstood aspects of intellectual property law. According to the U.S. Copyright Office, four major factors contribute to fair use.\textsuperscript{12} The first is “the purpose and character of the use,” which includes whether the use of the material is for financial gain.\textsuperscript{13} Non-profit companies tend to fare better on this point. The second is “the nature of the copyrighted work,” for example, whether the original has high value as a property,\textsuperscript{14} such as the music of The Beatles or Michael Jackson. The third is “the amount and substantiality of the portion used in

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\textsuperscript{9} The Axis of Awesome, 4 Chords (2011) Official Music Video, YouTube (Jul. 20, 2011), http://www.youtube.com/watch?v=oOldewpClZQ.


\textsuperscript{11} Ecclesiastes 1:9.


\textsuperscript{13} Id.

\textsuperscript{14} Id.
relation to the copyrighted work as a whole."\textsuperscript{15} The word often associated with fair use here is "transformative;" if the new use transforms the old work into something entirely new, it is fair use. The final factor is "the effect of the use upon the potential market for or value of the copyrighted work."\textsuperscript{16}

These points operate on some assumed yet unstated notion of originality. But if nothing under the sun is truly new or original, what is deemed original concerns not only the components of the work but also the arrangements of those components into a particular pattern that is determined to be new, original, unique, or transformative. As always, the question ultimately becomes, who gets to decide? And, thus, the problem that arises is that nobody can agree on any single decision or definition of "transformative" or "effect" on "potential market" in some of the grayer areas.

\textbf{V. The Legal Costs on Creative Arts Organizations}

Determining the transformative potential of a new work is where arts organizations hit a snag in production. If a copyright owner with sizable resources, such as a corporation, threatens action against a smaller producing arts individual or organization and quibbles that part of the work is infringement of rights and not fair use, the individual or small arts organization will always fold. In the United States, most performing arts organizations or artists do not have the resources to enter into a lengthy legal battle.\textsuperscript{17} Without the charity of pro-bono-willing attorneys sitting on non-profit boards of directors, legal bills can quickly jump into the hundreds of thousands of dollars, which is more than the operating budget of many of these arts organizations. So, even though the organization may be able to easily make the case of fair use, they cannot afford to. What’s worse is that many of these arts organizations would rather self-censor than risk the ire of the copyright holders. This chilling self-censorship is actually spelled out on the U.S. Copyright Office website, which makes the following suggestion to artists:

\begin{quote}
The safest course is always to get permission from the copyright owner before using copyrighted material . . . . When it is impracticable to obtain permission, use of copyrighted material should be avoided unless the
\end{quote}

\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} European arts organizations through helpful state funding and assistance, generally tend to fair better in these cases.
The doctrine of fair use would clearly apply to the situation. The Copyright Office can neither determine if a certain use may be considered fair nor advise on possible copyright violations. If there is any doubt, it is advisable to consult an attorney.\textsuperscript{18}

In short, artists have been warned; it may as well say “enter at your own peril” like some silly old action-adventure film. Fair use is decided on a case-by-case basis and the courts do not agree. The result then becomes the case that legitimate new works of art may be hindered or even disappear entirely before they ever enter the public consciousness.

\textbf{VI. Four Examples of Legal Costs and Their Detrimental Effect on Creative Arts Organizations}

Let us examine four examples where ownership and property rights hindered production. When one thinks of copyright infringement battles, one tends to think of digital media (recorded music, films, and digital images). Lawrence Lessig (the 2011 Roy L. Furman Professor of Law at Harvard Law School) has eloquently and precisely detailed how copyright hinders creativity in the world of digital media.\textsuperscript{19} Lessig urges a move away from “fair use” to “free use,”\textsuperscript{20} particularly regarding the non-profit sector, where most performing and visual artists live. He sees the problem as such: “[W]e are less and less a free culture, more and more a permission culture.”\textsuperscript{21} He understands that innovation and creation trapped in bickering over permissions are a threat to change and progress.\textsuperscript{22}

However, this article looks at examples from the performing arts because: (1) that is the author’s professional expertise, and (2) the copyright issues have not received the same attention as those of the massively funded campaigns from the Recording Industry Association of America (RIAA) or the Motion Picture Association of America (MPAA). All four examples arise from live theatre, but there are many other of these types of cases in the other performing arts.

\textsuperscript{19} See LESSIG, supra note 6.
\textsuperscript{20} See id. at 294-96.
\textsuperscript{21} Id. at 8.
\textsuperscript{22} See Larry Lessig on Laws that Choke Creativity, TED (Nov. 2007), http://www.ted.com/talks/larry_lessig_says_the_law_is_strangling_creativity.html.
A. The Wooster Group’s L.S.D. (... Just the High Points…)

The first case occurred in the early 1980s when an experimental performance group called The Wooster Group (film actor Willem Dafoe is a founding and current member) decided to include a short, sketch version of The Crucible by Arthur Miller in its production called L.S.D. (...Just the High Points...). Critic and theorist David Savran, in conversation with The Wooster Group in his book Breaking the Rules: The Wooster Group, presents at least one side of the discussion. In brief, The Wooster Group collectively constructed its performances, and it seemed fascinated with the comparison of Dr. Timothy Leary’s experiments with psychedelic drugs in the 1960s and the Salem witch hunt resistance lead by John Proctor, the lead character in Miller’s play. The Wooster Group always treats documents, fictional and historical, as texts of particular periods in American history and examines them for issues of truth, value, and importance.

The problem came when Arthur Miller was invited to watch The Wooster Group’s twenty-five minute version of his nearly three-hour play. Miller’s lawyer immediately served a cease-and-desist order in reaction. Miller seemed more concerned with his image (or “brand” in today’s parlance) than with the fact that The Wooster Group had used his original to create a wholly new and fascinating work of art. In its upending of Miller’s play, The Wooster Group discovered tantalizing issues hidden under the surface—how can a white man in the twentieth century accurately portray a black slave in the seventeenth century? The slave woman Tituba in Miller’s version was a marginal character, while in The Wooster Group production she became a central focus. Thus, the play is expanded from not only an examination of the motives behind the witch trials, but also the power constructs of class, race, and gender of the time periods, both the seventeenth century, the play’s setting, and the twentieth century. The Wooster Group could not afford to fight Miller and his publishers in court and agreed to remove that section from the performance. Because of Miller’s reaction, The Wooster Group’s artistic insights into the works, the periods, and the cultures were never to be seen by the Manhattan theatre-going public.

The Wooster Group’s study of The Crucible, though not a complete and outright lampoon, clearly is a transformative use of the original similar to many parodies. Miller’s fear that he may have been the butt of some joke should not be cause to close the show—based on

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24 Id. at 187-95.
that logic, we would not have *Saturday Night Live* or Mickey Mouse. *Saturday Night Live* is well known for its spoofs of other films, television, and celebrities. In fact, one of the most protected properties in the world and the icon of The Walt Disney Company, Mickey Mouse, was himself created in as an act of satire of an old Buster Keaton film, *Steamboat Bill, Jr.*

**B. Akalaitis’ Endgame**

Another theatrical production in the early 1980s suffered a similar conflict, but with a slightly better outcome. Experimental director Joanne Akalaitis (formerly of the Mabou Mines, known for producing composer Philip Glass) was directing a production of Samuel Beckett’s *Endgame* for the American Repertory Theatre (ART) in Cambridge, Massachusetts. Beckett’s famous tragicomedy only requires one rather stark and non-descript room:

*Bare interior.*

*Grey light.*

*Left and right back, high up, two small windows, curtains drawn.*

*Front right, a door. Hanging near door, its face to wall, a picture.*

*Front left, touching each other, covered with an old sheet, two ashbins . . . .*

*With such a basic setting, most theatre directors would feel free to adjust or add freely.* But the rule is that once you purchase the rights to produce a play you must produce the play as defined by the dialogue, which must never be altered, and the stage directions, which tend to be more fluid. Akalaitis took artistic liberty with the play directions and decided to set it in a post-nuclear-holocaust subway station. Many directors have altered settings in theatrical productions with little fanfare. But Beckett and his lawyers threatened

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25 Keep in mind, many of Disney’s greatest films would not exist without the free use of the Grimm Brothers [*Snow White* ("Sneewittchen"), *Cinderella* ("Aschenputtel"), *Sleeping Beauty* ("Dornröschen"), *The Princess and the Frog* ("Der Froschkönig"), *Tangled* ("Rapunzel")], and Hans Christian Anderson (*The Little Mermaid* and the forthcoming *Frozen*, based on *The Snow Queen*).


to close the production because of the changes in locale, saying that this was not the original intention of the playwright. After several meetings and a mounting legal bill (which many organizations smaller than ART could not afford), Beckett agreed to allow the production to proceed but that he would denounce it publicly and every printed program would carry the denunciation.

Both the Miller and the Beckett case call into question who owns what part of the property. The words are clearly the playwright’s, but how those words are performed or staged leads into grayer territory. Often on films, authors sign away all of their ownership rights to a studio and thus give the studio free reign to alter the text however they please. In live theatre the playwright may still revoke production rights if displeased with the artistic choices a production company makes. But is it not the act of interpretation in a way the significance here, transformative use, thus creating a new work of art out of an old?

C. Lavery’s Frozen

In a more recent case, British playwright Bryony Lavery created a Broadway hit in 1998 with her Tony Award nominated play, Frozen; that is, until it all fell down around her. The play follows a psychiatrist in her work with a serial killer and the mother of one of his victims. As many playwrights do, Lavery worked from and was inspired by many different source texts, including a 1997 New Yorker article from Malcolm Gladwell and New York psychiatrist Dorothy Lewis’s 1998 book, Guilty by Reason of Insanity. Indeed, Lavery used some of Gladwell’s exact words.

Gladwell documents the process of his reaction to the play’s plagiarism point-by-point in his book What the Dog Saw. Gladwell met with Lavery and began to come to an understanding of what occurred. Lavery said she thought of these pieces as “news” and therefore they were free to use in her play; her fair use was an attempt to be as true to the source materials in order “to be accurate.” When Lewis saw the play, she immediately recognized her own life being

28 Gerald Rabkin, Is there a Text on This Stage?: Theatre/Authorship/Interpretation, 9 PERFORMING ARTS J. 142, 146-49 (1985).
31 Id. at 238.
portrayed on stage. Gladwell was notified 675 of his words had been picked out and used in Lavery’s play.\textsuperscript{32} A clear case of plagiarism—theft!

But the position he ultimately took is that Lavery used his words and parts of Dorothy Lewis’ life and made them into something extraordinary and new. They were old words in the service of something entirely new. They had become art.

The damage had been done to Lavery’s career. Though she continues to write and produce in her native England, her next plays have largely been ignored in this country, though Frozen has had some continued life despite the controversy.

\textbf{D. Fuller’s As I Lay Dying}

Some of these new works even have to hide at the margins, self-conscious about their very right to exist. Two years ago, poet and playwright Janice Moore Fuller began a stage adaptation of William Faulkner’s American classic, \textit{As I Lay Dying}. Fuller is a Faulkner scholar and decided to adapt Faulkner’s work to live theatre, a task some would consider a Herculean feat considering Faulkner’s beautifully rambling and complex writing style. Fuller simultaneously started the process of seeking permission for theatrical rights to adapt the work and discovered a problem—the executor of the Faulkner estate was unwilling to respond after years of repeated requests to allow or deny the use. The literary rights are held by Random House, so she could apply to publish the adaptation. But the attorney who was the executor held the performance rights. There was a film adaptation announced for the story with actor James Franco behind the project. The film seems to be caught in “development hell,” and may never see the light of day. It remains unclear whether the performance rights have been secured.

Fuller has since continued to send letters and requests to the attorney but has received no response. One can only assume that since she is asking for the performance rights for theatrical production the attorney does not feel it worthwhile to even answer, maybe because it would not be a significant source of income if produced by regional arts organizations or colleges/universities instead of a film company. Though she collects copies of all of these attempts in case the attorney decides to come forth at some point, she worries that her adaptation will gather dust instead of doing the task she hoped for—connecting new audiences to the brilliance of Faulkner. Theatre companies, being

\textsuperscript{32} \textit{Id.} at 243.
local entities, still draw in thousands of audience members—a worthwhile enough constituency with whom to share Faulkner's stories, images, and language.

In the fall of 2011, Fuller’s adaptation saw the light of day in a college production. Some regional theatres, particularly those interested in Southern authors and playwrights, continue to discover the adaptation and show significant interest in producing the play. But these companies are going to be unwilling to risk a lawsuit when the question of theatrical rights still hangs in the air.

In all four cases, intellectual property became—and in some cases remains—a hindrance for something new and original from entering the world. Even though none of these cases ended up actually reaching a court for a decision, they still affected the world of production and illustrate the battle for control and ownership over creativity and innovation. Gladwell is an exception here, and only after a conscious moment of reflection. In their book, *Reclaiming Fair Use: How to Put Balance Back In Copyright*, Patricia Aufderheide and Peter Jaszi call ours a culture of fear and doubt. In service to the greater good, free use should be the norm. At the front of one’s mind should be not “where is the line,” but maybe “when do property and ownership inhibit process, and thus new product?” As Gladwell came to recognize, “I could also simply acknowledge that I had a good, long ride with that line—and let it go.”

**VII. IS THERE A LINE BETWEEN STEALING, PERMISSIVE BORROWING AND CREATIVE RIGHTS?**

Entering into such discussions about where the line is between creative rights and intellectual property rights assumes that there should be a line—a way of defining clearly, in legal terms, which is which. Yet as Americans continue to struggle with this issue in court, it seems increasingly clear that the attempt to find and define that line is ever elusive. Lessig argues for a drastic (to some) reconsideration of copyright law and ideas of ownership and permission. In service to the greater good, free use should be the norm. At the front of one’s mind should be not “where is the line,” but maybe “when do property and ownership inhibit process, and thus new product?” As Gladwell came to recognize, “I could also simply acknowledge that I had a good, long ride with that line—and let it go.”

But how many copyright holders out there are as brave and progressive as Gladwell? And how many corporate owners are willing to be that open with how

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34 See Lessig, *supra* note 6, at 8-9.
35 In a brave act of free use, I've decided not to cite the source.
their properties are used?

Americans shake their fingers in shame at China for its unwillingness to clamp down on copyright violations. What Americans citizens see as loss of profits in a massive sales market, the Chinese seem to see as freedom of creativity. Chinese authors have taken rigidly protected properties like the Harry Potter, Jurassic Park, and the Lord of the Rings books and (hilariously) smashed them together. Just consider the titles: Harry Potter and the Golden Armor (Harry rides a Tyrannosaurus Rex), Harry Potter and the Leopard Walk-Up-To Dragon (Gandalf from The Lord of the Rings trilogy assists the Hogwarts students to fight off foes), Harry Potter and the Chinese Overseas Students at the Hogwarts School of Witchcraft and Wizardry (adding Chinese students for local flavor), and Rich Dad, Poor Dad and Harry Potter (Richard Shaw’s classic 1969 novel and Harry Potter together, for some unclear reason).\(^{36}\) Obviously, none of these are sanctioned or approved sequels to the Harry Potter franchise. The author of the series, J.K. Rowling, has made plenty of money and will continue to for a very long time. The Chinese works are clearly transformative, yet they made profits and infringe on a highly protected property. Based on the four points of fair use described above, Rowling would clearly win a suit and therefore these sequels only exist in underground Chinese markets. But what true fan of the series (those who have probably bought the toys, the DVDs, the books, and probably some costumes) would not want to read them?

In this swing toward hyper-protective ownership, the world is out of balance. A world where the copyright industry’s primary job seems to have become, in some sense, the industry itself merely attempting to remain relevant and at play, and paid not for just what it is producing but primarily what it has produced. And the trend continues onward as illustrated by the stretch of Disney’s ownership of Mickey Mouse from his parodic appearance in 1928 indefinitely into the future. At this point, we begin eating our own, shooting down new ideas and new art before it can get off the ground. Gladwell says, “The ethics of plagiarism have turned into the narcissism of small differences: because journalism cannot own up to its heavily derivative nature, it must enforce originality on the level of the sentence.”\(^{37}\) Replacing “plagiarism” with “infringement,” and “journalism” with “the creative arts,” the sentence paints a strong picture of the current state of


\(^{37}\) GLADWELL, supra note 30, at 241.
intellectual property law. It is more interested in control than creation, though artists know it is creation that is always the source of success and a brighter future.

We need to have these discussions; they are vital as we move into grayer areas of new media, where YouTube and Vimeo videos recycle culture and arts over and over again. Is the government really going to shut down a group of teenagers who record and electronically share their dancing and lip-syncing to a Beyoncé song for the whole world to see? That may sound ridiculous but some current proposals would do just that.

**VIII. Conclusion**

In a battle of ownership, creators and artists will nearly always lose because they lack the financial and legal resources to fight back. Therefore, *pro bono* work from the legal profession becomes an invaluable and important resource for any arts organization. A non-profit organization without a lawyer on the board of directors is a disaster in the waiting.

As an artist and scholar, I have created numerous works that live under copyright. I understand that many people must survive from the royalties generated by those copyrights. Intellectual property rights exist to generate financial incentives for people to create, adapt, and innovate. However, as a director and creator of live performances, my performance work does not operate under copyright. My designs, my direction, my insights and interpretations, all of these I willingly share with my audiences. My books, after a time, become outdated on the surface; but some of the ideas may still resound with audiences: maybe I have solved a problem, built a better mousetrap, or offered a new insight. If you, in a new way, incorporate my creation into your own work and make something even better, then we all win.

So, please, feel free to steal my art. Just steal it well.
AMERICAN ENTREPRENEUR IN CHINA: POTHOLE AND ROADBLOCKS ON THE SILK ROAD TO PROSPERITY

Lawrence J. Trautman†

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I. OVERVIEW

In many ways China is the new frontier for entrepreneurship as it is perceived to be a logical primary source of economical manufacturing, raw materials, and component parts, in addition to being considered a major end market.\(^1\) China may also represent the most likely future competition for many American industries, as well as our major trading partner.\(^2\) Increased commerce between the United States and The People’s Republic of China (“PRC”) demands that U.S. entrepreneurs understand the basic foundation for doing business in the PRC. An increasing demand for United States citizens to engage in commerce, or to sit on boards dealing with significant exposure to Chinese developments has also become a reality. A comprehensive and exhaustive treatment of this subject is beyond the scope of this article. However, an identification of some major issues, with suggestions for further research, is attempted. Hopefully, constructive thinking will result from an overview of how conducting business is fundamentally different in the PRC along with an examination of relevant corporate governance issues.

This paper is an outgrowth of an earlier article written to discuss the fundamentals of Chinese corporate governance.\(^3\) However, it soon became apparent that any such attempt required an understanding of some of the basic ways the Chinese environment differs from that familiar to those experienced in the ways of American or European governance. For example, common shares in China do not represent the same ownership interest or have the same designated rights as in the United States, there is no law protecting private property as we know it, and the functions of true “free economic markets” (securities or goods and services) have neither been understood nor embraced by officials having a natural cultural instinct for governmental control of economic enterprises.\(^4\) Accordingly, with a view toward the perspective of the entrepreneur, an attempt is made to bring to the reader’s attention some of the more significant differences found in conducting business in the PRC. Recent headlines depicting closer

\(^4\) Id.
economic relations between the U.S. and China make the co-
dependence between the two countries inevitable. China now ranks as
the largest trading partner of the United States in terms of trade
balance, ranks first in terms of imports into the U.S., and ranks third
(behind Canada and Mexico) in terms of receiving U.S. exports.5
According to the World Bank, when measured by the “purchasing
power parity” method, China has the world’s second largest
economy.6 It ranks fourth (roughly equal to the economies of France
and Great Britain) behind the U.S., Japan, and Germany, when viewed
under the traditional market exchange method.7 When results for 2010
became available, China surpassed Japan as the world’s second largest
economy.8 China Daily reports that “China’s economy grew at an
annual rate of 9.5 percent in the second quarter of [2011], slower from
a 9.7 percent rise for the first quarter.”9

It has been said that the construction crane is the national bird of
China. While China enjoys perhaps the oldest of the world’s great
cultures, traveling through the PRC today and witnessing its dramatic
economic growth, makes it difficult to understand that the beginning
of relevant, modern Chinese legal development dates back only to
1979, with the Law of the People’s Republic of China (“Chinese
Company Law”) adopted in 1993.10 Even more astounding, the
modern roller-coaster development of Chinese securities markets is
essentially an experiment materially just twenty-something-years-
old.11 Donald C. Clarke has recently highlighted the pressing need for

5 U.S. CENSUS BUREAU, U.S. DEPT. OF COMM., U.S. INTERNATIONAL TRADE IN
GOODS AND SERVICES (July 2011); see also Angel Gonzalez & Ryan Dezember,
Sinopec Enters U.S. Shale, WALL ST. J. (Jan. 4, 2012),
http://online.wsj.com/article/SB10001424052970203550304577138493192325500.h
tml (providing an example of almost daily announcements illustrating increased
investment by Chinese in the U.S.).
6 China Overview, THE WORLD BANK,
7 China’s Economy Smaller in New Study: World Bank, CHINA DAILY (Dec. 18,
2007), http://www.chinadaily.com.cn/china/2007-12/18/content_6329427.htm; see
also BARRY NAUGHTON, THE CHINESE ECONOMY: TRANSITIONS AND GROWTH,
(The MIT Press, 2007).
8 Chester Dawson & Jason Dean, Rising China Bests A Shrinking Japan, WALL
ST. J. (Feb. 13, 2011),
http://online.wsj.com/article/SB10001424052748704593604576140912411499184.h
tml.
9 Xinhua, China Faces Pressure of Price Rises in Short Term, CHINA DAILY
09/26/content_13791250.htm.
10 GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW 5-8 (Hong Kong
Univ. Press, 2006).
11 CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA’S
continued . . .
scholarly research about comparative corporate governance, stating that:

[T]he last thirty years have seen a startling rise in the economic importance of other countries, particularly China and the rest of non-Japan Asia. From 1980 to 2006, for example, China’s share of world GDP (estimated on the basis of purchasing-power parity) rose from about three percent to about sixteen percent.\footnote{Donald C. Clarke, “Nothing But Wind”? The Past and Future of Comparative Corporate Governance, 59 AM. J. COMP. L. 75, 77 (2011).}

Indeed, we should all be grateful to Professor Clarke for “bring[ing] comparative law—an interest in what people in other countries do—into the mainstream of a branch of American legal scholarship.”\footnote{Id. at 109.}

II. WHAT BASIC NEEDS ARE DRIVING CHINESE POLICY?

Susan Shirk, a former Deputy Assistant Secretary of State for East Asia and Pacific Affairs, and now Professor at UC-San Diego, notes that “[e]very good diplomat knows that you can never get anywhere until you put yourself in the shoes of the person sitting across the table from you.”\footnote{Susan L. Shirk, China: Fragile Superpower: How China’s Internal Politics Could Derail Its Peaceful Rise 12 (2007).} Accordingly, all those seeking to do business in China are well served to constantly ask themselves “what we would want” if we were in charge of the PRC “controlled” economy. Law professors Norwood Beveridge, Tahirih V. Lee, Dean John Cooper and other commentators have observed that the motives of the PRC government appear to consist of the following four major objectives: (1) Increasing industrial productivity; (2) Seeking foreign exchange; (3) Import substitution; and (4) Job creation (perhaps the primary goal).\footnote{Norwood Beveridge, Professor, Oklahoma City University School of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); Tahirih V. Lee, Professor, Florida State University College of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); John F. Cooper, Associate Dean of International and Cooperative Programs and Professor of Law, Stetson University College of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); see also Michael Petrusic, Oil and the National Security: CNOOC’s Failed Bid to Purchase Unocal, 84 N.C. L. REV. 1373 (2006).}

Jamie F. Metzl of the Asia Society says “Driven by the need to deliver economic growth as a major justification for its existence, the
Chinese government has done a tremendous job of creating wealth and bringing hundreds of millions of Chinese people out of poverty.”

Development of capital markets and an efficient framework for capital formation should allow China to tap its internal assets and the resources needed from the rest of the world to finance and fuel the PRC’s impressive economic growth. Yuwa Wei contends that the decision to open and nurture the growth of the Shanghai and Shenzhen exchanges rested upon two primary purposes: “(1) to utilize domestic savings to facilitate social funds and private companies; and (2) to discipline the listed companies and accelerate the pace of building a modern corporate governance system.”

The PRC leadership’s enlightened motivation to raise funds for the National Social Security Fund may be seen through its activities of June 12, 2001, when all companies were directed by the State Council to include 10 percent of state-owned shares in all initial or follow-on stock offerings. The 2008-2009 global financial crisis, however, “made clear that China’s dependence for growth on the purchasing power of consumers in America, Europe and Japan creates a dangerous vulnerability.” China’s need to expand and reinforce a “formal social safety net” is expanding as more Chinese reach retirement age. This will add unprecedented costs that may shock an already over-taxed environment that is heavily dependent on infrastructure projects and other state-directed investments for growth. In light of this,

Even if China’s leadership makes major progress on domestic reform, it will find that the international environment is becoming less conducive to easy economic expansion. Higher prices for the oil, gas,

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18 Sandra P. Kister, China’s Share-Structure Reform: An Opportunity to Move Beyond Practical Solutions to Practical Problems, 45 COLUM. J. TRANSNAT’L L. REV. 312, 327 (2006) (explaining how deteriorating market conditions and political pressure resulted in abandonment of this requirement within just a few months).

19 Ian Bremmer, China’s Bumpy Road Ahead: Unrest, inflation and an aging populace stand in the way of the Middle Kingdom’s Touted Domination, WALL ST. J. (July 9, 2011), http://online.wsj.com/article/SB10001424052702303544604576430103921843770.html.

20 Id.

21 Id.
metals and minerals that China needs to power its economy will weigh on growth. The exertions of all those other emerging market players will add to the upward pressure on food and other commodity prices, suppressing growth rates and undermining consumer confidence, which have been the most important sources of social and political stability in China...

Strong growth in China, coupled with America’s unsustainable fiscal policies, high unemployment and weakened consumer demand, will generate friction between the world’s two largest economies—in particular, by significantly increasing the likelihood of protectionism on both sides. That’s a problem for American companies looking for access to Chinese consumers, but it’s far more troublesome for the Chinese, who rely more on U.S. fiscal stability, investment, technology and consumption.22

III. DOING BUSINESS IN CHINA IS NOT JUST LIKE DOING BUSINESS IN ANOTHER FOREIGN COUNTRY

Business decisions may prove unusually complex to foreigners seeking to do business in the PRC. Evolving from Confucianism,23 the traditional Chinese culture places much more emphasis on the nurturing and maintenance of relationships than in most other areas of the world. Relationships and connections, or “Guanxi,” are the “vehicle in which Chinese business is conducted. Nothing gets done without them.”24 In this system,

[family and social context define the individual, unlike the Western view in which the individual defines his own context. In other words, self-individualization is possible only through an interaction with others within the context of one’s own social roles and relationships. The self is always in relation to others, a rational self; a

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22 Id.
rational being.\textsuperscript{25} Under this powerful system of \textit{Guanxi}, “[p]eople’s sense of themselves, and their self-worth, is often determined by their relationships with others. The Chinese are both individualist and group-oriented and the relationships between group and individual are complex and deep-rooted.”\textsuperscript{26} Thus, it has been observed that personal and business relationships in China must be developed on two levels: “with the person as an individual, and the person as a member of a reference group.”\textsuperscript{27}

It is true that Westerners also develop \textit{guanxi}-type relationships and networks. What distinguishes the Chinese \textit{Guanxi} system, however, is that in China this same pattern of relationships is also central to the business world, on a quite explicit and open basis. Business associates within a network are referred to as being zi jia ren (one’s own family). In a Confucian society, \textit{guanxi} represents a natural blurring of the line between the professional and the personal . . . This complex system carries expectations that favors will be returned.\textsuperscript{28}

American businessmen in China should remain conscious of the \textit{Guanxi} system. While “[s]ome Chinese businesspeople dismiss \textit{guanxi} as old fashioned and . . . replaced by modern Western methods[,] . . . the Western business person should assume both approaches are relevant.”\textsuperscript{29}

\textit{Guanxi} and Western models of approaching a transaction need to be viewed in tandem: a strong enough relationship gains entry to the Western model of negotiation and hopefully to an eventual contract and continued relationship. The bigger the risk, the stronger the \textit{guanxi} will need to be. The process of securing a contract in China is rarely the free market auction paradigm Westerners expect. For example, the terms of a business may be determined by the parties; however, to be sure, all local implications of the business (like

\textsuperscript{25} Greenlee, \textit{supra} note 24.  
\textsuperscript{26} Id.  
\textsuperscript{27} \textsc{Tim Ambler, Morgen Witzel & Chao Xi}, \textit{Doing Business in China} 110 (2d ed. 2009).  
\textsuperscript{28} Greenlee, \textit{supra} note 24.  
\textsuperscript{29} Id.
suppliers) will be determined by guanxi.\(^{30}\)

### A. The Modern Chinese Legal System

The development of modern law in the different Chinese jurisdictions often rests upon fundamentally different foundations. Hong Kong company law is based upon British tradition.\(^{31}\) The Company Law of the People’s Republic of China\(^{32}\) of 1993 was based largely on the company laws of Taiwan, France, Germany, and Japan.\(^{33}\) Taiwanese law was heavily influenced by the German and Japanese Commercial Code.\(^{34}\) However, Taiwanese law was heavily influential upon the Chinese drafters substantially for language reasons; “[y]et Taiwan’s company law is itself a hybrid, since it was originally based on both German and Japanese law and, after World War II, came under U.S. influence.”\(^{35}\) The growth of the Chinese legal system has been described as

... one that our Chinese colleagues tell us is part of the civil law system (dalufa xi). Without debating the merits of that characterization here, or examining strong German, Japanese, and Soviet influences, there is a pronounced bias in Chinese lawmaking and the Chinese legal system towards positive, statutory law—rather than judicially articulated case law and jurisprudence. Whereas in the United States or

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\(^{30}\) Id.

\(^{31}\) Gu, supra note 10, at 10-11.

\(^{32}\) 中华人民共和国公司法 (COMPANY LAW OF THE PEOPLE’S REPUBLIC OF CHINA) (Adopted at the 5th Session of the Standing Committee of the 8th National People’s Congress on December 29, 1993; amended for the first time in accordance with the “Decision on Amendments to the Company Law of the People’s Republic of China” at the 13th Session of the Standing Committee of the 9th National People’s Congress on December 25, 1999; amended for the second time in accordance with the “Decision on Amendments to the Company Law of the People’s Republic of China” at the 11th Session of the Standing Committee of the 10th National People’s Congress on August 28, 2004; and further amended at the 18th Session of the Standing Committee of the 10th National People’s Congress on October 27, 2005), translated in THE COMPANY LAW OF THE PEOPLE’S REPUBLIC OF CHINA (Beijing: Foreign Languages Press, Beijing, China, 2001), also available at http://www.acga-asia.org/public/files/China_Company_Law_Amended_Oct2005.pdf (China).


\(^{34}\) Hou Xinyi, Professor & Vice Dean, Nankai University Law School in Tianjin China, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007).

\(^{35}\) Siems, supra note 33, at 66.
England, for example, one might expect to see a key concept like fiduciary duty elaborated in a fact-specific case opinion, in the Chinese context we would expect to see the same concept described in a formal statute or regulation, and then invoked by a public legal authority (like a court) in arriving at a decision or implementing an enforcement action. (It is worth noting in this context that many scholars, in fact, believe that the specific concept of fiduciary duty is best developed, and may only be available, in common law systems.)

B. No Concept of Private Property

American businessmen in China must understand the development and extent of private property rights in China. The 1949 dismantling of the Shanghai Stock Exchange, the third largest in the world at that time, by the Chinese Communist Party was the direct result of the inability to reconcile Marxist principles with the concept of private-share ownership. It was observed that, “the creation of a national stock market raised deep ideological concerns about the meaning of private property rights, the appropriate extent of state ownership, and the role of the planned economy in a socialist market economy.”

Regarding private property,

[w]hen China’s national stock exchanges were established, private property rights held only a feeble status. The word “private” had only recently entered the Constitution of the People’s Republic of China (the “Constitution”), when the 1988 amendment replaced the phrase “individual economy of urban and working people” with the phrase “private sector of the economy.” Article Eleven of the Constitution described the private sector as a mere “complement” to

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37 Kister, supra note 18, at 316-17.

38 Id. at 316.

39 Id. at 317 n.24 (citing XIAN FA [Constitution] art. 11 (1988) (China)) (footnotes in original omitted).
the dominant public economy.\textsuperscript{40}

Language contained in the fourth amended version of the Constitution of the People’s Republic of China, Article 13 states, “citizens’ lawful private property is inviolable” and “[t]he State, in accordance with law, protects the rights of citizens to private property and to its inheritance.”\textsuperscript{41} However, “[t]he State may, in the public interest and in accordance with law, expropriate or requisition private property for its use and shall make compensation for the private property expropriated or requisitioned.”\textsuperscript{42}

C. Accounting Standards: Auditor Frustration and Adoption of International Financial Reporting Standards (“IFRS”)

I seem to remember from my introduction to accounting course that “accounting” could be defined as “the language of business.” How can anyone manage, oversee or control any enterprise toward growth without reliable numbers to measure performance (or lack of it)?

The Wall Street Journal reports during 2011, that “[s]ince February, the so-called Big Four accounting firms have resigned or been dismissed from at least seven Chinese companies listed in the U.S., according to SEC filings . . . in three instances, auditors quit the accounts before completing the auditing of any financial reports.”\textsuperscript{43} Auditor verification of even the most basic of accounting items, such as cash, is proving difficult or impossible in China. “Problems with ‘bank confirmation’—the process by which an auditor checks with a company’s bank to verify its balances—have risen in about 10 recent disputes between U.S.-traded Chinese firms and their auditors, according to Securities and Exchange Commission filings.”\textsuperscript{44} The U.S. Public Company Accounting Oversight Board (“PCAOB”) inspectors “conduct regular evaluations of the firms that audit the

\textsuperscript{40} Id. at 317 n.25 (citing XIAN FA [Constitution] art. 11 (1988) (China)) (footnotes in original omitted).
\textsuperscript{42} Id. at § 3.
books of U.S.-traded companies in order to assess the firms’ performance and ensure they’re complying with auditing standards.\textsuperscript{45} But so far, “Chinese authorities haven’t allowed the PCAOB’s inspectors into their country to evaluate the work of the 53 Chinese audit firms registered with the PCAOB, including affiliates of the Big Four accounting firms.\textsuperscript{46}

This came at a time when “U.S. investors [during 2011] [had] lost billions of dollars in the face of scandals involving U.S.-listed Chinese companies that auditors have alleged misrepresented their business and financial position.”\textsuperscript{47} Moreover,

[a] court challenge against the China unit of accounting giant Deloitte Touche Tohmatsu by the U.S. Securities and Exchange Commission escalates a clash between U.S. and Chinese regulators on how much oversight the U.S. should have over the hundreds of Chinese firms listed on U.S. exchanges . . . In opening a new front in its battle to tighten oversight of U.S.-listed Chinese companies, the SEC argues that it isn’t clear what Chinese laws would be violated, if any, by turning over audit records . . . The dispute also highlights the shortcomings of regulation in China, which is complicated by vague laws, competing regulatory agencies and a tight rein on information.\textsuperscript{48}

In November 2005, the PRC announced a commitment to converge Chinese Accounting Standards (“CAS”) with International Financial Reporting Standards (“IFRS”), culminating efforts by the Ministry of Finance (“MOF”) since the early 1990s to establish standard accounting practices across diverse types of enterprises.\textsuperscript{49} The


\textsuperscript{46} Id.


\textsuperscript{48} Id.

business and financial news site Moneyweb reports,

[t]he process of convergence will involve integrating the IFRS principles into CAS and will result in the amendment of all existing standards and the issuance of an additional 22 Specific Standards. While the revised CAS will not reflect a literal translation of IFRS, their scope will include all IFRS principles. In addition, they will contain interpretive guidance to address the accounting for specific types of transactions (e.g., combinations of companies under common control) and industry accounting issues (e.g., extraction of petroleum and natural gas) . . . There will, however, continue to be a small number of differences between the revised CAS and IFRS to reflect unique circumstances in China. These differences, among other things, relate to (i) a prohibition of the reversal of asset impairment once it has been made; (ii) the accounting for certain government grants; and (iii) related party disclosures.\(^{50}\)

While listed companies in China adopted the new accounting standards during 2007, Liu Yuting, director of accounting for the MOF, announced during July 2007 that “central-level state-owned enterprises would comply with the new regulations by 2008 and the scope would be expanded to include all large- and mid-scale enterprises a year later.”\(^{51}\)

Perhaps as a move by the SEC to allow or require U.S. issuers to use IFRS (as a step towards a single set of globally accepted accounting standards), Chinese convergence takes place as the SEC announces that foreign private issuers will be allowed to file financial statements using IFRS, as published by the International Accounting Standards Board (IASB) without a reconciliation to U.S. GAAP (Generally Accepted Accounting Principles).\(^{52}\) This is effective with financial statements for the period ending after November 15, 2007.\(^{53}\) The SEC has recently solicited public comment regarding

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\(^{50}\) Id.


\(^{53}\) Id.
incorporating IFRS into the financial reporting system for U.S. issuers.\textsuperscript{54}

Systems for financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice. Yuwa Wei observes that Chinese law “does not clarify the status of internal auditors.”\textsuperscript{55} Total subjection to a general manager substantially weakens an auditor’s monitoring power.\textsuperscript{56}

D. Experience with Markets and “Corporate Form” is Disarmingly Recent

The experimental and pragmatic approach to economic development resulting from Deng Xiaoping’s vision created heightened tension among regulators.\textsuperscript{57} A curious paradox characterizes China’s framework for economic development. The government embraces an experimental approach in adopting new market systems, while it also insists on retaining crucial levers of control. The most important reform currently underway in China derives from this paradox.\textsuperscript{58}

Shortly after China introduced a stock market:

[T]he Chinese securities market regulator made a move to insure government control over the state-owned sector of the economy. It prohibited more than two-thirds of shares technically listed on the market from actually trading. This internal dysfunction – a phenomenon that is unique in the world – has produced a stock market that appears puzzling from the outside. The market has grown admirably from a market capitalization of only 105 billion renminbi (RMB) [13 billion U.S. dollars] in 1992, to 3572 billion RMB (443 billion U.S. dollars), representing approximately 34% of China’s gross domestic product, in 2005. But despite this growth, the market has faltered for years at about 46% below its mid-2001 level. One commentator has likened the performance of the market

\textsuperscript{55} Wei, supra note 17, at 218.
\textsuperscript{56} Id. at 219.
\textsuperscript{57} See, e.g., Kister, supra note 18, at 312.
\textsuperscript{58} See id.
since July 2001 to ‘passing through the valley of the shadow of death.’\textsuperscript{59}

China experienced corporate scandals and deceptive securities market manipulation during the late 1990s, culminating in a market sell-off during the first years of the new millennium.\textsuperscript{60} Much as the U.S. securities markets suffered from the likes of Enron, WorldCom, and Adelphia Communications,\textsuperscript{61} the PRC had its own long list of scandals including the Qiong Min Yuan case, the Zheng Bai Wen case, and the Chengdu Hingguang case.\textsuperscript{62} While it is tempting to consume many pages to describe the various methods employed to defraud innocent investors, suffice it to say that the Chinese experience rivaled that of the West, resulting in the destruction of investor confidence that would impact capital formation for several years. However, much like the U.S. experience, in just a few short years the investing markets seem to have suffered from an amnestic ability to ignore the painful lessons of the recent past, with Chinese markets soaring 98% for the Shenzhen Composite and 130% for the Shanghai Composite during 2006, producing 163% (Shenzhen) and 97% (Shanghai) returns during 2007; losses of 62% in Shenzhen and 65% for the Shanghai Stock Exchange Composite Indexes during 2008, but gains of 64% (Shenzhen) and 47% (Shanghai) during the first eight months of 2009.\textsuperscript{63} By September 26, 2011, the five-year non-inflation adjusted return for the Shenzhen index was 144% and

\textsuperscript{59} Id. at 312-13.
\textsuperscript{60} Wei, supra note 17, at 225.
\textsuperscript{61} See generally Victor Futter, An Answer to the Public Perception of Corporations: A Corporate Ombudsperson?, 46 BUS. LAW 29 (Nov. 1990) (including an account of pre-Sarbanes-Oxley corporate wrongdoing).
\textsuperscript{62} Wei, supra note 17, at 214.
\textsuperscript{63} Id.; see also Shanghai Stock Exchange Composite Index, BLOOMBERG, http://www.bloomberg.com/quote/SHCOMP:IND (last modified June 6, 2012) (“The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990 with a base value of 100. Index trade volume on Q is scaled down by a factor of 1000.”); Shenzhen Stock Exchange Composite Index, BLOOMBERG, http://www.bloomberg.com/quote/SZCOMP:IND (last modified June 6, 2012) (“Shenzhen Stock Exchange Composite Index is an actual market cap weighted index (no free float factor) that tracks the stock performance of all the A-shares and B-share lists on the Shenzhen Stock Exchange. The index was developed on April 3, 1991 with a base value of 100. Index trade volume on Q is scaled down by a factor of 1000.”); James T. Areddy, China’s Slower Profit Train Could Derail a Stock Boom, WALL ST. J., Jan. 3, 2008, at C1.
44% for Shanghai. For perspective, these results contrast with a loss of approximately 5% on the Dow Jones for the comparable period.

E. Banking in the PRC

Volumes have been written about banking opportunities and the Chinese banking system. While coverage of this topic in any substantial way far exceeds the scope of this article, a focus on the business risk associated with structural banking weakness needs to be mentioned. “China’s administrative and regulatory framework for banking as well as its judicial system, now only in their infancy, is faced with the challenge of attempting to deal with an aspiring 21st century banking system.” It seems likely such a new focus within China toward growing Western-style banks will introduce new systematic business environment risk for investors and those conducting commerce in the PRC.

China’s first regulatory agencies were formed in 1995 following its admission into the WTO. As part of its accession into the WTO, China agreed to “apply and administer all WTO-related laws, regulations and other measures in a ‘uniform, impartial and reasonable manner.’” Some commentators believe that this shift in the Chinese banking system may simply be “out of the reach [for the] fledgling [Chinese] administrative and judicial system[s].” The commentators note that the Chinese do “not have much experience drafting clear and detained regulations and [that they] lack a track record or tradition of administering law in an impartial and unbiased manner.”

Furthermore, the difficulties facing the Chinese government in regulating the banking industry are “not only organizational and technical but cultural as well.” One commentator points out that “China is a single party socialist state saddled with a transition

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64 Trautman, supra note 3, at 13 n. 37.
65 Id.
66 Id. at 13 n. 38.
69 Jirak, supra note 67, at 334.
70 Id. at 335.
71 Id.
72 Id.
economy, an immature legal system, and a historical legacy of more than two millennia in which the subordinate role of law as a means of achieving social order stunted the growth of a culture of legality.”

Cultural barriers, while difficult to quantify, undoubtedly play a factor in Chinese banking law risk.

While the current state of banking regulation in the People’s Republic may appear bleak, that “is not to say that no progress has been made.” China has made an effort in three of its five-year plans to “increase legal education and awareness.” Some examples of the Chinese government’s attempts to educate its people on the law include broadcasting of live trials on television and sponsoring “radio shows in order to educate citizens about their legal rights.” However, “continuing uncertainty in the judicial and administrative framework presents serious questions about China’s ability to handle a banking system vaulting into the 21st century.”

The non-performing loan (“NPL”) issue

Does the level of non-performing loans on the books of PRC banks remain a significant risk to all engaged in Chinese commerce, as well as to global political stability? One commentator believes that “[d]ecades of policy lending have saddled the four state-owned banks with an unhealthy level of non-performing loans from state-owned enterprises. Asset management companies have been created to manage these NPLs, but the situation is far from stable.” Further, “[a] lack of corporate governance has also created an environment where management of banks is opaque and corruption widespread.” Undoubtedly, the risks associated with

73 Id. (quoting Randall Peerenboom, Globalization, Path Dependency and the Limits of Law: Administrative Reform and Rule of Law in the People's Republic of China, 19 BERKELEY J. INT'L L. 161, 261 (2001)).
74 Id. at 335.
75 Id.
76 Id.
77 Id.
78 Trautman, supra note 3, at 15 n. 50.
80 Id.
the Chinese banking system are great.  

One commentator noted, “The existence of NPLs is a legacy of the role that China’s banking system played prior to the current reforms. At that time, banks served primarily as a funding source for programs dictated by state-owned enterprises.”

In fact, “[s]cholars have speculated [that] NPLs comprised anywhere from ten percent to forty percent of all banking assets. Dai Xianglong, the governor of the PBC ‘officially recognized that the ratio of NPLs to total outstanding loans at the Big Four was 25% in 1999.’” Standard and Poor’s (“S&P”) further corroborated this idea in 2001 and “predicted that the Big Four would require $540 billion, half of China’s annual GDP, to account for NPLs.”

Notwithstanding the estimates quoted above, “some Western analysts disagree with such assessments and put the amount of NPLs in the banking system at around forty percent.” In May 2005, S&P put the figure at around thirty-one percent. “Others suggest ‘the staggering figure of NPLs has already made the Big Four technically insolvent.’” Great pressure still exists to make loans to state-owned enterprises or recently privatized state-owned enterprises that are still controlled by party leaders.”

81 Id.
82 Jirak, supra note 67, at 336.
83 Id. at 337.
84 Id. (citing Robyn Meredith, China Fever: Mainland Stocks are Hot, but Many Are Just Sick, FORBES, July 4, 2005, at 83 (“Some of the Biggest China IPOs due this year are in the shaky sector of banking. Academics and economists outside China say 25% of all Chinese bank loans are bad. A bailout would cost China a punishing 17% of its gross domestic product, or $280 billion, UBS says.”).
85 Id.; see also Billion-dollar gamble: Another of China’s big banks finds illustrious foreign partners, ECONOMIST (Sept. 3, 2005), http://www.economist.com/node/4352061 (“To spruce themselves up for listing, the banks have been selling off their old non-performing loans: they even put their bad-loan ratios in single digits, although the true figures are probably still much higher.”).
86 Jirak, supra note 67, at 337.
87 Id.; see also Craig Phillips, Banks Have A Long Way to Go to Win Confidence, THE AGE (Oct. 21, 2005), http://www.theage.com.au/news/business/banks-have-a-long-way-to-go-to-win-confidence/2005/10/20/1129775901483.html# (“Meanwhile it was recently touted that to fix China’s bad loans fiasco in the country’s state-owned commercial banks alone, the Chinese government would have to fork out the equivalent of 44 per cent of the nation’s gross national product (GNP). This, according to the latest figures released by the World Bank, equates to approximately $US1 trillion.”).
88 Jirak, supra note 67, at 338; see also Brian Brenner & Dexter Roberts, Wanted: A Big Broom For China's Banks, BUS. WK., May 9, 2005, at 52; Lan Cao, continued . . .
In 1998, the Chinese government “bailed out [the Big Four] with capital infusion of $33 billion” and in 2004 gave over $45 billion to the Bank of China and China Construction Bank, in an effort to rid the banks of bad loans. In 1999, China also removed over $169 billion worth of NPLs from the Big Four and sent them to asset management companies. China hopes that these efforts will stabilize the banks and allow them to better cope with the increased competition that will come with the full opening of the Chinese market. However, only time will tell just how endemic the NPL problem truly is.

F. Banking Day of Reckoning Near?

What about China’s growth risks? “Officially, the large state-owned banks have reduced their nonperforming loans dramatically, to 300 billion yuan ($44 billion) in 2010 from more than one trillion yuan in 2005.” However, “the government spurred the banks to lend 1.4 trillion yuan in 2009, and even the optimists concede that some portion of these loans are starting to go south.” Can investors “trust the balance sheets of banks that are simultaneously arms of the state and listed companies?” Moreover, it has been argued that the world must pay close attention to Chinese fundamentals, including the stability of its banking system. Beijing will no doubt continue to insist on the principle of noninterference in its internal affairs, but there is a pressing need for greater transparency. As the Journal reports, China is the biggest player in the


90 Id. at 338 (citing Li Yong Yan, China’s $45 Billion Bank Headache, ASIA TIMES (Jan. 9, 2004), http://www.atimes.com/atimes/China/FA09Ad02.html).

91 Id. (citing Cao, supra note 88, at 565).

92 Id. at 338-39 (citing Yan, supra note 90).

93 Id. at 339; see generally James Kyenge, “Bold Action Needed” on China’s Banks’ Bad Loans, FIN. TIMES (LONDON), Oct. 1, 2002, at 14 (discussing speculation by some analysts who believe NPLs are actually increasing).


95 Id.

96 Id.
global steel market, yet nobody has a clear picture of how much it produces and consumes. The financial system is even more opaque, as official data are suspect and information that would be public elsewhere is still considered a state secret.97

One commentator warns that “[t]he liabilities of the [Chinese] shadow banking system are unknown and uncontrolled.”98 Moreover, the secrecy and tactics of the Chinese “add up to a financial system that in some respects is running out of control. The more liabilities build up out of sight of regulators, the more serious the risk that a financial crisis could catch authorities by surprise.”99

That same commentator believes that the “problem is twofold.”100 First, “[i]t is very difficult to capture information about nonbank sources of lending, which comprise everything from corporate balance sheets to unrecognized promises for future profits. Second, the bank regulators control only the banks, but not the whole economy.”101 Essentially, “[t]hey are in a tug of war both with China’s planning board—the National Development and Reform Commission—and local governments, all of whom have a vested interest in spending as much money as possible.”102

However, “the downside is more frightening. There is a rampant growth of credit, uncontrolled or even incalculable by the country’s top leadership. This means the financial system is generating liabilities that could easily turn sour and, come some kind of crisis, prove difficult to clean up.”103 A different group of commentators state that

[t]he first wave of problem loans originating from the 2009 economic stimulus is about to hit China’s banking system. If the reports citing anonymous officials are true, Beijing is considering assuming responsibility for some two trillion to three trillion yuan ($300 billion-$450 billion) of loans that were made to local government[s].104

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97 Id.
99 Id.
100 Id.
101 Id.
102 Id.
103 Id.
104 Carl E. Walter & Fraser J.T. Howie, Op-Ed., Beijing’s Financial Day of continued...
Such a bailout would be bigger than the U.S. Troubled Asset Relief Program and account for about 7% of China’s gross domestic product.\textsuperscript{105} How did this happen?

When the global financial crisis affected China’s exports in 2008, Beijing ordered its banks to support a massive credit expansion to create jobs and stimulate growth . . . The machinery to remove bad loans from the banking system is already in place. In 1999 Beijing created four asset management companies (AMCs) to acquire nonperforming loans. These “bad banks” were supposed to exist for only 10 years, during which time the government expected them to complete the sale or disposal of their portfolios.\textsuperscript{106}

In China, “national debt narrowly defined is 20% of GDP, but if all obligations of the sovereign were added up it is closer to 80%. This is before this round of local government loan acquisition, and before considering the other 70% of the stimulus loans made to state enterprises.”\textsuperscript{107} History has shown that these state enterprises have repeatedly been bad creditors.\textsuperscript{108} “With few voices able to question its actions, Beijing will apparently continue along the path of increasing systemic financial leverage. The weight of its inability to halt profligate spending by local governments and state enterprises will be put squarely on the backs of future generations.”\textsuperscript{109}

In spite of international praise regarding Chinese economic planning, the truth is that the Chinese government has wasted $400 billion.\textsuperscript{110} Had China been more responsible with this money and “added [it] to the National Social Security Fund, China might be several steps further along the path of creating an economy driven by domestic consumption rather than infrastructure investment.”\textsuperscript{111}

Perhaps Beijing’s willingness to assume a portion of local government debt shows the political will to act decisively. But it must be remembered that the central government approved these loans in 2008 and 2009 in


\textsuperscript{105} \textit{Id.}
\textsuperscript{106} \textit{Id.}
\textsuperscript{107} \textit{Id.}
\textsuperscript{108} \textit{Id.}
\textsuperscript{109} \textit{Id.}
\textsuperscript{110} \textit{Id.}
\textsuperscript{111} \textit{Id.}
the knowledge that many projects were of questionable quality. The experience of these two years shows that a large part of the Chinese economic miracle has been built on a foundation of ill-considered lending and accounting sleight-of-hand.\textsuperscript{112}

Those engaged in entrepreneurial activities or corporate governance either in China or other parts of the world (dealing with Chinese commerce) are well-advised to have a heightened sensitivity to the risk introduced by a fragile Chinese banking system.

\section*{IV. A CONTROLLED ECONOMY IS A BUREAUCRACY AFTER ALL}

\subsection*{A. Business Formation}

The number of required administrative approvals can be frustrating for a Westerner anxious to do business. Business formation may take legal counsel as little as an afternoon in the United States: to ascertain availability of a corporate name, draft, and then file a corporate charter and bylaws with the appropriate state authorities. Not so in the PRC. During my discussions with practicing Chinese attorneys while in the PRC during July and August 2007,\textsuperscript{113} a consensus suggested that it may take as long as two years to move a foreign joint venture or wholly-owned enterprise through the necessary approval processes. However, one U.S.-educated attorney observes,

\begin{quote}
[i]n my own practice, I believe that in major cities such as Tianjin it takes about one month to complete all the paperwork for a joint venture or WFOE ("wholly foreign-owned enterprise"). Many cities follow Tianjin’s model of establishing one-stop service centers to help overseas investors’ registration and pre-operating needs. The Tianjin Municipal Foreign Investment Service Center was established in the late 1980s and is the first one-stop service center in
\end{quote}

\textsuperscript{112} Id.

\textsuperscript{113} See Zhang Yong, Professor, Nankai University Law School in Tianjin China, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July, 9-Aug. 4, 2007); See generally DAVID GRANICK, CHINESE STATE ENTERPRISES: A REGIONAL PROPERTY RIGHTS ANALYSIS (1990) (providing detailed summaries of twenty case studies of large and medium-sized state-owned Chinese industrial enterprises, covering the period 1975 through 1984); JOHN HASSARD, JACKIE SHEEHAN, MEIXIANG ZHOU, JANE TERPSTRA-TONG & JONATHAN MORRIS, CHINA’S STATE ENTERPRISE REFORM: FROM MARX TO THE MARKET (2007).
Usually 20 “chops” (the official ‘stamp’ of the particular authority) will be required to navigate the many layers of relevant PRC governmental authorities having possible jurisdiction (often overlapping) over any new enterprise, with the following being most significant:

5. The State Council (the PRC’s major legal governing body). [It] is responsible for the bulk of regulation. If the project involves $100 million (U.S.) or more the State Council must approve. This is the mechanism where an attempt is made to ensure compliance with the state’s five-year economic plan;

6. The Ministry of Commerce (“MOFCOM”). [It is] the central agency located in Beijing that is responsible for approving any project over $30 million (U.S.) [except for Tianjin and Shanghai]; and

7. The Commission of Commerce (“COMCOM,” formerly COFTEC). [It is] the local branch of MOFCOM, may approve projects of $30 million (U.S.) or less.\footnote{115}

V. BRIEF HISTORY OF CHINESE SECURITIES MARKETS

The reemergence of the PRC during the past few decades as a world economic power of substantial proportions is intimately interwoven with its success in providing a pragmatic approach to capital formation. One author’s cogent description of the historical development of Chinese securities markets is included below.

The first stock exchange in Chinese history, the Shanghai Stock Exchange (Shanghai Gupiao Jiaoyisuo), was the largest in Asia before 1941.\footnote{116} It

\footnote{114} Interview with Gu Ming, Attorney, Oklahoma City, Oklahoma (May 30, 2008).
\footnote{116} Chenxia Shi, Competition in China’s Securities Market: Reform of Current Regulatory System, 3 LOY. U. CHI. INT’L L. REV. 213, 216 (Spring/Summer 2006) (footnotes omitted from original) (citing WILLIAM A. THOMAS, WESTERN continued . . .}
was established in 1905 following the formation of the Shanghai Stock and Stockbrokers’ Association in 1898. This exchange boomed in cotton and rubber share trading but also experienced highly speculative share trading, with sharp rises and falls, as a result of the [turbulent] political and social unrest from the 1911 Revolution until 1929. Political uncertainty and military activities in and around the International Settlement in Shanghai in the 1930s shook the “security and economic integrity of China’s premier port and financial center,” and resulted in a long period of share market depression.\footnote{Id. at 216-17 (footnotes omitted from original) (quoting W\ILLIAM A. THOMAS, WESTERN CAPITALISM IN CHINA: A HISTORY OF THE SHANGHAI STOCK EXCHANGE 211 (2001)).} Although this was momentarily relieved by the surge in price of rubber and other commodities, 1941 saw the closure of the share market and the stock exchange. After the Sino-Japanese War, the Shanghai Securities Exchange (Shanghai zhenquanjiaoyisuo) was opened in 1946, but its membership was limited to Chinese citizens. It was closed when the Communist Party defeated the Nationalist Government in 1949.\footnote{Id. (footnotes omitted from original) (citing W\ILLIAM A. THOMAS, WESTERN CAPITALISM IN CHINA: A HISTORY OF THE SHANGHAI STOCK EXCHANGE 211 (2001)).}

It can be said that the past twenty years of Chinese securities market evolution has been punctuated by a series of miscues, false starts, occasional scandals (like everywhere else) and chaotic changes in expectations. The Chinese economic reform effort envisioned by Deng Xiaoping as early as 1992 has depended heavily upon incorporation of Chinese companies and their listing of shares.\footnote{See \WALTER & HOWIE, supra note 11, at 280.} Walter and Howie write that the Chinese securities markets have “adopted all the infrastructure, accounting, legal, regulatory, and industry functions typically found in the West. Now stock markets do exist in China and give the outward appearance of any emerging market in the world . . . however, China’s markets are not the same.”\footnote{Id. at 280.}

Walter and Howie summarize major differences between Chinese
securities markets and those elsewhere to include:

1. **The past 15 years have clearly demonstrated that stock markets in an economy, every aspect of which is controlled by the state and rife with moral hazard, don’t work.** Yes, great sums of money have been raised for SOEs (state-owned enterprises), and yes, international fund managers have generally supported overseas SOE listings, at times with enthusiasm. But support domestically has been largely speculative, while internationally it has been the result of excess liquidity and a firm belief in China’s great future potential. . . . To a large extent, the very existence of Chinese company IPOs and the domestic markets have given the outward impression that China has changed in a fundamental way. It hasn’t. Nor has its markets developed in the same way as, say, the Indian market.

2. **China’s companies and financial institutions, particularly the so-called Blue Chips, are still overwhelmingly state-owned.** There has been no sign at all of the state’s interest in truly privatizing such companies. Even more important, however, is that all senior management is appointed by the still Leninist Communist Party; their careers are party careers and not bound up with the success or failure of the companies they manage. This year they are managers, next year they are vice governors of provinces and so on. To the extent that a non-state sector exists it does so by the party’s leave and its existence and success depends entirely on how well each entrepreneur manages his relationship with the government.

3. **There is no law protecting private property.** The March 2006 People’s Congress, enthralled by the view that foreign capital is taking over China, once again put off passing a law that would at last give some legal recognition to private property.

4. **China’s manufacturing sector actually shows the way forward.** Although ultra-nationalists may argue that foreign companies are taking over the economy, they miss the point. Who can say that Chinese companies have not benefited from the significant foreign presence? China is now filled with what seem to be highly competitive companies operating in every industry from convenience store chains, to Home Depot-like mega-stores to automobiles and auto parts.
5. The market needs more foreign participation, not less.

6. The Chinese securities landscape is rife with moral hazard. The exchanges are controlled by the state and the Party, as are the securities companies and the banks and corporates that lend and invest in them and the companies that list on them. Although there is a foreign presence in the fund management and insurance sectors, state companies continue to dominate trading and take direction from their various state owners. Together with the national pension fund, they have been blatantly used to ramp the market in support of state policy.

7. The regulator, deep in the industry’s pocket, is protectionist, and has done everything it can to benefit political favorites. This has created a culture of dependency on the state for everything, including bailouts. Such a feeling on the part of the retail investor, who has been used egregiously by all sides, can be understood, but the flip side of dependency is lack of accountability. Where are the court cases brought against those who committed the huge market frauds that brought the securities industry down?

8. The CSRC [China Securities Regulatory Commission], by catering to the industry and consistently ignoring the regulatory violations and outright fraud of major securities firms until too late, has prevented the market from developing the kind of infrastructure—legal, accounting, information transparency, sound corporate governance, and even-handedness—that would have enabled the domestic markets to grow, so that pushing Chinese companies off to Hong Kong would not have been necessary, if it ever was necessary. Its inaction has also precluded the development of true professional expertise, which would have allowed it not just to regulate more effectively, but also to encourage reform of the non-tradable share problem long before it became the issue that it has.

9. Listed companies have also paid a huge penalty, both economically and otherwise. The average first-day market pop for IPOs caused by the one-size-fits-all pricing formula set by the CSR . . . has ranged from between 50% and 180%. No doubt whoever got hold of shares was happy, but think of the money left on the table for hard-pressed SOEs.
10. **Over time, investors came to view all companies as commodities—if the CSRC treated them this way, why should anyone else do otherwise?** This included the underwriters, who had no need to learn how companies should be valued. Because shares were commodities the market simply lost sight of the underlying company. For all intents and purposes, companies were simply shells without identifiable characteristics other than perhaps their particular industry.  

In many ways, securities markets have developed in China despite the government, rather than because of purposeful, enlightened governmental policy. According to Walter and Howie, markets developed in rural China:

> Between 1978 and 1983, far away from the cities, small agricultural enterprises out of necessity began to raise funds and pay interest on things called “shares” but which more closely resembled fixed income securities. On July 3, 1979, the State Council affirmed this spontaneous practice in a notice saying: “It is permitted to take an appropriate amount of funds from the brigade or production group’s common accumulated funds to put in as (start-up) equity (gu).”

A. **Not Really Privatization**

The Chinese experience with capitalism has been an experiment, not an ideological commitment. The resultant “fits and starts” of progress seem entirely understandable, “since the Chinese governmental mindset has been one based upon balancing: the continued desire to maintain control of state-owned enterprises (“SOEs”) with a need to “monetize” state assets to raise hard currency necessary to finance the retirement and medical-care liability represented by China’s gigantic aging population.”

During his 1992 tour of Southern China, Deng Xiaoping set the stage for the Chinese experiment with the following forward thinking and history-changing words:

> Are securities and the stock market good or bad? Do they entail any dangers? Are they peculiar to

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121 Id. at 280-82.

122 Id. at 5.

123 John F. Cooper, Dean, Stetson Univ. Coll. of Law, Lectures at Nankai University, Tianjin, PRC (July 23 – July 26, 2007).
capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out. If, after one or two years of experimentation, they prove feasible, we can expand them. Otherwise, we can put a stop to them and be done with it. We can stop them all at once or gradually, totally or partially. What is there to be afraid of? So long as we keep this attitude, everything will be all right, and we shall not make any major mistakes. 124

Concerns about private ownership are so strong in the history of Chinese securities market development that regulators devised a schematic of share types focused on ownership characteristics, rather than the “rights” represented by the shares. 125 The share designations are as follows: A, B, H, L, and N, where

- “A shares” represent the largest class of Chinese shares; trading in the local currency (RMB) and are available only to Chinese residents and Qualified Foreign Institutional Investor (“QFII”) holders; 126
- “B shares” trade on either the Shanghai (in $U.S.) or Shenzhen ($HK) exchanges; where originally only foreign passport holders could own. Issuers here are usually smaller-cap companies; 127
- “H shares” are those of Chinese companies trading on the Hong Kong Stock Exchange; 128
- “L shares” are those of Chinese companies trading on the London Stock Exchange; 129
- “N shares” are those of Chinese companies trading on the New York Stock Exchange; and 130
- “Red Chips” are Hong Kong Incorporated companies trading on the Hong Kong Stock Exchange; with at least 30% of the outstanding shares held by provincial Chinese governments or other state-owned organizations. 131

124 Kister, supra note 18, at 317 (quoting DENG XIAOPING, SELECTED WORKS OF DENG XIAOPING 361 (The Bureau for Compilation and Translation of Works of Marx, Engels, Lenin and Stalin Under the Central Committee of the Communist Party of China trans., Foreign Languages Press 1994)).
125 Id. at 317-18.
127 Kister, supra note 18, at 318; Fung, supra note 126, at 255.
128 Kister, supra note 18, at 318; Fung, supra note 126, at 255.
129 Kister, supra note 18, at 318.
130 Id.
131 Fung, supra note 126, at 256.
B. Regulation Evolves

The task of establishing efficiently functioning securities markets during transition from a centralized government-controlled economy into modern capital markets is mammoth. The odds of successfully building a regulatory framework capable of handling this high-growth, almost-overnight transition from socialistic economic stagnation to pragmatic capital formation, seems beyond comprehension. Given no recent cultural experience, expertise, or appreciation of how capital markets function, it is understandable (even highly probable) that many “experimental” false starts and abrupt changes in strategy have been made on the road toward building the world’s fastest growing significant capital markets.

Emergence of the modern Chinese securities markets happened in an environment where regulators were focused on state-owned shares; highly cautious and concerned that they may be criticized for losing economic control of state assets.\(^1\)\(^{3}\) Kister points out that regulators “feared that the stock market could open up a channel for the misappropriation or depreciation of state assets, a concept captured by the Chinese phrase, ‘guoyou zichan liushi,’ or simply, ‘liushi,’ for which others could also hold them accountable.”\(^1\)\(^{3}\)

Since Deng Xioping’s “open door” policy was introduced during 1979, in less than thirty years, China has crafted a multilevel legal framework for regulation of its securities markets. Chenxia Shi observes that, “[t]he Company Law and Securities Law are the main legislative components; the State Council, CSRC, and other regulatory bodies supplement the Laws with administrative regulations and rules.”\(^1\)\(^{3}\)\(^{4}\) In describing the Chinese “regulatory fabric” for listed companies and stock exchanges, Chenxia Shi observes that the “regulatory framework . . . began a path of development in the early 1990s. Since then, the National People’s Congress (NPC), State Council, CSRC, and other relevant government agencies have promulgated laws and regulations governing securities markets, stock exchanges, and listed companies.”\(^1\)\(^{3}\)\(^{5}\) Shi observes the recent major laws and regulations making up this regulatory framework to include the Securities Law of the People’s Republic of China (“Securities Law”) and the Company Law of the People’s Republic of China

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\(^1\)\(^{3}\) Kister, supra note 18, at 318.
\(^1\)\(^{3}\) Id. at 318.
\(^1\)\(^{3}\)\(^{4}\) Chenxia Shi, Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement, 24 ARIZ. J. INT’L. & COMP. L. 451, 458 (2007); see also Fung, supra note 126, at 251-52.
\(^1\)\(^{3}\)\(^{5}\) Shi, supra note 134, at 458.
(“Company Law”), which regulate the issuing of securities and shares. 136 “Specifically, the Securities Law regulates the establishment and operation of stock exchanges and market intermediaries, information disclosure, insider trading, and market manipulation.”137

The regulatory framework of the securities market also includes supplemental State Council and CSRC regulations. Shi observes that:

These supplemental regulations are necessary because the laws lag behind China’s rapid development; new situations arise which are not covered by existing laws or regulations. To remedy this, the Chinese government established a unified regulatory body (the CSRC) for the securities market with rule-making powers that reports to the State Council.138

Included in these supplemental regulations are the Securities Investment Fund Law; Criminal Law; Administrative Measures on the Separation of Equity Ownership and Trading Rights of Listed Companies; The Measures on the Administration of Stock Exchanges; the Shanghai Stock Exchange Guidelines on Internal Control of Listed Companies; the Code of Corporate Governance for Listed Companies; and Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies.139

The catalyst for the development of regulation of its securities markets was China’s accession to the WTO in December 2001:

China made several commitments to the WTO: It would allow foreign securities institutions to trade B shares without a Chinese intermediary; allow offices of foreign securities institutions to become special members of Chinese stock exchanges; permit foreign service suppliers to invest up to 33% in joint ventures for managing domestic securities investment funds; and, within three years of accession (December 2004), permit foreign securities institutions to invest up to 33% in joint ventures to underwrite A, B, and H shares, . . . government bonds, and corporate bonds.140

136 Id. at 459.
137 Id. at 460-61.
138 Id. at 461.
139 Id. at 459-60, 485.
140 Id. at 461.
C. The People’s Bank of China (“PBOC”)

It is to be expected that the Chinese will have difficulty understanding the economic functioning and mechanics of the capital formation process and how to establish efficient securities markets from ground zero.\footnote{See generally WALTER & HOWIE, supra note 11, 5-43 (providing an excellent historical account of the Chinese experience with capital markets).} So too, it is difficult for Westerners to appreciate the internal struggle that has developed within the bureaucratic machinery that is China. Different agencies competing for “turf” is a considerable part of the history of how PRC securities market regulation has evolved.

Following twenty-five years of Soviet-style central planning, the People’s Bank of China emerged as the sole administrator and supervisor of the Chinese financial sector which includes both bank and non-bank financial institutions.\footnote{Id.} Although termed a “central” bank, Walter and Howie observe that this entity was very decentralized “with principal staffing and functions at the provincial level and a staff of a few hundred in Beijing.”\footnote{Id. at 46.} Further, the PBOC developed close relationships with local governments. This occurred in part because the local party had the right to nominate senior branch staff.\footnote{Id. at 49-50.} Although local branches of the PBOC reported on a direct line to Beijing, they “had strong links to local governments and were active proponents of the corporation wave that swept across China in the 1980s.”\footnote{Id. at 46.} Walter and Howie observe:

Against this background, it is clear that the PBOC was hardly an appropriate candidate to act as the national regulator of a rapidly evolving market-based experiment. Given the marginal nature of the shareholding experiment at the start, however, the government did not conceive of the need for a more independent regulator until much, much later.\footnote{Id.}

The close relationship between the PBOC and local governments continued to develop:

In 1988 local governments . . . with the active cooperation of local PBOC branches moved ahead to establish 34 securities companies and 100 trading
counters across the country . . . Local governments continued to pursue their own best interests together with the local branches of the PBOC, which began to establish their own brokerages. Eight years later, in 1996, the PBOC was the controlling shareholder in 43 of the nationwide total of 96 brokerages, all of which it had approved itself. It was long since clear that the PBOC was at odds with itself.\textsuperscript{147}

Walter and Howie observe that “it is no surprise that the government’s approach to securities markets regulation in the 1980s was haphazard and driven by local developments.”\textsuperscript{148} Moreover, the 1989 and 1990 hyper-stock craze culminated with August 1992 civil unrest and riots, resulting in the demise of the People’s Bank as market regulator and giving creation to the China Securities Regulatory Commission (“CSRC”) as securities regulator.\textsuperscript{149}

Many instances of false starts and unintended consequences of regulatory action are a major part of the historical development of Chinese securities markets. As noted earlier, a major goal motivating the PRC has been to raise much needed cash for their National Social Security Fund.\textsuperscript{150} An example of the unintended consequences of misguided market regulation is found in the State Council’s 2001 requirement that 10\% of all IPOs and follow-on offerings monetize state-owned shares by inclusion.\textsuperscript{151}

In the four months following this measure, the market dropped by 24.8\%.\textsuperscript{152} Investors reacted with hostility, claiming “the measure was suicidal because its dilutive effect would send prices plummeting and harm multitudes of individual investors.”\textsuperscript{153} Kister notes that the most troubling aspect of the measure was probably that it required the sale

\textsuperscript{147} Id. at 47.
\textsuperscript{148} Id. at 45.
\textsuperscript{149} Id.
\textsuperscript{150} Id. at 15.
\textsuperscript{151} See Kister, supra note 18, at 326-27 n. 93 (“Guowuyuan guanyu jian chi guoyou gu chouji shehui baozhang zijin zanxing banfa [State Council’s Temporary Measure Regarding Selling Down State-Owned Shares and Raising Social Security Fund] (promulgated by the State Council, Jun. 6, 2001), art. 5, available at http://www.molss.gov.cn/correlate/gf200122.html.5. To avoid conflict with the three-year lock-up on promoter’s shares, the measures stated that those issuers that had been established for less than three years would transfer (huabo) its shares to the National Social Security Fund.”). See also HEHONG CHENG ET AL., GUOYOU GUQUAN YANJIU [RESEARCH ON STATE-OWNED EQUITY] 321 (Ping Jiang ed., 2000).
\textsuperscript{152} Kister, supra note 18, at 327.
\textsuperscript{153} Id.
of state assets through the market during every initial and follow-on offering:

For investors, this signified the beginning of a long stream of dilutive releases into the market. For conservative politicians, it meant the weakening of a lever of control over the economy that the government had no power to stop arbitrarily. The political pressure grew so intense that the government abandoned the measure on October 23, 2001.\footnote{154}

**D. China Securities Regulatory Commission (“CSRC”)**

The early 1990s proved to be a difficult environment for the CSRC to wrestle away regulatory authority from the PBOC and other political bodies seeking to control regulation. Then again, any governmental body seeking to regulate the securities market, “bore the hefty burden of proving its loyalty to socialism, and that therefore the designers of the regulatory framework were concerned not with creating the most rational structure, but with creating the structure that would most likely be accepted politically.”\footnote{155}

During this time, the early IPOs of the 1990s in China were seemingly an enormous success based on high issuing prices. “Issuing prices of some companies in 1992, for example, represented price-to-earnings ratios of over 100.”\footnote{156} Kister observes that these “ski-high” prices had multiple causes: “For one, there was a surging demand for stocks from investors, many of whom lacked financial know-how. Another reason was poor regulatory oversight, which allowed companies to over-value their assets in the appraisal process. Finally, some argue that the CSRC’s price-setting mechanism artificially bolstered issuing prices.”\footnote{157}

But these high issuing prices were unsustainable and were followed by precipitous falls.\footnote{158} Nonetheless, even after sharp price declines, “shares still traded at price-to-earnings multiples several times higher than those of foreign counterparts.”\footnote{159} This prompted concern by the CSRC of “the dilutive effect that the entry of promoters’ shares into the market would have on the prices of

\footnote{154}{Id.}
\footnote{155}{Id. at 321.}
\footnote{156}{Id. at 319.}
\footnote{157}{Id. at 319-20.}
\footnote{158}{Id. at 320.}
\footnote{159}{Id.}
currently trading shares.”\textsuperscript{160} This “added a new reason, on top of existing political and ideological reasons, for limiting the tradability of state and state-owned legal person shares.”\textsuperscript{161}

Starting in 1994, the government began imposing non-tradable restrictions on state-owned shares and legal person shares.\textsuperscript{162} The restriction applied to both state and state-owned promoters and private companies. “As a result, . . . in the spring of 2005 approximately 69.7% of the shares of listed companies in China were non-tradable, representing 70.9% of the total market capitalization of China’s stock market.”\textsuperscript{163}

While the regulatory schematic for China’s securities markets remains in the early stages of development, the PRC’s entry into the World Trade Organization (“WTO”), rocketing economic growth during recent years, and increasing the pace of economic globalization has served as a catalyst for more effective securities market regulation.

Writing in 2005, Terry E. Chang observes that the Chinese securities markets had “outperform[ed] not only the Dow Jones World Emerging Markets Index but also the Nikkei 225 of Japan, the Hang Seng Index of Hong Kong, and the Dow Jones STOXX 600 for Europe.”\textsuperscript{164} Chang notes, however, that “despite these phenomenal statistics, the Chinese stock market suffers from seven negative traits.\textsuperscript{165} One such negative trait is the “dualist regime” of China:

China’s unique split in the market between government-subsidized and SOEs and private firms–has spawned a stock market with abnormal traits. Many of the irregularities arise from artificial barriers instituted by the CP [Communist Party] (e.g., low float ratio, quota systems, segregated shares, foreign exchange controls). Overall, the result is a market with an uneven consistency and volatility (e.g., where expansion is dominated by IPOs as opposed to share appreciation, by retail as opposed to institutional investors, by small-cap as opposed to blue chip stocks)

\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{163} Id. at 321.
\textsuperscript{165} Id. at 279.
that is rarely found in mature markets.\textsuperscript{166}

Other negative traits enumerated by Chang are:

1. Distortion in Incentives Produced by Government Ownership of Shares;
2. Political Favoritism of the Quota System;
3. Segregated Share System;
4. For-Ex Controls Block Flows Between PRC and Global Capital Markets.\textsuperscript{167}

E. Shanghai and Shenzhen Markets Develop

As noted previously, Yuwa Wei credits the decision to open the Shanghai and Shenzhen securities markets: “(1) to utilize domestic savings to facilitate social funds and private companies; and (2) to discipline the listed companies and accelerate the pace of building a modern corporate governance system.”\textsuperscript{168} The channeling of domestic savings is particularly important to PRC capital formation, since these funds equate to approximately 40\% of China’s GDP.\textsuperscript{169} Wei notes that channeling domestic savings to securities will increase economic efficiency:

Traditionally, domestic savings could only be deposited at state banks that channeled the money into state-owned enterprises as loans. This method was the least efficient use of the money, because a substantial number of the loans were bad. By channeling them to the securities market instead, the government hopes that domestic savings can be allocated more efficiently. Allowing and encouraging citizens to invest in securities increases the likelihood that the money goes to the best performing or most efficient enterprises. These enterprises will, in turn, further advance their economic efficiency.\textsuperscript{170}

The securities business in China has prospered since June 1990

\textsuperscript{166} Id.
\textsuperscript{167} Id. at 297-99.
\textsuperscript{168} Wei, \textit{supra} note 17, at 209.
\textsuperscript{169} Id. at 209-10.
\textsuperscript{170} Id. at 210.
when “citizens in Shanghai, Shenzen, and other business centers began to show great enthusiasm for share investments.” 171 The volatility of the early 1990s was followed by a bull market in 1996 and then two years of market stability. 172 A record high followed that lasted until 2001, “when the market once again tumbled and a bearish market surfaced.” 173

As noted previously, the Chinese markets produced impressive returns of 98% for the Shenzhen Composite and 130% for the Shanghai Composite during 2006, and produced 163% (Shenzhen) and 97% (Shanghai) returns during 2007; but losses of (30)% in Shenzhen and (36)% for the Shanghai Stock Exchange Composite Indexes during the first five months of 2008. 174 By September 26, 2011, the five-year non-inflation adjusted return for the Shenzhen index was 144% and 44% for Shanghai. 175 For perspective, these results contrast with a loss of approximately (5)% on the Dow Jones for the comparable period. 176

F. Is “Stock” Traded on the Shanghai or Shenzen Exchanges a “Security” as Americans Understand the Term?

Under U.S. law, the term “security” is defined in Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934. 177 Just because an investment is labeled “stock” does not necessarily mean that it fits the definition of “security” for the purpose of the Act(s). For example, the Supreme Court found that the shares of stock in United Housing Foundation, Inc. v. Forman constituted neither an “investment contract” as defined under SEC v. W.J. Howey Co. 178 nor the required attributes of ordinary stock. 179 The traditional Howey test for an investment contract (therefore “security” under Section 2(a)(1) of the 1933 Act) is: (1) an investment of money; (2) in a “common enterprise”; (3) with an expectation that profits will be derived “solely” through the efforts of others. 180 In 1985, the Court adopted a “plain meaning” approach to

171 Id. at 212.
172 Id.
173 Id.
174 Id. at 214; see also BLOOMBERG, supra note 63.
175 Wei, supra note 17, at 214.
176 Id.
180 Howey, 328 U.S. at 298-99.
the statutory definition of a “security” by holding that “stock” necessarily falls within the Act’s coverage if it possesses the following traditional characteristics:

(i) [T]he right to receive dividends contingent upon an apportionment of profits;
(ii) [N]egotiability;
(iii) [T]he ability to be pledged or hypothecated;
(iv) [T]he conferring of voting rights in proportion to the number of shares owned; and
(v) [T]he capacity to appreciate in value.

In the PRC, where “control” is evidenced in listed companies by concentrated ownership, commonly by a single State shareholder, does a “security” exist under either the common language meaning of the term in the United States or under case law? Is it still a “security” by Western standards in situations where effective control of corporate governance rests in State entities which may have an agenda conflicting with the interests of shareholders desiring profits and dividends? For example, state-controlled corporate governance may be driven by a desire to affect: either job subsidy, or the selling of products below market “cost” to achieve a desired social purpose. Professor Donald C. Clarke has observed:

[A]s long as state policy requires the state to stay as an active investor in firms of which it is not the sole shareholder, meaningful legal protection for minority shareholders is going to mean either constraints on the state’s ability to do precisely those things for which it retained majority ownership, or else a de facto separate legal regime for enterprise in which the state is the dominant shareholder.

Share ownership and market participation is inherently risky in a country still struggling to establish an effective rule of law. Terry E. Chang has observed that “[f]oreign investors are discovering that, on the new Chinese frontier, they will not necessarily enjoy the comforts of the legal protections afforded to them by the securities laws of their home countries (e.g., shareholder rights, corporate governance, and

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182 Id. at 686.
judicial enforcement).”

In a state-controlled scenario having a covert agenda of fostering job maintenance, it may prove unlikely that a shareholder will enjoy an unfettered “right to receive dividends contingent upon an apportionment of profits.” In a state-controlled scenario, can it really be possible for a shareholder to enjoy “the conferring of voting rights in proportion to the number of shares owned?” Further, in a situation where the state controls corporate governance, is it realistic for a shareholder to enjoy capacity for unfettered appreciation in value of the “stock” in question?

VI. DEVELOPMENT OF CHINESE CORPORATE LAW

A. The Chinese Corporate Law

Roots of the modern Chinese Legal System are much different from those of many Western nations. It was the Opium War, launched by the British government in 1840, which resulted in a measurable presence of foreign investment, business operations, and what may today be recognized as a “modern business enterprise” having the indicia and introducing the concepts of separate legal entities and limited liability. Prior to 1904, many Chinese family businesses were considered by many commentators to have been the “economic equivalent” of the modern American corporation, in that “the members of large clans worked together not merely out of affection for their kin, but also to accumulate capital and to pursue profits more effectively.” The first Chinese corporation law, patterned on the British Joint Stock Company Act (1856), the British Company Act (1862), and the Japanese Commercial Code (1899), dates back to 1904 (near the end of the Qing Dynasty, which was overthrown in 1911) and is known as the Da Qing Gong Si Lu.

184 Chang, supra note 164, at 281.
185 Gu, supra note 10, at 6.
186 Id.; see also Teemu Ruskola, Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective, 52 STAN. L. REV. 1599, 1605 (2000) (quoting Max Webber stating, “[I]n the absence of a law governing voluntary associations, most businesses were ‘merely’ family businesses”).
187 Gu, supra note 10, at 7.
188 Id.
189 Id.
190 Id.; see also The Principles of the Chinese Company Law (Zhongguo Gongsi Fa Yuanli) 7-8, The Social Science Documents Press (Beijing) (1998) (stating that “the contents of Da Qing Gong Si Lu could be found in Wang Baoshu and Cui Qingzhi); Graham Brown & Wei Xin, Introduction to Company Law, in China continued...
The beginning of relevant modern Chinese legal development dates back only to the 1970s, following the death of Mao Zedong. The *Constitution of the People’s Republic of China* (the fourth Chinese Constitution since 1949) was adopted at the Fifth Session of the Fifth National People’s Congress and promulgated for implementation by the Proclamation on the National People’s Congress on December 4, 1982. The most recent revision, *Amendment Fourth*, was approved on March 14, 2004, by the Tenth National People’s Congress at its Second Session.


B. *The New Company Law (effective January 1, 2006)*

Foreign investors in China will find the changes to *The New Company Law* particularly important since the statutes which govern direct foreign investment in the PRC require that operations by foreign
investors be conducted through a Chinese Limited Liability Company.\footnote{Id.}

The genesis of the Chinese \textit{New Company Law} may be found in the need to reform SOEs, resulting in many provisions lacking compatibility with the corporate law of many developed countries or regions.\footnote{Gu, \textit{supra} note 10, at 2.} With almost nothing of the old law surviving the 2006 revisions, \textit{The New Company Law} may be considered essentially a nearly complete revision.\footnote{Dickinson, \textit{supra} note 194, at 1.}

Gu Minkang observes, “The 1993 Company Law cannot be regarded as a well-drafted law for various reasons, such as its short history, insufficient experience, and changeable circumstances during the transitional period.”\footnote{Gu, \textit{supra} note 10, at 2-3.} Gu cites the following main problems: Chinese Company Law (1) reflects state administrative interference, (2) provides too many benefits and, therefore, preferences SOEs over other kinds of investors, (3) requires too much capital to establish a company, and (4) has substantial systematic flaws that, for example, limit autonomy of internal management, limit the amount of investments a company can make to 50\% of net assets, and provides weak protection for shareholders.\footnote{Id. at 3-4 (citing GUO FENG & WANG JIAN, \textsc{Vertical and Horizontal Discussion on Reform of the Company Law} (Gongsu Fa Xiugai Zhongheng Tan, The Law Press, Beijing 2000).}

Gu Minkang contends the following additional defects need to be corrected in Chinese Company law:

1. \textit{[T]o enhance the check and balance relationship between the shareholders’ general meeting and the board of directors [and to create the right of derivative action for shareholders];}

2. \textit{[T]o improve the check and balance relationship between the board of directors and the board of supervisors (or supervisory committee) [and to give the right of appointing and dismissing directors to the board of supervisors]; and}

3. \textit{[T]o improve the mechanism of protecting minority shareholders.}\footnote{Id. at 4; see also Varun Bhat, \textit{Corporate Governance in India: Past, Present, and Suggestions for the Future}, 92 \textsc{Iowa L. Rev.} 1429 (2007) (describing growth and suggestions for corporate governance architecture of developing countries).}
C. Convention on Contracts for the International Sale of Goods ("CISG")

Designed to create a uniform law for the international sale of goods, the United Nations Convention on Contracts for the International Sale of Goods ("CISG") has been the "Magna Carta" for international trade. China was an early adopter of the CISG, signed during 1980;\(^\text{204}\) ratified December 11, 1986;\(^\text{205}\) and effective January 1, 1988.\(^\text{206}\) Non-Asians, seeking to do business in the PRC may find the choice of law, choice of forum, and arbitration provisions of the CISG particularly helpful in structuring their relationships.\(^\text{207}\)

D. Arbitration and Dispute Resolution

As discussed more fully elsewhere in this article, China lacks the Western tradition of following the "rule of law" for dispute resolution. Instead, the Chinese culture has resorted to thousands of years of attempting to foster the goal of "harmony" in relationships, while minimizing conflict between families (often these extended 'families' have been comparable to Western corporations).\(^\text{208}\) The Chinese tradition of seeking the preservation of "harmony" when attempting to resolve disputes "involves drawing in more people involved with the dispute to resolve the difference. It does not appeal to parties, 'outsiders,' or non-Chinese to resolve what is essentially seen as a relationship problem."\(^\text{209}\) As a result, parties to the conflict are also unlikely to be satisfied with a decision handed down in the context of the Chinese legal system.\(^\text{210}\)

Attorney William Greenlee offers a practical assessment of arbitration and mediation in the Chinese cultural setting. He notes that "there is a strong preference for the resolution of disputes through conciliation–litigation is not favored, and, at least for most, may not be practical."\(^\text{211}\) Because mediation facilitates understanding between

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\(^{205}\) Id.

\(^{206}\) Id.

\(^{207}\) See generally Lee, supra note 115.


\(^{209}\) Id.

\(^{210}\) Id.

\(^{211}\) Greenlee, supra note 24, at 13; see also Stephan W. Schill, *Tearing Down the Great Wall: The New Generation Investment Treaties of the People’s Republic of continued*...
the parties to reach a solution, it is preferred to arbitration, which uses a “go-between . . . who has authority to render a decision based on the evidence presented by the parties.” Greenlee recognizes, however, that “arbitration is so ingrained in Western business thinking, China is learning to accommodate it.”

E. Bankruptcy

The Civil Procedure Law of the People’s Republic of China, adopted on April 9, 1991, provides in Chapter XIX a “Procedure for Bankruptcy of Enterprises as Legal Persons.” Over ten years in the making, China has been working on a modern bankruptcy regime, producing an “Eighth Draft” of a new bankruptcy law during June 2004, and a “Ninth Draft” from the Legal Committee of the National People’s Congress during 2005. Eu Jin Chua observes that proof of the effectiveness of the new law will be at the provincial level because the procedural idiosyncrasies in the Ninth Draft may make it difficult to implement and enforce against debt-laden enterprises. Additionally, with regard to state-owned enterprises:

The Ninth Draft provides a carve-out (as is the case in

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Chua, supra note 211, at 135 n.4.

214 Chua, supra note 211, at 135 n.4.

215 Id.

216 Id. at 160.

217 Id. at 161.

some other jurisdictions) for financial institutions and certain [SOEs]. The Ninth Draft now clarifies the extent to which China’s SOEs will be able to avail themselves of the carve-out by stipulating that the State Council will determine the time period and the types of SOEs that will be exempt from the Ninth Draft. Both the Eighth Draft and the Ninth Draft contemplate three different procedures: liquidation, reorganization, and conciliation.219

F. Intellectual Property Issues

The field of intellectual property rights, perhaps better than any other area of commerce, illustrates the vast differences between Chinese and Western cultures. Westerners who have not had an opportunity to study Chinese history and culture may be surprised to learn just how dramatically opposed the concept of Western intellectual property rights is to Chinese traditions thousands of years old. Carl Erik Heiberg notes that Confucianism is a major cause of the lack of development of IP rights because it mandates “that all individuals have access to a shared intellectual past.”220 Under Confucian philosophy, individuals “learned by copying the past,”221 and, therefore, copying was not a moral offense but rather “a ‘time-honored learning process’ through which people manifested respect for their ancestors.”222

Heiberg further notes that the first Chinese copyright law was formerly introduced in 1910, just one year before the Qing Dynasty was overthrown,223 and “when Mao Zedong’s Communist Party assumed control of China in 1949, all existing copyright laws were retracted as part of the national expulsion of foreign nationals and Western concepts.”224 Even as Mao Zedong attempted to replace Confucian values with Communist values, views on IP rights did not change because “owning property [in a Socialist system] is tantamount

219 Chua, supra note 211, at 161.
221 Id.
222 Id. (noting that discouragement of individual ownership of ideas was facilitated by a lack of means to mass produce literary works and a low literacy rate and citing Peter K. Yu, The Copyright Divide, 25 CARDOZO L. REV. 331, 361 (2003)).
223 Id.
224 Id.
Class struggles and revolution resulted in many intellectuals being imprisoned, killed, or sent away, and resulted in rampant copyright infringement. The treatment of intellectual property under Mao Zedong cast a shadow on its international reputation long after his death:

After Mao’s death and the end of the Cultural Revolution in 1976, Deng Xiaoping and other leaders sought to renew China’s commercial ties with the United States, Japan, and other Western developed countries. China’s lack of IP legislation and the historical treatment of IP under both Confucianism and socialism understandably made foreign nationals apprehensive about investing their technology and other IP into China. As China began entering into trade agreements with Western nations, foreign countries began pressuring China to enact more protective IP laws.

China’s focus on complying with Intellectual Property requirements of the WTO is credited with strengthening copyright protection in the PRC. China’s poor record of providing protection for intellectual property rights was a serious obstacle toward admittance to the WTO. Heiberg notes, “while WTO membership may have brought about improvements in legislation to reflect international standards, actual enforcement of those standards has remained inadequate.”

In a 2005 copyrighted story by The Economist Newspaper Limited, KPMG advocates adopted ten key strategies for use by multinational companies operating in China to help protect their intellectual property rights:

1. Seek to secure full ownership and managerial control

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226 Id.
227 Id.
228 Id. at 119, 229.
2. Assign budget and responsibilities in internal IPR housekeeping

3. Use direct sales and design outsourcing models

4. Conduct contractual audits on distribution and manufacturing partners; stay in touch

5. Keep tracking, tracing and labeling in control systems

6. Explore the feasibility of uniform pricing and product customization

7. Police inventory and manage the inventory cycle

8. Educate and stay in touch with consumers; send a strong corporate governance message

9. Find allies within the system: domestic enterprises and local officials

10. Avoid lawsuits, but draw on innovative measures when necessary.\textsuperscript{230}

In 2009, China issued its largest number of patents ever;\textsuperscript{231} however, “concerns are growing that new patent regulations and other initiatives may damp that growth.”\textsuperscript{232} In addition, Mark Cohen, an attorney at Jones Day in Beijing, has highlighted concerns that the implementation guidelines issued in January 2010 create “uncertainties that could result in extra expense and delay,” which could be used to disadvantage foreigners.\textsuperscript{233}

By 2011, China “is expected to spend $153.7 billion on R&D . . . , up from the $141.4 billion [spent in 2010], according to Battelle Memorial Institute . . . By comparison, Japan is expected to spend $144.1 billion [during 2011], up from $142 billion in 2010.”\textsuperscript{234} Anil


\textsuperscript{232} Id.

\textsuperscript{233} Id.

\textsuperscript{234} Gautam Naik, \textit{China Surpasses Japan in R&D as Powers Shift}, WALL ST. J., continued . . .
Gupta and Haiyan Wang report that “China today hosts about 1,000 foreign-owned R&D labs. Yet, with rare exceptions, these labs focus primarily on local adaptations of innovations developed elsewhere, rather than the development of leading-edge technologies and products for global markets.”

Gupta and Wang contend that “[i]f it wants to become a global technology leader, China needs open doors, strong intellectual property protection, and no stacking of the deck in favor of Chinese companies – a policy mix exactly opposite to some of its current indigenous innovation measures.”

Of concern, The Wall Street Journal reported an alleged “intellectual-property theft scheme that stretched around the globe, [in which] the U.S. company, American Superconductor Corp. of Devens, Mass., said . . . that it had filed suit in Beijing against China’s biggest wind-turbine maker, Sinovel Wind Group Co.” Accordingly, American accused Sinovel of agreeing to pay more than $1 million to one of American’s employees in Austria, who allegedly stole software that was expected to account for 70% of American’s revenue in 2011, and is now facing criminal charges.

G. U.S. Court Judgments in China: Enforceable?

As economic commerce continues to grow between the United States and China, a question that will increasingly be asked is whether judgments obtained in courts of the United States are enforceable in China. According to Professor Donald Clarke the answer is straightforward; U.S. judgments will not be enforced in China. “Chinese law requires the existence of a treaty or de facto reciprocity in order to enforce a foreign judgment; neither exists between the United States and China.”

Professor Clarke notes that he has found only three cases from China’s modern legal era in which a foreign judgment was

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236 Id.


238 Id.


240 Id. (noting that “[t]he basic rule of Chinese law on the enforcement of foreign judgments is set forth in Articles 267 and 268 of the Civil Procedure Law.”).
The cases involved uncontested divorce proceedings between Chinese citizens, at least one of whom lived abroad.\footnote{Id. at 3.} The parties in the cases asked merely that the Chinese courts confirm the validity of the foreign divorce decree.\footnote{Id.} Their requests did not even rise to the level of having the court enforce the judgment.\footnote{Id.} Thus, it is extremely rare that courts in China would recognize and enforce a judgment from any foreign court, and perhaps even less likely that Chinese courts would enforce a U.S. judgment.\footnote{Id.}

In short, there is to date no evidence suggesting that a Chinese court would enforce the judgment of a United States court, and considerable evidence suggesting it would not. Parties seeking the assistance of Chinese courts in their disputes should either seek arbitration – arbitration awards from New York Convention member countries are enforceable in China – or litigate in China.\footnote{Id. at 5.} See generally Donald C. Clarke & Angela H. Davis, \textit{Dispute Resolution in China: The Arbitration Option}, in \textit{CHINA 2000: EMERGING INVESTMENT, FUNDING AND ADVISORY OPPORTUNITIES FOR A NEW CHINA} 151-62 (Asia Law & Practice ed., 1999).

**H. Judicial System and the Practice of Corporate Law in the PRC**

Modern Chinese corporate law is very much in its infancy. Writing in 2006, Beijing-based attorney Eu Jin Chua observed an increased reliance upon Chinese law and Chinese dispute resolution organizations because foreign investors often realized, after the close of a deal, that “the relative certainty of law and judicial processes prevailing in the investor’s home states may not exactly be replicated in [the PRC].”\footnote{Chua, supra note 211, at 133.} As recently as 1999, before implementation of the Five-Year Peoples’ Court Reform Plan (“First Reform Plan”), it was common to find judges who lacked legal qualifications or any experience with commercial transactions.\footnote{Id. at 137.} Amendments to the \textit{Judges Law} during 2001 provided for stringent requirements for judges, including a university degree, continuing education, and passing a rigorous national judicial examination (for those judges

\begin{footnotes}
\item[241] Id. at 3.
\item[242] Id.
\item[243] Id.
\item[244] Id.
\item[245] Id.
\item[247] Chua, \textit{supra} note 211, at 133.
\item[248] Id. at 137.
\end{footnotes}
appointed after January 1, 2002).\textsuperscript{249} The First Reform Plan (1999)
also included anti-corruption regulations, with guidelines regulating
the interaction between lawyers and judges and providing for
disciplinary sanctions and even criminal liability.\textsuperscript{250}

The lack of legal analysis and reasoning in traditionally written
judgments has been a frequent criticism of the Chinese judicial
process.\textsuperscript{251} The judgments are often brief and may come as a surprise
to sophisticated investors who are more accustomed to the longer
opinions provided in most developed judicial systems.\textsuperscript{252} However,
according to Chua, the practice is slowly changing. More recent
judgments issued by higher-level PRC courts have provided more
legal analysis and reasoning behind the decision.\textsuperscript{253} “Although there is
no system of binding case precedent in China, such written decisions
can at least provide guidance to the public and legal practitioners.”\textsuperscript{254}

The Supreme People’s Court issued the Second Five-Year
People’s Court Reform Plan (2004-2008) (“Second Reform Plan”) late
independence of the courts, adopt a system of using significant cases
as guidelines for legal interpretation, and coordinate a consistent
understanding of the law across China.”\textsuperscript{255}

What about the conflict between Chinese traditional culture and
the transaction structure and corporate law as it is practiced in the
West? William Greenlee has offered that “guanxi” may explain the
relatively low profile of lawyers in commerce.\textsuperscript{256}

Chinese businesses rely on relationships rather than
legal bonds. The increased interaction with the West is
bringing with it the greater use of legal instruments.
The People’s Republic of China now recognizes that it
needs a system of legal enforcement of contracts and
that the traditional system (including guanxi) is no
longer enough.\textsuperscript{257}

\textsuperscript{249} Id.
\textsuperscript{250} Id.
\textsuperscript{251} Id. at 136.
\textsuperscript{252} Id.
\textsuperscript{253} Id. at 168, n.10 (stating “For example, the judgments published on the
website of Chinese Commercial and Maritime Trial Involving Foreign Elements,
are for foreign related cases, all include detailed reasoning”).
\textsuperscript{254} Id. at 136.
\textsuperscript{255} Id. at 138.
\textsuperscript{256} Greenlee, supra note 24, at 12.
\textsuperscript{257} Id. at 12-13.
From a practical standpoint, when entering into a commercial transaction with a Chinese entity, contracts should be drafted in both Chinese and English. It may even be prudent to have such important documents translated twice by independent translators and, then, in order to ensure that the contract language is unambiguous, to compare the two versions.\textsuperscript{258}

If a contract must be approved by Chinese government authorities, it does not become legally binding until an approval certificate is issued.\textsuperscript{259} Such approval by the government generally is not required, but it is important to note that the contracts do not become legally binding upon signature.\textsuperscript{260}

Sida Liu reports that “[e]ven in China, where the legal profession is still in its formative stage, a small sector of elite corporate lawyers has already emerged and controls much of the most profitable and prestigious legal work.”\textsuperscript{261} The nature of legal practice in China appears unusually diversified given the unique client mix of private enterprises, SOEs, and foreign corporations.\textsuperscript{262}

In the past thirty years, corporate law practice in China has changed drastically. It was as recent as only 1992-93 when the privatization process of law firms from state direct control took place.\textsuperscript{263} However, the corporate law market began developing in the late 1970s, when economic reform and revival of the legal system in China began to bring in foreign investment. Transnational law firms then began to enter China’s burgeoning market.\textsuperscript{264} Although foreign lawyers were not allowed to acquire a PRC lawyer’s license or to establish branch offices in mainland China, foreign lawyers conducted most high end corporate law practice in the Chinese legal system. Most local lawyers at the time did not have the expertise to handle complex international transactions because they were state employees working in legal divisions of government agencies.\textsuperscript{265}

The monopoly of foreign firms in corporate law practice in the early 1980s gave way to an emergence of local law firms specializing in transnational legal work in the 1990s.\textsuperscript{266} The government continued

\textsuperscript{258} Id. at 13.
\textsuperscript{259} Id.
\textsuperscript{260} Id.
\textsuperscript{262} Id. at 752.
\textsuperscript{263} Id. at 758.
\textsuperscript{264} Id.
\textsuperscript{265} Id. at 758-59.
\textsuperscript{266} Id. at 759.
to restrict licenses for foreign lawyers, and foreign lawyers were not allowed to interpret Chinese law. Thus, local law firms were, and remain today, the only firms permitted to provide formal legal opinions on legal projects involving questions of Chinese law. Consequently, “national barriers to transnational law practice gave birth to these elite local law firms in China.” Commenting on the emergence of local law firms in the corporate law arena, Sida Liu notes:

With the burgeoning of China’s market economy and the persistent government protection, by 2004, . . . a small number of elite local law firms had grown into crucial players in China’s corporate law market . . . and their practice areas all concentrate on high-end corporate legal work, including foreign direct investment (FDI), banking and finance, securities, mergers and acquisitions (M&A), real estate, corporate litigation and arbitration, and intellectual property . . . Although their collaborations with foreign law firms on big projects (especially FDIs and IPOs) are still frequent, with an increasingly large number of lawyers with foreign law degrees and experience with transnational law practice, these elite local law firms have already acquired great expertise in most areas of corporate law. Most of their lawyers graduated from prominent law schools in China, and the majority of them also obtained law degrees from Britain, the United States, Germany, or Japan.

In 1992, the Ministry of Justice granted twelve foreign law firms the right to establish administrative offices in the mainland. Eight of those firms were from Hong Kong. By 2004, there were 114 foreign law offices and thirty-five Hong Kong law offices in mainland China. Despite a strong foreign presence, local law firms continue to grow stronger and more profitable. “Not surprisingly, local corporate law firms have a wider client base than their foreign counterparts. Foreign companies seeking to make investments in

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267 Id.
268 Id.
269 Id. at 759-60.
270 Id. at 759.
271 Id.
272 Id.
273 Id. at 760.
China, large and wealthy SOEs, and some newly established but successful private enterprises constitute the three major client types for these elite local law firms.\footnote{Id. at 760-61.}

For both foreigners and seasoned senior managers of Chinese state-owned enterprises, the economic boom in the PRC creates the need to navigate a new “rule of law” minefield. Liu uses the metaphor of “feeding babies” to describe the unique expertise of local Chinese lawyers:

\footnote{Id. at 778.}

\begin{quote}
Even the most experienced and sophisticated foreign companies are sometimes reduced to babies who need to be spoon-fed with culturally contingent legal analyses; likewise, the newness of China’s rule of law and market economy reduces SOE managers and private entrepreneurs to neophytes who must be taught how to behave well.\footnote{Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819).}
\end{quote}

\section*{VII. DUTIES AND RESPONSIBILITIES OF DIRECTORS IN A CHINESE SETTING}

\subsection*{A. Comparison of U.S. Corporate Governance with that of the PRC}

About 190 years ago, Chief Justice Marshall in the \textit{Dartmouth College Case}, noted that “a corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.”\footnote{Securities Exchange Act of 1933, 15 U.S.C. § 77a et seq (2006); Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq (2006).} U.S. corporate governance has been evolving since that time with particularly formative periods resulting from the “great depression” \footnote{Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002); \textit{Gregory V. Varallo} \& \textit{Daniel A. Dreisbach}, \textit{Fundamentals of Corporate Governance} (Section of Business Law, American Bar Assn. 1996); \textit{see also} Leo E. Strine, Jr., \textit{The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face}, 30 \textit{Del. J. Corp. L.} 673 (2005).} and as an outgrowth of corporate abuses such as Enron, WorldCom, and Adelphia Communications around 2001 (Sarbanes-Oxley legislation).

China experienced its own securities and corporate governance scandals “involving false statements, misleading disclosure, insider trading, and market manipulation, such as the Qiong Min Yuan case,
the Chengdu Hongguang case, and the Zheng Bai Wen case.”279 The “bottom line” is that the U.S. experiment with corporate governance in a free economic system benefits from experience gained over approximately two centuries. The Chinese system, on the other hand, has evolved only within the last decade or so from a tradition of a socialist-controlled economy, suffering from: no business schools, no established accounting profession, untested and illiquid securities markets; no vision or experience as to how securities markets might facilitate capital formation if encouraged to function efficiently, an immature judicial system, and thousands of years of cultural conditioning that has provided no “vision” of corporate governance as practiced in the West.280

In terms of economic theory, a pragmatic Chinese government may optimize job creation and enterprise efficiencies by encouraging a policy of delegating the economic function of enterprise growth and efficiency to the “invisible hand” of enlightened corporate governance. Of course, the practical problem then remains of a lack of seasoned corporate management and directors.281

Gu Minkang observes that, similar to the situation in Hong Kong or the U.S., “Chinese Company law does not define the term ‘director.’”282 Further,

...some books describe a director as a member of the BOD [Board of Directors] and the legal standing organ of a company for carrying out business. In fact, Taiwanese scholars originated this kind of definition when they interpreted Japanese company law. In line with the continental legal system that Taiwan belongs to, the term ‘director’ means two things. Firstly, a ‘directorship’ is one of the organs of a company, and a director’s act is deemed to be the act of the company. Secondly, a ‘director’ is a person who has a mandate relationship (‘Wei Ren Guan Xi’) with the company, i.e. a director carries out businesses under the authorization of his or her company.283

279 Wei, supra note 17, at 214; see also Donald C. Clarke, Three Concepts of the Independent Director, 32 Del. J. Corp. L. 73 (2007).
280 Trautman, supra note 3, at 49.
281 Gu, supra note 10, at 131-39.
282 Id. at 131.
283 Id.
1. **Number of Directors**

Article 45 of the Chinese Company Law provides that there must be at least three directors in LLCs, and Article 112 provides that there must be at least five directors in JSCs. Neither Hong Kong nor the United States has the same number requirement. As Minkang points out, “[t]he Chinese Company Law fails to address the situation where the number of directors does not satisfy the statutory requirement or how the BOD shall work out a resolution to solve this problem . . . One contributing reason may be the short life of the Chinese Company Law.”

2. **Term of Office for Directors**

“Article 47 of the Chinese Company Law requires that the articles of association shall state the term of office of directors.” However, the term of office shall not exceed three years.

3. **Qualifications**

Gu Minkang describes qualification requirements in both positive (where these conditions are required) and negative (if met, dismissal is immediate) terms. These qualifications include:

(a)  
(i) **Nationality**: The Chinese Company Law does not provide this kind of limitation and it is particularly easy for foreign investors to take the position of director.

(b) **Requirements of Shareholding Status**: As is the case in Japan and Germany, the Chinese Company Law does not require directors to hold qualifying shares.

(b)  
“Despite the silence of the Chinese Company Law on the matter of share qualification, companies in China can require directors to be shareholders through their articles of association . . . in line with Chinese legal tradition, if a general law does not specifically prohibit one particular conduct, people may act without suffering legal consequence. Secondly, both Article 22(11) and Article 79(13) authorize companies to provide in

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284 Id. at 134.
285 Id. at 137.
286 Id.
287 Id.
288 Id. at 139.
the articles of association any lawful items that shareholders think necessary. These two provisions indicate a possibility that the articles of association may require directors to have qualifying shares.”

(c) **Legal Person Directors:** Gu Minkang reports that “The Chinese Company Law does not expressly state that a legal person director is not allowed.” Moreover, the remaining issue is whether it is possible to interpret the Chinese Company Law in a positive way. In order to do so, we have to carefully examine relevant theories and practice. The idea of legal person directors is subject to heavy criticism. The Review of the Hong Kong Company Ordinance (Consultant Report) 1997 offered a recommendation that “permitting corporations to be directors cuts directly across current preoccupations of proper exercise of directors’ discretion and board accountability. It should not be permitted.”

In China, the Mandatory Provisions for the Articles of Association of Companies Seeking to be Listed outside the PRC which governs Chinese companies listed outside China, clearly excludes a non-natural person from being a director of a company listed outside the PRC. This legal document has clearly indicated that Chinese relevant authorities have considered this issue and hold a negative position. One could argue, however, this legal document only applies to companies listed outside China, especially in Hong Kong. It has no direct connection to the Chinese Company Law, which is silent on the issue. On the other hand, we have seen that in practice, nominee directors (which are equivalent to legal person directors) commonly exist in China. For example, in Sino-foreign joint venture companies, directors are nominated by each party who invests in the companies. Obviously, further research is required before taking a proper position on this matter, but legal person directors should be permitted at least for domestic companies.

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289 Id.
290 Id.
291 Id.
292 Id.
293 Id.
294 Id.
295 Id. at 140.
296 Id.
(d) *Age of Directors*: No specific age limitation is provided by The Chinese Company Law, although most countries provide that for natural persons to have civil capacity, they must be of a specified age.²⁹⁷

(e) *Dismissal Provisions*: Gu Minkang lists the following situations of business ability, capacity, criminal record or credibility which should result in the automatic disqualification of a director:

1. He or she has no capacity or has restricted capacity for civil acts;
2. He or she was sentenced to criminal punishment for the crime of embezzlement, bribery, seizure of property or misappropriation of property or for undermining the socioeconomic order, and not more than five years have elapsed since the expiration of the enforcement period; or he or she was deprived of his or her political rights for committing a crime, and not more than five years have elapsed since the expiration of the enforcement period;
3. A director, or factory head or manager who was personally responsible for the bankruptcy or liquidation of a company or enterprise due to mismanagement, where not more than three years have elapsed since the date of completion of the bankruptcy or liquidation;
4. A legal representative of a company or enterprise that had its business license revoked for violating the law, where such representative bore individual liability therefore and not more than three years have elapsed since the date of revocation of the business license; and
5. A person with a relatively large amount of personal debts that have fallen due but have not been settled.²⁹⁸

(f) *Disqualification*: Directors should be automatically disqualified upon the development of any situations specified under Article 57 or 58 of The Chinese Company Law.²⁹⁹ However, Gu Minkang reports that “without proper procedures stipulated by the Chinese Company Law, directors cannot be

²⁹⁷ *Id.*
²⁹⁸ *Id.* at 141.
²⁹⁹ *Id.*
What then is a reasonable expectation for the Chinese corporate governance experiment that is now just a few years old? The PRC’s turbo-charged economic growth during recent years seems to have been achieved through a pragmatic borrowing of Western strategies such as the most basic of corporate governance concepts, rather than the earlier version of production-by-state-mandate. Examining basic corporate governance concepts through the prism of Chinese needs, reminds me of a speech I gave many years ago before the Harvard Business School Club of Greater New York on the topic of “What Exactly is Expected of a Director: A Few Thoughts About What They Must Do and What They May Do.” At that time, Roswell B. Perkins of the New York law firm of Debevoise & Plimpton provided a review of the history and issues involved in the decade-plus undertaking by the American Law Institute in their “Corporate Governance Project.” Perkins observed, “[C]orporations must be capable of succeeding in a competitive world environment. This requires entities that can move rapidly and that can take big risks.” This fundamental foundation calling for strong and effective corporate governance seems just as timely today.

Yuwa Wei makes the case that since “the key task for the Chinese government in establishing a modern enterprise system is introducing modern management mechanisms into China’s state-owned enterprises. Corporatization represents the only effective method to modernize China’s enterprise system.” Yuwa contends this theory follows because the conversion to wholly state-owned companies created problems with insider control, leading to a lack of transparency and oversight over management in those companies. Abuse of power and impropriety by the directors and boards of private companies are also a concern, because of the lack of a statutory framework and clearly defined corporate roles.
What then has been the historical view as to what corporate directors must do? Professor Harvey Goldschmid (before Sarbanes-Oxley) narrowed the focus of a board of director’s required functions to the following:

1. The election, evaluation and dismissal, where appropriate, of a corporation’s principal senior executives (perhaps the top six individuals);

2. To review and approve matters that the board or the principal senior executives consider to be major; and

3. Oversee the conduct of the corporation’s business (all major corporate commitments). 307

Professor Goldschmid states that a board must set acceptable goals, make sure that management is effectively pursuing those goals, and ensure that the firm is not endangered through exposure to unacceptable risks. 308 Among other things, it is important that directors and the board:

1. Select and elect the Chief Executive Officer and delegate to the CEO all the duties to manage the Company not specifically reserved to the board;

2. Monitor the activities of the management to assure that:

   a. The management is competent, properly structured and staffed; that provisions exist for succession to top management positions; and that programs exist to develop future managers;

   b. The management plans effectively the future activities of the Company;

   c. The management designs adequate targets in performance areas such as the following:

      • Return on investment
      • Capital allocation
      • Personnel management


308 Id. at 55 (citing Trautman, supra note 301).
• Future planning

3. Evaluate the performance of the Chief Executive Officer and other top management executives;

4. Monitor the management of pension funds;

5. Deal with matters that management brings to the Board or that concern the Board;

6. Respond to material issues which stockbrokers, government officials, or other groups may bring to the attention of the Board, either directly or through members of the top management; and

7. Ensure that the board gets all the information it needs to perform its duties (including an acceptable internal audit function with the company).³⁰⁹

In addition to the above, any foundation for skill-sets germane to the practice of U.S. corporate governance will include an understanding of: the duty of care and business judgment rule, duty of inquiry (duty to be informed), right of reliance, delegation issues, concept of rational belief, issues surrounding burden of proof, and the duty of loyalty.³¹⁰

B. Duty of Loyalty

Gu Minkang observes that “even though the Chinese Company Law does not expressly mention the ‘duty of loyalty,’ it can be inferred from several relevant provisions.”³¹¹ Moreover, Article 59 states that directors shall faithfully perform their duties, maintain the interests of the company and not take any advantage of their position, functions and powers to seek personal gain.³¹² Article 61 states that directors shall not operate on their own, or operate for others, the same category of business as the company they are serving, or engage in activities which damage the interests of the company.³¹³ Article 61 targets conflicts of interest, which are commonly seen around the world.³¹⁴

³⁰⁹ Id.
³¹⁰ Id.
³¹¹ Gu, supra note 10, at 147.
³¹² Id.
³¹³ Id.
³¹⁴ Id.
While the Chinese Company Law does not specifically mention the “duty to exercise powers for proper purposes,” Gu Minkang reports that “this duty could certainly be inferred from Article 59, which says that directors shall not use their position and powers of office to seek personal gains.”

C. Duty of Care

Gu Minkang reports that Chinese Company Law does not expressly provide for a duty of care. Article 63 holds directors liable to pay compensation if they violate the law or articles of association, in a way that damages the company. Though this provision seems to imply that the duty of care is related to a breach of the law and the articles of association, many cases demonstrate that the imposition of personal liability upon directors is rare in practice. However, actions considered to be a breach of the duty of care traditionally give rise to administrative or criminal liability in China. Article 63 of the Law of Wholly State-Owned Enterprises provides for administrative or criminal penalties for parties who cause heavy losses to the enterprise and the State due to errors in his or her work.

D. Disclosure

Professor Nicholas C. Howson states that “the touchstone of U.S. securities regulation is disclosure — the theory being that insofar as participants have adequate knowledge about the value or potential value represented by the abstract instrument that is a share of stock, they should be permitted to make their own purchase or sale transaction decision.” Howson observes that legal mechanisms which provide transparency and protect minority shareholders against oppression and manipulation could lead to a more active market and faster economic growth. Writing in 2005, Howson finds that simply imitating concepts foreign to China would be ineffective because its markets, companies, societal factors, and legal institutions all contain

315 Id. at 148.
316 Id. at 151.
317 Id.
318 Id.
319 Id.
320 Id.
322 Id. at 241.
unique elements. Some of the considerations that set China apart are the “dominance of state-tied controlling shareholders, the civil law tradition that many Chinese scholars and lawyers feel defines the Chinese legislative and judicial system, and the still-developing court system.”

Even before Sarbanes-Oxley, the role and value of the audit committee had been firmly established as an integral component of corporate governance in the United States. However, as observed earlier, required systems for effective financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice. Yuwa Wei observes that Chinese law “does not clarify the status of internal auditors. Total subjection to a general manager’s will substantially weakens an auditor’s monitoring power.”

E. Chinese Directors Report to the PRC Government

The state has a dominant role in most Chinese listed-companies. Minority shareholders do not have the influence to change management or select new corporate boards. The dominant shareholder is the state, which has to exercise its shareholder rights through agents. These agents appoint directors, who are likely to remain primarily loyal to the agent that appointed them rather than to the company. Additionally, directors can personally benefit from their appointments by entrenching themselves as de facto owners of their respective companies, thus using the company to pursue private goals rather than protecting the shareholder’s interests. Without any non-insider supervision, directors are free to take advantage of their

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323 Id. at 241–42.
326 See discussion supra Part III-C.
327 Wei, supra Part III-C.
328 Id. at 217.
329 Id.
330 Id.
331 Id.
position by taking action such as increasing their compensation and private benefits.\footnote{Id.}

Because Chinese directors ultimately report to the PRC Government, it may be argued that there is no stand-alone independent corporate governance practiced among Chinese corporations; rather, Chinese corporations remain a political sub-set of the state and shares are the functional equivalent of baseball trading cards at this time. Donald C. Clarke notes that because directors are supposed to be elected by shareholders, it is exactly the intended outcome of the voting system in China’s Company Law for the majority shareholder to out-vote minority shareholders.\footnote{Clarke, supra note 183, at 170 & n. 159.} Therefore, it is unlikely that directors representing minority shareholders could be elected to a board at all unless there is a fundamental change in the way directors are selected.

\section*{F. Two-Tier Board System}

Professors Donald C. Clarke and Yuwa Wei provide a helpful description of the relationship between the Chinese company board of supervisors and the independent director.\footnote{See id. at 173-75; Wei, supra note 17, at 218; see also Chao Xi, In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China, 22 CONN. J. INT’L L. 1 (2006).} Chinese company law creates a two-tier board structure with a board of supervisors and a board of directors.\footnote{Id., supra note 183, at 173.} Shareholders elect the board of supervisors, which play an oversight role in the company.\footnote{Id. at 174.} The board of directors plays a relatively active managerial role.\footnote{Id. at 173–74.}

While Chinese commentators compare China’s model to Germany’s, there are several important differences.\footnote{Id. at 174.} Under the two-tier model in Germany, the shareholders elect the supervisory board, which then elects the company’s board of directors.\footnote{Id., supra note 183, at 173.} Thus, in Germany the board of supervisors has a significant oversight role because it has the power to appoint and dismiss members of the management board.\footnote{Wei, supra note 17, at 218.} In contrast to Germany’s model, the board of supervisors in China lacks the ability to effectively monitor management because it does not have the power to elect the
management board.\textsuperscript{341} Company shareholders elect both the board of supervisors and the board of directors.\textsuperscript{342} In essence, China’s company law “expects the board of supervisors will perform a supervisory role by simply saying that it will, without actually giving the board any significant powers or providing structurally for its independence from those it supervises.”\textsuperscript{343}

Since the board of supervisors has no real power, its role in Chinese corporate governance is severely diminished.\textsuperscript{344} Clarke further explains that:

> In enterprises dominated by state ownership—a significant number—[of] the supervisors are enterprise employees and are subordinate to the head of the enterprise. Indeed, a recent study showing that over half the companies surveyed maintained supervisory boards with only the legal minimum number of members suggests that this institution plays no real role in corporate governance.\textsuperscript{345}

Independent directors, however, may be able to step in and fill the necessary monitoring role that the board of supervisors seems unable to perform.\textsuperscript{346}

G. Impact of Sarbanes-Oxley

As a reaction to corporate scandals such as Enron, WorldCom, and Adelphia Communications, the Sarbanes-Oxley Act of 2002\textsuperscript{347} contains provisions that require disclosure of governance practices and policies.\textsuperscript{348} The “independent director” concept runs heavily through

\begin{flushleft}
\textsuperscript{341} Wei, supra note 17, at 218.
\textsuperscript{342} Id.
\textsuperscript{343} Clarke, supra note 183, at 174.
\textsuperscript{344} Id.
\textsuperscript{345} Id. at 174–75.
\textsuperscript{346} Id. at 175.
\textsuperscript{347} Sarbanes-Oxley Act, supra note 278.
\end{flushleft}
the corporate governance literature in the West embracing the thought that “the need for non-management directors on the board to serve as a check on management is in the interests of shareholders.”\textsuperscript{349} According to Gu Minkang, Sarbanes-Oxley has had a significant impact on the development of Chinese securities and company law.\textsuperscript{350} Moreover, the Deputy Secretary General of the China Securities Regulatory Commission has said that Sarbanes-Oxley is important to Chinese “accounting practice[s], to the regulation of the capital market and to Chinese companies listed in the U.S.”\textsuperscript{351} While it is worth noting that the act will build healthy corporate governance and set the example for the rest of the world, it is exposing deficiencies in China’s corporate system:

Dr. Wang correctly pointed out that the problem in China is more than a corporate governance issue. ‘The difficulty lies with China’s failure to cope with the market economy, as [SOEs] still dominate the economy. And if the State does not make fundamental changes to become a more market-oriented system, no matter whether the enterprises are State-owned or privately-owned, corporate governance alone cannot solve the problem.’\textsuperscript{352}

H. Director and Officer Liability

Chenxia Shi states that before the recently passed new securities law,

[previous company and securities laws did not provide investors with effective civil remedies, such as the right of class actions. Because of the inadequacy of the laws in this area, investors in the Chinese securities market, particularly minority investors, were susceptible to market manipulation and fraud and were often left without redress.\textsuperscript{353}]

However, investors now have more protection after a recent Supreme Court ruling that a company or its directors could be sued upon a

\textsuperscript{349} Clarke, \textit{supra} note 183, at 154.
\textsuperscript{350} Gu, \textit{supra} note 10, at 14.
\textsuperscript{351} \textit{Id.}
\textsuperscript{352} \textit{Id.}
\textsuperscript{353} Chenxia, \textit{supra} note 134, at 227–28 & nn.120-21.
CSRC finding of fraudulent conduct.  The new law increases the liability of top corporate officials and requires senior management to take a more active role in combating fraud. The new law also reflects the correlation between disclosure and investor protection – “investors rely on publicly disclosed information to make their investment decisions.”

Gu Minkang reports an example of how the new law has been implemented:

[A] director may be free from any personal liability for the loss to his or her company caused by his or her negligence, as long as he or she does not breach the duties imposed by Articles 59 and 62 or if his or her actions are not in violation of the Chinese Company Law, administrative law and the articles of association.

The case of the Jin Hua Department Store Joint Stock Company (hereinafter referred to as the “Jin Hua”) is a typical example. In that case, the chairman of the BOD, Dan Hua, was sentenced to three years’ imprisonment for causing damage in the sum of Y1,041,000 to Jin Hua. The sentence was due to his responsibility for arbitrarily offering Y1,416,000 as the guarantee in Jin Hua’s name for the debts of other companies or other persons. In that case, the other 11 directors didn’t take any responsibility for the loss suffered by Jin Hua and were not asked to pay any compensation for the loss.

I. Role of the Chinese Communist Party in Corporate Governance

The Chinese Communist Party (“CCP”) has traditionally enjoyed a dominant influence in the making of laws, although such an arrangement would not be apparent from a reading of its Constitution. The Communist Party and Government may appear separate in relevant documents, but seem inextricably linked in practice. Sheehy argues that “the law has been a tool of the CCP. While the CCP has

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354 Id. at 228.
355 Id. at 229 (noting that the new law has a number of new requirements that affect senior management and directors: more continuous disclosure, strengthened regulation, and they must “include their opinions in the periodic reports of the company”).
356 Id.
357 Gu, supra note 10, at 151.
been seeking to change this status, change is still at an inchoate stage, and as a result for foreign commercial interests, access to predictable legal outcomes and enforcement has been very limited.\textsuperscript{358}

Westerners may encounter a special problem with their assumption of a “rule of law solution” to disputes within a PRC context under likely future bilateral trade agreements. Accordingly, Benedict Sheehy points out the peculiar results created by bilateral trade agreements, which “usually grant rights to private parties” and thus requires states to answer to citizens of foreign countries for their policies.\textsuperscript{359} This is particularly relevant to, and difficult for, China because the state has neither been forced to answer to its citizens nor has it faced scrutiny in its economic dealings.\textsuperscript{360}

State dominance over corporate governance is vividly illustrated by Donald C. Clarke, as he quotes the Dean of the Changjiang School of Business (who serves as an independent director) as saying, “I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state.”\textsuperscript{361} Sheehy observes that, unlike the Anglo structure of separation of powers, the official view of Chinese governmental structure is based on a unity of powers, where “the CCP, the government, and the people’s will are one . . .”\textsuperscript{362} While the CCP continues to consolidate functions of government in this fashion, the 2002 revision to the CCP constitution reflected the development of social strata in society and the shift from “politics in command” to “economics in demand.”\textsuperscript{363} Even as China ascends to economic power, the CCP makes strong efforts to maintain a “socialist market economy with Chinese characteristics.”\textsuperscript{364} To complicate things further, China’s dictator takes a different view of the government structure:

China’s dictatorship has viewed itself as a representative of the people and a democratic dictatorship born out of the coalition of four classes of people mentioned above. This view comes not only

\textsuperscript{358} Sheehy, supra note 208, at 226–27.
\textsuperscript{359} Id. at 261.
\textsuperscript{360} Id. at 261–62.
\textsuperscript{361} Clarke, supra note 183, at 171-72.
\textsuperscript{362} Sheehy, supra note 208, at 234 & n.32.
\textsuperscript{363} Id. at 235 (noting that the revision recognized “workers, peasants, members of the armed forces, intellectuals and ‘advanced elements’ of other social strata,” each of which being eligible for membership to the Party).
\textsuperscript{364} Id.
from the founding principles of the CCP, which have been subjected to various revisions and reforms, but also from the complex structure of China’s government. With 23 provinces, 5 autonomous regions, 2 special administrative regions and 4 municipalities, all with different amounts of power, China’s government is necessarily complex . . . China also has 56 ethnic minorities and a multitude of CCP organs and civil associations.

J. Foreign Corrupt Practices Act (“FCPA”)

It is likely that many entrepreneurs have had no occasion to be familiar with the Foreign Corrupt Practices Act (FCPA), nor believe it to be applicable to them. More and more, “[f]oreign operations constitute a major source of revenues and earnings for companies as diverse as ExxonMobil, McDonalds, Pfizer, Proctor & Gamble, or Walmart.” Trautman and Altenbaumer-Price (2011) observe, “[e]ven if a company is not currently doing business outside the borders of the United States, every director needs to be aware of the risk posed by the provisions of the Foreign Corrupt Practices Act (FCPA) to both the companies they serve and to themselves.” Moreover, increased enforcement by the Securities & Exchange Commission (SEC) and Department of Justice (DOJ) should incentivize company directors to be well versed in FCPA because the cost of failure to comply could result in “corporate catastrophe.” China and other fast-growing economies are an important illustration of the importance of company directors understanding the FCPA. As U.S. companies increase international commerce with China, they increase their exposure to potential corruption and running afoul of the FCPA.

While the goal of most businesses may be to operate effectively within foreign markets as an attractive business partner, to the extent that robust business results, the 1977 passage of the United States’ FCPA as amended:

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365 Id. at 235-36.
368 Id. at 147-48.
369 Id. at 148.
370 Id.
prohibits bribery of foreign officials. This prohibition applies to three categories of actors: (1) “issuers”; (2) “domestic concerns”; and (3) other persons who take any act in furtherance of the corrupt payment while within the territory of the United States. “Issuers” are companies whose securities are registered in the United States or that are required to file periodic reports with the SEC. “Domestic concerns” are defined as any U.S. citizen or company incorporated in a U.S. state or territory. Issuers and domestic concerns are both subject to the FCPA’s anti-bribery provisions anywhere in the world where they act.

Additionally, it is a crime for a U.S. company, or anyone affiliated with the company, to pay or offer to pay a foreign official to do anything that official would not have otherwise been obligated to do absent the payment. Under the FCPA, the official need not actually carry out the act he or she was paid to complete for the U.S. company to face liability. The FCPA also contains “books and records” requirements and internal control provisions dictating that all company transactions be accurately reflected.

Corruption Threatens China’s Future

Trautman and Altenbaumer-Price contend “[b]ecause of the sheer size of China’s economy and the growth in the business and economic relationship between the U.S. and China, the country provides an illustration for the impact of corruption in a given country in light of the rise in FCPA enforcement.” With particular focus on the PRC, Anbound, a consulting company, notes that “of the 500,000 bribery cases investigated in China over the last 10 years, 64 percent involved [non-Chinese] companies.” Failure to contain endemic corruption

\[\text{\textsuperscript{373}}\] Id. at 237-38.
\[\text{\textsuperscript{374}}\] Id. at 238.
\[\text{\textsuperscript{375}}\] Id.
\[\text{\textsuperscript{377}}\] Trautman, supra note 367, at 177 (citing Liu Jie, \textit{Slipping Stature}, CHINA continued . . .
among Chinese officials poses one of the most serious threats to the nation's future economic and political stability, reports the Carnegie Endowment for International Peace in its October 2007 study by Minxin Pei. Pei, an expert on economic reform and governance in China, argues that corruption "fuels social unrest [and] contributes directly to the rise in socioeconomic inequality," but holds major implications beyond its borders for foreign investment, international law, and environmental protection and roughly 10 percent of government spending, contracts, and transactions is estimated to be used as kickbacks and bribes, or simply stolen. Moreover, corruption could endanger economic development in China because, among other things, it undermines the governing institutions, makes inequality worse, and exacerbates public resentment. While measuring corruption in China is incredibly difficult because of a more general lack of transparency, official audits, press reports, and official anticorruption data demonstrate the high cost of corruption in China. Pei highlights five key findings with regard to corruption in China:

1. Though the Chinese government has more than 1,200 laws, rules and directives against corruption, implementation is spotty and ineffective. The odds of a corrupt official going to jail are less than three percent, making corruption a high-return, low-risk activity. Even low-level officials have the opportunity to amass an illicit fortune of tens of millions of yuan;

2. The amount of money stolen through corruption scandals has risen exponentially since the 1980s. Corruption in China is concentrated in sectors with extensive state involvement, such as infrastructure projects, real estate, government procurement, and financial services. The absence of competitive political process and free press make these high-risk sectors susceptible to fraud, theft, kickbacks, and bribery. The direct costs of corruption could be as much as $86 billion each year;

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379 Id.
380 Id.
381 Id.
3. The indirect costs of corruption (efficiency losses; waste; and damage to the environment, public health, education, credibility and morale) are incalculable. Corruption both undermines social stability (sparking tens of thousands of protests each year), and contributes to China's environmental degradation, deterioration of social services, and the rising cost of health care, housing and education;

4. China's corruption also harms Western economic interests, particularly foreign investors who risk environmental, human rights, and financial liabilities, and must compete against rivals who engage in illegal practices to win business in China; and

5. The U.S. government should devote resources to tracking reported cases of corruption in China, increase legal cooperation with China (to prevent illegal immigration by corrupt officials and money laundering), and insist on reforms to China's law-enforcement practices and legal procedures before tracking Chinese fugitives in the United States and recovering assets they have looted.382

"[C]orruption has not yet derailed China's economic rise, sparked a social revolution, or deterred Western investors. But it would be foolish to conclude that the Chinese system has an infinite capacity to absorb the mounting costs of corruption . . . Eventually, growth will falter,” writes Minxin Pei.383

Writing in the New York Times, journalist David Barboza reports "prominent corruption cases in China are often the outgrowth of power struggles within the Communist Party, with competing factions using the 'war on corruption' as a tool to eliminate or weaken rivals and their corporate supporters."384 Barboza continues, "[t]his may help explain one of the enduring contradictions of China's political and economic system: the government regularly publicizes an astonishing number of corruption cases, yet little progress seems to be made in uprooting corruption."385

For those desiring more on this topic, James Heffernan explores some of the obligations, both legal and ethical, facing U.S.

382 Id.
383 Id.
385 Id.
Corporations and the American attorneys representing them, when faced by authoritarian regimes such as China. 386

**K. Hong Kong Is Different**

Over a decade has now past since Hong Kong returned to Chinese sovereignty on July 1, 1997. Largely because of their different legal and philosophical backgrounds, the development of company law in Hong Kong is heavily influenced from its history as a colony of the United Kingdom. 387 Gu Minkang observes that the Companies Ordinance, along with supplemental legislation, is a large, complex statute that regulates companies in Hong Kong. 388 Hong Kong’s company law, however, will not merge with the rest of China’s law for some time, even though it became part of China in 1997:

Under the policy of “One Country, Two Systems”, it will be quite difficult to have a unified economic system shared by both Hong Kong and the mainland; this will not happen for at least 50 years. In this situation, the governments on both sides will have to operate with a limitation on administrative authority. For example, companies of mainland China can be listed on the Hong Kong Stock Exchanges. According to Hong Kong’s securities law, those companies should be supervised by the Hong Kong authorities. However, authorities in mainland China also have the power to supervise them because they are registered in mainland China. 389

That being said, efforts have been made to achieve more integration of Hong Kong and mainland China, even though changes to Hong Kong law have been difficult to make due to its diverse population and history. 390 The 2003 “closer economic partnership arrangement” effort and “mutual recognition of judgments in commercial matters” will likely result in more similar laws across all of China. 391

388 *Id.* at 9-10.
389 *Id.* at 10.
390 *Id.* at 10.
391 *Id.*
VIII. CONCLUSION

The economic expansion of the PRC seems without historical precedent. It is truly remarkable that such growth has been achieved within a legal framework that is less than thirty years old. Domestic securities markets have been crafted and capital formation infrastructure has been achieved within a scant seventeen-year period. The financial well-being of the global economy seems to depend on continued growth and manufacturing capacity of the PRC. China lacks the Western tradition of using law (or outsiders) to resolve conflicts. Evolving from Confucianism, the traditional Chinese culture places much more emphasis on the nurturing and maintenance of relationships, the vehicle in which Chinese business is conducted.

Shares of common stock in China do not represent the same “ownership interest” or have the same designated rights as in the United States. There is no history of protecting private property as we know it, and the functions of true “free economic markets” (securities or goods and services) have neither been understood nor embraced by officials having a natural cultural instinct for governmental control of economic enterprises. The four major objectives of the PRC government appear to consist of: increasing industrial productivity; seeking foreign exchange; import substitution; and job creation (perhaps the primary goal). Development of capital markets and an efficient framework for capital formation should allow China to tap its internal assets and the resources needed from the rest of the world to finance and fuel the PRC’s impressive economic growth.

However, non-performing loans may continue to comprise a large percent of all banking assets in the PRC. Those engaged in corporate governance either in China or other parts of the world (dealing with Chinese commerce) are well advised to have a heightened sensitivity to the risk introduced by a fragile Chinese banking system. Systems for financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice.

Because Chinese directors ultimately report to the PRC Government, it may be argued that there is no stand-alone independent corporate governance practiced among Chinese corporations; rather, Chinese corporations remain a political sub-set of the state and shares are the functional equivalent of baseball trading cards at this time.

The economic health and well-being of the PRC and its Western trading partners seem to be co-dependent. All involved have a significant vested interest in making the necessary transaction machinery work. With every passing year, increased commerce should foster a greater awareness of the extent to which the future of
individual members of the global economic community are linked. The economic engine of increased trade brings the promise for increased personal understanding and more probable peace among nations.

However, with less than a decade’s experience attempting to deal with complex questions of corporate law, as would be expected, the PRC is highly challenged by the stresses associated with providing adequate legal-system capacity, implementation of the *New Company Law*, the hiring and training of adequate numbers of legal professionals for implementation, and an adequate court system for enforcement. Entrepreneurs and corporate directors from Western countries are well advised to conduct their affairs with sensitivity to the cultural and institutional stress resulting from hyper-economic growth in the PRC.