

International Procurement

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This year in review article for 2011 focuses on developments in Chinese procurement law in the realm of socio-economic policies, most notably, policies aimed at (1) enhancing contracting opportunities for China's small and medium business, and (2) preferential treatment of domestically-developed technology products.

I. Developments in Socio-Economic Policies in Chinese Government Procurement

In 2011, China launched a significant experiment to increase public contracting opportunities for the country's small and medium enterprises but abandoned a key pillar of its domestic product purchase preference regime.¹

A. THE DEMISE OF PURCHASING PREFERENCES FOR "INDIGENOUS INNOVATION"

In 2006, China's central government formally launched a national industrial policy to encourage government agencies to "work cooperatively to develop measures that favor products that use Chinese-developed ideas and technology."² A significant component of this policy was to fashion preferences in government procurement for the purchase of domestically-developed, innovative products.

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1. Article 9 of China's 2002 Government Procurement Law provides that government procurement shall contribute to the development of the country's economic and social development targets, among them, the promotion of small and medium enterprises. Article 10 of China's 2002 Government Law favors the purchase of Chinese domestic products over the purchase of products of foreign origin. People's Republic of China, The Government Procurement Law (Order of the President No. 68) (June 29, 2002) [hereinafter Government Procurement Law 2002], http://www.gov.cn/english/laws/2005-10/08/content_75023.htm.

2. U.S.-China Bus. Council, *Issues Brief: China's Domestic Innovation and Procurement Policies*, 1 (2010), http://www.uschina.org/public/documents/2010/05/domestic_innovation_policies.pdf.

THE INTERNATIONAL LAWYER
A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

232 THE INTERNATIONAL LAWYER

From 2007 to 2010, the Chinese government issued a number of national level rules designed to qualify indigenously created technology products and to develop formulas for providing price advantages and evaluation point advantages in China's government procurement processes.³ This included the development of specific product lists identifying items slated for preferences by both central and local government purchasing entities.⁴

At the same time, China's trade partners began an all-out assault on China's "indigenous innovation," bemoaning the policy as disguised protectionism.⁵ Boisterous opposition drew Chinese regulators into a rather mature dialogue as to how the policy might be tailored to offset the concerns of foreign companies. Indeed, by 2010, revisions to the policy to ensure that foreign invested enterprise products produced in China were treated equally under the policy began to form.⁶ Thus, many were caught by surprise when China—first through an informal understanding during a January 2011 high-level meeting between Presidents Hu and Obama, and then again by formal decision at the May 2011 Strategic and Economic Dialogue between the two countries—abandoned the policy.⁷ The calmness of the policy's demise contrasted significantly with the loudness that accompanied its controversial formation. Five years of Chinese policy-making were shelved rather quietly. Chinese regulatory notices advising of the "separation" of government procurement from the broader indigenous innovation policy were quite brief, with no explanation or justification.⁸

The demise of China's indigenous innovation purchasing preferences was never going to suddenly level the playing field for contractors in China's government procurement market. An April 2011 report by the European Union Chamber of Commerce in China

3. U.S.–China Bus. Council, *PRC Policies, Laws, and Regulations that Provide Government Procurement Preferences for Indigenous Innovation Products*, 1–3 (2010), https://www.uschina.org/public/documents/2010/10/procurement_domestic_innovation.pdf.

4. *Id.* at 2.

5. Jason Matechak & Brett Gerson, *Can China's Government Procurement Market Be Cracked*, CHINA BUS. REV. (2010), <https://www.chinabusinessreview.com/public/1005/matechak.html>.

6. *Id.*

7. Hilary Rodham Clinton, Sec'y of State; Timothy Geitner, Sec'y of Treasury; Wang Qishan, Chinese Vice Premier; & Dai Bingguo, Chinese State Councilor, Joint Closing Remarks for the Strategic and Economic Dialogue (May 10, 2011), *available at* <http://www.state.gov/secretary/rm/2011/05/162969.htm>; Press Release, U.S. Chamber of Commerce, U.S. Chamber of Commerce Welcomes Results of S&ED (May 10, 2011), *available at* <http://www.uschamber.com/press/releases/2011/may/us-chamber-welcomes-results-us-china-sed>.

8. Zhongguó jiang quánmiàn shíshí zhèngfǔ cǎigòu yǔ zìzhù chuàngxīn fēnlí zhèngcè (中国将全面实施政府采购与自主创新分离政策) [China Will Completely Separate the Policy of Indigenous Innovation from the Implementation of Government Procurement], May 16, 2011, *available at* <http://www.cinic.org.cn/site951/zcdt/2011-05-16/480248.shtml> (reporting on Vice-Director of China's National Development and Reform Commission, Zhang Shaoqiang's, announcement that China had promised to separate the two policies); Cǎizhèng bù guānyú tíngzhǐ zhíxíng "zìzhù chuàngxīn chānpǐn zhèngfǔ cǎigòu yùsuàn guānlǐ bànfǎ" deng sān gè wénjiàn de tōngzhī (财政部关于停止执行《自主创新产品政府采购预算管理办法》等三个文件的通知) [Ministry of Finance Notice About the Stopping of the Application of 'Management Measures for Government Procurement Budget for Indigenous Innovation Products' and Three Other Documents] (issued by Ministry of Finance, Department of Treasury, June, 23, 2011), Document No. 85, *available at* <http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=153552>.

THE INTERNATIONAL LAWYER
A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

INTERNATIONAL PROCUREMENT 233

makes this clear.⁹ The report is the first effort by a Western outfit to track discriminatory practices on the ground in China at the level of contract formation. The report details a chaotic regulatory environment and a number of questionable practices by Chinese public purchasers, which sadly serve to limit access to China's substantial public procurement market.¹⁰

China continues to struggle with choices over whether to pursue further liberalization of its government procurement market by acceding to the Government Procurement Agreement of the World Trade Organization or by deepening a domestic product preference regime. Confusingly, China's Ministry of Finance (MoF), the chief regulator for China's government procurement market, apparently does not see these as incompatible choices, but as equal policies to be pursued with equal vigor.¹¹ Yet rational balancing of the overarching policy of open competition, in relation to ancillary socio-economic policies like "buy domestic," remains elusive.¹² A comprehensive draft regulation on the subject has yet to be finalized.¹³ Indeed, China's overall design for a domestic product preference regime in government procurement remains a work in progress.

B. CHINA LAUNCHES A TWO-YEAR EXPERIMENT TO FACILITATE THE ISSUANCE OF
LOAN AND PERFORMANCE GUARANTEES TO SMALL AND MEDIUM
GOVERNMENT SUPPLIERS

The year 2011 also witnessed China's first national level attempt to provide more public procurement contracting opportunities for small and medium enterprises. On September 15, 2011, China's Ministry of Finance issued its "Notice on Launching Experimental Work of Credit Guarantees in Government Procurement" (hereinafter MoF Document No. 124), which designates China's central government, Beijing municipality, Heilongjiang Province, Guangdong Province, Jiangsu Province, Hunan Province, Henan Province, Shandong Province, and Shaanxi Province as experimental jurisdictions to employ a surety bond and guarantee system designed to expand government procurement contracting op-

9. European Union Chamber of Commerce in China, *Public Procurement in China: European Business Experiences Competing for Public Contracts in China*, Apr. 21, 2011, http://www.europeanchamber.com.cn/images/documents/marketing_department/beijing/publications/2011/PP%20Study%20EN%20Final_0421.pdf.

10. *Id.* at 5; see also Daniel Mitterhoff, *Grappling with the Regulatory Environment for Chinese Public Procurement*, 3 INT'L GOV'T CONTRACTOR ¶ 17 (2006), available at http://digitalcommons.law.umaryland.edu/fac_pubs/545/.

11. Guanyú yīnfā 2011 nián zhèngfǔ cǎigòu gōngzuò yàodiǎn de tōngzhī (关于印发2011年政府采购工作要点的通知) [Notice of the Publishing of the Essentials for Government Procurement Work for Year 2011] (issued by Ministry of Finance, Treasury Department, 2011) Document No. 15, available at http://jsz.mof.gov.cn/lanmudaohang/zhengcefaui/201102/t20110218_455490.html.

12. See Daniel Mitterhoff, *Huigui 'sangong' genben yuanze kebu ronghuan* [The Imperative of Returning to the Fundamental Principles of 'Openness, Fairness and Justice'], GONGGONG CAIGOU [PUBLIC PROCUREMENT], Oct. 3, 2011, at 60–61, available at http://digitalcommons.law.umaryland.edu/fac_pubs/1162/ (arguing that China must make distinct choices in prioritizing its policies in government procurement and advocating China return focus to achieving open competition domestically before working further on either secondary socio-economic policies or accession to the Government Procurement Agreement of the WTO).

13. Guanyú "zhèngfǔ cǎigòu bēnguó chānpǐn guānlǐ bànfǎ (zhèngqiú yìjiàn gāo)" Gongkai zhèngqiú yìjiàn de gōnggào (关于《政府采购本国产品管理办法(征求意见稿)》公开征求意见的公告) [Management Measures for Government Procurement of Domestic Products (draft for soliciting opinions)] (issued by Ministry of Finance, June 21, 2010), available at http://www.mof.gov.cn/zhengwuxinxi/bulinggonggao/tongzhitonggao/201005/t20100521_318992.html.

SPRING 2012

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A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

234 THE INTERNATIONAL LAWYER

portunities for small and medium businesses.¹⁴ Under the experiment, which is to proceed from 2012 to 2013, each jurisdiction would promote guaranteed lending to small and medium government suppliers and, importantly, dispense with mandatory cash security for bidding and performance on government procurement projects. Instead, localities are now expected to accept bid and performance security provided by specialty guarantee companies on behalf of small and medium enterprises (SMEs). This new regulatory initiative is distinct from the use of corporate surety in construction, which runs under separate regulators charged with supervising construction, public and private.¹⁵ Indeed, the new Ministry of Finance initiative will largely cover the procurement of goods and services and have little to do with public construction in China.¹⁶

One key measure of the SME initiative requires public purchasers to amend their solicitation documents to instruct suppliers that they can “pay in” their bid and performance security in the form of a surety bond issued by a specialty guarantee company.¹⁷ This change arguably helps specialty guarantee companies as much as SMEs by targeting existing discrimination by public purchasers that favor bank-issued guarantees to the detriment of specialty guarantee companies. This policy does not eliminate cash and bank guarantees, which remain acceptable surety under the reform. The key shift is that now suppliers, not procuring agencies, will choose the form of security to post. Indeed, under MoF Document No. 124, government purchasers—whether directly or through commercial bidding agents—are barred from forcing suppliers to use bank guarantees or cash security.¹⁸ Those who violate the new policies are subject to penalties such as the withholding of budget funds from the purchaser, the cancellation of the license of the relevant commercial bidding agent, and even civil liability damages payable to harmed suppliers.¹⁹

By November 30, 2011, each relevant jurisdiction was required to submit an action plan for the implementation of the directives of MoF Document No. 124.²⁰ Thereafter, progress reports must be submitted every six months, with any pressing problems reported immediately to China’s Ministry of Finance.²¹

14. Cáizhèng bù guānyú kāizhān zhèngfǔ cǎigòu xīnyòng dānbào shìdiàn gōngzuò fāng'àn (财政部关于开展政府采购信用担保试点工作方案) [Ministry of Finance Notice Regarding the Launching of Experimental Work for Credit Guarantees in Government Procurement] (issued by Ministry of Finance, Treasury Department, Sept. 20, 2011) Document No. 124, available at http://www.ccg.gov.cn/cggt/201109/t20110920_1787871.shtml [hereinafter MoF Document No. 124].

15. See Guānyú zài jiānshe gōngchéng xiāngmù zhōng jīnyībù tuīxíng gōngchéng dānbào zhìdù yìjiān [Opinions on Promoting the Construction Guarantee System on Construction and Engineering Projects] (issued by Ministry of Construction, Market Administrative Division, Dec. 7, 2006), Document No. 326.

16. See Government Procurement Law 2002, *supra* note 1. Although China’s 2002 Government Procurement Law defines government procurement as, among other things, the purchase of goods, construction and services (Government Procurement Law, art. 2), China’s public purchasing system is not unified and the supervision of public construction remains largely outside the regulatory sphere of the Ministry of Finance. Accordingly, when one refers to “government procurement” in China, it means the purchase of goods and services under the system supervised by China’s Ministry of Finance and local finance departments. See generally, Mitterhoff, *supra* note 12.

17. MoF Document No. 124, *supra* note 14, ¶ 2.3.

18. *Id.*

19. *Id.* ¶ 5.

20. *Id.* at pmb1, ¶ 3.

21. *Id.*

THE INTERNATIONAL LAWYER
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INTERNATIONAL PROCUREMENT 235

MoF Document No. 124 actually builds upon reforms launched over a decade ago. In June 1999, China's State Economic and Trade Commission (since merged into China's Ministry of Commerce) issued "Guiding Opinions on Establishing Pilot Projects for the Guarantee System for Small and Medium Enterprises" (hereinafter SETC Document No. 540).²² SETC Document No. 540 began the official reliance on guarantee companies to tackle the problem of the lack of credit available to small and medium enterprises. In the 1990s, roughly two-thirds of Chinese bank lending went to China's state-owned enterprises, with a mere ten percent going to new entrants into China's socialist market economy.²³ To correct this imbalance, a multitude of financial guarantee companies emerged to serve as credit enhancers for SMEs seeking bank loans (*i.e.*, provide third-party guarantees for the repayment of loans to SMEs).²⁴ The fast development of the industry proceeded in the absence of strong regulation, with guarantee companies essentially qualifying themselves individually through entering into long-term arrangements with banks willing to accept their guarantees for individual loans. A national level document unifying the regulation of financial guarantee enterprises, with respect to licensing, required capitalization, posting of loss reserves, limits on writings, and other operational controls did not appear until 2010.²⁵

The emergence of China's guarantee industry temporarily alleviated the credit barriers facing some small, private enterprises in China,²⁶ but, recently, as the bills for China's 2008 stimulus package become due, the dearth of credit for all but China's larger state-

22. Guanyu jianli zhongxiao qiye xinyong danbao tixi shidian de zhidao yijian [Guiding Opinions on Establishing Pilot Projects for the Guarantee System for Small and Medium Enterprises] (issued by Econ. & Trade Comm'n, June 1999), Document No. 540.

23. MINXIN PEI, CHINA'S TRAPPED TRANSITION: THE LIMITS OF DEVELOPMENTAL AUTOCRACY 116 (2006). Interestingly, the private sector created over forty percent of the new jobs and over sixty percent of urban jobs during the same time-period. See RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 193 (2002) (citing INTERNATIONAL FINANCE CORPORATION, CHINA'S EMERGING PRIVATE ENTERPRISES, 2000).

24. By 2007, one source claimed that China had 4,000 registered guarantee enterprises in China. Liang Bao Zhong, Zhiyuan xingfang: Danbao tixi de gouzhu yu quan dongtai fengxian guanli [Round in Knowledge, Square in Practice: Overall Trends in Risk Management and the Formation of the Guarantee System] 6 (China Economic Publishing House 2007). By 2009, the number of guarantee enterprises reached 5,547. Peter Situ & the Working Group on Inclusive Finance in China, *Guarantee Funds for Inclusive Finance in China* 11, (April 2011), http://www.microfinanceforum.org/cm_data/WMFG-paper3_Guarantee_Funds.pdf. In contrast, China's 'Guaranty Alliance,' an informal national association of guarantee enterprises established in 2001 counts only 76 members. See ZHONGGUO DANBAO XIEHUI [CHINA GUARANTY ASSOCIATION] (中国担保协会) (Feb. 16, 2012), <http://www.cncga.org/huiyuan.asp>. In Beijing, the municipal Credit Guaranty Association cites a membership of 154 companies. BEIJING XINYONG DANBAO XIEHUI [BEIJING CREDIT GUARANTEE ASSOCIATION] (北京信用担保协会) (Feb. 16, 2012), <http://www.bjdbxh.org.cn/news/XHWZ/ZL/2011/47/1147152056AB4EJA17JH5HK16BGHB.html>.

25. Róngzì xìng danbao gōngsī guǎnlǐ zhàn xíng bàn fǎ (融资性担保公司管理暂行办法) [Temporary Measures for the Management of Financial Guarantee Companies] (issued by China Banking Regulatory Comm., The Nat'l Dev. & Reform Comm'n, the Ministry for Indus. & Informationalization, the Ministry of Fin., the Ministry of Commerce, the People's Bank of China, and the State Admin. for Indus. & Commerce, Mar. 8, 2010), Order No. 3, available at http://www.law-lib.com/law/law_view.asp?id=311548.

26. Zhang Jianhua, Zhongguo noncun duocengci xindai shichang wenti yanjiu [Research on Problems in the Small Loans Market at all Administration Levels in Rural China] 2 (contending that by 2006 the level of SME borrowing from financial institutions had reached around forty-five percent of all such enterprises).

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236 THE INTERNATIONAL LAWYER

owned enterprises has come back with a vengeance.²⁷ This may help explain why China's Ministry of Finance is trying to hoist the pre-existing guarantee enterprise system onto government procurement, expanding the system's remit beyond mere loan guarantees to providing bid and performance surety bonds on individual procurement projects.²⁸

MoF Document No. 124 purports to employ market mechanisms to spread risk and reduce costs to SMEs in government procurement.²⁹ This is belied, however, by the plan set out in the document and the nature of financial guarantees in China. China's guarantee industry still relies on large public subsidies to compel its commitment to policy prescriptions and assume the risks associated therewith.³⁰ Only by allowing investors to leverage the public subsidy, and other public support, for commercial ends can the Chinese government recruit private investment and skilled management to the guarantee industry. In return, the commercial guarantee entity manages the policy-driven credit enhancement programs desired by the government.³¹

MoF Document No. 124 offers nothing different. Indeed, in the document, the Ministry of Finance expects each experimental region to designate only one guarantee company to forge implementation of the policy. Remarkably, MoF Document No. 124 expressly identifies China National Guaranty and Investment Company, China's largest guaranty company and a good example of the hybrid policy/commercially driven enterprise,³² as the designated guarantee company for carrying out the new SME government procurement guarantee system policy at the national level.³³ For the listed experimental localities, it is not clear whether the designated guarantee company will be a pre-existing outfit or a new rent-seeking group that establishes an entirely new guarantee enterprise in response to the reforms. Much will depend on the level of internal public support, as MoF Document No. 124 makes clear that any guarantee premiums charged must be of a reduced nature to make the system more affordable to small and medium enterprises.³⁴ Noticeably, MoF Document No. 124 fails to mention how much public subsidy is going to be provided to each designated guarantee company to induce the same to issue guarantees on behalf of SMEs in Chinese government procurement. Nevertheless, clues on implementation are offered by experiments in Heilongjiang Province, which paired a government-designated guarantee entity with a more commercial-oriented guarantee enterprise to jointly issue such guarantees. Through the provincial designated entity, the provincial people's government provided ¥1.688 billion (U.S. \$267.9 million) to the endeavor.³⁵ MoF Document

27. *China's Economy: Hitting the Kerf*, THE ECONOMIST, Oct. 22, 2011, at 79–80, available at <http://www.economist.com/node/21533412>.

28. See MoF Document No. 124, *supra* note 14, ¶¶ 4.1–4.3.

29. *Id.* at pmb1.

30. See Situ, *supra* note 24, at 13.

31. *Id.* (but “government involvement remains very much present, either through direct or indirect investments in guarantee institutions from governments of different levels, or through the latter’s *de facto* regulatory functions, which to some extent control [the guarantee entity’s] business scope and management orientation”).

32. See The Introduction of China National Investment and Guaranty Co., Ltd., <http://www.guaranty.com.cn/en/about/index.htm> (last visited Feb. 3, 2012).

33. MoF Document No. 124, *supra* note 14, ¶ 3.

34. *Id.*

35. *Caizhengbu kaizhan zhengfu caigou xinyong danbao shidian* [The Ministry of Finance Launches an Experiment in Credit Guarantees in Government Procurement], GONGGONG CAIGOU, [PUBLIC PROCUREMENT], Oct. 3, 2011, at p. 49.

THE INTERNATIONAL LAWYER
A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

INTERNATIONAL PROCUREMENT 237

No. 124 also fails to identify the expected penal sum value of the new bid and performance bonds envisioned in the reform. Arguably, the government should set this value low, as it is directly related to the ultimate cost of the guarantee product to the SMEs. Government purchasers, however, may want higher penalty bonds to offset greater risks presented by small-and medium-sized government contractors.

Surprisingly, MoF Document No. 124 provides an appendix with both a bid bond form and a performance bond form, which, for China, are rather detailed. Importantly, the bond forms read as conditional bonds, rather than demand instruments, which among other things require the project owner to prove supplier default, and no breach of its own, before it can collect on the bond.³⁶ Thus not only does MoF Document No. 124 relieve SMEs of the burden of providing unaffordable cash deposits to the procuring agency (and the associated risk of wrongful forfeiture of the same), but the written bid and performance bonds that they will provide in the future as substitute allow the SME (and the surety) the chance to dispute the legality of the claim before having to make payment (with a forum-selection clause included in the bond forms).³⁷ An important question remains, however, as to whether the conditional nature of the guarantee will persuade the issuing guarantee companies to refrain from requiring the SME post high value collateral for the guarantee company's issuance of the bond. Excessive collateral requirements might defeat the overall purpose of MoF Document No. 124, which is to free up capital for SMEs to better participate in China's government procurement market. Indeed, China's national government may eventually find itself heeding the advice of the Director of Tianjin Municipality's Government Procurement Center, who argues for dispensing with bid and performance security entirely in order to lower the cost of supplier participation in the government procurement market.³⁸

36. MoF Document No. 124, *supra* note 14, at apps. 1–2.

37. *See id.*

38. Chen Yan Ping, *Tianjinsbi zhengfu caigou zhongxin de sbijian yu sikao* [Considerations and Practice at Tianjin's Government Procurement Center], 1 Conference Papers of the International Public Procurement Forum II: New Directions, New Discipline, New Profession, Central University of Finance and Economics 204, Oct. 10, 2010 (on file with the author).

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