

## Civil Fraud v. Criminal Fraud: Criminal Proceedings Not a Silver Bullet to Resolve Business Disputes in China

*Henry (Litong) Chen and Carlo Carani, MWE China Law Offices*

### *Introduction*

International investors and businessmen often discover that fraud is not uncommon among their counterparts in China. There exists the perception among some foreign firms that the alleged fraud must be reported to the police in order to successfully resolve contractual fraud disputes. However, this is not always the ideal method and in fact may be detrimental to successful dispute resolution.

There are instances where the police have refused to help foreign investors because purely economic disputes are outside of the jurisdiction of local law enforcement. In one case, a foreign investor and a Chinese partner jointly established an escrow account for the operation of a joint venture. Access to the escrow account required the signatures of both parties. The Chinese partner, however, withdrew money from the escrow account by counterfeiting the signature of the foreign party. The foreign investor reported this case to the police but was refused by the police on the grounds that the case related to general business transactions.

In another case, a foreign investor intended to purchase assets from a Chinese party but did not pay the full purchase price. Afterwards, the Chinese party sold the assets to a third party and refused to refund the money to the foreign investor. The foreign investor resorted to the police for dispute resolution, and, again, the police declined to accept the case.

The above examples indicate that the way China handles economic fraud cases contravenes with the foreign investors' general understanding of how the system works. This article attempts to explain, from both a legal and practical perspective, the difference between civil and criminal fraud, and analyze the pros and cons of commencing criminal proceedings in China to resolve foreign-related economic fraud.

### *Civil Fraud Versus Criminal Fraud*

Fraud appears in both China's civil law<sup>1</sup> and criminal law.<sup>2</sup> China's Civil law stipulates that:

. . . any party purposely conveys any false information to the other party, or purposely disguises any fact so as to induce the other

---

© 2010 Bloomberg Finance L.P. All rights reserved. Originally published by Bloomberg Finance L.P. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

The discussions set forth in this report are for informational purposes only. They do not take into account the qualifications, exceptions and other considerations that may be relevant to particular situations. These discussions should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Any tax information contained in this report is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. The opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content contained in this report and do not make any representation or warranty as to its completeness or accuracy.

party into making any false declaration of will, such act shall be determined as a fraudulent act . . . <sup>3</sup>

A contract is void if . . . a party uses fraud or coercion to conclude a contract, thereby harming the interests of the State . . . <sup>4</sup>

A party has the right to petition a People's Court or an arbitration institution to modify or rescind a contract if a party used fraud or coercion or took advantage of the other party's vulnerability to cause him to conclude a contract which was contrary to his true intention, the injured party has the right to petition a people's court or an arbitral institution to modify or rescind the contract.<sup>5</sup>

China's Criminal Law of 1997 provides that:

Those defrauding relatively large amounts of public or private money and property are to be sentenced to three years or fewer in prison or put under criminal detention or surveillance, in addition to fines; or are to be fined.<sup>6</sup>

Whoever, for the purpose of illegal possession, uses one of the following means during signing or executing a contract to obtain property and goods of the opposite party by fraud, and when the amount of money is relatively large, is to be sentenced to not more than three years of fixed-term imprisonment, criminal detention . . . <sup>7</sup>

Of special note is that the English translation of the Chinese criminal and civil laws interchangeably use the words "fraudulent", "defrauding" or "fraud". In Chinese, these words actually are not always the most accurate translations. Civil law uses the Chinese word "qi zha" or "欺诈" (in Chinese) to describe fraud or fraudulent acts, while criminal law uses "zha pian" or "诈骗" (in Chinese) to describe fraud or defraud. In Chinese, "qi zha" means to defraud people in sly ways while "zha pian" denote deception and swindle.<sup>8</sup> In China, "zha pian" is a much more severe act than "qi zha" in terms of the degree of harm inflicted on others' interests. This perception is consistent with the distinction between a less serious civil fraud and a more harmful criminal fraud.

Although the subtle differences in the Chinese wording for fraud indicate a distinction between civil and criminal fraud, the key difference between the two lies in the intent of the accused. By law, civil fraud only requires the wrongdoer to have an intention of fraudulence while criminal fraud requires the much more vicious intent of illegal possession. Generally speaking, intent of illegal possession is more likely to exist if a suspect conducts one of the following behaviors: (a) signing a contract in another's name or a false work-unit (e.g., company or enterprise); (b) using forged, altered, or invalid bills or certificates of property rights as a guaranty; (c) trapping the other party into continuing signing or performing the contract by means of partial fulfillment or small-amount contracts, instead of actually fulfilling the contract; (d) absconding with the goods, payment for goods, or payment in advance or guaranteed property; or (e) fraudulently obtaining the other party's property by any

other means.<sup>9</sup> Note, however, that the existence of the above scenarios alone does not necessarily equal the existence of intent of illegal possession. In practice, identifying the type of intent is difficult and requires a case-by-case analysis. (We will conduct a case study below.)

In addition, a monetary threshold must be reached in order to file a criminal fraud case with the police. Specifically, individuals must reach at least 5,000 RMB and companies must reach at least 50,000 RMB.<sup>10</sup> This type of monetary limit does not exist in civil fraud.

### *Distinguishing Between Civil and Criminal Fraud in Practice*

Even with the current laws in place, distinguishing between civil and criminal fraud is no easy job. This is not only because wrongdoers exhibit similar traits in both civil and criminal cases, but also due to the difficulty in reaching the legal thresholds required for a criminal case. There are instances in which the public security bureaus, the prosecuting institutes and the courts have different understandings of the nature of contract fraud.<sup>11</sup> In order to better perceive the differences between civil and criminal fraud, we provide the following case analysis.

#### *Case Study 1—Civil Fraud*<sup>12</sup>

A Chinese company ("Company Chi") had a long-term cooperative relationship with a world famous multinational company ("Company Multi"). During this time period, Company Chi learned that Company Multi intended to transfer proprietary technology to another company ("Company Buyer"). Mr. X, an employee of Company Chi, learned through his personal network that Company Multi's ideal recipient of the technology was Company Buyer. To take advantage of the situation and earn some commission, Mr. X attempted to broker the deal between Company Multi and Company Buyer. Mr. X made and presented some pictures and documents in his office and pretended to be an employee of Company Multi, and then invited the representatives of Company Buyer to visit his office.

The efforts of Mr. X paid off—Company Buyer signed a cooperation agreement with Mr. X as the agent of Company Multi. The agreement bore the logo of Company Multi on the top of each page which was falsified by Mr. X.

After Company Buyer signed the agreement and paid the deposit, Mr. X sent an amendment letter to Company Buyer. In the amendment letter, Mr. X confessed that he was actually an agent of Company Chi, and he signed the agreement with Company Buyer based on information that a technology transfer agreement will be signed between Company Multi and Company Chi. In addition, Company Buyer can only negotiate an agreement with Company Multi via Mr. X. Otherwise, Company Buyer would breach the agreement with Mr. X. Company Buyer did not raise any objection towards the amendment letter, nor did it demand a refund on its deposit.

In an unexpected twist, Company Multi entered into a technology transfer agreement with Company Chi where the latter paid a transfer fee to Company Multi from the deposit paid by Company Buyer. Company Chi's ultimate aim was to retransfer the technology to Company Buyer. However, the transfer of technology from Company

Chi to Company Buyer was not successful because Company Multi prohibited a sub-transfer. Later, Mr. X made a great effort and successfully facilitated the direct cooperation between Company Buyer and Company Multi. Of course, Mr. X refused to refund any deposit to Company Buyer. The prosecutors found Mr. X guilty of contractual fraud because Mr. X signed a contract under another company's name to illegally obtain property from Company Buyer.

However, the court ruled that Mr. X was NOT guilty of criminal contractual fraud due to lack of criminal intent.

The court held that although Mr. X committed fraudulent activities during the negotiation and signing of the cooperation agreement, Mr. X did not have the intent of illegal possession. The court observed that Mr. X did not personally use the money paid by Company Buyer, nor did he go into hiding. Rather, Mr. X used part of the deposit as the transfer fee required by Company Multi. Therefore, the court found that Mr. X's direct motive of signing the cooperation agreement with Company Buyer was to facilitate the technology transfer of Company Multi, thereby obtaining the margin between the deposit and the transfer fees. Additionally, the court found that Mr. X, as an agent of Company Chi, had the capacity to perform the cooperation contract. Also, Mr. X actively made additional efforts to facilitate the technology transfer upon realizing the contractual technology restrictions. These facts denote that Mr. X tried to perform the contract in good faith and did not intend to defraud Company Buyer of its deposit. Moreover, the court observed that although Mr. X's inappropriate behavior during initial negotiation sessions of the cooperation agreement did mislead Company Buyer, the Company Buyer's representatives still signed the cooperation agreement with Mr. X after visiting Company Chi. Therefore, Company Buyer cannot be deemed as having been defrauded. On the contrary, Company Buyer achieved its purpose of cooperation with Company Multi through Mr. X and is in reality a beneficiary of the whole project. In view of all the reasons above the court concluded that Mr. X did not have the intent to possess the deposit.

#### Case Study 2—Criminal Fraud <sup>13</sup>

In January 2000, Company A signed a processing agreement with a Thai company. The agreement was later terminated. In October 2000, a land leasing contract between Company A and the Chinese government was also terminated. By November 2000, Company A's total debt exceeded 120,000 RMB. In March 2001, Mr. Y, the legal representative of Company A, established Company B with a fictitious registered capital of 6 million RMB to continue the processing project. From December 2000 to March 2002, Mr. Y signed agreements with several construction companies in the name of Company A and Company B for an alleged construction of road, factory and store houses for the processing project. The construction companies paid more than 807,000 RMB to Mr. Y. All of that money was spent by Mr. Y.

During the court hearing, Mr. Y defended his actions by arguing that the money was spent to attract investment and that this should be a civil, not criminal, dispute.

The court ruled that Mr. Y was guilty of contractual fraud. Firstly, the court observed that Mr. Y falsified the continuation of the processing project and tricked the construction companies into signing a contract. Secondly, the court held that given

the debt carried by Company A, the fictitious registered capital of Company B, and the expiration of the land leasing contract indicated that Mr. Y would be unable to fulfill its contractual obligations with the construction companies. Lastly, Mr. Y spent all the money after obtaining the deposit, therein demonstrating that Mr. Y was not, in fact, willing to fulfill the contract at all.

These case studies illustrate that deceptive behavior does not necessarily result in criminal charges for the wrongdoers. Ultimately, the intent of the wrongdoers determines the nature of the case and this intent can only be assessed on a case-by-case basis. In general, the following points are worthy of consideration:

1. The existence of any deceptive behavior during the signing or fulfillment of the contract;
2. The party in question's ability to fulfill the contract;
3. The manner in which the party in question dealt with the obtained property;
4. Whether the party in question is liable for breach of contract;
5. The reason why the party in question failed to fulfill the contract.

### *Pros and Cons of Filing a Criminal Fraud Case*

Filing a criminal fraud case has both advantages and disadvantages. Typically, filing a criminal fraud case will alleviate the burden of proof from the victim's side due to the intervention of the police and the prosecution. A victim can leverage the state's power to investigate and collect evidence critical to the legal dispute. Facts already accepted as evidence in criminal proceedings are generally automatically accepted by the court and does not require an additional acceptance for civil proceedings<sup>14</sup> for compensation.<sup>15</sup> Also, the accused, if convicted of certain crimes by the court, is more willing to provide compensation for their crimes in exchange for a reduced sentence.<sup>16</sup>

However, it may not always be in the foreign investor's interest to use criminal procedures. According to the Criminal Procedure Law and subsequent judicial interpretations, victims who suffer material losses because of a crime have the right to seek compensation by filing a civil action incidental to the criminal procedure. The identical trial court that tried the criminal cases then decides the complaint on civil compensation. An incidental civil action, however, can be heard after the trial of the criminal case closes.<sup>17</sup> This is the so called principle of "criminal precedes civil". In practice, an ongoing civil procedure will be stopped if the police or the prosecutor suspects that a criminal fraud is involved in the disputes.<sup>18</sup> The existence of "criminal precedes civil" results in the undue delay of compensation to the victim due to the procrastination of the incidental civil action.<sup>19</sup> In addition, as civil compensation is "incidental" to the criminal proceedings, many judges simply require the victims to state the amount of compensation they would like to seek during the trial and do not organize the parties to examine the evidence once such evidence has been crossed during the criminal procedure, thus depriving the victims of their procedure rights.<sup>20</sup>

Moreover, the attitude of law enforcement agencies may influence the effectiveness of dispute resolution through criminal proceedings. For example, in 1989, 1992, 1995 and 1997 the Ministry of Public Security issued notices that barred its subordinate bodies from interfering in economic disputes.<sup>21</sup> The Office of the

Supreme People's Prosecuting Institute also issued a statement in 2002, stating that they will consider the facts of the case thoroughly before arresting individuals if the concerned contract is valid and if guilt is difficult to establish and arrest is impossible without clear facts and adequate evidence, especially if the dispute is purely economic and not an economic crime.<sup>22</sup> In other words, the law enforcement agencies would intervene only if the fraud goes far beyond pure economic disputes and they will do so in a scarce and prudent manner.

In addition, the general status of rules of law in China also indicate that laws and regulations are not without loopholes and law enforcement agencies are susceptible to inappropriate influence by concerned parties, particularly in the criminal case against foreign investors. For foreigners that wish to invest in China, a strong relationship with local authorities is one of the cardinal requirements. In contrast with foreign investors in China, local individuals and enterprises generally have stronger relationships with local governments and can leverage their relationships to affect governmental decisions to their favor. This is not unlike the situation in foreign countries where corporations can lobby their governments. This leads to the idea that using the public security bureau to solve economic disputes may not be the best idea because of the strong relationship between local businesses and government.

### *Conclusion*

In the end, criminal proceedings are not necessarily the most effective way to "get things done" considering the differences between civil and criminal fraud in China. The key distinguishing feature between the two is the intent of illegal possession inherent in criminal offence—this intent requires careful consideration and must be prudently based on concrete facts in order to be proved. Moreover, the existence of "criminal precedes civil" in practice and the legal environment in China may affect the effectiveness of criminal proceedings. After all, resorting to police can only be used as a tool to bring the Chinese party back to the negotiation table. It is advisable that foreign investors consult with their Chinese legal counsels as to best methods of dispute resolution for each specific scenario. This is particularly true if foreign investors decide to start a criminal proceeding in China.

*Henry (Litong) Chen, the Commissioner of the Economic Committee of All China Lawyers' Association, is a partner of MWE China Law Offices, a leading Chinese law firm based in Shanghai. Mr. Chen is licensed in the PRC and the State of New York. Mr. Chen's practicing areas include international arbitration, domestic litigation, compliance with the Chinese Anti-Monopoly Law, anti-trust filings, Foreign Corrupt Practices Act (FCPA) investigations and auditing, risk management under anti-commercial bribery laws and other corporate services. E-mail: HenryChen@mwechinalaw.com.*

*Carlo V. Carani is a foreign counsel for MWE China Law Offices. Mr. Carani focuses his practice on helping lead multi-disciplinary international teams in proposing, negotiating, and achieving solutions for companies doing business within the greater China region. In particular, he has extensive experience with corporate legal and ethical compliance reviews and regularly advises clients on matters concerning the protection of companies, directors and officers from various risks of liability and losses. He is licensed in the State of Illinois. Email: ccarani@mwechinalaw.com*

<sup>1</sup> For the purpose of this article, civil law means laws and regulations governing civil relationship, including but not limited to General Principle of Civil Law (1986) ([http://www.chinacourt.org/flwk/show.php?file\\_id=5139&key=%C3%F1%B7%A8%CD%A8%D4%F2](http://www.chinacourt.org/flwk/show.php?file_id=5139&key=%C3%F1%B7%A8%CD%A8%D4%F2)) and Contract Law (1999) ([http://www.chinacourt.org/flwk/show.php?file\\_id=32430&key=%BA%CF%CD%AC%B7%A8](http://www.chinacourt.org/flwk/show.php?file_id=32430&key=%BA%CF%CD%AC%B7%A8)) and their respective judicial interpretations.

<sup>2</sup> For the purpose of this article, criminal law, unless otherwise provided as the Criminal Law, means laws and regulations governing criminal relationship, including but not limited to the Criminal Law (1997) ([http://www.chinacourt.org/flwk/show.php?file\\_id=27762&key=%D0%CC%B7%A8](http://www.chinacourt.org/flwk/show.php?file_id=27762&key=%D0%CC%B7%A8)), the Criminal Procedure Law ([http://www.chinacourt.org/flwk/show.php?file\\_id=24866&key=%D0%CC%CA%C2%CB%DF%CB%CF%B7%A8](http://www.chinacourt.org/flwk/show.php?file_id=24866&key=%D0%CC%CA%C2%CB%DF%CB%CF%B7%A8)) and their respective judicial interpretations.

<sup>3</sup> The Opinions of the Supreme People's Court on Several Issues concerning the Implementation of the General Principles of the Civil Law of the People's Republic of China (For Trial Implementation), Article 68.

<sup>4</sup> Contract Law (1999), Article 52.

<sup>5</sup> Contract Law (1999), Article 54.

<sup>6</sup> Criminal Law (1997), Article 266.

<sup>7</sup> Criminal Law (1997), Article 224.

<sup>8</sup> See the explanation in China available at <http://www.ourdict.cn/> (last visited on January 2, 2010)

<sup>9</sup> Criminal Law (1997), Article 224.

<sup>10</sup> Provisions of Supreme People's Prosecuting Institute and Ministry of Public Security Bureau on the Standard of Prosecuting an Economic Crime.

<sup>11</sup> Guo, Weiqun (郭卫群), *Shi Min Shi Wei Yue Hai Shi He Tong Zha Pian* (是民事违约还是合同诈骗) [Civil Defraud or Contract Fraud?], 30 *Jian Cha Feng Yun* (检察风云) [Prosecutorial View], 4(2003)

<sup>12</sup> The People Court Daily (January 20, 2003).

<sup>13</sup> The People Court Daily (November 18, 2004).

<sup>14</sup> According to Article 78 of the Criminal Procedure Law, if a victim has suffered material losses as a result of the defendant's criminal act, he shall have the right to file an incidental civil action during the course of the criminal proceeding.

<sup>15</sup> Several Provisions of the Supreme People's Court on Evidence in Civil Procedures, Article 9.

<sup>16</sup> Regulations of the Supreme People's Court on the Scope of Civil Suit Collateral to Criminal Proceedings, Article 4.

<sup>17</sup> Criminal Procedure Law, Article 78.

<sup>18</sup> Provisions of the Supreme People's Court on Several Issues concerning the Involvement of Suspected Economic Crime during the Trial of Economic Disputes, Article 11.

<sup>19</sup> For example, an incidental civil action can be procrastinated if the suspect is a fugitive as there is no default judgment in the Chinese criminal procedure.

<sup>20</sup> Jiang, Wei (江伟), Fan, Yueru (范跃如), *Xing Min Jiao Cha An Jian Chu Li Ji Zhi Yan Jiu* (刑民交叉案件处理机制研究) [On How to Handle Cases Involving Both Criminal and Civil Elements], 4 *Fa Shang Yan Jiu* (法商研究) [Studies in Law and Businesses], 31(2005); Foshan Intermediate Court of Guangdong Province (广东省佛山市中级人民法院), *Xing Shi Fu Dai Ming Shi Su Song An Jian Diao Shen Li Yu Zhi Xing Qing Kuang De Diao Cha Bao Gao* (刑事附带民事诉讼案件审理与执行情况的调查报告) [Investigation Report on the Trial and Enforcement of Civil Action Incidental to a Criminal Proceeding], 7 *Fa Lv Shi Yong* (法律适用) [Journal of Law Application], 57(2008).

<sup>21</sup> Notice of the Ministry of Public Security on the Prohibition of Public Security Organ from Unlawfully Intervening in Economic Disputes (1989); Notice of the Ministry of Public Security on the Prohibition of Public Security Organ from Interfering in Economic Disputes and

Unlawfully Detention (1992); Notice of the Ministry of Public Security on the Strict Prohibition of Public Security Organ from Exceeding Powers to Interfering in Economic Disputes and Unlawfully Detention (1995); Notice of the Ministry of Public Security on Handling Economic Contract Fraud Cases (1997).

<sup>22</sup> Notice of Supreme People's Prosecuting Institute on the Prohibition of Prosecution Organs from Exceeding Their Power to Interfere in Economic Disputes and Unlawfully Detain People (1992).