New England IN-HOUSE
A Quarterly Publication of Lawyers Weekly, Inc.
May 2007 / NEIH

Feature Story

By John O. Cunningham

The China boom is in full swing, and sooner or later your company will be doing business in China. If you aren't there now, one of your competitors probably is.

Domestic companies are rapidly establishing relations with Chinese suppliers, hiring lower-cost Chinese workers, and landing in China's cities to sell directly to a burgeoning middle-class and a fast-growing business sector.

The stats are telling. For example, last year China's stock market doubled, and for the first time ever S&P 1500 companies reported more capital spending overseas than at home (much of it in China).

The explosive growth means in-house lawyers have to get up to speed now on the intricacies of doing business in China – from bridging the cultural divide to knowing the key differences between U.S. and Chinese laws and regulations.

Crossing the cultural divide

The cultural adaptation needed for business success is perhaps the biggest hurdle Westerners face in China.

Absentee owners, short-term business plans with quarterly turnabouts, and American views of business as competition are not accepted in China.

"You must be flexible in your approach to business, and learn to do things the Chinese way," said Edward Epstein, who works in the new Shanghai office of Atlanta-based Troutman Sanders.

For example, "time is not money there," Epstein explained. "And deadlines can't be used as a negotiating lever because they just have to get comfortable with you."

Meetings over meals with prospective partners can seem endless to Westerners, but they are an essential predicate to negotiation of a deal.

"You must establish a relationship before you negotiate a contract, because in China you only do business with friends," said Lucia Lian of Goulston & Storrs in Boston. Lian, who lived in Shanghai for years, said an immediate desire to "just get down to business" can even be offensive, and "you should never talk business during meals."

Even the exchange of business cards can be important in China because American firm names can translate as meaningless babble there. "Names there have meaning," said Lian, who helped Goulston Storrs to develop a translated name that took on a "relationship" meaning with just a slight twist to the literal translation. (Lian's own name means "water lilly" in China).

"You must also remember that seating arrangements are important in meetings," added Dan Avery of Goulston & Storrs. "The most serious and important person sits in the middle."

Once a deal is struck, there is an even bigger cultural variation. “A deal is never really done in China, even after it is done because the relationship just begins at signing,” said Samuel Shafner, co-chair of Burns & Levinson’s international group.

“All of this looks very odd from over here,” said Jack Daniels, president of international consulting firm Eastbridge Partners. “But everyone there has lived this way for a long time. Chinese mercantile culture and values are 5,000 years old and our business methods a few hundred years or so.”

Another cultural wrinkle: Customs, values and laws can vary by region. “China was unified by a written language 2,000 years ago, but politically and culturally the country was not unified until recently,” said Epstein, adding that “local influences are still important and parochialism still prevails despite the central government.”

Westerners also need to understand the importance of “follow-up” in the business relationship, said Shafner, noting that business relationships equate to commitments in China that demand leadership presence and hands-on training and care.

The cultural differences in business are a lot to digest, but not understanding the differences will lead to failure.

“Companies who fail don’t adjust to Chinese culture and values, don’t understand the [Foreign Corrupt Practices Act], don’t localize supply, don’t train and promote Chinese to top levels of their business, or don’t make a commitment that top management physically go there at least four times a year,” Daniels said.

“Your organization must have one ‘champion’ with authority for China,” he added.

Laws and regulations

Laws on both sides of the Pacific Ocean affect American business ventures into China. A good lawyer from China is an essential part of any entry team.

For Americans, the Chinese system may look similar, but it is not. While both the U.S. and Chinese systems have central, provincial and local levels of government, and many written regulations, the similarities end there.

As Lian explained, most regulations are directed at specific industries, and the executive, legislative and judicial branches overlap in such a way that the creation, interpretation and enforcement of rules may be done by the same commission.

The rules can also change abruptly, according to Shafner, because power is vested in political groups that are shifting – sometimes to the benefit or the frustration of foreigners.

“The rule of law means something different in China,” said Robert Woll of WilmerHale’s Beijing office. “It is more of a planning and control mechanism than a predictor of outcomes. The regulatory framework looks very complex, but you have to understand the agency motivations more than the language to get interpretations right.”

Epstein explained: “An enforcement or approval authority interprets the law with great discretion there, and that can work in your favor or it can work against you. You can often get an approval in one place and a rejection in another based on the same law.”

There is no “arbitrary and capricious” standard of review applied to agency decisions, Woll noted. “But the good thing for business clients is that once something is approved it’s legal, and rarely if ever does a decision change,” he said.

“Black and white regulations don’t mean what they do in [America],” said Lian. “Lawyers must help clients find the right government agency and the right people to get the best interpretation."

While China is moving toward more Western process and procedure, in the meantime getting consistent interpretations from agencies or even courts is challenging.

"Having a reliable method of dispute resolution is particularly important in case anything goes wrong," said Jason P. Matechak of Reed Smith's Washington D.C. office. Matechak, who often recommends using arbitration clauses in commercial agreements, noted that Chinese parties are accustomed to Hong Kong, London and Stockholm Chamber of Commerce tribunals.

Lian cautioned that parties must be "very specific" about the language they use in contracts to make arbitration clauses binding. "China has more than 200 arbitration [tribunals] and they are governed differently," she said.

As for intellectual property rights, China has a very different approach than in the U.S. Pharmaceutical, clothing, and electronics companies have all been embroiled in major disputes there. That is one reason Matechak cautions clients to make sure IP registrations and rights are buttoned down before heading to Asia.

"If you do get in a dispute over IP rights, the U.S. Embassy and the Quality Brand Protection Committee in China might help you find a remedy before going to court," said Woll.

U.S. law can also trip up companies if they are unprepared, said Tim Bancroft of Goulston & Storrs, noting the impact of the Patriot Act, foreign trade agreements, and the Foreign Corrupt Practices Act (which draws fine lines between "bribes" and "facilitating payments" that can be legal in a foreign country).

Individuals can also violate export control rules before leaving the country. For example, "If Chinese nationals come here to see your technology, this could violate a technology export rule because you may need an export license to share data," Matechak said.

He noted U.S. Commerce Department rules also add a 200 percent duty for specified products, and companies need to know which party is paying the duty in any transaction. Matechak also noted that a 27 percent duty may be soon imposed on many more products to protect domestic industry. More information on duty rules can be found at www.doc.ita.gov.

But the most active area of U.S. enforcement activity involves "anti-dumping" rules designed to prevent "unfair competition" from overseas labor, and companies need to take these rules into account for any business plan.

Potential risks

Of course, doing business in China carries its share of risks.

"You must be very careful about vetting your partners in any transaction. The Chinese have a saying about the dangers of 'lying in the same bed, but dreaming different dreams' and that's especially important there," said Epstein.

Lawyers agreed that failures in due diligence have afflicted many Eastern pioneers. Matechak noted that "it's very hard to untangle a deal in China."

Nonetheless, it may be legally or commercially necessary when a mystery partner turns out to be the Chinese military or a significant competitor, explained Matechak, who cautioned that "China has more [legal and cultural] differences and requirements of adaptation than any other country."

Lian elaborated. "Westerners think of business purely as competition, but it is about Guan Xi [pronounced "Gwen-Shee" and meaning "relationship"] in China," she said. This view of business affects everything from contractual formation to interpretation and enforcement, she said.

* * *

The allure of China

Unlike mature economies, China's economy has room for growth in virtually every sector, leading domestic companies to look eastward for faster growth and better returns.

Companies of all sizes are sizing up how to get in on the ground in China to take advantage of the opportunities.

The Chinese government is welcoming foreign participation in achieving its stated goal of quadrupling its gross domestic product by 2020.

"The government is encouraging foreign participation in almost every industry," said Robert Woll of WilmerHale's Beijing office "Even in media there is acceptance of non-political magazines about fashion, sports and self-improvement." Woll also noted that companies like Fidelity are managing state pension funds now, an unthinkable prospect until just recently.

Weaving China into investment strategies is now practically a given.

Jack Daniels, president of international consulting firm Eastbridge Partners, said "many VC [venture capital] firms require companies they are funding to have a China strategy because that is the future."

China will soon be the largest market in the world, said Daniels, noting "there may be 800 million Chinese who are poor, but now there are 600 million who are not, and 200 million of them are doing well enough to buy cars, appliances and computers."

Many companies have literally plowed new ground in Chinese real estate, which was also closed to Westerners not long ago. While many restrictions still exist for ownership or development of projects affecting local housing, commercial development is almost solely predicated on the approvals of government authorities.

"It is a lot easier [in China] to get a government approval because there is no transparent public participation in commercial development," explained Edward Epstein, who works in the new Shanghai office of Atlanta-based Troutman Sanders.

In fact, the Chinese are building numerous nuclear power plants and clean technology operations that would take years to permit in the U.S. where even windmills draw local opposition.

"Alternative energy is a big focus that's developing quickly because of government tax credits and incentives," said Lucia Lian of Goulston & Storrs in Boston.

Some manufacturing and textile companies believe a China presence will be critical to their survival, said Dan Avery, also of Goulston & Storrs. "One client told us: 'We have to be there because our biggest competitors are either there or will be going there soon.'"

This trend is fast increasing because labor costs average a 12th of what they would be in the U.S.

Perhaps the biggest opportunities are for financial services companies.

"There are pent-up demands for investment products and fast-growing demands for various insurance products because of developing affluence," said Woll, noting the China Securities Regulatory Commission (akin to the Securities and Exchange Commission), the China Banking Regulatory Commission and China's Insurance Regulatory Commission have liberalized their rules in recent years.

Firms like Goldman Sachs, UBS and Morgan Stanley now have a Chinese presence so they can help with public offerings.

Companies are also pursuing opportunities involving insurance, credit cards, mortgage loans and other financial products that are relatively new to a richer China, according to Goulston & Storrs attorney Tim Bancroft. “We also see Western companies selling entire divisions to China and [young] tech companies looking there for profitable exit strategies because they don’t have to rely on NASDAQ offerings alone now.”

Many companies feel pressured to go to Asia for competitive labor markets or for Chinese customers – businesses or individuals – who are already buying their products. However, Daniels cautioned, “The best time to go is before you’re pressured into it – when you have good markets and technology, but have time to plan your future in China.”

*** * ***

Due diligence and strategic planning

Careful research and planning is essential to avoid the traps China presents for Westerners.

“China has a seductive appeal, but you can’t check your common sense at the border,” warned Edward Epstein, who works in the new Shanghai office of Atlanta-based Troutman Sanders.

“Often Westerners see five-star hotels and glittering lights in Shanghai and Beijing, but those are not true representations of China. Beneath the veneer of modernity is a different world,” he said.

Robert Woll agreed.

“Clients see the mega-cities and think the communist party is gone, but much of the economy is still under state control,” said Woll of WilmerHale’s Beijing office.

In fact, the National Development and Reform Commission still prepares a “foreign investment catalog,” a laundry list of industries in which foreign investment is encouraged, restricted or prohibited. “Regulations there are complex and industry-specific, [and there are] special investment regions for foreigners, so you should plan your entry well,” Woll said.

Jack Daniels, president of international consulting firm Eastbridge Partners, urges U.S. companies to “take one step at a time because there is such a steep learning curve to China. Government relations must be a key part of your implementation plan.” He also noted the Chinese consulate in New York City has an office of commerce to help people understand how China operates.

In some situations, the government requires foreign entities to have a Chinese joint venture partner and sometimes such a partner is needed to facilitate distribution or expansion. Even without a joint venture, U.S. companies need knowledge of local managers, employees and government officials affecting their business.

“The need for a joint venture has been obviated in many industries, but you still need the right business partners and the right people who can help you because China is a minefield for a false step,” said Tim Bancroft of Boston-based Goulston & Storrs. He warned that some people are so eager for U.S. partners they will tell you what you want to hear.

Assessing your Chinese managers or partners is complicated by the fact there are few, if any, means to do credit checks, media searches and other background research on their histories, noted Jason P. Matechak of Reed Smith’s Washington, D.C office.

“It is much more important to have intelligence on the ground in China than anywhere else in the world,” said Samuel Shafner of Burns & Levinson in Boston. “You have to find people who know China, who know your business and are trustworthy.” He suggested that companies entering China with intellectual property concerns would be wise to consider the possibility of using offshore operations in Korea or Japan and shipping into China.

But for those who need a China presence, Lucia Lian of Goulston & Storrs advises companies to consider wholly-owned foreign subsidiaries (known as “WOOFIEs”). A WOOFIE offers an owner greater control than a joint venture and less difficulty in unwinding a business if problems occur.

Lian also suggested an entry plan should consider tax credits and government incentives provided for certain industries or locations (known as “special economic zones”).

“You have to be sure you use the appropriate structure and location for your entry strategy, in part, because of tax reasons,” added Epstein, noting that “special purpose investment vehicles” can get favorable tax withholding reductions in Hong Kong, for example.

Daniels stressed, “There are many value-added taxes and special taxes that need to be addressed in doing transactions.”

Another critical consideration is currency exchange. China’s Yuan cannot be removed from the country or exchanged except by approval of the Authority on Financial Execution, which allows for annual exchange only after payment of all taxes. The government also requires 10 percent of profits remain permanently in China to further develop the business in the country.
