

Doing business in China: **How the state of 1.3 million** **can tap the nation of 1.3 billion**

by Kim Newby

The market for Maine exports and investment

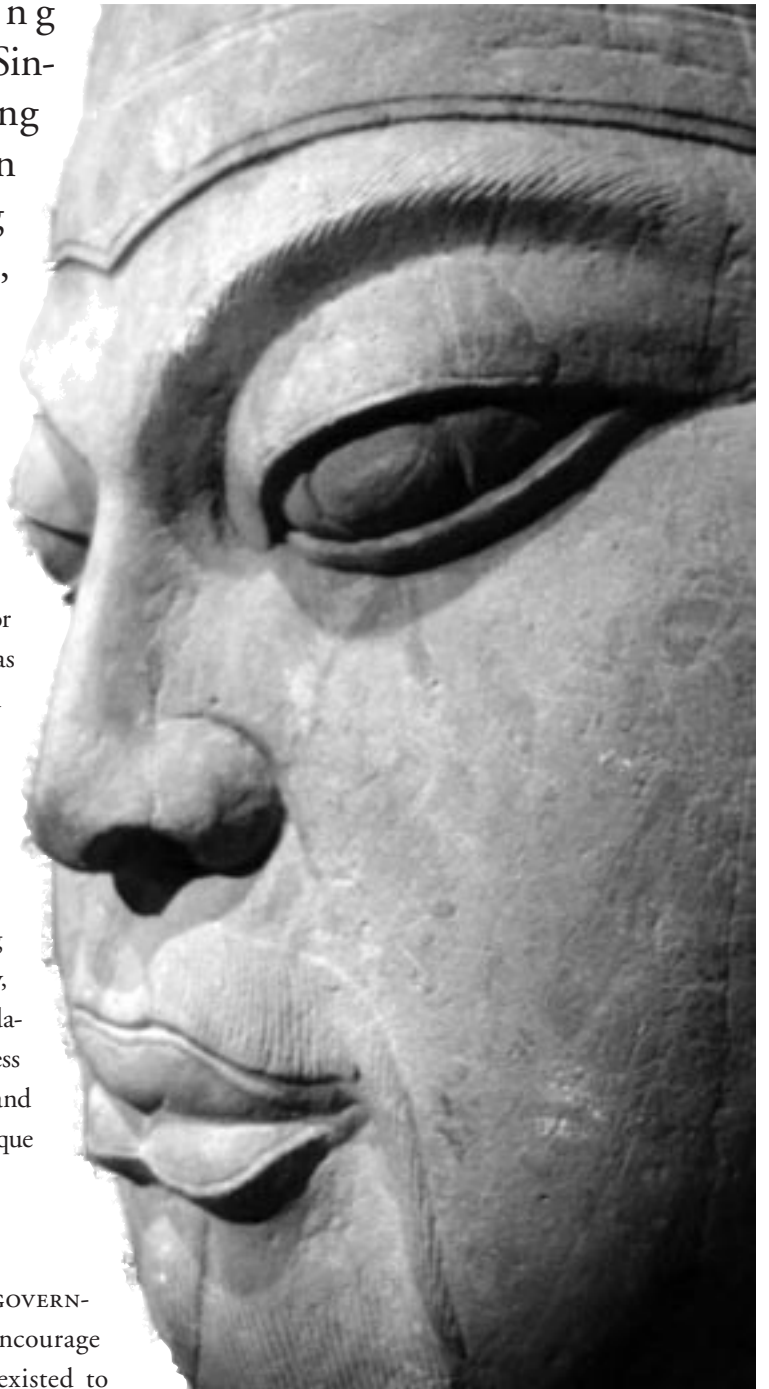
Whether exporting medical equipment to Singapore, manufacturing integrated circuits in China, or outsourcing software programming to Malaysia, Maine's businesses are increasingly looking to Asia for expanding business opportunities.

The People's Republic of China, in particular, has attracted enormous interest. According to the Massachusetts Institute for Social and Economic Research, Asia accounted for six out of the ten largest export markets for Maine's products in 2002. During the same year, China was the eighth largest market for Maine products and sixth in terms of growth. In just the last four years, exports to China have grown more than 300 percent. Indeed, expectations are high that the Chinese market can absorb even more Maine goods.

What legal skills are needed to advise clients who want to test Chinese waters? Lawyers experienced in negotiating major business transactions, protecting intellectual property, and preparing license agreements will understand the fundamentals involved in doing deals in China. However, real success in China requires an understanding of more than legal and business fundamentals. It requires familiarity with the unique characteristics of the Chinese legal and business culture.

A murky legal setting

OVER THE PAST TWENTY-FIVE YEARS, THE CHINESE GOVERNMENT has created an impressive legal framework to encourage foreign trade and investment. Prior to 1979, no laws existed to



guide American investment in China. That year, as part of the country's "open door policy," China passed its first major law governing foreign direct investment: the Sino-Foreign Equity Joint Venture Law. This was followed by a flood of new legislation designed to encourage foreign investment, including the Foreign Economic Contract Law, the Wholly Foreign-Owned Enterprise Law, the Sino-Foreign Cooperative Joint Venture Law and laws allowing the establishment of special economic zones that provided preferential treatment to foreign investments in specified coastal regions of China. Such legislation marked a fundamental change in Chinese economic strategy, recognizing the benefits of opening the country's previously isolated markets to the outside world. The result was an explosion of activity in foreign economic trade and investment.

Despite this change in attitude, the initial burst of legislation sorely lacked sophistication. New laws were quickly outpaced by even newer concepts introduced by foreign businesses. When it came to structuring deals, introducing technologies, or creating business arrangements, companies often found themselves operating in ways never contemplated by the Chinese or covered by the laws in place. Thus, many companies and their legal advisors moved in untested waters, although their actions frequently influenced the further development of Chinese business law. Such situations have become less frequent now as the Chinese legal environment has matured. Nonetheless, businesses looking to push the envelope on Chinese business activities are still at risk, if proposed arrangements are not specifically covered by current laws.

Interpreting laws through secret rules and local agendas

THE RELATIVE IMMATURITY OF CHINESE BUSINESS LAW IS JUST one impediment to the successful completion of a business deal in China. Another obstacle is presented by the Chinese method of legal interpretation. In China, business regulations are not interpreted precisely or consistently. Unlike the United

Kim Newby is a transactional attorney and founder of the Maine-based corporate law practice JurisN (www.jurisn.com). She has more than a decade of experience negotiating Asian contracts while living in Hong Kong and China. She has worked for the international law firms Preston, Gates & Ellis and Skadden, Arps, as well as for the U. S. Department of Commerce. Her Maine practice is focused on technology licensing, corporate contracts, and international business transactions. She is fluent in Mandarin.

States, China does not adhere to a precedential system, so each application of a law is done without the benefit of prior interpretations. This lack of uniformity in the application of laws can frustrate foreign businesses looking for definitive answers when making investment decisions.

Furthermore, China has a system of internal, unpublished rules operating beneath the normal system of published law. This accounts for actions by government agencies and administrators that often are inexplicable and unpredictable to foreigners. In many instances, the secret system trumps the published one, totally frustrating those under its purview, since such rules have historically been inaccessible to foreign investors. The system of internal rules is so pervasive that, as part of its World Trade Organization commitments, China agreed to increase transparency in its legal and administrative systems, pledging to make all of its regulations publicly available.

Foreign businesses must also be prepared for an interpretation of the law that is influenced by local agendas and prior local experiences with foreigners. Local authorities often have priorities that differ from Beijing with resulting interpretation of national laws that conflict with interpretations in other localities. Such local power should not be underestimated: a business plan will not move forward without the backing of local authorities. Thus, communicating the benefits of a foreign business project to the locality is an important part of a successful investment plan.

Connections and cultural nuances

FROM THE INCEPTION OF A PROJECT, FOREIGN COMPANIES should approach local officials humbly and with open attitudes. Such an approach deflects the stereotype of aggressive arrogance often attributed to Americans, opening the way for cooperation based upon a perception of respect for local authority. In many cases, long-term business relationships with the Chinese are only clinched when local officials conclude that foreigners are sincerely listening to their concerns and have an agenda based upon mutual benefit and respect.

On a related note, communication style is important for successful Chinese negotiations. Where Americans are verbally direct, Chinese typically are not. Vital points of negotiation are often communicated through behavioral nuances. For example, Chinese etiquette requires an offer of generosity be initially declined, even if the offered goods or services are truly desired. Eager acceptance is considered impolite and unrefined. By the same standards, however, it is expected that the offer will be

repeated in a form that communicates insistence and allows subsequent polite acceptance. While it is not necessary to master the myriad of cultural nuances that exist in China, having an awareness of the major differences between Chinese and American culture and a respect for those differences will help in developing relationships with Chinese business partners.

Due diligence

ONCE PROJECT DISCUSSIONS ARE UNDERWAY, PATIENCE IS ESSENTIAL. Before documenting a transaction, foreign investors must take the time to conduct thorough due diligence of the relevant Chinese parties. In the United States, this process of investigation and evaluation of a target company by a potential investor is a tedious yet straightforward exercise. Typically this involves a target company providing answers to a list of wide-ranging questions covering its business, legal, and financial background.

Due diligence is a concept distastefully alien to the Chinese. Chinese companies are not comfortable with outsiders inspecting books, records, and management practices. The Chinese view a detailed request for information as reflecting a lack of trust. Even Chinese companies with a history of foreign business interactions may be reluctant to share sensitive information with a foreign party. Sending a standard multi-page due diligence checklist to a Chinese target company is a common mistake made by American investors and one that can be a deal killer. Instead, investors must meticulously explain the due diligence practice. This explanation must describe not only the items needing review but also the level of detail required and the justification for such detail.

In the United States, due diligence is mostly associated with acquisitions and joint ventures. In China, due diligence is crucial for every type of project. Several areas of due diligence are particularly important for Chinese ventures.

Who is the contracting party? In China, it may often be difficult to work through the web of relationships to determine exactly who the contracting party will be and what related entities might be involved in a transaction. More specifically, foreign investors should inquire about government ownership in a target entity or any of its affiliates. This information is particularly important given provisions of the United States Foreign Corrupt Practices Act that prohibit payments to foreign officials for the purpose of improperly directing or influencing business. Further, business licenses, trade, import and export authorizations, and restrictions on business operations should be reviewed to understand the limits on a Chinese company's legally permitted scope of business activities.

What drives personnel loyalty? Business partners must allow time to gain familiarity with a target company's key management personnel and employees. Knowing how long a company's employees have been in place and their terms of employment may uncover important aspects of company culture and what makes it a successful enterprise. Furthermore, competitive practices in Chinese business can be cutthroat. Competitors will entice away key employees after a foreign investment is completed in order to steal skills, knowledge, and intellectual property. Understanding what keeps employees at the target company and what will motivate them to stay, even in the face of competitive pressures, may help prevent such poaching.

What is the market? Target business operations should be examined for sales, revenue, key customers, core contractors, competitors, potential market restraints, and distribution networks. This information is much more difficult to obtain in China than in the United States. In order to obtain reliable information, it may be necessary to hire professional investigators.

Are there any legal ambushes? Finally, due diligence in China must include investigation for violations of child labor, environmental, health, and other relevant laws. Ethical and human rights standards that are applicable in the West are equally applicable to American companies operating in China.

Strong agreements

CHINESE PARTIES OFTEN COMPLAIN THAT AMERICAN CONTRACTS contain too many irrelevant, unnecessary clauses and are simply too long. Contract lawyers must be prepared to negotiate an acceptable compromise between a five-page model agreement issued by the Chinese authorities and a 60-page American-style agreement covering every imaginable indemnity, representation, and warranty. To attorneys with Asian experience, a middle ground agreement is always possible. The Chinese can be persuaded to sign a longer document covering all key points and contingencies, while Americans can live with more concise language. No issues of importance need be left out of a skillfully negotiated Chinese-American business agreement.

Keep it simple. Boilerplate, all-inclusive clauses that may be standard in United States contracts should be avoided in China. Every clause should be reviewed for conciseness and plain language. When one word will do, the American legal laundry list that follows should be deleted. Not only will the Chinese appreciate conciseness, but fewer mistakes will occur when the document is translated into Chinese.

The escape clause. A clear exit strategy should be negotiated into any initial agreement. Chinese parties may be hesitant to incorporate specific contingencies for exiting a venture, because such provisions often are interpreted as a lack of good faith and trust. However, business investment in China is inherently riskier than similar investment in the United States. Consequently, clarification of exit rights is a crucial part of all potential business endeavors. This lesson was made clear in the 1990s, when many China investors were unable to terminate their failing joint ventures.

Lost in translation. In most cases, business agreements will be signed in both Chinese and English. Due to the complexity of both languages, a professional translator with experience in business language must be hired to review the final drafts for accuracy. This is essential even when Chinese contracting parties provide their own translations. It is important to note that translators are sometimes frustrated business and legal advisors and may take it upon themselves to edit documents during translation. Because of this tendency, translators should be prohibited from making independent legal assumptions or business decisions.

Memorialization. The Chinese often will request that parties memorialize various stages of a negotiation with a signed document. Not only do such interim agreements satisfy a cultural practice of ritualizing negotiation, but formal documents also are required by the Chinese in order to obtain administrative approvals for various stages of a business project. In extreme cases, signed statements may be required on a daily basis to document progress in negotiations. The Chinese see these documents as part of the bureaucratic process of the project but not necessarily binding commercial agreements between the parties. This can be a point of particular frustration to American negotiators when their Chinese counterparts brazenly re-open points set forth in such signed documents. In fact, the Chinese often do not consider negotiations fixed, even after definitive documents have been signed and a transaction is underway. An understanding of both the ritual aspects of Chinese negotiation and the fluidity of Chinese attitudes toward seemingly fixed agreements can provide a basis for the patience required to succeed in a business endeavor in China.

Protecting intellectual property

PROTECTION OF INTELLECTUAL PROPERTY RIGHTS IS ONE OF THE largest concerns for American businesses entering the Chinese

market. Unfortunately, such concerns are well grounded in the history of Chinese foreign investment.

A system in transition. Officially, China has developed a comprehensive legal framework for the creation, utilization, and protection of intellectual property. In 1980, China joined the United Nations World Intellectual Property Organization, which administers treaties that establish international rights and common standards for intellectual property protection. China also is a signatory to the major international conventions for the protection of intellectual property rights, including the Paris Convention (providing protection for patents, industrial designs, and trademarks), the Berne Convention (providing protection for literary and artistic works), and the Madrid Protocol (providing protection for trademarks). Most recently, China joined the World Trade Organization, which requires adherence to requirements set forth in its own Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

As a result of the TRIPS Agreement, China has revised its intellectual property laws to make them more consistent with international standards. This is good news for American businesses working in China. As a result, copyrights have been expanded to include architectural designs and internet publications. Patent duration has been extended, coverage expanded, and definitions of patentable technologies increased. Trademark law has been revised to allow registration of visual marks, three-dimensional symbols, and color combinations.

A problem of enforcement. Foreign investors should be warned, however, that China's legal reforms have exceeded its enforcement abilities. Although China seems committed to its reforms, it still lacks the legal infrastructure to competently and efficiently handle intellectual property disputes. Moreover, Beijing's ability to enforce its intellectual property regulations is seriously hampered by local resistance to change, particularly when local authorities sense that such change will take power out of their hands.

The most common method for foreigners to assert their rights in China has been through administrative action. Such action involves local branches of governmental bureaus: the State Administration for Industry and Commerce, the State Intellectual Property Office, the National Copyright Administration, local customs bureaus, and the State Drug Administration. Fines imposed through this route are meager when compared with the United States. However, administrative proceedings are usually efficient and relatively inexpensive.

China has recently expanded judicial remedies available to foreigners seeking civil or criminal penalties for infringements. Special courts have been established for intellectual property cases and more severe penalties for intellectual property infringement have been implemented. Pursuing a remedy in court may seem like a logical first step to many American businessmen. A favorable court verdict, particularly in a criminal case, may send a powerful message to infringers. However, the pursuit of judicial remedies in China remains a costly gamble. The courts impose a high burden of proof for a claimant alleging intellectual property infringement. Simply collecting that proof could take months and result in costly investigators' fees. In addition, judges in China are subject to local influences. Accounts of prejudice against foreign parties, stalling tactics by courts to deter foreign suits, and blatant discrimination in rulings persist. These shortcomings clearly discourage foreign businesses from seeking judicial remedies. The advantages of criminal and civil remedies lie in decisions that are made public, giving foreign businesses the ability to make examples of intellectual property pirates. However, judgments are neither certain nor inexpensive. For smaller businesses, the costs in extra effort, time, and money may outweigh any potential benefits.

Implementing an intellectual property strategy. Given this uncertain climate for enforcement, foreign investors must take proactive and defensive measures to protect their intellectual property. Valuable intellectual property assets should not be brought to China without due consideration of the potential consequences if such assets are misappropriated. Foreign parties should consider introducing technologies slowly based on their suitability to a project and an environment sufficient for their effective protection.

Any use of intellectual property by a Chinese entity should be strictly defined by the terms of a license agreement. A license should identify the rights and obligations of both the licensor and the licensee and must painstakingly spell out what is being licensed: for example, a trademark for use only on certain items in specified ways, or a technology for use in manufacturing processes only to create specific products. The more clearly and precisely a license is drafted, the better control the licensor has over the licensed property. In the past, Chinese licenses implicitly conferred ownership to the licensee after a limited time period. Without specific language, this precedent may give Chinese partners the impression that they will take ownership of a licensed technology upon using it.

Protective clauses. The license is the key document controlling rights to intellectual property, but not the only one. All agreements with Chinese parties should be reviewed for intellectual property protection. This includes agency agreements, sales distribution contracts, joint venture agreements, and work-for-hire arrangements. Clauses protecting relevant intellectual property should be prominent and clearly spell out infringement consequences. Employees should be required to sign confidentiality agreements containing restrictive covenants to discourage defections to competitors with plans to misappropriate foreign technology.

When dealing with a partner who has control over a manufacturing or distribution process, it is critical that the main agreements directly address the extent to which subcontractors, agents, or other third parties are allowed access to a foreign party's intellectual property. Further, the agreements should stipulate that written arrangements must be in place before third parties are allowed to have such access. Signing substantive non-disclosure agreements with all parties holding access to key information further strengthens a foreign party's position in the event of unauthorized disclosure.

Finally, basic physical security measures should be implemented. These include strict control over technical documents and need-to-know distribution practices. When practical, information should be compartmentalized so that no one party has all the data needed to re-create a key asset.

Conclusion

DOING BUSINESS IN CHINA CAN UNSETTLE SEASONED LAWYERS and investors, even ones with years of transactional experience in the United States. However, the right strategies in the market can bring immense long-term rewards. In the end, those who succeed in Chinese business endeavors are the ones who understand Chinese legal systems, accept the importance of local politics, work within cultural norms, exhibit patience and perseverance, and work with advisors experienced in the region. ▀

Writing for the *Maine Bar Journal* is a little like working *pro bono*. You don't get paid, but there's considerable satisfaction in doing something that helps others. And you do actually get something tangible out of it: a \$50 CLE discount, and the real prospect of as many as five CLE credits from the Board of Overseers.