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6.901 Fall 2005

December 19, 2005

Strategies for moving a U.S. business into China

In an increasingly more globalized world, American inventors and businesses are looking to expand their business overseas. American small businesses have been successful thus far in Europe, but have yet to expand into the fruitful markets that Asia has to offer. Within Asia, China serves as an ideal location for foreign businesses. With their growing population and their rising economy, China presents huge business potential. China boasts a surging population of 1.3 billion people and has the second largest economy in the world with strong growth rates as evidenced by the quadrupling of the GDP in the last two decades.

With a multi-billion dollar trade surplus and heavy foreign investment driving the economy, it is no wonder that the Chinese economy is so vibrant. In this paper, we will discuss several different aspects one must consider before moving a business into China, ranging from business to cultural to legal considerations.

Billions of dollars are being invested in start up manufacturing operations annually in China. There inventors have access to the largest market in the world, where 1/3 of the people on earth live. Since China opened its doors to foreign manufacturing investments years ago, several international corporations have set up assembly and

manufacturing in China. And China encourages this foreign investment, particularly for the increased numbers of jobs and industrial potential, in order to improve industry and infrastructure, and for long term goals of collecting tax revenues, despite the initial tax concessions offered to inventors to entice them.¹

There is no doubt that moving a venture into China can be very profitable. But there is risk that independent inventors should understand in order to be prepared for even the worst case scenario. Some wonder about China's status as a Communist country; is it possible that they might suddenly close and confiscate foreign businesses? Although theoretically possible, such an action will almost definitely never occur. China relies on foreign enterprise; the nation depends on the jobs, tax revenues, and production of businesses from other countries.² Closing even one business would be devastating for China, having lasting social and economic consequences, including scaring away many current and potential businesses fearing that the same treatment could occur to them.

The possibility of this risk which has such a low chance to occur does not compare to the enormous benefits of moving businesses into China. The cost to manufacture is lower, giving a competitive advantage to the business. Also, because of the lower operating costs, there is lower initial investment capital needed, and therefore less risk; faster return on initial investment allows easier exit in case of problems with the business. Further, there is security for even the smaller independent inventors in China;

¹ See <http://business-china.com/service/outsourcing/>

² See Reference 1

hundreds of international businesses have been operating in China for decades, and will continue to do so for decades to come.

One of the several factors of a successful move into China is the transfer of technology. Most technology is transferable, but the status of some computer and weapon technology in particular must be reviewed by the United States government's Export-Import and Legal departments early to avoid unnecessary and unexpected complications.³ The parent company transferring its technology into China must decide how it wishes to do so; does it wish to be compensated for transfer of ownership rights? Since the overall corporation is benefiting from tax deductions overseas, some type of tax revenue should be compensated to the home country to build the profit. Other ways to transfer include with licenses or with the possibility of receiving royalty payments to the mother company on a regular basis. Regular payments can be profitable if the subsidiary is projected to succeed in the long term, for this would ensure a lifetime of steady revenues.

Financially, China offers special Economic Zones to promote foreign investment.⁴ This benefits China because they want the jobs and technical knowledge and future tax returns that businesses bring. These zones give large tax breaks for the initial years of a business; these are subject to change slightly each year, but typically there is no tax during the initial startup years before the company starts to make profit. Then, two more

³ See <http://www.ccpit.org/servlet/org.servlet.en.OrgWebEn?actionType=Home&OrgId=1>

⁴ See Reference 3

years are allowed to expire without taxation. Then, two years pass when the venture pays half the normal tax rate, and then the company pays normal taxes. These time frames are slightly different in different provinces in China, but they are similar across the country.

Incorporation could occur as a wholly foreign enterprise (WOFE) or as a joint venture (JV). WOFE's are 100% foreign owned and operated; they are tougher to start up, especially if there is little familiarity with China and the locality.⁵ These are usually set up with sole export purposes, and are usually not allowed to sell products into domestic markets. These normally are found in special economic zones. JV's occur with a local Chinese partner owning roughly 50% of the firm, or usually a little bit less. The reason for establishing a joint venture include the following: gaining access to domestic markets (every Chinese citizen can sell to domestic market places), being able to use the knowledge of the local partner, and getting help gaining approvals, getting services, etc. But, the drawback of course is that profits must be shared. Yet, this means that investment risk can also be shared. WOFE's usually find it very difficult to gain access into domestic markets. The government of China tries to push ventures into establishing JV's. To gain access to the market, a Domestic Sales Right is needed from the government. Companies can sometimes get these if they offer services or goods that the Chinese companies don't provide, or if the product is high technology.

Moving businesses into China proved slightly difficult even up until the 1980's, but since then the process has become more standardized, as well as much less

⁵ See Reference 3

complicated. For example, Robert H. Rines, founder of the Franklin Pierce Law Center, helped to move businesses into China while he was working with the Chinese government in 1985 to revamp its patent system.⁶ Then, Rines says that larger companies had more success with ventures in China, especially if they did not utilize higher technologies and have high complexity interfaces with their technology. But now, says Rines, China offers a workforce graduating thousands of more engineers each year than even the United States. “There are great opportunities of various kinds,” he says: “[specifically] wonderful opportunities for small ventures.”

Raising the necessary capital to start a new business in China can be a formidable task. Adequate capitalization can be crucial to whether the company succeeds or flounders. Therefore, the amount of capital and the timing for its infusion into the new business must be carefully planned and should allow for unforeseen challenges. There must be sufficient funds to cover not only the cost of establishing the operating facilities, but also to pay for the initial operating expenses that can range from purchasing materials to hiring and training new employees from China. There must be enough capital available to pay for the often unavoidable operating cash flow deficiencies until the business can generate sufficient cash from operations to be self-sustaining. There are a number of sources for obtaining those funds, but the capital markets in China are relatively unsophisticated: private capital can be difficult to obtain in China, the banking sector supplier credit is virtually nonexistent, and the stock market is still in its infancy.

⁶ Personal Communication with Professor Rines

To qualify for credit, new companies must have comparatively large amounts of equity capital already infused into the business by the owner/investor to convince a new lender to take a risk. Those companies should also have a workable business plan for their products, and reasonable projections for the expected operating results. If sufficient equity is raised and the business plan is viable, the source of the balance of the necessary financing can range from local institutional bank credit to private equity placements and/or venture capital in China (or possibly some combination of all of them).⁷

Concerning venture capital sources, China changed its policy to encourage foreign investment in new businesses in 1978.⁸ Recognizing that the country's future economic growth will rely heavily on foreign capital, China adopted an open door policy for that source of funds. Therefore, one strategy to obtain new capital investments is to approach foreign companies or foreign venture capitalists based in China. Generally, the cost of starting a particular business enterprise will determine how China will grant approval. Usually, if the total cost is less than US\$30 million, the liabilities of the business are expected to be financed locally.⁹ However, if that cost is more, the ministry of the particular industry in Beijing must grant its approval to permit the foreign currency to be exchanged.¹⁰

⁷ See Doing Business in China. <http://chinaunique.com/capital.htm#Capital>, Dec. 10, 2005.

⁸ See Reference 1

⁹ See Reference 1

¹⁰ See Reference 1

Another important consideration is the risk of possible Chinese government intervention that can occur at any time. For example, foreigners can own no land.¹¹ Almost all land in China is owned by the Chinese government. Long-term land leases can be obtained by foreigners with terms up to 50 years.¹² However, the government can still do as it pleases even during the effective term of the lease. They may change the rules whenever they deem it desirable for such important considerations as the permitted use of the leased facility and even change the terms of the lease itself. In addition, there are more regulations in industries such as pharmaceuticals, retail, media and finance than in the United States. Therefore, understanding the organization and requirements of the local, provincial and even national-level governments is critical for a new business to succeed in China. Finally, it is advisable to understand the existing applicable laws and pending legislation as it relates to the new business being considered.

Although there are some challenges with respect to Chinese governmental regulations, there are also some incentives that the government has created to encourage foreign investment. Such foreign investment brings much needed jobs, technical knowledge and can even serve as a future source of tax revenue. Therefore, China has developed Special Economic Zones (SEZ's) which are designated areas offering significant tax concessions for foreign start-up companies that establish a presence

¹¹ See <http://chinaunique.com/business/sez.htm>, Dec. 10, 2005.

¹² See Doing Business in China. <http://chinaunique.com/capital.htm#Capital>, Dec. 10, 2005.

there.¹³ A few of SEZ's include: Guangdong Province, Fujian Province, Hainan Province, Hunchun and Shanghai.¹⁴ Typically, no taxes on income are assessed for newly created business established in SEZs for the first two years. Then, only one-half of the income taxes must be paid in the third and fourth years. Only by the fifth year will the new company be required to pay taxes at the full tax rate.¹⁵ However, the rules relating to SEZs are subject to change by the Chinese government at any time. Therefore, it is advisable to contact other foreign companies engaged in similar businesses to learn about the local requirements and thus avoid unexpected surprises. However, if carefully researched to take advantage of the incentives and properly structured to address possible adverse events, the creation of small, start-up companies can result in lucrative returns for the foreign investor.

The workforce must be trained sufficiently, just as it would have to be in America. If a business needs to import starting products from a Chinese company, the foreign business is encouraged to thoroughly review the processes, standards, and physical site of operation of these other companies, and businesses can even contact the ISO, the international standards association, to find companies with ISO certification and high ratings. The workforce is on average of equal or arguably higher quality than what it is, so the workers must be trained, and quality must be enforced, whether communication by English or Mandarin. All the while, cultural awareness is absolutely

¹³ See Reference 5

¹⁴ See Reference 5

¹⁵ See <http://chinaunique.com/business/sez.htm>, Dec. 10, 2005.

necessary. The Chinese believe in general that businesses must be conducted between friends, and these friends customarily have meetings and dinners together, and those running businesses should take part in these in order to establish relationships of trust and friendship, and honor.¹⁶

The Chinese have a strong sense of pride in their ancient history and culture. Therefore, understanding the country's key cultural values and traditions are paramount for succeeding in Chinese business. One important cultural concept is "guanxi", the Chinese idea of a value-laden relationship that is formed through mutual respect, trust and cooperation.¹⁷ Guanxi forms the basis of a network of relationships consisting of various parties that cooperate together and support each other for the collective good of the company. In China, long-term business ties are considered more valuable than single, transaction-oriented relationships. Therefore, initial business meetings often resemble a social event. In many instances, business negotiations are not mentioned. Instead, topics discussed are usually more personal rather than business.¹⁸ It is accordingly more important to engage in small talk. Overall, the main idea of guanxi is to treat colleagues with decency and trust. That practice translates into minimizing difficulties and frustrations for the company as a whole.

¹⁶ See <http://chinaunique.com/business>

¹⁷ See <http://chinese-school.netfirms.com/guanxi.html>, Dec. 10, 2005.

¹⁸ See Reference 10

Another key cultural consideration is the importance of “mian-zi”, the Chinese term for maintaining one’s face and personal pride.¹⁹ “Mian-zi” forms the basis of an individual’s reputation and social status. Those traits are especially important in a Chinese business setting. Praising someone in front of his colleagues can be a form of “giving face” and can be good for relations, earning respect and thus, ongoing business.²⁰ In contrast, causing a colleague to lose face can be extremely damaging to the relationship and to all of the individuals involved. Therefore, if a conflict arises with a colleague, discussing the situation in private may be the better way to handle the situation and prevent jeopardizing the dynamics of the relationship.

Another key cultural concept is understanding the teachings of Confucianism. For centuries, Chinese culture has been influenced by the lessons of Confucius, the ancient philosopher who lived in the 6th Century B.C.²¹ His teachings stressed the importance of relationships and the elements of responsibility and obligation in both family and business life. Those values were vital to the development of Chinese culture, and they still remain prevalent in many aspects of Chinese society today. For example, Confucius emphasized the importance of the “collective good” and believed that this order and structure could be achieved through a social hierarchical system. The concept of a clearly defined hierarchy is often seen in modern Chinese companies. In some instances, there is strict observance of rank and *chain-of-command* where the individual

¹⁹ See <http://www.communicaid.com/chinese-business-culture.asp>, Dec. 10, 2005.

²⁰ See Reference 12

²¹ See Reference 12

is subordinate to the larger organization.²² Therefore, understanding the hierarchy within a Chinese organization and each individual's fit within its "pecking order" are important considerations for successfully doing business with that company.

When moving a business into China, one must also understand the laws of China. Beijing, Shanghai and Guangzhou are the three most influential commercial centers in China. Beijing, China's capital and administrative center, sets the legal and regulatory framework for most of China's economic activity as it is a key center for capital markets, dispute resolution, project finance, and intellectual property work.²³ Shanghai is the industrial dynamo of China, and has attracted massive development and investment in recent years.²⁴ The city is a key centre for banking, finance and property work. Guangzhou's proximity to Hong Kong and its large, low-cost workforce have made it the traditional focus for foreign investment.²⁵ Its role is diminishing somewhat, however, as Shanghai's status continues to grow. Good transport links ensure that it remains the base for numerous manufacturing facilities.

The United States China Business Solutions (USCBS), a strategic business service focusing on connecting businesses in the US and China, has outlined 10 broad legal considerations for US companies interested in expanding into China which is listed below here:²⁶

²² See Reference 12

²³ See http://www.icclaw.com/as500/frames/ch_fr.htm

²⁴ See Reference 16

²⁵ See Reference 16

²⁶ See <http://www.uschinabiz.com/uscsb/TopTens/Legal/tabid/102/Default.aspx>

1. Doing business in China for US companies involves considerations not only of Chinese law, but also of US law. Companies need to understand the impact of both countries' laws on their business dealings with China.
2. China's commercial laws are changing rapidly to correspond to Western commercial laws, but the process is not yet complete, and there remain many uncertainties.
3. What the law says in China and how it is implemented are not always the same, just as it is in the U.S. Although the laws have improved, implementation of the laws is sometimes spotty.
4. China has numerous laws that encourage, restrict and prohibit investments in specific industry sectors. If you are thinking of investing in China, learn whether any of these laws apply to your project.
5. China has made many improvements in its laws for the protection of intellectual property. However, enforcement of these laws remains a problem. U.S. companies doing business in China need to structure their transactions and draft agreements with their Chinese counterparts with an eye toward minimizing the risk of intellectual property rights violations.
6. China has not yet completed its transition from rule of man to rule of law, and recourse to China's court system often is not effective. Even more than in domestic business transactions, business strategies should be designed with an eye to minimizing the risk of disputes with Chinese joint venture partners and suppliers.

7. Remember that differences between Chinese and US cultural norms can lead to parties attributing different meanings to the same set of facts. It is important that in any agreement, you and your Chinese counterpart have a common understanding of what is expected of each of you and what you are agreeing to.

8. If you are going to import Chinese merchandise into the United States, determine whether these imports are subject to restrictions under US trade laws. Even if the merchandise is not currently subject to import restrictions, you should plan your business activities to minimize the risk of future import restrictions being imposed.

9. If you intend to export goods or know-how to China, even for use in your own Chinese operations, they are subject to US export laws. Many exports to China are not restricted, but exports of certain products and technology to China are restricted. There are severe penalties for violating US export laws, so it is important to check on the export requirements for the specific product or technology you intend to export.

10. Although gift giving is an important part of Chinese culture, the US Foreign Corrupt Practices Act prohibits American companies from making "corrupt payments" of money or anything of value to foreign officials for the purpose of obtaining or keeping business. This includes both direct payments and indirect payments through intermediaries. The law provides an explicit exception for "facilitating payments" for "routine governmental action" such as obtaining permits, processing governmental papers, and securing services such as police protection, mail pick-up and delivery, phone service, power and water

supply. However, the lines between “corrupt payments” and “facilitating payments” can sometimes be hazy, so when in doubt, seek advice of counsel.

The abovementioned legal considerations are good broad general issues to consider but there are more specific legal issues to consider, including: laws related to data protection, intellectual property, privacy and other statutory requirements.²⁷ We will focus on intellectual property as this is probably the most important and complex issue for most companies thinking about moving into China.

In the area of intellectual property, the Chinese government has made vast changes and improvements over the past few decades. The Chinese government recognized that it needed to protect intellectual property in order to attract foreign investment.

Accordingly, China began passing comprehensive intellectual property laws in the 1980s.²⁸ The Chinese government grants patents for “any invention or utility model that possesses novelty, inventiveness, and practical applicability.”²⁹ Under China’s current regulatory framework, an inventor can designate China on a PCT (Patent Cooperative Treaty) application within twelve months of filing a U.S. application, whereby the Chinese filing date is retroactive to the U.S. filing date.³⁰ The PCT only provides additional time as the inventor must still file for a patent in China. There are several key differences in U.S. and Chinese patent prosecution. For example, while China recognizes patents of invention and industrial design patents (similar to U.S. utility and design

²⁷ See <http://wistechology.com/article.php?id=2007>

²⁸ See John H. D’ Antico. *A Quick Primer on Chinese Patent Law*. IP Insider (2003).

²⁹ See http://www.most.gov.cn/English/Polocys/patent_law.htm

³⁰ See Reference 21

patents), it also recognizes utility model patents, which provide limited protection for improvements relating to shape or structure, but for which there is no U.S. equivalent.³¹ Also, in China, foreigners must appoint an agent designated by Chinese authorities to represent them before the State Intellectual Property Office in Beijing. In addition, patents granted in China do not extend to Hong Kong or Macao, which both maintain separate and independent patent systems.³²

With so much potential for success due to the huge market, it is no wonder that many businesses have recently been moving into China. However, only some of these businesses are successful as many underestimate the difficulty of moving a U.S. business into a foreign country, much less a foreign country with a completely different business culture. Business, cultural, and legal considerations are the most pivotal issues that companies must grasp and fully understand if they want to be successful in China and we have tried to outline these points in order to advise businesses who are interested in moving into China. Although there are many challenges one will face by moving their business into China, the potential rewards are well worth the risks.

³¹ See Reference 21

³² See John H. D' Antico. *A Quick Primer on Chinese Patent Law*. IP Insider (2003).