CHINA: THE ART OF LAW

Chronicling deals, disasters, greed, stupidity and occasional success in the new China

Mark E. Schaub

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To Shanghai, the city where I first met Connie my wife and where my daughter Rebecca came to the world.

PRAISE FOR CHINA: ART OF LAW

"His book does an excellent job of demystifying China for the uninitiated. At the same time many China-savvy professionals will find the book valuable with its hard facts coupled with Schaub's obvious experience in China that is supported by relevant and amusing anecdotes"

— Insight — review by Timothy Lamb,
American Chamber of Commerce

"Both legal manual and business guide, this book is the first thing to read once you have decided to get involved in the world's most frustrating and confusing nation...In his fine book, Mr Schaub informs, entertains and strips away mystery... China: Art of Law just about has everything"

— Far Eastern Economic Review —
review by Gordon Chang

"In doing business with China, the principle should be caveat investor. Mark Schaub highlights the many snares and pitfalls, and shows how foolish and arrogant foreigners can make things worse."

— John Gittings former China correspondent
for The Guardian

"A must-read, if you are planning a joint venture or another major operation in China buy the book and not only because of the dazzling amount of hilarious anecdotes."

— China Herald — review by Fons Tunistra

"This is the first time that I have laughed out loud when reading a legal book... In short: informative and amusing. If it had come out earlier we would have saved ourselves a lot of trouble."

— Bernd Scheubel, Managing Director,
Refratechnik Holdings

"In doing business with China, the principle should be caveat investor. Mark Schaub highlights the many snares and pitfalls, and shows how foolish and arrogant foreigners can make things worse."

— John Gittings, former China correspondent
for The Guardian

"The book gives a lot of detailed, useful explanation and hands-on advice. Do not leave home without it."

— Harry H. Xiao, General Manager, STC —
AMT Shanghai Technology Center

"Love the book. Absolutely hilarious and at the same time incredibly informative."

— Emma Schumacher, Head of Publications,
German Industry & Commerce Shanghai

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ABOUT THE AUTHOR

Mark E. Schaub has lived and worked in Shanghai for almost 15 years. He has worked as a lawyer with both a German and US law firm before joining China's King & Wood law firm in 2000, the first foreign lawyer to do so. He has acted as a board member for several joint ventures and WFOEs and also as liquidation chairman for a joint venture. In addition, he was named one of Asia Law's "Lawyer of the Year" in 2003, 2004 and 2005. This is his first book.

The author would welcome any feedback and can be contacted by e-mail: mark.schaub@kingandwood.com.

FOREWORD

This book does not chronicle the exploits of the Fortune 500 companies in China.

They have, in my opinion, been sufficiently covered by other books and magazines.

The book does attempt to highlight the failures and successes of the other thousands of large, medium and small foreign enterprises investing in China. These enterprises have been my clients over the last 12 years. More importantly, the experiences of these companies and lessons learned are probably more relevant to the average investor in China than the actions of the favoured few large corporations such as GM, VW, Microsoft, Siemens, Toyota, etc. These Fortune 500 multinationals with their greater resources and corporate power face challenges, problems and temptations different from those encountered by other companies.

In order to make this book more readable, I have liberally used case studies. The details of the actual cases such as the industry, location and name have been amended. These changes have been made to protect the guilty, the foolhardy, the corrupt and the hopeless.

The innocent — well, they did not normally make it to signing.

Shanghai, October 2006

ABBREVIATIONS

Much of the jargon used in China in respect of foreign direct investment is likely to be unfamiliar to the newcomer. Please find set out below some of the most important terms:

CCPIT	China Council for the Promotion of International Trade
CIETAC	China International Economic and Trade Arbitration Commission
CJV	Cooperative Joint Venture
COFTEC	Commission of Foreign Trade and Economic Cooperation[1]
EJV	Equity Joint Venture
ETDZ	Economic and Technological Development Zone
FESCO	Foreign Enterprise Service Group Co., Ltd.
FICE	Foreign-invested Commercial Enterprise
FIE	Foreign-invested Enterprise
FTZ	Free Trade Zone
IPR	Intellectual Property Rights
JV	Joint Venture
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce[2]
NPC	National People's Congress
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
SEZ	Special Economic Zone
VAT	Value-added Tax
WFOE	Wholly Foreign-owned Enterprise

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1. Since MOFTEC was restructured into MOFCOM, the situation of COFTEC (the local subsidiaries of the former MOFTEC) varies from place to place. Some of the local subsidiaries have changed their names while some others still use the original name "COFTEC". For convenience of reading, all subsidiaries are referred to as COFTEC in this handbook.
2. The former Ministry of Foreign Trade and Economic Cooperation ("MOFTEC").

INTRODUCTION

"In China ... everything is possible ... nothing is easy."

— China expatriate manager

The company was simply the most non-compliant company I had ever seen in my 12 years of working as a corporate lawyer in China.

The client was interested in acquiring a majority stake in a company manufacturing plastics near Wenzhou. We had been requested to carry out due diligence in respect of the company.

The basket cases in China can normally be identified as soon as you enter the factory[1]. The factory had smoke billowing out of its smokestacks and an unusual, unnatural green oozed out of the cement. The employees were either asleep or sipping tea from Nescafe glass containers. Unlike the client, I had few expectations in respect of the target and I had only been there for half an hour.

In any event, the due diligence report was prepared and I was subsequently asked by the client to present the findings to the business development group.

The findings were brutal. Basically, the legal shareholders were not the same persons with whom the client had been negotiating the acquisition. Most of the assets were in the name of different, unrelated companies. Although many Chinese companies have compliance issues, this company was actually being sued by the local environmental bureau — at the same time when the client's business development manager was heralding the target's "incredible connections" with the local authorities.

Perhaps the defining result of the due diligence was in respect of human resources. In a bid to obtain extremely lucrative preferential tax treatment, the company officially employed a few hundred handicapped

1. Indeed as can the location of the toilets.

persons to fall under a special scheme to promote employment of the handicapped. However, these "official" handicapped employees did not actually work at the factory but were merely ghosts on the books. The actual employees were employed via an outsourcing contract with yet another company. Naturally nobody was paid his social contributions; few were paid their salaries. This scheme combined daring tax evasion with severe political incorrectness.

In short, it was not so much a due diligence report as an obituary for the project.

Or so I thought.

The presentation concluded and a shocked silence descended over the room.

After a few moments, and as they so often do, the client's consultant broke the silence. He leaned over the table, looked me in the eye and asked:

> *"But does any of this really stop us from doing a share deal? I mean, really, are any of these problems material?"*

Welcome to foreign investment in the People's Republic of China in the early 21st century.

It is without a doubt that China has witnessed breathtaking changes in recent decades. Rapid development in the economy has not only resulted in China becoming increasingly seen as the world's premier production hub, but also a wealthier local consumer base that attracts more and more foreign companies. China has become an important economic force that can no longer be ignored. Indeed, for many companies, it is no longer a question of "if China" but "when China". Unfortunately many fail to ask the question: "How China?"

Despite the vast inflows of foreign investment into China, doing business in and with China is still very much a mystery for many foreign companies.

Despite the booming economy and investment, many a foreign investor has come a cropper in the Middle Kingdom. The bad press about foreign investment in China often outweighs the good. There have been many stories about failed joint ventures, ruined careers, stalled projects, etc. Invariably, China and Chinese partners are exclusively blamed for these downfalls. The reasons for the failure of foreign businesses in China have become a major topic of discussion.

On this point, I wish to state that I do not think all foreigners fail. Based on personal experience, I would go so far as to venture that most seem to succeed. A few even succeed far beyond their expectations. However, the successful are clever enough to heed the Chinese warning:

"The fat pig is the first executed."

For this reason, the successful often do not seek to draw attention to themselves or their success for fear of negative repercussions.

Curiously, the failures have been less circumspect. And there have been failures — massive, abject, total failures.

However, if you look beyond the journalist's by-line or the protests of management, you will find that a fair share of the blame for these failures in most cases lies with the foreign investors and cannot be solely laid at the feet of China or the Chinese partner.

This book will attempt to provide guidance on how a company can avoid failure in China. Hopefully your company can be a fat but quiet pig in China — successful and quietly smug about such success.

"China today is like a castle being besieged. Those outside want to get in. Those inside want to get out."

— Liu Mingkang, Chairman of the Bank of China

Being a movie buff, I have divided the book into three sections to reflect a trilogy.

The first section "Planning to Siege" deals with strategic considerations prior to investing in China. Items covered include: an overview and comparison of the various investment vehicles and business models available (joint ventures, wholly foreign-owned enterprises, representative offices, outsourcing, distribution, etc); an introduction to Chinese law related to foreign investment with a focus on the issues most likely to bedevil and frustrate; an overview of joint ventures and their somewhat exaggerated stories of decline; an overview of wholly foreign-owned enterprises with hints on the possible pitfalls to avoid; an introduction on the issues to pay attention to when engaging in outsourcing and sourcing; the perils of being a minority shareholder; an exposé of representative offices; musings on the strategic issue of location; and finally some pointers as to the introspection and research required before making decisions on investing in China.

The second section "Laying Siege to the Castle (Project Implementation)" deals with the often overlooked challenges of actually operating a company in China. Indeed, I will argue that poor implementation is the single greatest contributing factor to the failure of foreign-invested enterprises in China. This section is divided into two parts. The first part looks at: implementation before the establishment of project — namely, involving the head office; choosing a consultant (although the gifted ones make it seem as if they choose you); the joys of liaising with Chinese authorities; and a detailed chapter on joint venture documentation. The second part deals with implementation after the project is established (ie when it is too late) — the challenges of finding the right General

Manager, ongoing support by external consultants, human resource management and intellectual property issues.

The third and final section "Manning the Ramparts/The Honourable Exit" ends the book with the *lighter* topics of fraud, non-compliance and liquidation. After the discussions in the earlier parts of the book on how to put together a project in China, the last section deals with how to take them apart — either exit or by restructuring failed projects.

Much of the content in this book will be common sense. Much will seem familiar. Much will resemble what you do in your own country. Much has been ignored when doing business in China.

"Make it as simple as possible but no simpler."

— Albert Einstein

CONTENTS

PART I: PLANNING THE SIEGE

1. Donald Rumsfeld.