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“Connecticut-China Transactions: The Legal and Business Culture”

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Good afternoon, ladies and gentlemen. It is a pleasure to be here to share with you some of the thoughts I have on the Chinese legal and business culture and its importance for Connecticut traders and investors wishing to test the Chinese waters. I use the term "Connecticut" because we are here focusing on China-related businesses in this great state, but my comments will be equally applicable to such businesses in other states.

The Market for Connecticut Exports and Investment

Whether exporting biotechnology or medical equipment to China, or manufacturing consumer products there, or outsourcing software development to Chinese programmers, American firms are increasingly looking to China for expanding business opportunities. So are businesses in Connecticut in particular. I don't have the statistics as to whether China is already yet the largest market for Connecticut-sourced products, nor the rank in terms of Connecticut-China business growth. But I do know that in recent five years or so, exports from Connecticut to China have significantly grown. If not quite yet, China may well become the largest export markets for Connecticut's products. And there is a growing need for Connecticut-sourced technology and investment in China, too, which can benefit both investors and Chinese partners. Indeed, expectations are high that the Chinese market can absorb even more Connecticut-sourced goods, services, technology and capital.

What legal skills are needed to advise businesses in Connecticut and elsewhere who want to do business in China? Lawyers skillful in negotiating major business transactions, protecting intellectual property, and preparing license agreements understand the fundamentals involved in doing business in China, and are ready to be of assistance. However, success in China requires an understanding of more than legal and business fundamentals. It also requires familiarity with the unique characteristics of the Chinese legal and business culture.

The Legal Setting

26 years ago when I started law school at Peking University, there was very little to study on actual statutes and regulations, because there were few. All you could find were just a few pieces of national legislation that were in force, including the 1978 Constitution and the 1979 Environmental Protection Law. We had to focus our studies on legal concepts, theories and international and foreign law. No laws existed to guide foreign investment in China until after the summer of 1979 when, as part of Deng Xiaoping's "open door policy," the Standing Committee of the NPC passed China's first major law governing foreign direct investment, the Sino-Foreign Equity Joint Venture Law. The 1979 Joint Venture Law was

followed by a flood of legislation designed to regulate, protect and encourage foreign trade and investment. Such first round of legislation included the following:

- The 1982 Trademark Law
- The 1984 Patent Law
- The 1985 Foreign Economic Contract Law;
- The 1986 Wholly Foreign-Owned Enterprise Law;
- The 1988 Sino-Foreign Cooperative Joint Venture Law; and
- The 1990 Copyright Law.

Such legislation marked a fundamental change in China's economic strategy, recognizing the benefits of opening the country's previously isolated markets to the outside world. This resulted in an explosion of activity in foreign economic trade and investment in the 1980's and part of 1990's.

Despite this change in attitude, the initial spurt of legislation lacked sophistication. New laws were quickly outpaced by even newer concepts introduced by foreign traders and investors. When it came to structuring deals, introducing technologies, or creating business arrangements, companies often found themselves operating in ways never contemplated by lawmakers and businesses in China or covered by the laws in force. Thus, many companies and their legal advisors moved in untested waters, although their actions frequently influenced the further development of Chinese business law.

Nevertheless, such situations have become less frequent now as the Chinese legal environment has been maturing. Particularly in the last fifteen years, China has created an impressive legal framework to encourage and protect foreign trade and investment by amending existing laws and enacting new ones. Such new legislation includes the following:

- The 2004, 1999, 1993 and 1988 amendments to the 1982 Constitution;
- The 1999 uniform Contract Law that replaces the 1985 Foreign Economic Contract Law;
- The 2000 amendment to the 1986 Wholly Foreign-Owned Enterprise Law;
- The 2000 amendment to the 1988 Sino-Foreign Cooperative Joint Venture Law;
- The 2000 and 1992 amendments to the 1984 Patent Law;
- The 2001 and 1993 amendments to the 1982 Trademark Law;
- The 2001 amendment to the 1990 Copyright Law;
- The 2001 amendment to the 1979 Equity Joint Venture Law;
- The 2002 Government Procurement Law;
- The 2004 and 1999 amendments to the 1993 Company Law;
- The 2004 amendment to the 1994 Foreign Trade Law, and, most recently,
- The 2005 amendment to the 1998 Securities Law, and
- The 2005 amendment to the 1993 Company Law.

There have been many other national laws, administrative regulations and local enactments affecting foreign trade and investment, including those allowing the establishment of special economic zones that provided preferential treatment to foreign investments in specified coastal regions of China.

Uncertainties

On the other hand, signs of uncertainties with the Chinese legal framework remain. Companies looking to do business in China are still at risk, if proposed transactions are neither specifically covered by current laws nor protected by carefully drafted contracts, agreements and other legal instruments taking uncertainties into consideration.

Relative Immaturity

The relative immaturity of Chinese business law may be just one obstacle to the successful completion of a business deal in China.

Inconsistent Legal Interpretation

Another impediment is presented by the Chinese method of legal *interpretation*. In China, business laws and regulations are not interpreted precisely or consistently. Unlike the United 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 trade and investment decisions.

Internal Rules

Moreover, 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 traders and investors.

The system of internal rules is so pervasive that, as part of its WTO commitments, China agreed to increase transparency in its legal and administrative systems, pledging to make all of its laws and regulations publicly available. Fortunately, China has made significant progress in this regard. Fewer and fewer internal rules are governing Sino-foreign transactions, except for matters that by their nature generally fall within the administrative discretion of government agencies.

Local Agendas

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 the central government 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.

Business Culture

Local Connections

Establishing and maintaining proper connections with the locality can be crucial. 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 Chinese partners are only secured when local officials conclude that foreigners are sincerely listening to their concerns and have an agenda based upon mutual benefit and respect.

Cultural Nuances

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. On the other hand, due diligence is a concept relatively alien to most Chinese. Chinese companies are not comfortable with outsiders inspecting books, records, and management practices. They 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.

Thus, straightforwardly 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 would better carefully explain the due diligence practice. This explanation must describe not only the items requiring 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, on the other hand, due diligence can be 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 network of relationships to determine exactly who the contracting party will be and what related entities might be involved in a transaction.

Is Government Ownership Involved?

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 prohibits payments to foreign officials for the purpose of improperly directing or influencing business.

What Business Licenses and Restrictions Do They Have?

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. Competitive practices in Chinese business can be cutthroat. Competitors will entice away key employees after a foreign investment is completed in order to acquire 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 behavior.

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 Traps?

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 and too complicated. Traders, investors and their lawyers must be prepared to negotiate an acceptable compromise between a five-page model agreement suggested by Chinese authorities and a 60-page American-style agreement covering every imaginable aspect of indemnity, representation, and warranty.

To attorneys with Chinese experience, a middle ground agreement is always possible. Chinese counterparts can be persuaded to sign a longer document covering all key points and contingencies, while businesses in Connecticut and other parts of the U.S. 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. All-inclusive clauses that may be standard in Western-style 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 Chinese counterparts appreciate conciseness, but fewer mistakes will occur when the document is translated into Chinese.

The Escape/Exit 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, while the returns may be potentially significantly higher, 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 legal translator with experience in business and legal 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 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

Chinese partners 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 Chinese partners 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. Chinese partners and officials 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 re-open points set forth in such signed documents. In fact, Chinese counterparts 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

Connecticut is a state full of great scientists, scholars, institutions and businesses of innovations. Protection of intellectual property rights is one of the largest concerns for Connecticut businesses entering the Chinese market. Unfortunately, such concerns are well grounded in the history of Chinese foreign investment.

A Legal Framework in Transition

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 that provides protection for patents, industrial designs, and trademarks, the Berne Convention that provides protection for literary and artistic works, and the Madrid Protocol that provides protection for trademarks. Most recently, China joined the WTO, 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.

- 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

These are great developments for Connecticut and American businesses entering into China.

Enforcement

On the other hand, it remains a problem that China's legal reforms have exceeded its enforcement abilities. Although China is committed to its reforms, it still lacks the legal infrastructure to competently and efficiently handle intellectual property disputes. Moreover, China's ability to enforce its intellectual property laws and regulations is seriously hampered by local resistance to change, particularly when local authorities sense that such change will take power out of their hands.

Administrative Remedies

The most common method for foreigners to assert their rights in China has been through administrative action rather than through civil litigation. Such administrative action involves local branches of governmental bureaus:

- State Administration for Industry and Commerce
- State Intellectual Property Office
- National Copyright Administration
- Custom
- State Drug Administration

Penalties imposed through administrative action may sound insignificant when compared with the United States. However, administrative proceedings are usually efficient and relatively inexpensive. Further, in some cases, administrative fines may in fact exceed those possible under U.S. law.

Judicial Remedies

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 than would an administrative bureau. 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 do exist.

These shortcomings clearly discourage foreign businesses from seeking judicial remedies. The advantages of criminal and civil remedies, though, 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 by Protective Licensing

Given this uncertain climate for enforcement, investors or licensors must take proactive and defensive measures to protect their intellectual property. Valuable intellectual property assets should not be made available to the licensee without due consideration of the potential consequences if such assets are misappropriated. Such investors and licensors 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 licensee 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 spell out what is being licensed – *e.g.*, 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, licensing agreements in China implicitly conferred ownership to the licensee after a fixed period of time. Without specific language, this precedent may give the licensee in a Sino-foreign project the impression that they will take ownership of a licensed technology upon using it. Be mindful of this.

Protective Clauses in Other Agreements

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 an intellectual property proprietor'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

Entering into business transactions with Chinese counterparts can be a challenge for Connecticut traders, investors, and their lawyers, 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 familiar with the legal and business culture.