

Going to China

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“Going to China” is something heard with increasing frequency from companies looking for value and quality in their sourcing of products and services — and with good reason. China is the manufacturer of a significant and increasing amount of the world’s products. It is also intent on becoming a leading provider of services.

From its economic opening 30 years ago, China has been driving an economic development that will enable it to create a middle class society of reasonable means. This transformation stands as an undertaking of historic proportions. Initially, China focused its economic development on manufacturing and the successes have been dramatic. Increasingly, however, China has been focusing its manufacturing capabilities on higher-end products and processes, including pharmaceuticals and electronics and other technology.

Despite its success, China needs substantially more economic development. It also needs to address some of the undesired consequences of its staggering growth. Notably, China needs to address a rapidly urbanizing population¹ and the significant environmental issues associated with its current manufacturing industries, including the consequences of heavy polluters and high energy consumption in low-end manufacturing. In the face of these needs and associated domestic and international pressure, the Chinese government has developed its current “Harmonious Society” socio-economic goal of advancing economic growth that promotes better societal balance. As part of its effort to promote such balance, China is now making a very concerted effort to grow its services industry, seeking to leverage its successes as the world’s manufacturer to become the world’s services provider.

The Chinese market for the sourcing of products and services is dynamic and evolving. Would-be buyers of products and services from China must carefully analyze the market to determine which products or services can be viably sourced from China and the appropriate manner for arranging such sourcing. Approached properly, however, for a growing number of products and services, China ranks as one of the most attractive sourcing markets in the world and indications point toward this trend continuing, if not accelerating.

Fortunately, would-be buyers of products or services from China can draw on lessons learned from many years of sourcing experience, their own and those of others. Although different sourcing environments inevitably present certain unique challenges and combinations of challenges, prior sourcing experience of buyers over many years can be leveraged to enable would-be buyers to approach China sourcing with significantly heightened confidence and capability, positioning themselves not only to benefit from current China sourcing opportunities, but also to grow and evolve their China exposure as further opportunities develop, while maintaining manageable levels of risk.

The China Sourcing Environment

The Chinese government has embraced the notion that developing services capabilities offers significant economic development benefits, consistent with its Harmonious Society objectives. The need to encourage development of its services industry is all the more urgent for China because portions of its current manufacturing base will almost certainly not survive the transition to an acceptable, ecologically responsible production environment. The result has been a trend away from the dominant manufacturing focus, evidenced by a steady reduction of processing trade incentives over the past five years and an increasing emphasis on higher-end production and processes, including services.

With a clear eye toward India's success in its outsourcing services industry, the Chinese government has designated 11 cities to be "Outsourcing Services Base Cities"² where it is concentrating infrastructure developments and incentives. Through such efforts, China is seeking to encourage multinational companies to shift offshore outsourcing services to China, as well as to promote the development of large and medium service outsourcing enterprises, with particular focus on software and technology-related service providers. In addition, a number of other regional and municipal governments have taken it upon themselves to implement programs promoting development of services industries in their areas, all in the effort to promote the Harmonious Society objectives.

The Contract – Special Challenge to Sourcing from China

One of the significant challenges facing any buyer interested in sourcing from China involves the sourcing contract. Significant sourcing arrangements, especially those involving services, are typically based upon sophisticated contractual arrangements in which the buyers must have reasonable confidence that their contractual rights are enforceable. Serious limitations on either of these sourcing prerequisites (contract and enforceability) will limit the extent to which buyers will view any sourcing opportunity as viable, irrespective of the actual capabilities of the supplier.

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A supportive contracting environment is dependent upon two factors: first, a level of commercial contracting capability on the part of suppliers to enable buyers (and suppliers) to negotiate and execute acceptable contracts; second, a legal infrastructure that affords reasonably efficient and predictable

enforcement of such contracts. Within China, both these factors stand as works in progress. The adoption of laws in China over the past 10 to 15 years supporting commercial transactions has been dramatic. In fact, by many estimations, China has adopted a reasonably adequate base of commercial law. The major challenge facing China in this area, however, is the enforcement of those laws.

The challenges associated with contracting in China are of greater significance in services transactions than in product sourcing transactions. Service contracts are typically more complex than product contracts — reflecting, in many ways, the practical differences between services and products, including the frequently more interactive relationship between buyer and supplier involved in the provision and receipt of services. Thus, as China looks to build its capabilities, effectively building its contracting capacity is a critical challenge. As effective enforcement of law is developed, the scope of both products and services viewed as viable candidates for sourcing from China will almost certainly increase. In turn, the contracting capability of Chinese suppliers to support such broader range of sourcing transactions will undoubtedly develop as the opportunities for such development are presented.

Other Challenges and Strengths of China Sourcing

There are a number of other challenges to sourcing from China that may impact whether, or the way in which, a particular sourcing is undertaken. These challenges include the level of English ability within China, concerns over intellectual property protection and regulatory compliance, and arrangements for effective dispute resolution.

The level of English ability within China is frequently noted as a challenge facing international businesses considering sourcing from China. Despite the prevalence of Chinese as a spoken language (by some accounts the world's most widely spoken language), English continues to be the primary language for international business communication. While a number of the services initially targeted by the Chinese government for development (for example, software services that involve work in common programming languages) are not wholly dependent

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on broad English capabilities throughout the supplier organizations, English language ability still stands as a challenge impacting the scope and nature of sourcing that many buyers believe can be currently undertaken effectively from China.

Significant efforts are underway to increase English capability within China. For example, beginning in 2001, English became compulsory throughout the country from Grade 3, and larger cities such as Beijing and Shanghai have introduced English at Grade 1. Through such efforts, the significance of this issue will no doubt diminish over time. In fact, some have estimated that within a few years there may be more English speakers in China than in India.

Protection of intellectual property is another concern. Despite China's adoption of laws generally consistent with international standards of intellectual property protection, enforcement of these rights remains a significant problem. A variety of best practices can be helpful in protecting intellectual property, including careful due diligence in human resource and business partner selection and thoughtful design, implementation and enforcement of intellectual property compliance programs. Further, practical protections

based in the design and control of the production and performance processes may provide effective protection for critical intellectual property — by not allowing it to be accessed and copied in high risk environments. Such an approach often involves compartmentalizing activities and sourcing different parts or processes to different suppliers or in some cases retain critical portions within the buyer's home organization. Where such arrangements are not feasible, and critical intellectual property will be unavoidably accessible and subject to being copied, the owning company may determine that certain products or services are not currently suitable for sourcing from China.

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Another area of concern for prospective buyers considering sourcing from China is regulatory compliance. For example, US buyers must address compliance issues associated with US export control laws, the US Foreign Corrupt Practices Act, and

Sarbanes-Oxley obligations that might be impacted through sourcing arrangements. As with intellectual property protection, regulatory compliance can be promoted through care in human resource and business partner selection and well designed and implemented compliance programs. However, certain activities may simply be inappropriate candidates for sourcing due to the regulatory risks. Further, care must be taken that the sourcing contract provides necessary flexibility for addressing changes in applicable regulatory requirements — reflecting the sophistication required in sourcing contracts.

Effective dispute resolution is another concern for companies considering sourcing from China. This concern is particularly pronounced in view of the previously noted challenges associated with contract interpretation and enforcement in China. International sourcing arrangements frequently provide for a governing law other than China's and for a dispute resolution process that is not dependent upon the developing legal infrastructure of China.

Choice of law provisions in contracts are generally recognized in China, although a number of important issues remain subject to local law, including certain issues concerning intellectual property ownership, labor laws, land ownership, insolvency and enforcement of foreign judgments or awards. The process for dispute resolution frequently desired by foreign companies sourcing from China (after efforts at negotiation between the parties have failed) is arbitration conducted outside of China under an international alternative arbitration in China. Such arrangements must be clearly stipulated in the sourcing contract. Finally, however, actual enforcement of arbitral awards in China present their own set of challenges, which must be considered in any sourcing evaluation and structure.

Sourcing Market Considerations in China

Two additional factors respecting sourcing from China present specific challenges to would-be buyers from China. These are the fragmented service provider market and the

challenges of performing effective due diligence on Chinese service providers and other business partners in China.

China's nascent services industry is extremely fragmented, with no reasonably defined set of leading service providers. The government's efforts to develop the services industry have been focused largely on general development in the various designated base cities, without concerted focus on defining and developing specific capabilities. The result is that the market is diffused with competition among the cities and regions that has tended to dissipate any development of a distinctive China services practice or brand. In short, there tends to be more and more to choose from in China in terms of service offerings, but not a strongly coherent pattern of practice or even capability.

Ultimately, success or failure of any product or services sourcing from China is largely dependent upon the quality and capabilities of the supplier, as well as other business consultants and partners used in the China activities. Effective due diligence on Chinese parties tends to be a significant challenge. This is due to a wide variety of factors, including the fragmented market as well as language and cultural issues. It is very important, however, for a company to obtain a clear understanding and adequate comfort level regarding the capabilities and ethical standards of the parties with which it is dealing. Effective due diligence often requires significant patience, effort and expense, but its importance must not be underestimated.

Strategies and Vehicles for Initiating Sourcing from China

China's liberalized investment rules generally allow a foreign buyer looking to source products or services to select from a wide range of sourcing models: including classic third party outsourcing arrangements where the buyer contracts with the supplier, sourcing through joint ventures and even through wholly owned (foreign) enterprises. As with any sourcing, the challenge is adopting the most appropriate model for the particular transaction mix — considering the buyer, the supplier and the subject of the sourcing. Fortunately, buyers seeking to source from China can utilize most of the strategies historically used in offshore sourcing.

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For example, a buyer may initiate its China sourcing through any, or a combination of, the following classic entry strategies:

- Utilization of pilot programs to become familiar with and confirm viability of the sourcing (test the waters) — although this approach carries risks of insufficient commitment which can set the stage for failure;

- Providing for an extended transition period to allow for confirmation of successful assumption of responsibility and performance by the supplier — although this approach, like the pilot program, can carry the risk of insufficient commitment, making change management associated with the sourcing more difficult;
- Utilizing of shorter term contracts with extension rights to allow for flexibility in substituting solutions — although this approach can be less attractive to suppliers and nonetheless create a long-term dependence on the part of the buyer despite the shorter term; and
- Limiting offshore direct reliance and exposure by utilizing a US or other home-country supplier with China capabilities — although this strategy necessarily reduces savings opportunities.

Again, lessons learned from prior sourcing experiences can and should be applied in evaluating and approaching the dynamic and evolving Chinese sourcing market.

Expectations for China Sourcing

Despite the challenges currently presented in sourcing from China, the potential benefits are compelling. As China further addresses areas of concern to international buyers, these benefits should increase as the risks decrease. The economic stakes for China are high. There is every expectation that, through its government and growing ranks of suppliers, China is, and will remain, vitally interested in developing and maintaining an environment that will enable international buyers to source from China with increasing confidence and enthusiasm. ♦

Endnotes

¹ Urbanization is generally recognized as both a product of economic development and prerequisite for broad-based economic development. China's urbanization remains significantly lower than other developed countries and as a concerted governmental policy, China is promoting very rapid urbanization.

² The eleven cities designated as Outsourcing Services Base Cities are: Chengdu, Dalian, Shenzhen, Shanghai, Xi'an, Beijing, Tianjin, Nanjing, Wuhan, Jinan and Hangzhou.