Tuesday, October 21
4:30 pm-6:00 pm

710 Succeeding in China and India: The Next Ten Years

Jeffrey M. Klink
President, Chief Executive Officer and General Counsel
Klink & Company, Inc.

Max W. Laun
Senior Counsel
Alcoa Legal Department

Paul Marcela
Associate General Counsel and Assistant Secretary, Law Department
Dow Corning Corporation

Dennis Unkovic
Partner
Meyer, Unkovic & Scott LLP

This material is protected by copyright. Copyright © 2008 various authors and the Association of Corporate Counsel (ACC).
Materials may not be reproduced without the consent of ACC.
Reprint permission requests should be directed to ACC's Legal Resources Department at ACC: 202/293-4103, ext. 338; legalresources@acc.com

Faculty Biographies

Jeffrey M. Klink

Jeffrey M. Klink is the president, CEO and general counsel of Klink & Co., Inc., an international risk-consulting firm with offices in the United States and London, and with affiliate offices in Asia, Europe, Africa, and the Middle East. Prior to forming Klink & Co. in 2001, Mr. Klink was a managing director for Kroll Inc., a publicly traded corporation that performed consulting services.

Mr. Klink has been appointed an independent compliance consultant by the Securities and Exchange Commission regarding the Foreign Corrupt Practices Act. He has been qualified in Pennsylvania as an expert witness on fraud. He acts as an advisor to public corporations, law firms, hedge funds, financial institutions, manufacturing concerns, and Fortune 100 corporations regarding transnational due diligence, corruption and governance. Mr. Klink has performed fraud and due diligence investigations in over 40 countries. Additionally, Mr. Klink is also the founder and owner of KlinkCheck™, a background services firm that operates globally.

Mr. Klink earned a BA from the University of Pittsburgh and is a graduate of the University of Pittsburgh School of Law.

Max W. Laun

Max W. Laun is senior counsel, mergers and acquisitions, with Alcoa Inc. in Pittsburgh. His experience includes leading major international transactions in Italy, Brazil, Iceland, and Russia, and the recent 26-country, multi-billion dollar divestiture of a packaging business. Mr. Laun has also participated on various committees and teams, including professional development and pro bono committees.

Prior to serving as senior counsel, Mr. Laun worked as general counsel in mergers and acquisitions and attorney in acquisitions and dispositions at Alcoa Inc.

Mr. Laun is Programs Vice President for ACC's Western PA Chapter, and also serves as an advisory board member for the University of Pittsburgh School of Law, Center for International Legal Education.

Mr. Laun received a BA, cum laude, from Rice University. He also studied at the Universitatea Babes-Bolyai in Romania as a Fulbright Scholar. Mr. Laun is a graduate, magna cum laude, of the University of Pittsburgh School of Law.

Paul A. Marcela

Paul A. Marcela serves as associate general counsel and assistant secretary of Dow Corning Corporation in Midland, MI. Mr. Marcela's primary practice areas are mergers and acquisitions, securities, corporate, and finance. As assistant secretary, Mr. Marcela is also responsible for the operations of Dow Corning's office of the corporate secretary.

Mr. Marcela is active in the ACC, and has previously served as President of ACC's Michigan Chapter. He has also served as chair of the in-house counsel committee of the State Bar of Michigan Business Law Section, president of the Midland County (MI) Bar Association, and president of the Detroit chapter of the American Society of Corporate Secretaries and Governance Professionals. In addition, Mr. Marcela is second vice president of the Alumni Board of the Case Western Reserve University School of Law.

Mr. Marcela received a BS from Allegheny College and holds a MBA from Central Michigan University. He is a graduate of Case Western Reserve University School of Law.

Dennis Unkovic

Dennis Unkovic is a partner with Meyer, Unkovic & Scott LLP, a law firm composed of 63 attorneys in Pittsburgh. He focuses on structuring and negotiating corporate business transactions, including acquisitions, divestitures, strategic alliances, joint ventures, and mergers. Traveling to 45 countries over the last 30 years, Mr. Unkovic has a wide-ranging background in handling complex international legal deals, with particular emphasis on the Pacific Rim. He also has extensive experience in the People's Republic of China, Japan, Korea, India, and Southeast Asia.

Mr. Unkovic has worked for both American and European multinational companies setting up wholly owned subsidiaries, creating joint ventures, acquiring existing companies, and transferring technology in Asia and elsewhere. Currently, he is overseeing eight projects in the People's Republic of China on behalf of foreign investors. He has also represented Japanese, Chinese, Malaysia, Korean, Singaporean, and many European companies doing business in the United States.

Prior to joining Meyer, Unkovic & Scott LLP, Mr. Unkovic served in Washington, DC as the legislative director for Hugh D. Scott, former United States Senate Minority Leader; he simultaneously served as assistant counsel to the Senate Judiciary Subcommittee on Patents, Trademarks, and Copyrights.

Mr. Unkovic received a BA with distinction from the University of Virginia and is a graduate of the University of Pittsburgh School of Law.

The Past -- 1980

The Two "Also Rans": *China & India*

- Similar-sized GDPs
- Poor Infrastructures
- Rural-Based Economies
- Non-Competitive Manufacturing Sectors
- Weak Currencies and Undercapitalized Financial Institutions
- Historical Reluctance to Embrace Foreign Investment
- Ineffectual Governmental Regulation and Planning

The Present -- 2008

They Aren't "Also Rans" Anymore

China

- World's fastest growing economy for the last 25 years
- Goal is to become the global leader in manufactured products for export markets and to supply the growing demands of its domestic sector
- Looking outside for investment opportunities

India

- Lagged China's growth for 20 years because it intentionally discouraged foreign direct investment
- Capitalizes on its highly-educated workforce that is proficient in the English language and business practices
- Has emerged in last five years as a world-class competitor in providing services to companies around the world.

The Future

What does the next ten years hold for China and India?

<u>Part One</u>:

Four Trends About China You Must Know

One: Rich China / Poor China

- There is a vast disparity in income throughout China. This places significant pressures on the Chinese government to spread the benefits of national economic growth throughout China in order to maintain political stability.

© Dennis Unkovic 2008

Two: China's Vast Economic & Geographic Diversity

- Hong Kong and the Pearl River Delta
- The East Coast and Fujian Province
- The Shanghai Economic Region
- Beijing and Tianjin in Northern China
- Central China (Wuhan, Xian, Chengdu, Sichuan, Kunming)

© Dennis Unkovic 2008

Three: China's Current Political Landscape Under Hu Jintao

- China's most powerful leader since Mao
- Comprehensive crackdown on governmental and institutional corruption
- Decline of Shanghai's political influence and the rise of Beijing and Tianjin
- Continuation of economic policies of his predecessors – "Economics over Politics"

Four: China's National Priority to Acquire New Technologies

- Recently announced national priority for broad-based technology acquisition no matter where it exists
- China will raise the level of its existing manufacturing competence and expand into new areas by utilizing technology
- Technologies will be sourced throughout the world for use by Chinese enterprises in China and elsewhere

Part Two:

Is the Sun Setting in China for Foreign Investors?

China's Plate is Full

- Since 1980, China has attracted massive FDI from throughout the world
- China now has over $1.5 trillion (U.S. dollars) in foreign currency reserves
- China has been successful in acquiring new technologies
- China now needs less and less from outside sources to maintain its economic growth

Five Hundred Years of Western Domination

Prior to Mao's victory over Chiang Kai-shek in 1950, Western influences dominated China for 500 years. During this period, diverse foreign influences nurtured strong feelings against the West within China that still exist today.

In 2008, the Chinese are actively replacing Western values and reasserting their unique culture which developed over the last 5,000 years. This will have a direct impact on foreign investors.

Environmental Issues

- China is experiencing widespread environmental problems that need to be addressed
- Water shortages for both individual consumption and industrial uses are already restricting future growth opportunities throughout China
- Polluted air is a serious problem in most Chinese cities
- Power shortages are still common, so most factories need their own generators to avoid shutdowns
- Greenhouse gas (GHG) issues unsettled

Infrastructure

- Despite over $40 billion spent on the 2008 Olympic games, China still has significant infrastructure needs
- For example:
  - Water is not potable in many China cities
  - Railroad lines connecting China are deficient
- The Lesson: China must devote massive resources to its infrastructure if its economic growth is to continue into the future

China's Drive for Outbound Investment

- Assured access to energy and natural resources is a critical priority for China
- The need to acquire new technologies will drive overseas investment strategies for Chinese companies
- Distribution networks for Chinese-made products will be highly sought after in both the U.S. and Europe as China tries to capitalize on its industrial capabilities
- Less opportunity for classic foreign direct investment into China

Part Three:

Overview of India in 2008

© Dennis Unkovic 2008

Demographics of India

- 16% of world's population
- One billion people
- 58% between ages 15 and 58
- 25 cities with over 1 million people
- Rapidly growing middle class

India's Diverse Religious Culture

Predominant Religions

- 83% Hindu
- 12% Muslim
- 5% other

Ethnic & religious strife has historical roots but has been well controlled in recent years

Personal Incomes in India

- 2% of the population make $13,000 USD per year
- 8% make $3,500 USD per year
- Middle class = 200,000,000 people, which is larger than the Chinese middle class

Government in India

- Indian Federation
  - Six Union territories
  - Twenty-nine States
- Parliamentary Government
  - Upper House (Rajya Sabha)
  - Lower House (Lok Sabha)
- Constitution

Indian Courts & Legal System

- Single integrated court system which administers state and union laws
- Traditionally the court system is very slow to make decisions
- Most commercial disputes are resolved by arbitration, not by the court system

Regulating FDI in India

- Until 1995, India pursued a governmental strategy of discouraging FDI
- While there are still restrictions on foreign investors, those restrictions are being rapidly liberalized
- 100% ownership is now permitted in some industries and the approval process is streamlined

Part Four:

Is the Sun Rising In India?

Options for Foreign Investors in India

- Liaison (representative) office
- Branch office
- Project office
- Joint venture
- Subsidiary

Joint Ventures in India

- Approval by the Reserve Bank of Delhi is normally required for joint ventures with non-Indian partners
- Automatic approval in most cases if the foreign company has minority interest
- If foreign company desires majority control, various categories of industry sectors exist which are favored for approval
- Joint ventures are prohibited in certain sections of the economy

Youthful Population: The Double-Edged Sword

- India has a very young population because of its high birthrate
- It is the opposite for China where a “one child policy” has created demographic problems for China’s future labor needs
- With appropriate widespread educational resources, India’s large youthful population can be the greatest resource for India’s economy

Language

- There is widespread English language competency throughout India
- English competency creates growth opportunities in India
- The language of the Internet is English; this is unlikely to change

Educational Resources & The “Brain Drain”

- India already has and is developing more world class educational institutions
- These will enable India to educate the future academic business and government leaders
- India’s “Brain Drain” of the 1980’s & 1990’s has ended with many Indian professionals who were educated abroad returning to live and work in India or managing networks of service providers on a periodic travel basis.

Democracy & Religion

- As the largest democracy in the world, India appears to have evolved a stable political system despite a diverse population
- With one predominant religion (Hinduism), the prospects for the kind of religious conflicts that exist elsewhere in Asia appear controllable

Part Five:

How Will China and India Influence America Over the Next Ten Years?

The Impact in America Varies

- The United States is not a single economy -- It consists of diverse regional economies clustered around sprawling metro areas
- China and India are affecting different geographic regions of the country in different ways, some of which are beneficial and others negative

How India and China are influencing the future economic prospects of 12 representative U.S. metropolitan areas.

Conclusion - China

Over the next decade, new FDI in China is likely to decline for two reasons.

1. Chinese government policies will discourage new inbound foreign investment and instead encourage Chinese companies to invest outside China. Many Chinese investors will target opportunities in America.

2. China must seriously address infrastructure shortcomings and environmental problems in order to permit China's economy to grow fast enough to meet the demands of the Chinese people.

Conclusion - India

Over the next decade, FDI in India will continue to grow. India appears to have taken permanent steps toward opening up its laws and governmental oversight to attract foreign investment. India will be the beneficiary of increasing FDI if it can control its population explosion which threatens to consume India's booming economic prospects. India is now beginning to emphasize manufacturing in addition to service industries.

748671
Copyright Dennis Unkovic, 2008

OUTSOURCING & DOING BUSINESS IN INDIA

Dennis Unkovic
Meyer, Unkovic & Scott LLP

I. OVERVIEW OF THE INDIAN SUBCONTINENT

A. Demographics

Although India is home to 16% of the world's population, it is frequently overlooked by those involved in international business. Of the approximately 1 billion people living in India, about 58% are between the ages of 15 and 60. Although the population is still predominantly rural, India, with more than 25 cities having a population of over 1 million, is in the midst of transforming itself from an agricultural to a more industrial society. Approximately 2% of Indians (about 20 million people) have a per capita income of over $13,000.00 USD, which accounts for a large potential market of consumers. Another 8% have a per capita income of over $3,500.00 USD. These are part of the 200 million who are considered to comprise the Indian middle class.

B. Economic Growth Trends

The Indian economy grew over 8% during 2007, despite the fact that overregulation of business by the Indian government continues to restrict its ability to grow even faster. The greatest area of economic expansion is occurring in Southern and Western India (Mumbai, Chennai, Bangalore, Mysore, Hyderabad), which currently has over 50% of India's production and research capacity. It may grow to 60% by the end of the decade.

C. Languages

Although the official language of India is Hindi, there are at least 13 other major languages in daily use. However, under the *Official Languages Act*, English is used widely throughout India as a second language and is especially widespread in the field of commerce and business. Fluency in English is a major advantage for Indian businesses seeking foreign direct investment.

D. Religions

About 83% of the Indian population adheres to precepts of the Hindu religion. While there are numerous other religious sects including Sikhs, Christians, Buddhists, and Jains throughout the country, the second major religious group by size are Muslims (representing about 12%). For historical reasons, most of the major conflicts related to religion occur in Northern India.

E. The Indian Federation

Unlike the United States, India is a federation (or federal system). There are six centrally administered union territories and 29 states. New Delhi is the capital where the union territories are administered. Each of the states and union territories also maintain their own separate capitals for local administration.

F. Parliamentary Government

The Upper House (Rajya Sabha) and the Lower House (Lok Sabha) make up the Indian Parliament. The Parliament is the country's highest legislative body, much like the Congress in the United States. It operates in a manner similar to the British parliamentary model. Every five years there is a major national election, unless there is a failure of support for the coalition government in power.

G. Constitution and Court System

India declared itself a Republic in 1950, three years after the English departed following a century of colonial rule. India has a Constitution which is in some ways similar to the U.S. Constitution. The Indian Constitution provides for a single integrated court system which administers both union and state laws. The highest court is the Supreme Court of India, which is located in New Delhi. Each state has its own high court with subordinate courts below them. Under India's Constitution, the Supreme Court of India is to be independent of political and outside influences. Decisions by the Supreme Court are binding on all other courts within India. Historically, the courts in India have been extremely backlogged and are very slow in rendering decisions (sometimes taking decades). Since 1991, attempts have been made to alleviate the burdens on the courts by appointing Special Tribunals. These efforts to expedite trials have met with only modest success.

H. Arbitration in India

Since the Indian courts move very slowly in making decisions, Indian businesses often elect to use arbitration as an alternative in an effort to resolve commercial

disputes in a timely manner. Indian arbitration is based upon the *Indian Arbitration and Conciliation Act* which is modeled after the provisions contained in the United Nations UNCITRAL Rules. Indian courts will adhere to and enforce final foreign arbitral awards because India is a signatory to the *UN Convention for the Enforcement of Arbitral Awards* (the New York Convention).

II. INDIA'S POOR RECORD OF ATTRACTING FOREIGN INVESTMENT

A. Slow Economic Growth (1980 to 2000)

While 70% of the Indian population still resides in villages where agriculture is the main source of income, more than 350 million Indians live in cities. India represents a large potential source of available low-cost labor. Why then did India experience such a poor record of economic growth between 1980 and 2000? The primary reason is the past policies of its central government. Until relatively recently, the Indian government directly and indirectly discouraged foreign investment with the hope of enabling domestic industrial concerns to grow and prosper without outside (foreign) competition. Unfortunately, these policies failed and ended up severely retarding the potential of the Indian economy since its independence in 1950.

B. India's "Brain Drain" (1980 to 2000)

Although past Indian government policies discouraged foreign investment, at the same time India undertook an effort to fund numerous world-class educational institutions such as IIT (Indian Institute of Technology) throughout the country. For years these institutions produced top-notch graduates in a broad range of disciplines such as engineering, medicine, research and development, computer software and design, and the sciences. Unfortunately for those Indian graduates, few job opportunities were available within India. As a result, India experienced a heavy "brain drain" to other countries which offered greater economic opportunities (such as the United States). Thus India's economic growth between 1980 and 2000 of less than 4% was hurt by the loss of well-educated technical graduates. The "brain drain" has slowed in recent years, but India still sees many of its best and brightest leaving for foreign opportunities. With the rapid acceleration of economic opportunities in Western and Southern India, this has begun to change as increasing numbers of highly-educated Indians move back home to take part in these emerging markets.

C. How the Chinese Model Differs from India

It is interesting to compare the People's Republic of China to India during this same period. The Chinese government pursued a different path by aggressively

seeking out foreign investment and creating world-class contract manufacturing export capabilities, particularly in Southern China and along the coast. From 1980 to 2000, China's growth averaged a spectacular 9%, which meant that China's per capita income by the year 2000 was 70% higher than India's. India's growth was less than half during this same twenty years.

III. HOW INDIA'S ATTITUDE TOWARD FOREIGN DIRECT INVESTMENT IS CHANGING

A. New Views of Foreign Direct Investment

Over the last decade, India has slowly begun to alter its traditional opposition to foreign direct investment. With a rapidly growing population, the Indian government has finally recognized that a more stimulated economy funded by foreign investors is key to growth.

B. India and the WTO

India was one of the founding members of the *General Agreement on Tariffs and Trade* (GATT) in 1947. The World Trade Organization (WTO), as the successor to GATT, is now working to further open up global trade. The WTO is putting pressure on all countries including India to make their markets available to foreign competition and to encourage outside investment. India now appears to be going along with this movement toward liberalization.

C. Best Regions for Foreign Direct Investment in India

India is a geographically and economically diverse country. The economic growth nurtured by foreign direct investment has not been evenly spread throughout all of India. Some regions of India have benefited more than others. Western and Southern India have experienced the most success to date. One reason is many of India's finest institutes of higher learning are located in these regions in key cities such as Bangalore, Chennai, and Mysore. It is in those areas that significant foreign investment has found previously untapped potential and highly educated individuals with in-demand skills.

D. The English Language

India has one strong advantage over China in that with English as a second language, Indian workers are much more capable of interacting with foreign partners and investors than the average Chinese. This has encouraged significant investments from both American and European multinationals.

IV. FOREIGN DIRECT INVESTMENT IN INDIA

A. The Role of the Indian Bureaucracy

For decades, India's large and unwieldy bureaucracy has acted as a major barrier to foreign companies wishing to invest in India. Beginning in 1991, the Indian government finally initiated an effort to dismantle some of its bureaucracies in order to create a more responsive environment for qualified foreign investors. Regions like Central and Southern India have tended to be more successful in these efforts.

B. Options for Foreign Direct Investment in India

Foreign direct investment is permitted in India, but Indian laws treat industrial sectors differently. Some are favored for foreign investment, while for others more restrictions exist. For example, there are statutory restrictions on how much capital a foreign investor can bring into India and what percentage an outsider can own in an Indian company in certain industrial sectors. In some areas, foreign direct investment is permitted up to 100% without governmental interference. This is called the "automatic route". In those industries where foreign direct investment is not permitted under the automatic route, permission from the government is necessary to make an investment, and the size of the investment (percentage of foreign ownership) may be constrained by statute or regulations.

1. To the extent that an overseas investor wants to own any business in India in the field of agriculture, such companies must obtain general or special permission from the Reserve Bank of India. India continues to closely protect its agricultural sector.

2. If a foreign investor does not want to establish a subsidiary or form a joint venture with an Indian partner, they can set up business operations in India in several ways. Specifically, an investor can establish a branch office, a project office, or a liaison office. Approval of the Reserve Bank of India is normally required for opening such offices.

   a. A liaison office (often known as a "representative office") is set up by foreign companies to oversee their existing business interests in India. It is important to understand that a representative office cannot itself undertake any direct commercial activity. If no revenue is generated, then there are no significant tax implications for a foreign company. At the same time, a foreign company with a representative office in India cannot repatriate money out of India.

b. A branch office is not an incorporated company but an extension of a foreign company in India. Its activities are limited by Indian law and regulations govern what a branch office can and cannot do.

c. A project office is set up to carry out projects in India that have been awarded to a parent company. A project office on a limited basis works only on projects which are normally government-funded. When a project is completed, such offices are closed.

3. Under the *Indian Companies Act*, it is possible to set up a joint venture between an Indian company and a foreign investor. This is a common vehicle for foreign companies. A joint venture in which a foreign entity does not own more than 51% can normally receive automatic approval by the Reserve Bank of India. For other joint ventures in which a foreign entity has greater ownership or equity interests, there are various categories of industrial sectors which get different treatment. For example, there are certain industries (35 currently) where the Indian government gives favorable priority because India is seeking investment in these areas (such as drugs and pharmaceuticals, electrical equipment, fertilizers, and biotechnology). You need to carefully review Indian statutes and regulations to determine what level of investment is permitted before making any commitment to a joint venture.

4. Another alternative is setting up a subsidiary. There are many restrictions on foreign investors that need to be reviewed in order to analyze if this is a real option. However, foreign direct investment of 100% is now permitted in the hotel and tourism sector, real estate development, and the pharmaceutical industry. Foreign investors are also permitted in most circumstances to establish 100%-owned operating subsidiaries in certain industries.

C. The Indian Stock Market

The Indian stock markets have been open to foreign institutional investors since 1993, permitting an infusion of capital into publicly traded companies. There are still limitations on foreign investors in the Indian stock market, depending on the share capital and industrial sector of the Indian company involved.

D. Intellectual Property

For years it was difficult to adequately protect intellectual property in India. With the advent of the WTO and an increased government desire to attract quality foreign direct investment, the protection of foreign intellectual property is slowly improving. For example, India recently passed the *New Trademark Act*. Instead

of seven years, there is now a ten-year term for trademarks. India is now prepared to review the concept of registering servicemarks, collective marks, and “well known” marks. The Indian approach is that well-known marks are entitled to higher levels of protection because they are more likely to be the target of improper imitations. For many foreign investors, this is a helpful development.

V. FIFTEEN KEY QUESTIONS TO ASK WHEN EVALUATING PROSPECTIVE SERVICE SUPPLIERS OR JOINT VENTURE PARTNERS IN INDIA

You always need to be cautious when selecting a foreign service supplier or a joint venture partner. This is particularly true in India since it is so geographically distant from the United States, and Indian businesses operate differently from their American counterparts. The labor market is also unlike what most U.S. companies are familiar with. You should not rely on the advice of others in the selection of a foreign provider; you must travel to India and conduct significant due diligence. What follows are a number of considerations to weigh when seeking the best possible supplier or partner:

A. How long has the Indian company been in business? What is its general reputation? If it is a start-up venture, who is behind it, and are they reliable?

B. How well capitalized is the Indian company?

C. Is it a stand-alone company or is it part of a related group of companies? Are any related companies financially strong and will they be available to offer support financially and otherwise?

D. Has the Indian company and its management ever been involved in a joint venture or a contractual relationship with foreign investors? Were those engagements successful? Can you talk to any of those foreign investors about your prospect?

E. Were any of the key employees of the Indian company educated in the United States or did they live for a period of time in America? Do they understand American business practices?

F. Has the Indian company worked with other companies in the past which would be considered potential competitors?

G. Does the Indian company have any experience in serving the particular needs you are exploring?

H. What is the size of the Indian labor force currently working in the company, and does the company have a good reputation for treating its workers well?

I. How important is English fluency in Indian workers to your company's needs? Is English widely used in the geographic region where you may locate your operations?

J. What type of wages does the Indian company pay its workers? What is the average tenure of an employee at the Indian company?

K. Is the Indian company located in a geographic region where there are adequate pools of potential workers possessing the requisite skills if your needs in India require more workers in the short term?

L. Is the Indian company located in a part of India where ethnic or religious tensions could result in potential problems or work stoppages?

M. How do workers at the Indian company get to the workplace? Is there adequate public transportation available, or must the Indian employer supply specialized transportation to its workers?

N. Is the Indian company able to provide proper financial and accounting data to conform to the needs of your U.S. operations?

O. If your operations in India are to be on a 24/7 basis, can the Indian company guarantee its level of performance to this standard?

VI. CONTRACTUAL ISSUES TO CONSIDER WHEN OUTSOURCING SERVICE REQUIREMENTS TO AN INDIAN ENTITY

The following are points you may want to include in an agreement for outsourcing services to India.

A. Services

Clearly define the type of "services" that are to be provided by the Indian company. This should include daily/weekly/monthly service levels acceptable to the U.S. company. Quantify wherever possible the criteria for evaluation.

B. Best Efforts

Define "best efforts" in a quantitative sense wherever possible when determining what will be expected of the Indian company. This should include what levels of quality performance are minimally required and what steps will be taken and in what time period to correct any errors or omissions.

C. Invoice Disputes

Set forth the maximum time period in which invoice disputes may be raised and the method by which disputes are to be resolved between the parties.

D. Guarantee of Performance

A U.S.-based company is best advised to seek guarantees of contractual obligations of an Indian company. Consider requiring a letter of credit or standby letter of credit from the Indian entity. This will enable you to put pressure on the Indian company if and when significant problems arise or disruptions in service occur. Make sure the letter of credit stays in place after the contract terminates so termination is not used as a basis to void obligations secured by the letter of credit.

E. Onsite and Offsite Supervision

Provide that the U.S. company has the right at its own expense to conduct permanent or episodic inspections of the facility in India. This would include the right to oversee the hiring, retention, and evaluation of service personnel. The U.S. company should insist on full and unrestricted access (online remote) for all computers, telephones, storage devices, and related sites on a 24/7 basis.

F. Confidentiality

The parties must agree that all proprietary information and contracts will remain confidential during the term of the contract and after termination. Also, provide for the return of all files and related materials in a timely manner upon termination of the Indian supplier.

G. Force Majeure

The U.S. company must have the right to terminate the agreement in the event of the occurrence of a force majeure. The parties must determine how long such an event can continue (*i.e.*, 15, 30, or 45 days) before termination is effective and whether such events can be cumulative.

H. Termination by the U.S. Company

Carefully define each of the bases for termination of the Indian company. Tie this into the definition of "services" and "best efforts" requirements.

I. Deconversion

You will need to provide for the possibility that the U.S. company in the future may elect to award its business to an alternative service supplier. In this case, require the affirmative obligation of the original Indian company to continue supplying services until such a transfer (conversion) is complete. Consider tying this obligation to the letter of credit to be supplied by the Indian company.

J. Indemnification

In the event the indemnification of the Indian company is not satisfactory, try to get the indemnification of a related company.

K. Limitation of Liability

Negotiate whether there will be limitations on liability of the Indian company. Research whether any insurance coverage is available for possible claims and related costs.

L. Dispute Resolution

Avoid Indian courts if at all possible. Binding third party arbitration is preferable. If possible, have arbitrations conducted outside of India. If the Indians refuse to arbitrate in the U.S., consider Asian-based arbitration. Two good impartial alternatives are the Hong Kong International Arbitration Centre (HKIAC) and the Singapore International Arbitration Centre (SIAC). Either should be acceptable to the Indians, and each arbitration can be conducted in the English language.

M. Change in Control

To the extent there is a "change in control" of the Indian company as defined in the agreement, provide this as a basis for the U.S. company to terminate if it so elects. Also, do not allow any assignment of the obligations of the Indian company to a third party without prior written consent of the U.S. entity.

N. Termination by the Indian Company

In the event the Indian company desires to terminate, provide for adequate notice so an orderly transition is possible without disruption of service. Again, try to tie this to the letter of credit or standby letter of credit.

VII. FOUR EXAMPLES OF SUCCESSFUL FOREIGN DIRECT INVESTMENTS IN INDIA

Below are four examples of foreign investments in India which have taken advantage of the high-quality human resources currently available there at below-market wage rates.

A. Example One: Engineering Services

India annually graduates thousands of highly competent and well-trained engineers in a broad variety of disciplines. Most graduates are fully conversant in the English language. One example is a company which handles significant engineering projects around the world and regularly bids on tenders for the construction of major global infrastructure projects. This company found that it can prepare basic preliminary drawings and estimates from its existing operations in Europe and the United States and then transfer the raw drawings via the Internet to its associated company in India each day. Within 12 to 14 hours, more finished and detailed drawings are completed by its Indian engineers and draftsmen and returned to the company. This professional work can be accomplished at approximately 20% of the cost of the same work if it were done in either the United States or Europe. These cost savings enable this foreign investor to be much more competitive.

B. Example Two: Call Centers

The next time you call your credit card company with a question or account inquiry, you will most likely assume you are talking to a service representative located nearby. You are probably wrong. Many companies like Amexco have decided to locate their call centers in cities like Bangalore and staff the centers on a 24/7 basis with educated, English-speaking Indian workers. The call center market is also being increasingly used by those U.S.-based financial institutions which have to respond to phone inquiries from customers but find the cost of employing full-time service representatives in the United States too high. This is why financial centers in India are emerging as a very large business.

C. Example Three: Software Research and Development

Some of the finest software developers in the world are Indian-born and trained. One company I represent has a software staff of 90 highly qualified Indian engineers located in India and dedicated to creating and maintaining a sophisticated proprietary software system. The cost of maintaining the same team in the United States would be at least four times as high. Companies such as Microsoft have recognized the importance of cost-effective software development and are now targeting large-scale investments in India.

D. Example Four: Medical Transcription

748671 Copyright Dennis Unkovic, 2008

An example of India's future potential is Acusis, LLC, a limited liability company with its home office located in Pittsburgh. The concept behind Acusis is simple. All patient histories, doctors' notes, treatments and records under law must be transcribed by hospitals, doctors' offices, or medical institutions on a timely basis. There is no alternative to complete and accurate medical records. Companies like Acusis have found that medical transcription can be accomplished more quickly, with greater accuracy, and at a much lower cost by doing the actual work in India. Basically what happens is that the doctor or medical professional dictates into a digital recorder. The dictation is then downloaded to a PC, immediately encrypted, and then sent to India via the Internet for transcription into the format specifically requested by that particular healthcare provider. The completed transcription is sent via the Internet back for approval and finalization, usually within 12 to 24 hours. The cost of having this work done in India is about a third of what it would be in the United States.

VIII. CONCLUSIONS

A. While India has great economic potential, foreign investors should make comprehensive efforts to learn as much as possible about India's unique systems and laws before moving forward.

B. The Indian government continues to exercise significant oversight over foreign direct investment. Some parts of the economy are more regulated than others.

C. Foreign direct investment in India is heavily clustered in certain parts of India (south and west) for a variety of reasons.

D. The Indian court system is normally bypassed in favor of arbitration as a way to resolve commercial disputes in a more timely manner.

E. While joint ventures with Indian companies have been the traditional route for foreign direct investment, wholly-owned operations are becoming more prevalent among sophisticated foreign investors.

F. There is a large pool of highly-skilled, educated workers and managers in India who possess strong English-language skills.

748670 Copyright © Dennis Unkovic, 2008

AN INSIDER'S VIEW OF DOING BUSINESS IN CHINA

Dennis Unkovic
Meyer, Unkovic & Scott LLP

The greatest challenge for any company seeking Chinese business opportunities is realizing how different the business climate, laws, and attitudes are in China as opposed to the U.S. and elsewhere. Foreign investors must accept the necessity of altering their normal modes of doing business. In a sense, they must become "insiders" when approaching the Chinese market.

Being a successful company at home is no guarantee of success in China. This outline examines key issues companies should address before making a major foray into that part of the world.

I. CHINA'S ECONOMIC EXPANSION FROM 1972 TO 2008

A. In 1972, former President Richard M. Nixon's unexpected and historic visit to China opened up the possibility of commercial activities between American companies and the Chinese for the first time in decades. However, few substantive business relationships developed over the next six years. The reason was that under Chinese laws and regulations until 1978, direct foreign investment into China was virtually prohibited. Up until then, China's role in the international marketplace (excluding Hong Kong and Taiwan) was extremely limited (less than 10% of national income involved foreign trade).

B. This all changed in 1978 when China first publicly announced its "open door" policy that was aimed at attracting much-needed foreign capital and technologies, particularly from the United States and Europe. This radical new policy was a direct result of actions by Deng Xiaoping, who forced China's leadership to reverse its traditional opposition to foreign trade and investment. Deng believed foreign investment and technology were the only way that a modernized, industrial China could evolve over a short period of time. Over the next quarter century, China has periodically introduced new laws and implemented extensive regulations specifically designed to govern and encourage foreign investment activities. From 1979 to 1986, 7,500 foreign investment contracts and memorandums of understanding (MOUs) were signed in China with a value of

approximately $19.1 billion USD. Since 1986, the number of investments has increased tenfold.

C. The death of Deng Xiaoping on February 19, 1997, marked the final transition to a new generation of leadership in China. Deng's hand-picked successor, Jiang Zemin, promised to uphold the economic revolution initiated by Deng. This held true through 2002, when the Chinese leadership again changed. After a two-year transition, in September 2004 Jiang Zemin formally ceded all of his official positions to his successor Hu Jintao. Over the last five years, Hu has continued the official government policy of his predecessors to encourage foreign investment in China.

D. China's economic statistics are staggering:

1. Annual economic growth between 7% and 13% from 1989 to 2000. Growth in 2001-2002 was more modest, but returned to torrid levels from 2003 to 2008.

2. Factory output has risen 25% on an annualized basis for a decade.

3. A more recent phenomenon is the growing consumer market throughout the People's Republic of China. China is no longer just focusing on exporting. Much of what is produced in China now goes toward satisfying the demands of Chinese consumers for goods and services.

4. There are 1.3 billion potential customers in China.

II. CHINA AS A WORLD ECONOMIC POWER IN 2008

A. For the last 25 years, the Chinese economy has experienced unprecedented rates of growth. China's gross domestic product (GDP) in 2004 was estimated at $7.262 trillion USD (purchasing power parity)[1] as opposed to Japan's GDP of $3.74 trillion USD and $11.75 trillion USD for the United States. If you assume China's internal growth rates continue at current levels and the U.S. remains stable, the size of China's economy could exceed America's by 2023.

B. Chinese central government policies over the last two decades have been specifically implemented to guarantee that China will someday become the world's largest provider of contract manufactured goods (the U.S. currently holds the top spot; Japan is second). At first, contract manufacturing in China focused primarily on creating products solely for sale to export markets. Today, however,

[1] *A 9.1% increase over 2003.*

748670 *Copyright © Dennis Unkovic, 2008*

increasing volumes of Chinese-made products are targeted for domestic (Chinese) consumption.

C. Significant foreign direct investment by American, Japanese, Korean, European, and Taiwanese (through indirect channels) investors has financed much of China's economic boom over the last two decades. To the surprise of many, China surpassed the U.S. as the top destination for foreign direct investment for the first time in 2004 and continued to retain the top ranking in 2005, 2006 and 2007.

D. Although the Chinese market is the world's most attractive destination for foreign direct investment, there are many business and commercial risks that foreign investors must understand. Many Western and Japanese companies have failed badly in their Chinese investments over the last several decades.

III. THE CHINESE VIEW OF CONTRACTS AND INTELLECTUAL PROPERTY

A. Before exploring the specifics of doing business in China, foreign investors need a clear understanding of how the Chinese view contracts and the intellectual property of foreign investors. What becomes quickly apparent is that there are real differences between Western and Chinese attitudes toward these important issues.

B. The traditional Chinese view of commerce is one based on personal relationships. This is why so many companies and enterprises in China are centered around families (unlike Japan where a more corporate mentality dominates). Prior to the 20th century, contracts played little or no role in China's commerce except among foreign investors. You should never underestimate the importance of familial relationships in China.

C. The rise of Communism under Mao in the 1930s created an aberration in traditional Chinese attitudes toward commerce by artificially imposing a totally planned central economy in which no individual financial incentives were permitted. That policy significantly eroded following the death of Mao and the rise of Deng Xiaoping.

D. As foreign investment in China rapidly expanded after 1978, contracts (although not favored) became more common as an accommodation to foreign investors who brought needed capital and technology to China. As foreign investment became more important to the Chinese economy, the willingness of Chinese partners to accept written contracts changed.

E. China has a civil code governing all commercial business activities conducted by both domestic and foreign persons. Only a "legal person" has rights and the

ability to contract in China. This has many implications and potential risks for foreign investors. The "Rule of Law" in the Western context as it applies to the use of contracts is still not accepted by most Chinese.

F. China's Ministry of Foreign Trade developed form contracts that Chinese companies (particularly those which are partially or totally government-controlled) typically attempt to use during negotiations. It is helpful to research in advance whether a potential Chinese partner is likely to use such form contracts as the basis for negotiations.

G. The Western concept of protecting intellectual property (patents, trademarks, copyrights, and trade secrets) is an area of significant risk for foreign investors with technology in China. For decades, foreign investors have had their partners and others wrongfully use their intellectual property, and Chinese laws and courts were not helpful in enforcing their rights. Now that China is officially a member of the World Trade Organization (WTO), protection of intellectual property is supposed to be a higher priority among Chinese enterprises and the Chinese government. Nevertheless, a company must carefully evaluate how and if it can protect its key intellectual property if it manufactures and distributes its products in China -- real risks remain.

IV. CONTRACT MANUFACTURING IN CHINA: WHY, WHERE, AND HOW

A. "Contract manufacturing" of products in China (*i.e.*, a factory utilizing Chinese labor to produce components or fully-assembled products for export or domestic Chinese consumption), while less expensive from the standpoint of labor costs, is not always the right business decision for foreign companies. There are a variety of factors to analyze prior to approving an investment.

B. Before selecting a specific geographic location in China, a key issue to resolve is whether you intend to manufacture products there for export or expect to sell them for consumption within the domestic Chinese market. Transportation is a factor in either case; however, it is usually more important in producing goods intended for export. Unless your products can be exported by air cargo, proximity to a port is crucial. In that case, locating a manufacturing facility near a port such as Shanghai, Tianjin or Hong Kong is a definite advantage.

C. During the 1980s, Chinese-based manufacturing was primarily located in Hong Kong and the nearby "New Territories". However, as the cost of labor in Hong Kong rose over twenty years, much of the manufacturing capacity there relocated to Mainland China.

D. The Pearl River Delta, for example, is a large geographic region located north of Hong Kong. The Delta was one of the first special economic regions sanctioned

by the Chinese government to encourage contract manufacturing primarily for export purposes. Today, over 30,000 manufacturing facilities are located there, most of which are partially or completely owned by foreign investors. There are three major cities in the region -- Shenzhen, Dongguan and Guangzhou. About 45 miles north of Hong Kong, Shenzhen is a city of about 9 million people. Surrounding Shenzhen are tens of thousands of factories which stretch all the way to the other major city, Guangzhou, with Dongguan in between. The costs of labor in the Pearl River Delta though are currently outpacing the rest of China, which makes other areas more attractive to new investors.

E. During the 1990s, manufacturing began to spread from the Pearl River Delta up to Shanghai and elsewhere throughout China. There are now thousands of larger and smaller foreign-owned manufacturing operations within 100 miles of Shanghai and Suzhou, with a significant number of metal and related industries located in that region. Shanghai has emerged as the key financial center for all of China, which further incentivizes foreign multinationals to set up operations and/or headquarters there.

F. Fujian Province, a region along China's coastline located directly across the straits from Taiwan, is also growing rapidly. Some of the foreign investment in this region comes from Taiwan which accomplishes this through foreign corporations that invest in Chinese enterprises. Dell Computer is an example of an American manufacturer with a major presence in that province.

G. During the 1990s, the vast majority of foreign investment took place along the Chinese coast from Hong Kong stretching north toward Beijing. That began to change around 2000. The Chinese government, worried about all of the investment along China's eastern coast with little inland, decided that cities inside Central China should attract investment so the entire country would benefit. As a result, the Chinese local governments are now offering special incentives, including tax holidays, to foreign investors who are willing to consider inland locations. Wuhan, a city of 9 million, is one example of how a city in Central China is attracting significant foreign investment.

H. Beijing and its neighbor Tianjin will see enormous growth over the next decade.

V. Eight Factors To Consider When Outsourcing Manufacturing To China

***Factor One*: Government Involvement In Your Business**

Determine where in China you expect to do business and investigate what government bodies will influence or regulate your business activities. Below are important questions to ask:

748670 Copyright © Dennis Unkovic, 2008

1. Will the central government or a specific ministry have direct regulatory influence over your anticipated activities in China?

   a. Do you expect the Chinese government or a ministry to be a potential buyer of your products or services? How will this affect your marketing activities?

   b. Is mandatory licensing or prior governmental clearance required in order to sell in China? (*Example*: Pharmaceuticals or medical equipment need to be pre-approved before being sold in China.)

   c. Should you initiate contacts with key government officials to explore issues prior to formal negotiations?

   d. Is it advisable to utilize a Chinese intermediary to interface with government officials before, during and after negotiations? Does the intermediary have a pre-existing relationship with those officials?

2. Will the provincial government(s) in China exercise influence over how your business is conducted in their jurisdiction?

   a. Registration requirements?
   b. Licensure?

3. What role will local governments play?

   a. Will early meetings with local government officials help smooth later negotiations?

   b. Do you know what local labor regulations, environmental requirements, and taxation statutes might influence your deal?

***Factor Two*: Tax Considerations**

1. For any intended business activities in China (national, provincial, local), analyze what tax statutes are involved and what filings may be required.

2. Joint ventures can present a variety of potential tax pitfalls for foreign investors. For example, some Chinese joint ventures with non-Chinese investors are initially approved with preferential tax treatment (tax holdings) offered as an incentive for investment in a particular geographic region. Research in advance what the dissolution of a joint venture or buyout of a local partner at a later point might have on your tax status, such as the future recapture of previously deferred taxes.

748670 Copyright © Dennis Unkovic, 2008

3. Determine whether as a foreign investor in China you are permitted to operate without a local partner. If your Chinese venture is failing, line up a new partner before initiating discussions to terminate your existing joint venture partner. Otherwise, your tax treatment may be drastically altered.

4. In most Asian countries, you are prevented from transferring assets from one entity to another until all formal notifications are filed and mandated government approvals are issued.

5. Foreign investors entering China are now taxed on the same basis (with some exceptions) as Chinese companies. This “leveled playing field” is a relatively recent development.

***Factor Three*: Accounting Issues**

Whether you elect to invest in a joint venture or set up a wholly-owned foreign enterprise (WOFE) in China, various accounting issues will influence the transaction. Consider the following:

1. Will the accounting methods used in China be consistent with your U.S./European-based accounting systems?

2. Will problems arise with U.S.-based tax returns in the event of a dissolution or assumption of a local party’s joint venture interest?

3. You should perform in-depth periodic audits to assure you truly know about the success of or problems with your joint venture.

***Factor Four*: Employee And Labor Issues**

Employee and labor issues in a foreign joint venture are time consuming and less predictable in China than in a U.S.-based joint venture. Some unique issues to consider are:

1. American companies commonly assign one or more of their executives to work overseas in a foreign joint venture. These expatriate employees are authorized to work in a foreign country based solely on their direct and active involvement at the managerial level in the joint venture. To the extent the legal status of a joint venture changes, you may discover that the immigration status of your expatriate managers is adversely affected. Often the “right of abode” and ability to work is granted for a set period and subject to periodic review by foreign labor and/or immigration officials. This possibility mandates advance examination and ongoing monitoring in order to avoid unpleasant surprises.

Copyright © Dennis Unkovic, 2008

2. Foreign labor statutes impose obligations on joint venture employers. Be aware that terminating a joint venture or transferring its assets to another entity (or a new entity) may create separate sets of problems.

   a. Executives: In restructuring a joint venture or buying out a partner, an executive or director may be entitled to termination benefits based upon local labor laws which can take precedence over contractual obligations with the venture itself. For example, where foreign corporate regulations require that a local person serve on a board of directors, such a director may be entitled to compensation (even if it is a part-time or titular position) in the event a joint venture is restructured or terminated.

   b. Professional Staff: Professional employees in China have statutory rights. Reviewing the alternatives with local legal counsel is encouraged early in the process because professional staff in a foreign joint venture understands their rights under local statutes and will act accordingly.

   c. Workers: Whether workers are represented in their activities by labor unions varies from country to country based upon local laws. For example, labor unions exist in China and may assume a role in determining wages, working conditions, and terminations. In Asian countries where labor unions are not a factor, the statutory rights of laborers are usually triggered in the event of dissolution of a joint venture or change of control.

***Factor Five*: Licensed Technology**

When doing business overseas, U.S.-based companies commonly license their technologies to joint ventures in which they have an equity stake. License agreements can facilitate the legitimate transfer of royalties (hard currency) out of a country back to the United States. Research in advance the implications of technology licensing into China. For example, will U.S. governmental oversight or approvals be required?

***Factor Six*: Banking And Financial Concerns**

Despite recent public announcements to the contrary, China still has a currency in the reminbi (yuan), which is largely inconvertible. This means it is difficult to take profits or money out of China which were earned in reminbi. This poses problems for foreign companies doing business in China, whether in a joint venture or a WOFE.

1. Consider bank loans. Will the dissolution of a joint venture or the sale of interest to the U.S. partner by the Chinese accelerate any loan payment obligations or create related problems under existing loan covenants?

748670

Copyright © Dennis Unkovic, 2008

2. Letters of credit are the most common form of transferring money and paying obligations in international business transactions. It is critical that nothing adversely affects the ongoing viability or enforceability of letters of credit (either incoming or outgoing). This will arise in an unamicable breakup of a joint venture because one party has an economic or personal interest in not supporting the viability of the surviving entity.

3. Parent companies in international transactions are frequently asked to guarantee performance obligations of their ventures through various financial mechanisms. This is particularly true for those involved in international construction and infrastructure projects or long-term supply arrangements. Evaluate what kinds of activities in a joint venture would void or trigger unexpected obligations under guarantees of payment.

4. The best course of action is to meet with your foreign bankers as early in the process as possible to obtain their acquiescence to the proposed changes in the existing joint venture or to review how you expect to handle your financial arrangements.

***Factor Seven*: Customer Relationships**

One major rationale for creating a joint venture between an American or European company and a Chinese company is to facilitate a good working relationship with local consumers through the contacts and presence of the Chinese partner. If a Chinese joint venture is dissolved or is expected to continue without the direct involvement of the local partner, you must place a high priority on maintaining existing customer relationships. Consider making personal visits to customers and/or facilities to occur simultaneously with any public announcement of a change in the structure or ownership of your joint venture.

***Factor Eight*: Foreign Distributors And Agents**

It is normal practice for foreign joint ventures to work with and through local agents and distributors as a way to heighten the effective penetration of markets. In many foreign countries, including China, formal representative and distributor relationships may be registered with appropriate government authorities. In the event of a reorganization, determine whether re-registration or re-appointment of agents and/or distributors is required. A related question to resolve is whether dissolution of a joint venture will allow an agent or distributor to void ongoing obligations to the joint venture in the future.

VI. SELECTING THE BEST BUSINESS STRUCTURE FOR CHINA

There are a number of alternate structures available to foreign investors desiring to do business in China.

Copyright © Dennis Unkovic, 2008

A. **Selling Through A Chinese Distributor**

Many foreign companies initially decide to sell their imported products in China through Chinese distributors. These distributors purchase foreign-made products and resell them within China. Most Chinese distributors are independent entities, so it is important to investigate their background as carefully as possible before designating one. Exclusivity of distributors can be an important issue -- you do not want your Chinese distributor simultaneously working for your competitors.

B. **Forming A Joint Venture In China**

1. Many foreign governments in Asia, including China, tend to favor joint ventures composed of foreign investors and local businesses because a joint venture allows the government to exercise greater control over a foreign investor's activities. Specific statutes will mandate how a joint venture must be structured. You should analyze the provisions of joint venture laws in advance of making any decisions.

2. The next step is to determine whether the relevant foreign investment regulations require the participation of both a foreign and a domestic partner in order to legally engage in a particular commercial activity.

3. Often foreign joint ventures must receive advance formal approvals from government officials before they are permitted to engage in any business activities. You should check at an early stage what filings are needed in order to legally constitute a joint venture.

4. I strongly recommend in the joint venture agreement or initial memorandums of understanding that you specifically outline what rights and control the non-Chinese partner will be able to exercise over the activities of the joint venture.

5. As part of your pre-investment planning activities, prepare for what will happen if the joint venture later fails. For example, before forming a joint venture, research whether "pre-dissolution approval" is required by Chinese government authorities either at the national, provincial, or local levels before dissolution can take effect. If so, you may want to rethink a joint venture and possibly consider forming a WOFE.

C. **The Wholly-Owned Foreign Enterprise (WOFE) In China**

1. A wholly foreign-owned enterprise (WOFE) is formed by foreign investors exclusively with their own capital in accordance with Chinese

Copyright © Dennis Unkovic, 2008

law. There is no Chinese partner in a WOFE. WOFEs require government approval.

2. Since the mid-1990s, the WOFE has gained increasing favor with foreign investors in China because the traditional roadblocks on both practical and administrative levels have lessened. These roadblocks were a primary reason why foreign investors in the past sought politically-connected Chinese partners.

3. As foreign-owned companies gain more knowledge about the workings of China, there will continue to be a marked growth in the WOFE as a preferred structure by foreign investors. Joint ventures in my view are likely to decline in popularity as a result.

D. Recent amendments to China's foreign trade laws have made China more flexible for foreign investors. Since China became a member in the WTO, it has been required to rescind its old system of granting a virtual monopoly to domestic Chinese companies that deal in importing, exporting and distribution. It is possible for foreign investors and companies to ship goods to the Chinese Mainland without the necessity of going through a Chinese-owned and controlled trading company. These appear in the *Regulations on the Administration of Foreign Investment in the Commercial Area.*

1. A "commercial enterprise" includes sales and retail outlets, wholesalers, and franchises.

2. As of 2008, foreign investors can now own up to 100% of most "commercial enterprises". This overturns previous legislation which in many cases only allowed partial foreign investment in commercial enterprises by the use of a joint venture.

3. Minimum capital for commercial enterprises has been reduced significantly for wholesale enterprises, retail enterprises, and service and consulting enterprises.

4. Franchising in China, which was prohibited in the past, is now more open to foreign investors.

5. These and other reforms should make China more available and attractive to smaller foreign investors who in the past found it quite difficult to exploit Chinese opportunities for many reasons, including the minimum size required of a foreign investor.

748670 Copyright © Dennis Unkovic, 2008

VII. TEN UNIQUE BUSINESS RISKS IN CHINA

International business will always pose significant challenges. What follows are ten unique business risks American and other foreign investors looking at China must be prepared to solve.

***Risk #1*:** The Chinese government currently operates its economy based upon a strictly-regulated currency -- the reminbi (yuan). Any profits earned or monies received which are in Chinese reminbi are subject to strict controls that limit how and when reminbi can be converted into another (hard) currency and sent outside China. This poses real problems particularly for small to medium-sized foreign investors who need to take profits and capital out of China on a regular basis. Foreign investors should plan in advance for what will happen when the Chinese government significantly revalues its domestic currency in the future. Because the value of the reminbi does not currently float on international markets, any revaluation will affect all foreign investors and especially smaller companies.

***Risk #2*:** China's court system and administrative structures are less established and predictable than the systems of most developed countries. Transparency is an ongoing problem. It is a fact of life that Chinese laws can change with little or no advance notice at the local, provincial, and national levels. This unpredictability makes the process of planning for a business project in China, in both the short and long run, difficult and potentially expensive for foreign companies.

***Risk #3*:** Chinese business enterprises are often owned, directly or indirectly, by the Chinese government, its military or high-level government officials. It is not always apparent to a foreign investor whether the Chinese government maintains an ownership position in a company with which it might seek to do business. Therefore, it is critical that foreign investors fully investigate any potential Chinese joint venture partner or business supplier before entering into a contract or investing. Unlike Japan, the Chinese government has the potential to actively involve itself in private business activities. The role and involvement of foreign investors is carefully tracked by the government of China. One consequence of this oversight is that foreign investors may find their activities subject to closer scrutiny by Chinese government officials than are Chinese-owned businesses.

***Risk #4*:** Foreign companies which own or rely on valuable intellectual property -- patents, trademarks, copyrights, or trade secrets -- must be very careful when disclosing or transferring their IP and technical information in China. This is true whether such disclosure is part of a license agreement or made to a joint venture partner. It is difficult to protect intellectual

748670 Copyright © Dennis Unkovic, 2008

property in China through contracts or relying on Chinese courts for enforcement.

***Risk #5*:** The Chinese banking system continues to experience significant economic stresses. Several of the largest Chinese banks have a high percentage of "non-performing loans" on their books (*i.e.*, no interest or principal payments made on a commercial loan for six months). Such questionable loans weaken the stability of those Chinese banks. Foreign investors in China should carefully evaluate where they deposit their funds and try to work only with the best and most financially secure Chinese banks. The Chinese stock markets are unevenly regulated, which makes Chinese capital markets unpredictable.

***Risk #6*:** Compared to Japan, the United States, and much of Europe, the overall costs of Chinese workers and laborers are very low. However, the labor situation in China is not uniform, and you will encounter real differences in Chinese labor costs from one geographic region to another. For example, labor costs in the Pearl River Delta (Southeast China including Hong Kong, Shenzhen, and Guangzhou) are now rising at about 15% per year as opposed to other areas of China. Also, the productivity of Chinese workers is not presently equal to workers with similar jobs in Japan or the U.S. This means it may take more Chinese workers to accomplish a task than in Japan, Europe or America. Careful planning is essential to make sure you select the best possible location in the short, mid-, and long term. Quality control is an ongoing challenge in China. Chinese workers require close oversight while setting up an operation. Foreign investors are forced to spend much time training workers and perfecting systems to improve quality control. Finally, to the surprise of many, China has organized labor groups which can and often do involve themselves in the operations of a foreign investor.

***Risk #7*:** Although joint ventures are a common corporate structure for foreign investors doing business in China, real risks exist for a foreign investor who owns a minority or majority interest in any joint venture with a Chinese partner. This makes it advisable to study the liabilities and plan for a joint venture in China before agreeing to participate.

***Risk #8*:** Corruption exists everywhere in the world, including China. In the last five years, the central Chinese government has taken very aggressive steps to eliminate governmental corruption at the national, provincial, and local levels. Nevertheless, foreign investors may encounter improper requests for payments when seeking the approval of local government officials. Foreign investors must avoid involving themselves in any improper payments or activities in China -- the Chinese government is increasing its oversight of such activities.

Copyright © Dennis Unkovic, 2008

Risk #9: Business taxes are another continuing challenge to foreign companies in China. Tax laws can change quickly and with little or no notice. Even for foreign companies in China that have properly negotiated a "tax holiday" or preferential tax treatment, it is not unusual for tax regulations to change without notice for political reasons. This makes planning for doing business in China very difficult, particularly when a foreign company is considering making a significant capital investment. Another area of tax risk involves customs duties and value added taxes (VATs) which Chinese officials apply to certain activities of foreign investors in China. Compliance with these laws is critical for foreign investors. The penalties for non-compliance can be very severe for a foreign investor.

Risk #10: Foreign investors will sometimes find their commercial activities in China encountering problems because of political considerations. For example, Japanese companies are currently the target of widespread public demonstrations throughout China. Anti-Japanese demonstrations in Shanghai earlier this year are an example of why Japanese companies must plan their business activities in China carefully. One way to lessen the risks is for a Japanese company to cooperate or form a joint venture with an American or European company in China.

VIII. CHINESE IMPORT REGULATIONS: CUSTOMS DUTIES & TAXES

A. China will permit a foreign company to import raw materials into China without the assessment of customs duties and VATs to manufacture products as long as those raw materials are strictly accounted for to Chinese officials and the products manufactured are solely for export sales.

B. In order to take advantage of these laws, you need to qualify your company in advance with the Chinese government. This may mean working with a Chinese trading company. Larger companies can now report electronically to and deal directly with Chinese customs officials.

C. Failure to comply can result in significant potential penalties for a foreign company operating in China. In some cases, this can amount to penalties calculated on the total value of the products imported in multiples of the tax that could have been imposed (customs duties and VATs combined equal about 30%).

D. The most serious penalty for violations is a company being prohibited from doing business in China as well as potential criminal penalties for those involved.

Copyright © Dennis Unkovic, 2008

IX. WHEN THINGS GO WRONG: HOW TO SALVAGE YOUR INVESTMENT

A. The effective settlement of contractual disputes in China remains an area of risk for foreign investors.

B. In China, contractual disputes between foreign investors and Chinese parties are rarely litigated, although this is beginning to change as the number of foreign investors in China continues to grow. At least in the short term, though, foreign investors should opt for arbitration (where available) over settling disputes through legal actions filed in the Chinese court system.

C. Consultation and mediation between parties are always the preferred alternatives for settling disputes in China. This has been the main method used for thousands of years. Only if this fails should you take it to the next step.

D. Consistent with tradition, the Chinese *Equity Joint Venture Laws* and *Contractual Joint Venture Laws* provide that consultation and mediation are the preferred means for resolving disputes. Both contract laws provide that if a dispute arises over an economic or foreign contract, the parties shall attempt to settle through consultation; if consultation is not successful in settling the dispute, either party may request that the state department governing the contract mediate the dispute.

E. I recommend inserting a provision into contracts between a U.S. company (or other foreign investor) and a Chinese enterprise that provides for arbitrating any commercial disputes in Hong Kong. Ad hoc arbitration is never a good idea; instead I recommend that contracts provide for a neutral arbitration body to handle such disputes. The Hong Kong International Arbitration Centre (HKIAC) is an excellent resource and in my experience will often be an acceptable tribunal to the Chinese parties located on Mainland China who have a dispute with foreign parties.

X. CHINA'S LONG-TERM CHALLENGE: INFRASTRUCTURE

A. If China expects to continue its historical high rate of economic expansion, a serious problem it must solve is its infrastructure in the areas of power, energy and transportation is deficient.

B. The Chinese economy, like all other industrialized economies, must have access to sufficient and reliable energy supplies, including oil, coal, nuclear, and natural gas. Coal at this point is the most important resource in China. The Chinese economy in 2006 is highly dependent upon energy generated by burning coal. In 1985, 85% of Chinese energy was based on coal, and in 2008 coal is responsible for 70%.

C. An efficient infrastructure is key to meeting China's growing energy needs. Even if a country has adequate resources of energy, it is critical to get energy where it is needed. For example, China's serious shortcomings in its transportation infrastructure limit its ability to move vast reserves of coal from the mines to where the coal is consumed. China produced about 1.4 billion tons of coal in 2006, and this should increase to 2 billion tons by 2010. A railroad network is the only practical way to transport coal. The United States has about 200,000 kilometers of railroad track, and major revenues of American train companies are derived from hauling coal. China, on the other hand, has only about 70,000 kilometers of track, which is not adequate to move enough coal to meet internal demands for energy. Enough coal cannot reach the industrial consumers throughout China. Even though China is adding about 3,000 kilometers of track per year, most experts predict that it needs to add at least 6,000 kilometers of new main line construction per year to meet current demands. This is a long-term challenge for China as its energy needs grow.

D. Most observers predict China will continue to experience periodic energy shortages over the next 20 years until its infrastructure imbalance is solved.

E. Any company planning on establishing manufacturing operations in China, should consider operating multiple (instead of single) factories in China. Where practical, these factories should be located in different regions of China in order to lessen the risks from energy shortages.

XI. FIVE EMERGING TRENDS IN CHINA

***Trend One*:** The Chinese economy's demands for energy of all kinds will continue to grow over the next decade. This will force up the costs of Chinese labor and manufactured goods and will put pressure on Western consumers for the same resources. Prices for commodities are unlikely to moderate.

***Trend Two*:** China's growing domestic consumption of Chinese-made goods and services will create additional opportunities for foreign direct investment. This will accelerate the demand by Chinese entities for key technologies and intellectual property currently owned by foreign companies.

***Trend Three*:** Unless China more aggressively addresses its infrastructure weaknesses, economic growth rates will be suppressed due to unreliable energy for Chinese manufacturing facilities.

***Trend Four*:** China's major foreign partners will continue to pressure Chinese officials to float the reminbi on international monetary markets. The external pressures for greater transparency and stability in the Chinese economy

will continue to accelerate. In the short run, this will add to instability and pose problems for foreign investors.

***Trend Five*:** Chinese companies are becoming more aggressive in seeking partners and acquisition targets in key industries outside China as they attempt to recirculate massive foreign currency reserves. Two examples are (1) Lenovo's purchase of the IBM computer line, and (2) the failed $18.3 billion USD bid by the Chinese National Oil Company for the U.S. petroleum giant UNOCAL. This trend presents both an opportunity and a threat to American, European, Australian, and Asian companies with interests in China.