

SOURCING IN CHINA

Lessons from Experience

國人民銀行

BY HOWARD B. HILL

China has come a long way since formal recognition by President Carter in 1978 allowed ordinary U.S. citizens to visit and explore business opportunities in what was and is the world's most populous market.

In the early years, U.S. business in China was conducted at the Canton Trade Fair, which, at the time, resembled a job fair in an American high school gym. To get there from Hong Kong meant carrying your bags across a bridge at the border of the New Territories into China to board the Orient Express for Canton (Guangzhou). Upon arrival, all foreigners stayed at a designated hotel where the mosquito netting hung over the beds was so full of holes that it precluded only flying chickens.

Years later, Beijing and Shanghai had grown from quiet surroundings marked by dull grey Mao jackets and Communist architecture to gleaming office buildings and hotels. No longer did one have to carry in spare parts for the copier and cheese for the resident expatriates cooped up in hotel rooms doubling as offices.

The trade statistics speak for themselves: based on U.S. Department of Commerce figures, the United States has a projected trade deficit with China in 2005 of over \$209 billion—the largest single deficit with any one country. The main attraction for sourcing is the low cost of manual labor and minimal overheads, such as expensive health care and pension legacy costs, and environmental and OSHA compliance.

Deciding to Source in China

All overseas sourcing has hidden costs and risks, but these are magnified with China and must be carefully weighed.

Costs

China offers great savings when product costs involve a high percentage of manual labor. These savings are reduced when manufacturing is highly automated. Given the great distance and dependence on ocean shipment, your client can face increased freight costs and risk delays. Other less obvious costs to your client include those for carrying a “safety stock” of inventory to cover delays or defective products; China’s need to import oil and many raw materials, for which availability and cost become an issue on the spot market; and the inability to quickly change product mix as the market changes. Duties may also have to be paid on both raw material imported into China and finished goods imported into the United States. Further, China’s wages have increased over the years and its currency also faces continual revaluation to ward off U.S. protectionism.

Communication

China’s distance from the U.S. and the significant time zone and language differences make communication more difficult and increase the time and effort required to conduct business. Travel to and from China is a minimum of four days, jet lag is very real, and Chinese visas must be secured in advance.

Competitors

Sourcing in China may result in putting a low-cost competitor in business against your client using the client’s technology. Companies sourcing in China will spend considerable effort in transferring their designs, tooling, quality procedures, patents, and know-how to en-

sure that the products the company buys will be of the same quality as those currently produced in the United States. Once knowledge and technology are transferred, they are difficult to reclaim. China has a problematic legal system and business culture, which fails to adequately protect technology, particularly know-how.

Political Factors

The decision to source from China inevitably leads to a reduction in labor force and plant closures in the U.S. This in turn could generate adverse labor union/local community and government reaction. This can also eliminate your client’s backup supply in the event problems develop with overseas sourcing. China itself also faces future uncertainty—government succession, Taiwan reunification, and U.S. trade protectionist restrictions on imports.

Finding/Qualifying Suppliers

Finding the right supplier in China can be difficult. A Chinese company lured by the higher prices and foreign currency earned with foreign sales may exaggerate its capability and resources. Moreover, it may not be the actual manufacturer, but a third-party broker/export company. Using such third-party brokers can be more expensive for your client, but may also provide the added benefits of bilingual capability, greater familiarity with Chinese business culture, and much-needed on-site after-sales service for companies with limited resources.

Begin by developing a detailed checklist of what criteria any supplier, either a manufacturer or third-party broker, must possess for your client’s job, and then gather all relevant information concerning the supplier—industry experience, trained personnel, factory capacity, state-of-art equipment, necessary technology, competence, reliability and ethics of management, and access to financing. Ask about



FAST FACTS

Know the hidden costs and risks of Chinese sourcing.

Research the supplier and Chinese business culture.

Don’t assume anything; have detailed product specifications and quality inspections.

the supplier's access to raw materials: are they imported, available, and at what cost? Are they available only from a politically unacceptable or unstable source? Find out if the supplier markets in China and what it markets there. Ask if it has a U.S. presence. Review the supplier's annual reports and financials. Find out if it shares government ownership. Ask a local attorney to check the government registry to confirm the supplier is in good standing with local governmental authorities. Check references and find out about the sup-

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plier's general reputation. Ask if the supplier has worked with other foreign customers, and get specific names and phone numbers of the supplier's other foreign customers for follow-up.

Once the list of potential suppliers is narrowed based on the results of your investigation, visit the manufacturers' and their major subcontractors' plants in China. Bring along a seasoned manufacturing expert with industry experience who can meaningfully observe whether the plant is run well and can produce the quality goods your client desires in a timely fashion.

Once due diligence is completed and discussions begin, advise your client to be discrete with imparting his/her own valuable information. Do not disclose information beyond publicly distributed annual reports and product catalogues. Do not provide CAD/CAM drawings with the new product designs. Warn clients not to reveal valuable know-how during discussions that may constitute a major portion of your client's competitive edge.

Negotiations in Chinese Business Culture

All cultures are unique and complex, and few Americans have had the opportunity to study the Chinese culture or language. Chinese business culture can be radically different from that of the U.S. Provincial Chinese authorities act independently, and rivalries between local provincial heads of government and the various agencies seeking investment will affect the success of your client's business dealings there.

In China, the western-style written contract is less important than the personal long-term relationship developed with your counterpart to engender trust and flexibility. This will evolve over time. Nurturing this relationship is a time-consuming task that will require multiple in-person visits per year.

The Chinese business culture values preparation, and the system is one of careful consensus. There is a frequent need for Chinese managers to consult other groups after a meeting. Refrain from pushing for an immediate decision if there is hesitation. Most meetings end with some form of written "memo of understanding" that may be related more to goodwill generally than your client's deal

specifically. Negotiations may never end. Even if the contract is signed, a continuum of discussions and requests for clarification will follow, particularly if business circumstances change.

Be wary of the apparent ability or inability of your counterpart to speak English. "Yes" may mean "I hear you," not "I agree with you;" or it may serve as cover for an area not clearly understood. On the other hand, your counterpart may understand more than you believe, so care is advised in private conversations. The ability to read nonverbal communication is as important as verbal in these settings.

Interest in controlling expenses often outweighs interest in quality. Therefore, it is essential to provide detailed material and product specifications to a supplier. A tailored shirt once ordered by the author in Hong Kong without specifications as to the strength of the thread or thickness of the buttons returned from its first wash without its sleeves and entirely without buttons.

Unique Contract Issues

The major concerns with Chinese contracts are defining the product, setting payment terms, protecting the technology, assuring quality, and handling claims and disputes.

Product/Service

Don't assume the supplier has the same product in mind as your client. Detailed specifications as to the product, performance criteria, quality, composition of raw materials, and unique packaging or design should be attached to the contract. Know exactly what is being purchased. Don't assume anything.

Payment Terms

Letters of credit may be requested on the first few shipments if your company is unknown or small. Instead of lump-sum payments, schedule progress payments keyed to specific events: contract signing, shipment, arrival in the U.S. port, and final inspection of the goods. Retain at least 15 percent of the total price as a performance bond to be paid after the goods arrive and pass the quality tests. Insist on a right of set-off for bad product and any costs in repairing bad product stateside, since shipping it back to the Chinese factory is not cost effective. Be aware of who selects the shipping, insurance, or warehousing companies. Chinese carriers frequently rebate money back to the Chinese vendor. Either way, your client will pay these charges, but he/she should factor it in when negotiating price.

Protecting Technology

Product counterfeiting remains a problem in China, despite official proclamations to the contrary. Street copies of the latest films are available before the film is officially released. While there are now Chinese laws on secrecy and against counterfeiting, practical enforcement in China is difficult and generally nonexistent. Always sign U.S.-style secrecy agreements with authorized signatories before any

discussions begin, and make sure that subcontractors are also covered. If products are covered by patents, copyrights, or trademarks, make sure the filings are current in China before discussions begin.

Quality

Formerly, the biggest problem of Chinese products was the quality. The local market was not demanding, and all the companies were government-owned, designed to keep workers employed—not produce quality—which invariably costs more. Things have changed dramatically, but it is still essential to have local representatives continually visit the factories and inspect the goods before shipment. This could forestall a cost-prohibitive return to China of a shipload of defective product sent to the United States.

Claims and Disputes

It is not in the Chinese culture or personality to sue. The preferred method of dispute resolution is to discuss problems and reach agreement. As Chinese companies have grown in size and sophistication, many have hired U.S. lawyers, resulting in underlying disputes over governing law. The Chinese may request that you accept local Chinese arbitration. This is not advised, as the influence of the Chinese government on its judges may still be strong. A frequent compromise is to provide for arbitration in a neutral forum, such as Sweden or the International Chamber of Commerce in London or Paris.

If a Chinese vendor has any government ownership—frequently provincial government—make sure there is a waiver of sovereign immunity so there is no argument over whether the Chinese company can be sued. Also, add the words “without reference to that state’s conflict of laws principles” to minimize the chances of a U.S. court’s referral of the matter back to Chinese jurisdiction.

Be advised, however, that regardless of where a judgment on the contract dispute is entered, it is difficult to enforce a judgment in China. Foreign judgments must be confirmed by a Chinese court within six months of entry and meet the Chinese tests of fairness. Having a right of set-off is helpful, but knowing the location of any U.S.-based assets of the Chinese company, such as a bank account, warehouse, or sales office, is important for recovery. Extensive due diligence prior to entering the contract will assist your client in this regard.

The liability issue is magnified when a U.S. company sells a defective Chinese-made product in the U.S., resulting in a product liability damage award against the U.S. company exceeding the amount available for set-off. Require the Chinese company to carry U.S. product liability insurance with a reputable U.S. carrier for such claims. Although the client will likely pay for the premiums in the cost of the product, it may be well worth the expense, particularly if the product is dangerous or defective.

Other Clauses

Other useful clauses in a Chinese contract include a requirement that the vendor obey all laws, including, without limitation, the

U.S. Foreign Corrupt Practices Act and the Export Administration Act, which governs export of U.S. goods to certain countries. Corruption is always a potential factor in overseas sourcing, and China has traditionally exported to countries not deemed desirable by the U.S. government.

If your client has major competitors also sourcing from China, a covenant not to compete and not to handle, manufacture, and/or supply competitive products should be sought from the Chinese supplier. Most clients’ upper management would not be happy with

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the prospect of their future designs, technology, or pricing strategies being available for use by the Chinese company or incorporated into products sold to competitors.

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In some cases, your client’s customers may require their suppliers to comply with business ethics codes. These codes usually deal with use of child, prison, or slave labor, payment of a fair or living wage, safe and healthy work conditions, and compliance with environmental standards. In addition to including such provisions in the supply contact, periodic visits must be made by the U.S. supplier to audit and ensure actual compliance.

Never Assume or Take Anything for Granted—Follow Up

After the contract is signed, constant monitoring and follow-up is required. Commit the resources necessary in China, with either your client’s personnel or those of a hired representative. Care is advised because things may not always be what they appear, but by being aware of differences, doing your homework, and being open to change, successful sourcing from China can be concluded. ♦



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