



China Insights

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China Insurance Update

Despite the challenges posed by China's failure to comply with many of the commitments made upon its admission to the World Trade Organization in December 2001, U.S. businesses will continue to take advantage of the tremendous growth of China's economy. It should come as no surprise that the growth of direct foreign investment in China has resulted in significant changes in China's insurance industry.

Historically, China has been closed to foreign insurance underwriters and brokers. Fortunately for foreign participants in China's economy, these past restrictions are now being eased. Many of the world's largest insurance companies are entering the Chinese market, providing more choices for both domestic consumers and foreign investors, and this trend is expected to continue. Insurance premiums in China have increased roughly forty percent since December 2001; however, competition driven by the rapidly expanding insurance market in China has kept premiums in line with rates in many other countries.

There are many differences between the insurance products and services available in China and those provided in the United States. For example, historically, very little in the way of health and welfare benefits were available in China, except for state supported programs. Many of these programs are being enhanced

or modified to reflect current trends and comparable plans in other countries. Indeed, as of January 1, 2004, Chinese employers are required to contribute to occupational injury insurance funds and, as a result, employees should now have access to medical treatment and additional benefits upon certification of work related illnesses and injuries. The premiums for this coverage will be established by local governments. In another recent regulatory change, automotive liability policies must now provide for minimum coverage of RMB 200,000 (c.

\$25,000), an increase of RMB 150,000.

China's vast geography leads to many potential natural hazards including earthquake, windstorm, drought and flood, which reportedly result in upwards of RMB 100 billion (c. \$12 billion) of property damage each year. Proper risk assessment of these hazards is critical when considering a business venture in China. While customary property, liability, aviation, marine and other traditional product lines are available in China, policy limits, deductibles and specific perils covered may vary substantially from standard coverage in the United States.

Changes in China and its insurance market are taking place at a rapid pace. There continue to be many unanswered questions involving, among other things, the application of recent regulatory changes. Accordingly, much care should

“Proper risk assessment of these hazards is critical when considering a business venture in China.”

be exercised when considering risk management and insurance issues surrounding business and direct investments in China. Future issues of *China Insights* will, from time to time, address China's insurance market in greater detail.

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Golf Courses And Panhandlers

The desire to portray "images" appealing to foreign investors and thus fuel China's continued modernization, is creating legal and socio-economic struggles with far reaching ramifications. China's social structure grows more complex with the increasing affluence in certain cities and provinces. The central government's inability to enforce many important existing laws, while abandoning or abolishing others, raises questions as to whether these struggles may ultimately wreak havoc in a rapidly modernized communist society.

A recent Chinese newspaper reported that the proliferation of golf courses, without proper authorization from the central government's Ministry of Land and Resources, is undermining that ministry's efforts to plan and control the use of China's lands. China's land per capita is already less than half of the world's average, and arable land is disappearing at an alarming rate to, among other uses, golf courses. Why? Because local governments approve the construction of golf courses to portray the image of a good "investment environment" in development zones so as to appeal to

foreign investors. There are continued efforts to limit the wasteful and excessive use of arable land, but the desire of local government officials to woo foreign investment continues to stymie those efforts. Recognizing the immense population of China—truly many mouths to feed—preserving arable land for agricultural uses needs to be balanced with the desire of local governments to create affluence in their districts by attracting foreign investment.

In contrast, an article in the *New York Times* reported that China's larger cities are experiencing a marked increase in panhandling and homeless people. Again, the debate over what actions the government should take is peppered with concerns over "image", troubled by the effect panhandlers might have on tourists and foreign investors. (This debate is remarkably similar to the one in New York City not so long ago, as well as in other major U.S. cities.) Formerly, Chinese citizens were bound by a system of household registration and police could detain or repatriate a citizen not

"...China is experiencing the symptoms of rapid modernization."

carrying proper identification for their city. The abolishment or suspension of police ability to enforce the former "residency restrictions" in certain affluent cities and provinces has increased the mobility of Chinese as well as allowed for a growing recognition of individual rights. Adopting and enforcing legal remedies to preserve images of clean and prosperous cities without offending the growing recognition and appreciation of individual rights (and their applicability to rich and poor) in a communist society may be a daunting task.

The conclusion that can be drawn from these starkly different problems is simply that China is experiencing the symptoms of rapid modernization. The question that remains, and that we see

debated in U.S. papers daily, is whether the central Chinese government will be able to treat those symptoms and control the socio-economic side-effects of modernization through adoption of coherent laws and consistent enforcement of those laws.

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Constitutional Changes Address Human Rights and Property Rights

"The State respects and protects human rights..."

"Legally obtained private property of the citizens shall not be violated."

These two fundamental principles are now expressed in amendments to China's Constitution, formally approved on March 14, by the nearly 3,000 legislators attending the 10th National People's Congress in Beijing.

Human Rights

Chinese commentators suggest that elevating respect for, and protection of, human rights to a constitutional level indicates that securing citizens' rights will be promoted at a very high level, and recognizes the advances that China has made in achieving human rights protection over the past 20 years. Critics point out that, despite existing Chinese laws providing for freedom of speech and assembly, it is not uncommon for dissidents to be jailed, for protestors to be dispersed and for the press to be subject to censorship. The long term consequences of this constitutional recognition of human rights will depend on the extent to which implementing laws are adopted and, more importantly,

on the extent to which such laws are enforced by governmental officials.

Property Rights

The constitutional recognition of property rights reflects the reality that China's economy requires protection of such rights in order to attract investment and otherwise compete on a worldwide basis. Many existing Chinese laws already protect property rights, including many of the property rights of foreigners. It remains to be seen whether this constitutional recognition will result in an improved level of protection—particularly in the area of intellectual property, where protection remains problematic. The constitutional mandate does formally place the protection of the private property of Chinese citizens on an equal footing with public property. It is also possible that this amendment could address the growing complaints by farmers and other small landowners whose property is confiscated by local governments for the benefit of bigger businesses. As in the case of human rights, future legislation and enforcement will determine the long term outcome.

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Weighing the True Costs of Sourcing from China

It has been frequently touted that by sourcing goods and materials from China, many U.S. companies can significantly reduce manufacturing costs. It is not uncommon for companies that pursue a strategy of foreign sourcing to receive initial quotations from Chinese firms that equate to cost savings in excess of 50-70%. These lower-cost Chinese firms often prove to be a reliable and efficient source in a domestic company's supply-chain, therefore allow-

ing the company to achieve increased profits while not sacrificing overall product quality.

Before pursuing any strategy of foreign sourcing, however, it is important that companies consider the myriad of additional expected and unexpected costs to accurately gauge the true savings that might be realized. Without careful planning, unanticipated costs and problems associated with sourcing from Chinese firms can result in thinning rather than expanding profit margins, as well as disgruntled customers.

Freight costs are typically the most sizable expense. Shipping costs from China to a U.S. port often range from \$3,000-\$4,000, and these costs are only expected to rise given increased port security costs. Domestic shipping costs must also be factored in and can add an additional \$1,000 or more to the overall shipping expense.

Shipments may also have to be warehoused upon arrival in the U.S., as lead times of 60-90 days for Chinese sourced goods and materials is not uncommon. Therefore, careful planning is required if companies want to employ just-in-time manufacturing and avoid having to incur the costs associated with inventoried shipments. Many companies are staggering shipments so that there is always one shipment being loaded in China, another shipment in transit, and yet another shipment being unloaded domestically.

Furthermore, a company can expect to incur added costs relating to documentation of shipments, supplier monitoring, and resolution of product issues. There are international trade agreements, customs requirements, and assorted taxes

that all must be considered depending on the nature of the goods and materials being sourced.

To ensure high product quality and consistency, as well as timely delivery of shipments, it is essential that companies take sufficient time and exercise a

“...a failure to accurately gauge many unanticipated expenses can turn a cost cutting venture into a high cost nightmare.”

great deal of diligence in establishing a relationship with one or more reliable manufacturing sources. One way of doing this is to utilize well-qualified individuals who have extensive experience in selecting such manufacturing sources as well as in overseeing the entire China sourcing process.

Ultimately, if a company carefully plans its China sourcing strategy and engages well-qualified people with strong previous experience to facilitate the process, the venture can produce huge cost savings while maintaining or improving overall product quality. Companies, however, should pursue such a strategy very cautiously, as a failure to accurately gauge many unanticipated expenses can turn a cost cutting venture into a high cost nightmare.

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New Rules for Certain Foreign-funded Commercial Enterprises

Based on recent China press accounts, it has been reported that on April 16, China's Ministry of Commerce issued the “Administrative Measure on Foreign Investment in Commercial Areas.” This

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measure purports to implement certain commitments made by China in connection with its ascension to the World Trade Organization in 2001.

This measure replaces a pilot rule on foreign-funded commercial enterprises implemented in 1999, and purports to lower restrictive conditions that have been imposed on foreign-funded commercial enterprises by, among other things, curtailing requirements and restrictions on the location and number of foreign funded joint venture-owned stores after December 11, 2004.

Such foreign funded joint ventures are currently required to operate through joint ventures in which foreigners can hold a maximum 65 percent stake; and the location of the stores owned by such ventures have been permitted to operate only in major cities.

We expect that there will be further developments as more experience is gained in the implementation of these measures.

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OUR MISSION

Our China Group's mission is to assist U.S. companies in a wide range of industries to develop successful strategies for competing in an increasingly global economy. Although competition from China-based manufacturing will continue to stress U.S. manufacturers, increased commerce with China can also afford significant opportunities for U.S. companies to become stronger, more competitive and more stable by increasing their profitability and expanding their markets.

We assist U.S. companies in transactions involving: (1) developing U.S.-based solutions to competition from China; (2) sourcing components or products from China; (3) establishing strategic alliances and joint ventures for manufacturing and/or distribution in China; and (4) establishing wholly owned manufacturing or other business operations in China. We also assist in accessing China's growing markets.

We have extensive experience in counseling clients and helping them to structure China-related transactions, as well as in the negotiation and documentation of all aspects of such transactions, including capitalization structure, and operating control and governance issues.

We also understand the critical importance of intellectual property issues in China-related transactions. Our intellectual property lawyers are experienced in working with their China-based colleagues and with governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property.

We have an established network of experienced, competent and reliable U.S. and China-based service providers with whom we can orchestrate a complete China business solution for clients. These providers enable us to coordinate U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other matters for our clients—all in a seamless, cost effective manner.

HIGHLIGHTS

April 21-23, 2004

Allan Goldner met with industry representatives and governmental officials in Qingdao while participating in *The Chinese Investment & Trade Talks: Business Cooperation in the Automobile and Auto Parts Industry*, sponsored by the Qingdao Municipal People's Government, the China Association of Automobile Manufacturers, the China First Automobile Group Co., Ltd. and the Qingdao International Cooperation Association of Medium & Small Enterprises.

April 25-27, 2004

Allan Goldner met with officials of industrial parks designated as special trade zones in Suzhou and Wuxi.

For more information or to discuss any aspect of your China strategy, contact any member of our China Group:

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