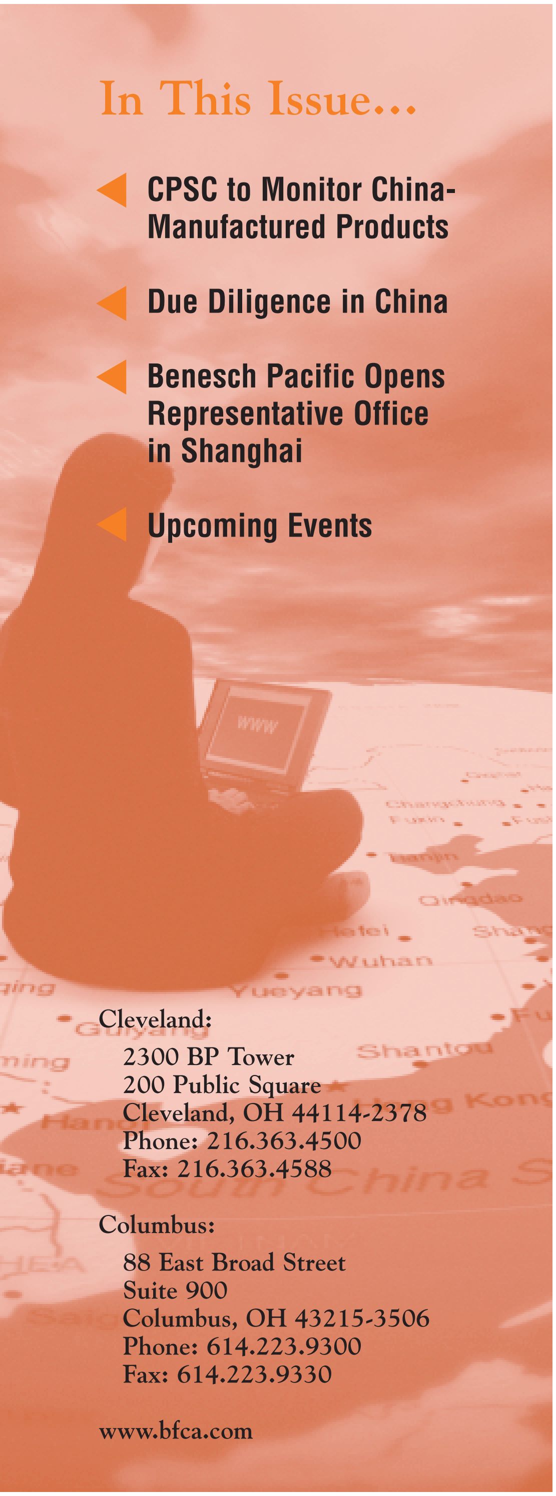
China Insights

September/October 2005



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CPSC to Monitor China-Manufactured Products

The Consumer Product Safety Commission (CPSC) has made public a detailed plan to monitor more closely the compliance of consumer goods imported from China into the United States. After conducting surveys involving product safety, the CPSC determined that China is the largest foreign source of unsafe consumer products to the United States. Specifically, the CPSC determined that "China is the leading foreign source of consumer goods for which the CPSC has directed product recalls or for which there have been seizures at ports of entry." In an area closely monitored by the CPSC, children's toys, the average annual recalls for toys manufactured in China account for more than 40 percent of all recalls.

In reaction to this finding, the CPSC recently announced the "International Consumer Product Safety Program Plan - China," a draft of its plans to influence and regulate the quality of products manufactured in China and imported to the United States. Initially, the CPSC's draft proposal suggests that it will focus efforts on the types of imported products that have been the subject of recalls or seizures. These products include:

- Clothing, textiles and toys;
- Hazardous products such as cigarette and multipurpose lighters;
- Home appliances;
- Hazardous chemical consumer products; and
- Bicycle helmets.

However, the long-term intent of the plan is plainly to develop a system of cooperation that will ultimately assist the CPSC in creating a uniform system of safety standards for products manufactured overseas, beginning with China as the United States' most significant trading partner. If the CPSC's plans become a reality, the systems put in place can easily be expanded to include other products, and other countries can use the system as a model. As a result, the CPSC's proposal could have far-reaching implications for all Chinese manufacturers and all importers of Chinese consumer products.

The first step in the CPSC's plan is to undertake a detailed comparison of the standards applicable to Chinese consumer products versus the equivalent U.S. product standards. This comparison will involve not only the mandatory rules and practices but also the applicable voluntary standards. The purpose of the CPSC review is to target the manufacturers and importers and to promote compliance with all applicable U.S. standards by emphasizing the fact that the CPSC requires compliance with both mandatory and voluntary consumer product standards. The CPSC hopes to reduce product recalls by educating Chinese manufacturers and importers on the fact that a failure to comply with a "voluntary" standard can cause a product to be deemed defective in a manner that creates a substantial product hazard resulting in a product recall.

The CPSC's proposed plan makes it clear that the CPSC's sights are set upon influencing its counterpart in China, the General Administration of Quality

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Supervision, Inspection and Quarantine (AQSIQ) to adopt and mandate standards equivalent to those in place in the United States. The two organizations have already entered into a "Memorandum of Understanding" (MOU) that outlines the common goal of protecting consumers of the five product types listed previously. Specific agreed-to MOU actions include an exchange of regulatory and technical information, joint participation in training laboratory and inspection personnel, and consulting on product safety issues. The two organizations intend to eventually develop a complete "Plan of Action on Cooperation" detailing the practical implications of the cooperative effort beginning in the fall of 2005. The CPSC and the AQSIQ intend to hold Biennial Consumer Product Safety Summits to discuss progress on addressing consumer safety issues.

Finally, a key part of the CPSC's plan is to seek the cooperation and involvement of governmental agencies in both the United States and in China. The CPSC plans to cultivate relationships with Chinese government officials on both a national and local basis as needed. Specifically, the CPSC intends to involve the China Standards Attaché in Beijing, the U.S. Embassy in Beijing and the U.S. Department of State when necessary to resolve issues. In the United States, it is most notable that the CPSC is developing plans to work more closely with the U.S. Customs and Border Patrol, presumably to evaluate the target products for compliance with United States standards before they cross the border for dissemination to U.S. consumers.

The proposed plan circulated by the CPSC is a "draft" that will be modified based on comments received from all sources, product-related experience, and further consultation with the Chinese government. No modification, however, will eliminate the clear message to importers and manufacturers of Chinese consumer products: if the consumer product was manufactured in China and falls into one of the five product classes currently identified by the CPSC, it will face heightened scrutiny by the CPSC. Now more than ever, strict compliance with U.S. standards - both voluntary industry and mandatory standards - is essential to avoid the threat of a costly product recall.

To have your products evaluated during the preproduction stages for compliance with applicable safety standards or to resolve product safety issues related specifically to products manufactured in China and targeted by the CPSC for industry evaluation, contact Mariann Butch at 216.363.4198 or mbutch@bfca.com.

Due Diligence in China

China's incredible economic growth is causing more and more businesses to develop a China strategy. These strategies often involve direct investment in China in the form of a newly-formed business, a joint venture with an existing business, or the acquisition of an existing business. The latter category can take the form of either a stock or asset transaction and may involve a purchase of (or from) a state-owned enterprise (SOE) or a privately-owned business with either Chinese or foreign owners or a combination of owners. This article considers some aspects of the due diligence process in connection with acquiring a business, establishing a wholly-owned business or entering into a joint venture in China (which, for purposes of this article, will be generally referred to simply as an "investment"). The information provided in this article is by no means comprehensive but rather should serve as a starting point for companies considering an investment in China.

In any China-based investment, the due diligence process will be the most critical step. China's legal system and courts are catching up with the country's rapid economic development; however, there is still much work to be done. As a practical matter, contracts in China may or may not be enforceable and, accordingly, there may be limited (or no) remedies available to a foreign investor seeking redress for a contract breach.[1] The uneven enforcement of commercial contracts in Chinese courts makes due diligence even more critical than in a U.S. or European based transaction.

As an initial matter, identifying a target will require extensive market knowledge (often from trusted third parties on the ground in China) and may include multiple trips to China to build a good relationship with the prospective seller or partner. Even after the "target" has been identified, it is safe to assume that business, legal and financial due diligence will be more difficult and time consuming than in the United States, or anywhere else in North America or Europe for that matter. Three of the most critical areas of diligence (and the ones where we most often see and hear of significant issues arising) are: employees' compensation and social benefits, taxes, and real estate and environmental matters, any of which could have a significant economic impact on an investment.

As any experienced China practitioner can attest, if you complete your diligence without uncovering material issues, you haven't looked hard enough. Moreover, there are many examples of otherwise prudent businesspeople taking unusual and unnecessary risks in China transactions in order to "get a deal done."

Such risks include having relied predominantly (and, in some cases, almost exclu-

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[1] While the parties cannot be assured as to the enforceability of their contracts, contracts are nonetheless very important for establishing a road map as to how the parties intend for the business relationship to work and to establish expectations between them.

Benesch Pacific Opens Representative Office in Shanghai

We are very pleased to announce the opening of a Representative Office, located in Shanghai, China, by our subsidiary, Benesch Pacific LLC. We are also pleased to announce that Benesch Pacific has hired Joanna Liao to manage our operations in Shanghai.

As you may know, we have been assisting clients with China-related legal and business matters since the mid-1990s. This work really started growing in the late 1990s and by the beginning of 2004, the volume and sophistication of our clients' China-related work expanded to the point that we established a China Practice Group. Today, this practice group is thriving, and Benesch Pacific having a Shanghai liaison office will permit us to better serve our clients.

In just the past 18 months, we have increased the size of our China Group to ten lawyers, including Yanping Wang, who is licensed to practice in both the P.R.C. and Ohio. Five of our lawyers have spent significant amounts of time in China on behalf of clients. The opening of the Benesch Pacific Shanghai liaison office and adding Ms. Liao are indicative of the firm's strong commitment to our China practice, and to serving our clients' China-related needs.

Ms. Liao, a non-lawyer, has both an engineering and business background. Her most recent business experience was as the manager for the Shanghai office of a U.S.-based global consulting firm. She is fluent in both Chinese and English, and is very familiar with working with governmental officials and business persons, and with managing a liaison office.

One Corporate Avenue (left), in Shanghai's LuWan District, home to Benesch Pacific's office

We look forward to continuing to expand our China practice as well as the scope of services we can offer our clients. Ms. Liao can be reached by phone at 86 21 6122 1098 and by fax at 86 21 6122 2418. Her e-mail address is jliao@bfca.com.

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sively) on their own relationships with the target's principals or with others who supposedly have connections and relationships with the target's principals or with governmental officials whose approvals may be required. To be sure, relationships (including positive special relationships sometimes referred to as "guanxi") can be very important. Indeed such relationships are often absolutely necessary in order to get a deal done, as well as in connection with the successful operation of the business going forward. Although relationships may be necessary, they are only part of the equation and they are not a substitute for conducting proper due diligence and negotiating and preparing complete documentation.

In the U.S., one way to limit the buyer's risks in an acquisition may be to structure the transaction as an asset sale instead of a stock sale. In an asset transaction, a buyer is able to pick and chose those liabilities that it is willing to assume, with the intention of avoiding "successor liability" claims. In China, however, successor liability is driven to a large degree by the status of the seller. If the seller is an SOE, successor liability is a given. If the seller is a private Chinese-owned business or a foreign-owned business, the legal concept of successor liability may not strictly apply -- but it is nevertheless likely to be a practical reality. Explaining to a vendor or a local tax official that you "only bought the assets and are not responsible for their unpaid claims" is not likely to be a successful method of dealing with unassumed liabilities. The same issue can also arise in the context of a joint venture with an existing business in China, as the addition of a new foreign joint venture partner often leads to a government audit for tax and social benefits compliance of the underlying business. It is possible that the new investor will find that large numbers of previously ignored regulations are suddenly being enforced and, moreover, that there is liability for unpaid past obligations as well as liability going forward.

Of course, there are many other considerations beyond due diligence in structuring an investment in China. These include selection of the type of entity to serve as the vehicle for the investment [a wholly foreign-owned enterprise (WFOE), an equity or contractual joint venture, a foreign invested commercial enterprise (FICE), or other type of entity] which will be driven by a number of factors. Other considerations are the overall tax structure, often including transfer pricing considerations, which should be evaluated by competent tax advisors as well as capital structure (i.e., total investment and registered capital), valuation of assets contributed as capital, business licenses, and repatriation of profits, to name a few.

Conducting proper business and legal due diligence is one of the challenges facing a company contemplating an investment in China. While conducting due diligence in China requires attention to a number of China-specific cultural considerations and local business circumstances, care must be taken to ensure that focusing on those special factors does not distract the investor from being as diligent as it would be in a domestic transaction. In other words, investors should not check their common sense and business judgment at the Chinese border.

For additional information, please contact Rob Marchant (rmarchant@bfca.com or 216.363.4489) or Peter Shelton (pshelton@bfca.com or 216.363.4169).

How We Work With Clients

We help U.S. companies: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally-related legal issues in China; (5) source components or products from China, and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We help clients structure, negotiate and document China-related transactions, and provide counsel with respect to capital structure, operating control, governance, due diligence and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers enable us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost effective manner.

Upcoming Events

For additional information, contact Megan Thomas at 216.363.4174 or mthomas@bfca.com.

September 28, 2005 – *Shanghai Office Reception*
Come celebrate the opening of the Representative Office in Shanghai by our subsidiary, Benesch Pacific LLC. Networking, cocktails and hors d'oeuvres.
Location: The Cleveland Benesch office

November 3, 2005 – Megan Mehalko and Peter Shelton will be presenting on China-related issues at *Opportunities in Manufacturing and Distribution,* a seminar co-sponsored by Benesch and Howard, Wershbale & Co.
Location: Cleveland, Ohio

November 10, 2005 – Peter Shelton and Marc Blubaugh will be presenting on China-related and logistics issues at the CEO Summit sponsored by Benesch, Plante & Moran, and Supply Chain Edge.
Location: Rosemont (Chicago), Illinois

October 2005 – Allan Goldner, Peter Shelton, Yanping Wang, and Benesch Managing Partner Jim Hill will be traveling extensively in China during the second half of October on behalf of clients and to meet with and further expand our network of business and legal contacts in China.

FOR MORE INFORMATION OR TO DISCUSS ANY ASPECT OF YOUR CHINA STRATEGY, CONTACT ANY MEMBER OF OUR CHINA GROUP:

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