China's Outbound Investment: Lessons From the Past

By Daniel F. Roules

Our world confronts a crisis in which the economic engines of the United States and Europe that have powered global development in recent decades have shuddered to a halt, and we look with both hope and trepidation to a new power rising in Asia. Many predict a wave of overseas investment by China-based companies, acquiring scarce resources and global brand names, in the coming decade. We experienced something similar in our recent past. In the 1980s, America's new economic policy combining tax cuts and massive defense spending had produced soaring federal budget deficits. The resulting inflationary expectations prompted America's central bank to push interest rates to their highest levels, nearly bringing the world's strongest economy to a halt. Meanwhile, a divided Europe was hobbled by the excesses of its state and private sectors. At that time, Japan's gradual development in prior decades caused it to emerge as a dominant global power. The covers of leading business magazines in the United States bore headlines such as "Japan Moves In," "Japan Invades Hollywood" and "Where Japan Will Strike Next," and scholars and business leaders struggled to understand what made Japan strong and to anticipate where its overseas growth might lead.

Will China's overseas expansion in the next decade be different from Japan's of 20 or 30 years ago? More importantly, what lessons can China-based companies learn from Japan's experience? As PRC-based companies expand their operations abroad, they will inevitably encounter legal risks that are unlike those in China. The goal of this article is to identify those risks and assist PRC-based companies in managing them. We will do this by first considering how China's overseas expansion today is both similar and different from that by Japan in the 1980s. We then articulate lessons that Japan-based companies learned, often from painful experience, two or three decades earlier. We will close with practical suggestions for those PRC-based companies that choose to participate in such outbound investment.

Because the legal systems of the world are so diverse, this article will focus on investments from China to the United States.

Comparisons of Overseas Investment by China and Japan

At the close of the world war in 1945, Japan was shattered, both economically and politically, yet it retained a well-educated and homogeneous population that had previously experienced substantial industrialization. In the years immediately following the war, Japan pioneered a softly authoritarian model for development in which the central government established collective goals for the nation and then encouraged the private sector to implement those goals through incentives and political or social pressure. In the 1950s, this system prompted Japan-based companies to take advantage of low-wage labor costs in its development of textiles and light industry. By the 1960s, Japan's success in those sectors allowed the country to begin to focus on economic growth through export and to actively seek to import technologies and manufacturing capabilities from abroad that would enable it to focus on more capital-intensive sectors such as automobiles, electronics and hi-tech. As a result, during the latter half of the 1960s and throughout the 1970s, Japan was emerging as a leading exporter to the world across many sectors. Then, by the 1980s, Japan's export-fueled growth had created the capital resources needed for a shift from export growth to foreign direct investment, principally in natural resources in Asia and the Middle East, in low-tech manufacturing in Asia and Latin America, and, eventually, in investments in developed markets such as the United States and Europe, particularly in the financial services sector.

China has adopted a similar model, but with a much more active role for the state. In 1970, China's economy was focused on heavy industry (defense, metals and chemicals), all directed by central planning rather than coordinated market forces as in Japan. Beginning with the reforms of Deng Xiao Ping in 1978, China began to liberalize its economy and to increasingly focus on textiles and light industry for export, much as Japan had done 25 years ago, but with more central direction. Such developments were pursued primarily only in certain coastal areas that were designated by the state as economic development zones and subject to substantial control. As that system has eased over the past 20 years, we have seen China, like Japan, shift its focus from labor-intensive exports to more capital- and technology-intense sectors such as automotive and hi-tech. And, like Japan in the mid-1980s, China today has the financial resources and the will to begin to shift its economy from one linked to export growth to one in which foreign direct investment plays a much more significant role. This also enables China to accomplish other strategic goals, such as securing the natural resources needed to sustain its development in the years ahead and to enhance its diplomatic standing.

The bulk of China's overseas investment to date (excluding round-trip investments designed for reinvestment back into China) has targeted the acquisition of strategic resources, primarily in lesser-developed regions. However, Chinese investors have generally demonstrated a reluctance to acquire entire companies, preferring minority interests and asset purchases. Such reluctance may, in part, result from concern about the ability to manage foreign operations and confront the risks endemic in operations in foreign jurisdictions. This paper now looks at some of those risks.

Lessons From the Japanese Experience of the 1980s

Despite the obvious cultural, historic and economic differences between Japan in the 1980s and China today, the preceding paragraphs reveal similarities that may offer lessons that will benefit PRC-based companies expanding to the United States. The US legal system contains features that created significant issues for Japanese investors and pose similar challenges for Chinese investors.

Prevalence of Litigation. The United States has the world's highest number of lawyers per capita, and Americans typically resolve more disputes through litigation than other countries do. Foreign companies operating in the United States, particularly those from Asia where litigation tends to be far less common, must be cautious in defending against legal actions.

Damages Recoverable Through Legal Actions. Perhaps the most important single factor is the far greater extent of damages that a party may recover through litigation than is the case in almost any other country. In most cases of business litigation – such as in a breach of contract case – a plaintiff may recover all damages that result from the breach, often including reasonably foreseeable consequential damages. In many cases, those damages may be far in excess of the profit expected from the contract or the total amount to be paid. By contrast, the PRC legal system typically does not allow for the recovery of consequential damages.

Jury System. In the United States, a jury comprised of ordinary citizens with no legal training will, in most cases, decide both who wins at trial and the amount of damages the losing party should pay. Jurors may be influenced by a wide range of factors unrelated to reason or fairness, which may lead, for example, to favoring an individual in its fight with a large company or to favoring a domestic company over a company from overseas.

Class Actions. Another factor that results in more lawsuits in the United States is the procedure called a "class action" in which, in certain circumstances, a group of individuals who have similar claims against a business or other party may combine their claims in a single lawsuit. This allows certain claims to be brought that would be too small to bring individually. Some of the most well-known recent class action cases in the United States have involved product liability cases against the tobacco industry or pharmaceutical companies, although class action cases are increasingly appearing in other areas, such as employment matters.

Unions. Although China has trade unions, there is no tradition of collective bargaining in China, and the mobilizing of laborers to protest the actions of a domestic employer is not encouraged. By contrast, many industries in the United States have experienced hostile and even violent clashes with union members. Adjusting to such a work environment may present challenges (or at least concerns) for PRC-based companies investing in the United States.

Anti-Discrimination Laws. The United States has adopted laws broadly prohibiting discrimination in the workplace on the basis of race, religion, age and gender, and protecting the rights of the disabled.

China's legal regime contains fewer such protections, and, consequently, practices that may be widely followed in China may result in damages or even criminal action if conducted in America.

Enforcement of Laws. China has some of the world's most advanced and stringent laws and regulations; however, enforcement in China is often uneven from one location to another. Partly due to its public court system, which generally upholds precedent and allows any court to follow the decisions of another, enforcement in the United States tends to be much more uniform, and laws, particularly bribery, IP protection and environmental laws, are strictly enforced. PRC-based companies must not rely on their ability to avoid detection in the enforcement of laws and regulations that may seem needlessly restrictive (or even contrary to customary business practices) in other areas of the world.

Practical Steps to Better Manage Legal Risks

With those features of the US legal system in mind, what practical steps should a PRC-based company take when entering the US market to better manage its legal risks?

Be Careful With Contracts. Most importantly, be aware of the basic ways in which one can manage risk through appropriate contract provisions. In any commercial relationship, certain contract provisions will favor one party, and other provisions the other party. So, although the contract needs to express the basic business arrangement, contractual provisions typically address important strategic considerations that can be extremely important in the future relationship between the parties, especially in the event of a dispute. If the other party prepares the first draft of any contract, one should assume that the provisions of that draft are those that favor that party, which is one reason why it is typically best to be the party that prepares the first draft of any contract. Following are some of the most important examples of such strategic provisions.

Limit Your Liability. As noted earlier, many companies from overseas are not aware of the extent to which their business in the United States may expose them to liability. A contract provides an opportunity to manage that exposure by limiting the liability that a party would have to the other party under the contract. For example, in a sales contract, a seller may limit its liability to the sale price of the product sold, rather than potentially being exposed to much larger damages. That requires the seller to add a provision to the contract that the buyer might prefer to avoid. Other limitations may be appropriate in other types of contracts, and it is important to consider whether such limitations would be appropriate in any contract.

Understand Indemnities. Contracts often contain indemnities – provisions under which a party assumes liability in addition to that which may arise from a breach of the contract. A party should analyze any indemnity provision very carefully and fully understood how it works before agreeing to it.

Specify How Disputes Will Be Resolved. Consider very carefully how disputes under the contract will be resolved, e.g., by litigation or by arbitration, and in what forum, and where. Given the cost of resolving disputes in the US, consider whether it would be prudent to specify that the party that wins any legal action will be entitled to recover its attorneys fees in addition to its regular damages. This can be a critical factor if a party needs to enforce a contract – for example, a nondisclosure agreement in which damages may be difficult to prove and the cost of enforcing the agreement may be high.

Be Alert to Export Control Issues. Particularly in the hi-tech area, the export of products and technology from the United States is strictly controlled, and the "export" of technology may be particularly easy to overlook. It may occur by carrying information out of the country in documents or on a computer, or by sending an email or fax overseas, or even by merely disclosing information to a foreign citizen in the United States. If products or technology are to be exported from the United States, all parties involved should understand the level of regulation involved and what level of government authorization may be required.

Protect and Respect Confidential Information. The United States has strong laws – both criminal and civil – protecting confidential technology and other business information. All companies should be sensitive to minimize cases in which they may come into possession of another company's confidential information – for example, through business relationships and when hiring employees – and to ensure that they have the right to appropriately use any third-party confidential information obtained. In addition, a company needs to ensure that it fully understands and strictly follows any nondisclosure agreement it may sign.

Be Mindful of Employment Matters. If a PRC-based company hires any US-based workers, it will become subject to US labor laws. This is a complicated area even for US domestic companies, and any employer needs to understand the basic rules applicable to such issues as hiring, management, promotion and discharge of employees, and try to avoid any issues of discrimination or sexual or other harassment. Unfortunately, this may be a particular risk for companies that have smaller offices in the United States since they cannot generally afford the sort of professional human resources staff that larger companies have. Smaller offices managed by executives sent from overseas may have the highest risk of making mistakes in this area, and the resulting potential liability may be out of proportion to the size of the office.

Carefully Select and Educate Personnel. Picking the right personnel to send to the United States or to involve with US business projects may be the most important legal risk management step that a PRC-based company may take. In many cases, legal problems could be directly attributed to personnel who were simply not suitable for the job they were sent to the United States to do. They may have been very effective business persons in their home country, but they were individuals who did not devote enough time to understanding the basic legal risks in the United States and to conducting their operations in a way that would comply with the applicable rules in order to minimize those risks. It makes sense to select personnel who will be well-suited for the environment in which they will be working and to give such personnel the basic training they will need to help them deal with the risks that they will encounter. That requires an investment of time and money, but it is far better and more economical to pay for such preventative medicine rather than to be exposed to the consequences that can arise from poor legal risk management.

Engage Experienced Legal Counsel. Finally, when investing or establishing operations in the United States, it is essential to have the advice of lawyers experienced with both US law and the laws and customs of China, can identify the risks that may be lurking and provide counsel on how best to control those risks before liabilities or problems arise.

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