



North American Suppliers In China: Adjusting To What Lies Ahead

Center for Automotive Research
Management Briefing Seminar

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DyKEMA
Results. Value. Dykema.

Center for Automotive Research



- Management Briefing Sessions for more than forty years
- Think of all the change that has occurred in auto during that time!
- Through CAR's sustained efforts, MBS has provided a splendid forum for needed discussion on a host of critical issues (e.g., a forty year "on-going dialogue")
- It's an important setting to interact and share views and theories
- Appreciate the opportunity to participate

The China Auto Market



- China – One of world's largest passenger vehicle markets
- Will continue to grow *significantly* within next few years
- “Virtually irresistible” to foreign automakers and suppliers

China Can Be Highly Profitable, But...



- Doing business profitably may be tough
- Many reasons – some legal
- Presentation will briefly address:
 - Why, in such a booming market, the China auto market can still be daunting for North American manufacturers;
 - Several recent legal developments in China of note and the potential impact of each; and
 - Legal concerns when importing products from China (and elsewhere)

Dykema's Automotive Practice



- 75 years of experience representing the automotive industry (www.dykema.com)
- Foreign and domestic OEMs and suppliers – extensive experience
- National practice – full service (e.g. corporate, litigation, regulatory)
- Member, World Services Group, see www.worldservicesgroup.com

*Please recognize that nothing in this presentation or any comments offered during the panel discussion should be taken as legal advice. It is not.

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Purpose(s) for Investing In China?



- Traditional reasons
 - Low manufacturing costs
 - Access to enormous markets
- Certain legal “assumptions”
 - Intellectual property (2nd generation technology)
 - Labor (employee relations) (low wages)
 - Mergers & acquisitions (opportunities to expand)
 - Tax (credits & incentives)
 - Attractive legal combination for FDI
- Focus on examples of how legal landscape is evolving, perhaps significantly

China Automotive Policies & Regulations

- Government “owns” *and* “regulates” the auto industry
 - Foreign Ownership of OEMs restricted to no more than 50% (expanded by Chinese government to include engines, too)
 - Max - two JVs for passenger vehicles & two for commercial vehicles per foreign company
 - Automotive projects require scope & investment approval by government (National Development and Reform Commission)
 - Of note, automotive standards & regulations aligned closely with Europe, not the United States
- Two preliminary points

1. China's Government (i.e. Central and Regional) Has Enormous Influence Over Auto Industry

- “Authoritarian capitalism” – Wolf, Financial Times (11/7/08)
- Nationally, the Chinese government has designated the auto industry as one of the country's “pillar industries” (i.e., national policy – organized and globally competitive)
- Provincially, separate goals and challenges, different stages of development
- Need to understand how to do business in different provinces (e.g. established v. emerging)
- China's government has an auto industry consolidation plan; industry will clearly consolidate
- Ultimate goal of China's government to develop national brand vehicles

2. Relationships are Crucial



- Finding and developing the right network of people (can be very time consuming)
- Cornerstone of doing business
 - Getting the operation started
 - Getting things done
 - Sustainability
- Do so legally (e.g. FCPA)

Foreign Corrupt Practices

- United States government has increased enforcement
 - DOJ collected \$627 million in fines in 2009 – up from \$87 million in 2007
- Generally, covers corrupt payments to foreign officials – defined broadly
 - In China, this includes a broad spectrum of individuals as the state heavily influences the economy
 - For example, employees of state-owned companies are considered government officials
- China has its own anti-bribery laws

Consider: There is no run-around the FCPA – know what is illegal under the FCPA, enact proper protocols, train for compliance, and detect such activity within your company.



Legal Challenges



- How to begin your operation?
 - Equity (DFI)
 - Contract (Supplier or License)
- If equity – Percentage Ownership
- Location – Incentives, Land, Logistics
- Sustaining your operation
- Many others
- Focus on five key examples

Intellectual Property



- Aggressively register Intellectual Property
- Monitor Registries – Dedicate people to IP protection
- Watch the markets for products like yours (e.g. reverse engineering)
- Educate suppliers re: enforcement
- Agreements to retain key employees
- “Second generation technology” – “pay to play”
- “Indigenous differentiation” – may win battle (e.g. short term gain), but lose war (e.g. IPR) (China model)
- Forces “foreign...companies to anguish over balancing today’s profits with tomorrow’s survival.”

“China Fuels Trade Tension with Policies, Report Says,”
Wall Street Journal (July 2010)

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Recent Major Legal Reforms

1. Labor
2. Tort
3. Antitrust
4. Tax



China Labor Contract Law

- Effective January 1, 2008
- All employers must maintain an employee handbook setting out the basic rules and regulations of employment
- Greatly limits the use of term contracts and probationary periods
- Additional restrictions on termination of employment
- All labor contracts must be in writing; greater role for labor unions
- Significant penalties for non-compliance (e.g. gives employees the right to private action)
- 2008 – 280,000 labor disputes
2009 – 30% higher

Consider: Take steps now to make sure you are in compliance, be proactive, reduce chance of getting sued



China's Anti-Monopoly Law

- September 2008 – Anti-Monopoly Law took effect (after thirteen years of study)
- New regulations and guidance continue to be issued. The law:
 - Requires notification of pending mergers and suspension of closing pending review and approval;
 - Prohibits “horizontal monopoly agreements” (e.g. price-fixing and market division); and
 - Prohibits “vertical monopoly agreements” (e.g. restricting resale prices of distributors).

Consider: When contemplating an acquisition with an effect in China, plan for review by MOFCOM (Commerce) and start consultations early.



Tort Liability Law

- Effective July 1, 2010
- Essentially summarizes existing tort-related liabilities, although contains new developments worth noting
 - Adoption of punitive damages for products liability
 - Extends recall process for defective products
 - Enhances liability for environmental pollution
 - Enhances protections for privacy
 - Increases employers' liabilities for dispatched laborers

Consider: It remains to be seen how this law will actually be enforced. It is likely, however, to encourage and facilitate greater tort litigation (foreign employers?).



Enterprise Income Tax Reform

- Attempts to unify tax law for Domestic Enterprises (“DE”) and Foreign Invested Enterprises (“FIE”)
- New Tax Resident Concept
- Removed many existing tax incentives for FIEs
- Removed reinvestment relief
- Removed dividend withholding exemption for FIEs
- Applies preferential rates for certain types of businesses
- Holds that Chinese bi-lateral tax treaty provisions take precedence over domestic law provisions when there is a conflict

Consider: Appropriate structures may be adopted to minimize the risk of being considered a tax resident enterprise in China. Otherwise, overseas business activities/ units may be deemed as a “tax resident enterprise” and exposed to worldwide tax in China.



Application of Laws



- Five attractive legal “assumptions” have been reformed in just the last two years
- Of particular note, China’s legal system enables selective enforcement

Permanent State of Transition



- So why could making a profit be challenging when sales forecasts are so enormous? (usual suspects)
 - Ferocious competition
 - Volatility of trade policies and exchange rates
 - Consolidation of foreign and domestic OEMs
 - Many other causes (e.g. expansion of entrants, overcapacity, margins, work stoppages)
- In addition, China's legal landscape continues to change
- Currently in a period of Made *In* China
- May be moving to Made *By* China
- If so, how long will that transition take?

In-Bound Legal Concerns – An Example



- Legal developments in the United States, too
- Conference focus on China – So just one example!
- Importer Liability
- FMLAA – *Proposed* Legislation

Consumers & the Public

Importer Liability

- Vehicle Safety Act definition of “manufacturer” includes importers, 49 USC 30102(5)
- Vehicle Safety Act prohibits, among other things, importing motor vehicles or items of motor vehicle equipment unless it satisfies all applicable FMVSSs, 49 USC 30112(a)
- Importers are responsible in U.S. to conduct and pay for recalls or other field campaigns
- Potential liability can include civil fines, criminal penalties, and product liability exposure (e.g. jurisdiction)

Imported Product Safety



- Import Crisis from China (2007)
 - FTS Tire
 - Unregulated aftermarket auto parts
 - Milk
 - Toothpaste
 - Other products

Memorandum of Cooperation

(September 12, 2007)


- Collaborative Response by China and United States
 - Health, safety, environmental
 - Consumer protection important to both nations
 - Enhance cooperation in matters relating to motor vehicle technical regulation & safety
- Example of mutually beneficial response to a crisis

U.S. Government Response to Crisis



- A Report to the President, “Protecting American Consumers Every Step of the Way: A strategic framework for continual improvement in import safety” (September 10, 2007)
- A Report to the President, “Action Plan for Import Safety: A roadmap for continual improvement” (November 6, 2007)

Import Safety – Action Plan



- Framework for cooperation
- 80 pages, www.importsafety.gov
- 14 broad recommendations
- 50 specific action steps (examples)
 - Best practices
 - Compliance
 - Supply chain monitoring for safety
 - Recall rapid response plans
- 73 Fed Reg 79207 (December 24,2008 (history))

Foreign Manufacturers Legal Accountability Act (FMLAA) (Proposed Legislation)

- H.R. 4678 – Voted out of House Energy and Commerce Committee July 21, 2010
- Objective – Subject foreign manufacturers to same legal liability as U.S. companies for defective products sold in U.S.
 - Original bill did not include NHTSA or motor vehicles or equipment; bill amended to add NHTSA and motor vehicles and equipment on June 30, 2010
 - Foreign companies that export products to U.S. must maintain registered U.S. agent for service of process unless (1) foreign companies are owned or controlled by U.S. entities with greater assets, or (2) have U.S. affiliate which agrees to be responsible for any liability
 - Products of non-complying foreign companies would be subject to import ban
 - Covered products include components incorporated into U.S. finished products; agencies would have authority to set minimum product volume threshold

Conclusion



- China is an incredible country
- Very dynamic and complex times in the *evolving* legal relationship between the United States and China
- Understandably, both governments have plans and have taken action to enhance their automotive industries
- As China's government implements policies that favor domestics, it raises understandable concerns for U.S. companies in China
- Critical to assess where China is (legally) *as well as* where it appears headed – level of investment warrants no less

Conclusion



- We have a responsibility to the Chinese
- They need our assistance to adapt just as we need China (e.g. two ends of telescope)
- Sustained open dialogue is essential
- Discover common ground, collaborative solutions, and mutual success (e.g. September 12, 2007 MOC)
- So, what lies ahead? Are we on the road from made in to made by China? Perhaps. Or perhaps it will be made *with* China - e.g. R&D in China).
- “It’s too early to tell” - Deng Xioaping

Contact Information



Thank you!

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The logo for the Motor Business Summit (MBS) is displayed in large, bold, white letters with a slight shadow effect. The background of the entire page is a blurred, high-speed photograph of a car's front end, showing the headlight and wheel, with a warm, golden-yellow color palette.

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