

# **ÆGIS**



## ***Addressing threats that affect your bottom line***

Volume 8 Number 2, February 2005

From the case files of

**The LUBRINCO Group**

<http://www.lubrinco.com/>

and

**Financial Examinations and Evaluations, Inc.**

<http://www.feeinc.com/>

**Asset location in fraud, theft, and divorce? Call us!**

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**L. Burke Files will be speaking at the Offshore Summit**  
**21-22 April in Miami, Florida**  
*[www.samuelgroup.com](http://www.samuelgroup.com)*

**Richard Isaacs will be speaking at CPM 2005 West**  
**24-26 May 2005, Las Vegas, Nevada, USA**  
<http://www.contingencyplanningexpo.com/information/invitation.asp>

## **1. Asset Location and Due Diligence — Western style v. Chinese style**

We have often described due diligence as an independent fact finding process to determine who is the fox and who is the rabbit, with the result often being a surprise.

In the West, the information needed for the exercise of due diligence is readily available: Who owns what; where people have gone to school; what idea or patent or copyright belongs to whom. We are able to search public databases, public courts corporate filings, licensing bodies, et cetera. In the West we have an open culture of sharing information not only among ourselves, but with anyone who is willing to read or do the research. There are books on how to do competitive intelligence. There are seminars on how to research your competitor. There are books, courses, and legal requirements for companies to conduct some type of due diligence before investing or making representations to investors.

Until 20 or so years ago, China was a closed society deeply embracing Communist values, societal roles, and norms. The information needed for the exercise of due diligence was not available. Information was centralized and tightly controlled, if not classified. It was proprietary, and a source of power. (Information has always been a source of power). Nor had such information ever been available in that fractured country. China began opening to the world just as WWI and WWII raged. The internal factions during this time subsided just long enough to fend off the Japanese and then closed again in the late 50s. Centralized information was the property of the state, not of commerce, because the state was the engine of all commerce.

The Chinese are a highly developed culture and deeply engrossed with internal commerce, so this did not mean that the Chinese were blind and faithfully trusting one another. Rather, the Chinese developed a strong desire to do business and trade with those people they knew and with whom they were friends. People, for the most part, are by nature not going to take advantage of those with whom they are close. Nor are they going to mistreat or behave poorly in a closed community. If they were to do so, the

information grapevine would broadcast their misdeeds and that would be the end of that person's reputation. In this best of all possible worlds, friends don't cheat friends and family doesn't cheat family.

This process of socialization also allows prospective participants to gage one another's abilities. It is a process of sizing up one's business partner, or opponent that is as old as the ages and to a keen person is finer than all of the fancy due diligence documents prepared by the likes of us. But it takes time and it takes a commitment to the process.

Lacking a formalized public information structure, the Chinese method of due diligence was to share with the other party information about your family, about your method of doing business, and a correct impression of your abilities and values. This ritualistic process has its rules and etiquette. And you need to learn more about them to avoid making the big mistakes.

As a foreigner, one of the biggest mistakes is thinking that you are the more knowledgeable, or somehow superior. You are a foreigner in a foreign land – a land that is thousands of years old, has well established rules, and where most foreigners have behaved abominably for the last several hundred years. That is why you may be thought of as a “foreign devil,” for that is what most of us have been until the last 20 years or so.

Another mistake is thinking that you can get done what you need to do in a few days. That will not happen: The Chinese do not work that way. Unless you are looking to waste your commercial time in China avoid the quick trip.

While the Chinese work the social and professional grapevines for past information, their due diligence is very much future driven. It is about forging relationships and working toward developing those relations today, and into the future.

The Western process of due diligence is about historical information. Has this person or company ever done something bad in the past, or have they disclosed all of the required items, and does the third party verification of those items support or contradict the disclosure? It is a process of matching what has been done with what is represented as having been done. It is past and present driven.

For due diligence to work, consumers of the information produced by the exercise of due diligence must – MUST – subordinate their egos to the dicta of the information.

The Chinese know that many Western businessmen get reports and put them in a drawer, and many Chinese have no qualms about skinning another

ignorant hard-charging businessman who is arriving with the new “Chinese Strategic Stratagem Strategies” (whatever they may be) to help his company. By some estimates, over 50% of embassy time of Western embassies is spent dealing with failed Chinese Strategic Stratagem Strategies with embassy workers looking at the opportunities that once were. The post mortem is almost always the same with the cause of death listed as “death by misadventure” followed by, “These are well known problems. Why didn’t they do their homework?”

## **2. OPSEC, Economic Espionage, and Competitive Intelligence — Intellectual property in China**

China has intellectual property laws that have, from time to time, been enforced. Like all other intellectual property cases, they are never as straightforward as they may seem at first.

As an example, China has a body of law for trademarks. One can register the trademark in China relatively inexpensively. The trademark laws conform to most international standards, with a few quirks that are best explained by Chinese legal counsel.

The Chinese also have patent laws, and one can file a patent in China. This is not as easy as a trademark filing, but that is no surprise. Trademarks are more of a declaration that a governing body accepts with little fanfare or research. It is up to you to defend it. A patent is a monopoly on a significant item of technology that is considered to be so unique that its use and licensure is given solely to the patent holder by the issuing governing body. Thus, those who submit for a patent need to submit for a patent examination with a clear defensible position of its uniqueness.

The Chinese have an extensive library of what has gone before and are not as likely to grant a patent as, say, the US or Europe. Further, as is their sovereign prerogative, while patenting something in the US or EU may give you a defense in other parts of the world, it will give you none in China. If you want patent protection in China you need to file your patent in China.

Patents are public information, and Chinese entrepreneurs know this and keep a watchful eye on those patents that have been issued. Once issued in the US or Europe, a Chinese person may just copy the already issued patent and file it in China. Why? Because they can, if you have not protected yourself by filing in China. Thus, if you have filed for a patent or a trademark in the US, and later file for a patent or a trademark in China, you run the risk that an intellectual property squatter has arrived before you.

Remember, all of the Internet domain name squatters from a few years ago? It's the same game, different ball.

Enforcement of international patents is done on a case-by-case basis. If the Chinese company violating your patents and trademarks has significant local employment, you may have great difficulty. You may be able to stop the exportation of the pirated product, but it is unlikely that domestic consumption will be halted. On the other hand, if you can show that Chinese patents and trademarks that have been filed, you may find yourself quite surprised – and pleasantly so – by the reaction of both the courts and the new Chinese enforcement mechanisms.

The essential caveat is you must also be sensitive to the differences between domestic manufacturing for export and domestic manufacturing for local consumption. If you are not concerned about local knockoffs, so be it. If you are concerned about the domestic Chinese market, then you need to be prepared to defend your property. One interesting tactic is to make the product useless without some additional work. One of our clients designed their mechanical gizmo (it was explained what it did for cars, but it was lost on us) to have a special controller part installed after it had reached Canada. Thus, while the unit was mechanically sound when it left China, it was not operable. It was not a functioning part until after the controller unit was installed. It is a simple old tactic of getting the most labor intensive parts made in one location, and a sensitive and key part made in another, with the two being married at a third destination that is under your control.

In summary, the bad news is that commercial properties and technology will be taken as you move operations overseas, whether it be to China, India, Mexico, or France. The good news is that if you are aware of the potential problems, defensive measures can be constructed in advance. Know your environment and prepare for it in advance.

### **3. Executive Protection — China**

The threat of being kidnapped to any western executive in your charge is very small. The threat that any western executive will suffer from any other harm is very low, unless of course that executive arrives on a pretext and starts spouting free Tibet rhetoric, or advocating other items of social unrest. If this is the case you can consider your charge dropkicked out of the country. Bad guests are bad guest no matter where they are.

The real challenges will come from the difference in cultures and information gathering styles.

## ***Food***

The Chinese eat a wide variety of foods. We have had deep fried baby shrimp and fish, squid egg soup, 1,000-year-old eggs (actually only about 90 days), donkey (it tastes like horse), eel, chicken intestines, and fish gelatin. We like to eat different foods, and all of these dishes – and many more – were very tasty. We are beholden to our hosts for opening the many different facets of Chinese high cuisine to us. Now, when we discussed this with our office staff, a few of them choked and nearly gagged. If you do not like this variety of foods, tell your host in advance, but do not insult them by refusing something. One globetrotting executive is a vegetarian. On her many trips to China she has explained this in advance and has had no problems. Thus, she has not had to refuse food and embarrass herself or her hosts. Even better, because her hosts understood this in advance, they took the effort to introduce her to some very fine and rare desert melons, which she would not otherwise have encountered.

## ***Liquor***

Some like to drink alcohol, others do not. If you don't like to drink, tell them that and take tea or soft drinks. If you like to have a drink, steel yourself for Chinese Rice Liquor. It is about 60-proof. If you wish to try it in advance you can find it at most Chinese grocery stores around the globe. The rice liquor is milder in flavor than Japanese sake, but with a powerful kick. It is taken neat at room temperature in small glasses. Part of what your hosts are looking for is how you conduct yourself when drunk: Are you a braggart? Are you an angry drunk? Are you the same person after the liquor as you were before the liquor?

## ***Ladies***

It is not uncommon to offer the male executive female companionship. Make your mind up in advance if you will accept the offer. If not, be prepared with a polite “thank you, but I must not.” Don't be rude or shocked: It is an offer of some significance.

## ***Information***

The Chinese gather information the old fashion way: They listen, watch, and digest what you do and say. You will find opportunities at bars and social clubs to discuss the day's events and future strategies. But odds are that if you are a person of significance, someone will be listening to what you are

saying. If you are at one of the social clubs in the hotels that cater to western visitors, you can be sure of it. This is done in most countries. It is done in the US and Europe, especially France, all the time. In fact, competitive intelligence in the US is sometimes harvested by hanging out at “company” bars. The Chinese are just better at it and more organized than most.

### ***Equipment***

The importation of technical equipment into China can be difficult and perilous. If the inspector does not know what it is, it may not get in. If someone does know what it is, it still may not get it. If it looks valuable, it may just disappear, just like in the San Juan airport. As always, airlines disavow losses of bags or damage to fragile items unless declared and insured in advance. There are many different ways to clear this equipment, but what needs to be done can be very specific to the equipment. One company was importing livestock embryos for implantation. While the embryos were permitted, the container that held them was not, and was opened to see what was inside. End of embryos.

Always clear what technical equipment you are going to bring into the country, and do it well ahead of arrival.

### **4. Technical Issues — Standards and non-standard standards**

In order to facilitate international trade, China is overhauling its national technical standards to make sure they comply with domestic economic development needs.

What they are trying to do through the Standardization Administration of China is to eliminate outdated and ineffective national standards, while taking a hard look at how China’s compulsory standards conform to the World Trade Organization’s Agreement on Technical Barriers to Trade (WTO/TBT).

As simple as standardization sounds, it is an enormous problem, both for Chinese manufacturers making and shipping goods abroad, as well as those wishing to sell into China.

We may not be aware of them, but there are many different standards that have been adopted throughout the world. These standards have harmonized trade, and normalized many of the goods and products we purchase and consume.

For example, long before we purchase a drill made in Italy, that drill has been submitted to an independent laboratory for the testing of the standards

it is required to meet, not only for sale within the country, but for sale in other countries. For a drill there are many safety standards, and there are electrical emission standards. If these manufacturing standards are not met, or the drill emits too much extraneous electrical interference, the drill will have to be redesigned to meet those standards. Failure to meet those standards renders the product un-importable.

China has compulsory standards for many of the goods manufactured domestically for the consumption by its citizens. Whether these standards are better or worse is not the issue: The issue is that they are different. Further, there are many items for which China has not developed standards, where such exist in the rest of the world.

The problem is seen when a container of toasters not been certified to meet the standards required to allowed entry into the US arrives on a dock in Seattle. When this occurs, the exporter claims there are trade barriers. The destination country retorts and says no barriers only standards, and these goods have not been certified to meet those standards, so no entry.

Nearly 14 percent of China's 20,906 national standards are compulsory. They cover areas such as products, safety, hygiene, and environmental protection. The remaining national standards will be removed, modified, or merged with similar standards, depending on how they fit in with economic development and market demands. More than 2,300 new national standards that were planned before 2000 are still being drafted. China is trying to step up its adoption of advanced international standards, which are key to production efficiency and international trade. By the end of 2003, 44.2 percent of China's national standards were based on international and foreign standards. However, many were based on foreign standards that were issued decades ago. By 2006, China expects to have 70 percent of its national standards derived from advanced international and foreign standards.

The success of China's shipbuilding sector demonstrates the importance of following global standards practices. More than 80 percent of its technical standards are based on international standards, a fact that has helped China chalk up sales of \$8.5 billion between 2000 and 2003.

In the past the Chinese believed foreign enterprises controlled an industry, and held Chinese rivals back by formulating these "standards." The standards eventually realized that companies don't make profits through secretive standards – the standards are published and public – but that companies prosper through use of other advantages in given markets, with products that meet or exceed accepted standards.

## **5. Real Stories from the Field — We're not in Kansas any more!**

The people of China are wonderful and we always enjoy the opportunity to travel to our offices in Beijing, help clients, and learn more.

But to think that business practices and customs are the same in China as they are in the West is a fools dream. To reiterate, 50% or more of the time spent in western nations embassy is devoted to untangling business “issues” that would have been avoided through the foreknowledge that comes from the exercise of due diligence. This figure came from a China specialist with the IMF. While this appears to be an exaggeration to some degree, the damage done to those who have their “China Stratagem” blow up in their face is not.

“I have spent too much dissecting the fetid corpses of business persons’ Chinese Stratagems.” This wonderful word picture of the troubles of foreign business owners floundering in China is from a senior government official who inherits the messes when they fail, which they do with startling regularity.

Why does this happen? Each failure has its specific reasons, but all have the common thread. A failure happens when a business strategy does not work up to your expectations. The higher and more unrealistic your expectations, and the poorer your planning and due diligence, the more likely it is that you will fail.

You are leaving your home country not because you wish to, but because your industry has competitive pressures. Often, labor costs and regulations in your home country are killing your operation, to the point you soon will be, or are currently, no longer competitive. You have a problem, and your expectation is that a trip or two to China will solve the problem. After all, you say, many others have done it so why can't I?

However, you cannot share in their learning curve: You have to create part of your learning curve. But not all of it!

Learning from scratch is what most entrepreneurs tend to do, and it is expensive and often self-defeating. A saner alternative is to work with a professional firm, with roots in China, which can help you avoid some of the pitfalls of the new country, and also help develop custom solutions to your custom problems.

Expectations, when going into China – or for that matter anywhere other than where you are intimately familiar – are often very high. You have landed upon what you believe a solution to your problem and maybe even a new opportunity or two. But ....

China has an economy of favors. As with any other centrally planned economy where government plays a strong role, whom you know and how you can get to them is part of the currency of favors that keeps the economic engine rolling.

## **6. Book and Product Reviews**

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