A P E C CONFERENCE MAY 8 & 9, 1997

LEGAL ISSUES SURROUNDING ACCESS TO ASIA PACIFIC MARKETS INTRODUCTION OF THE FIRM:

It gives us great pleasure to participate in this year's Apec Customs Industry seminars in association with the Canadian Chamber of Commerce and the Government of Canada. Our presentation on legal issues surrounding access to Asia Pacific markets will be divided into three parts and presented to you by myself, Mitchell Brownstein, Managing Partner of Brownstein, Brownstein & Associates, Mr. Prashant Ajmera, our Asia Pacific Regional Director sitting at my right and Mr. Herbert Brownstein, Senior Partner sitting to my left.

We are a law firm who specializes in international business collaboration and business immigration. Representatives of our firm, including your three speakers today, have all participated on the Team Canada missions to Asia during the last several years and have provided seminars in Asian countries in association with the Chambers of Commerce from these foreign jurisdictions in order to inform our Asian counterparts of the legal issues surrounding access to Canadian markets. In addition to providing legal services, our firm specializes in finding the appropriate partners, customers or franchisees and ensuring that our clients both in Canada and abroad receive the proper legal advice based on the laws of the appropriate jurisdictions.

In order to determine if ones business is suitable for expansion in a particular country in the Asia Pacific region, a study must be undertaken to ensure that the laws of the foreign jurisdiction allow the existence of your type of business, the company structure that you may so desire and many other factors including cultural practices, enforcement considerations and political expectations to name but a few.

Once the preliminary study has shown the potential for positive results, the entrepreneur must consider whether they wish to operate in the foreign jurisdiction as a:

1. Direct operation

2. Joint Venture.

If the company feels that they have the ability to operate directly in the foreign jurisdiction without entering into a partnership with a local representative. One has to determine whether the direct operation should be:

a) A branch office

b) A representative office

c) Subsidiary company with a full operation which may provide service or manufacturing facilities.

A branch office would require the setting up of a direct extension of the head office in Canada in order to represent the company's products abroad for marketing and sale in the foreign jurisdiction.

A representative office is generally used for preliminary investigation in the foreign jurisdiction in order to promote a particular product or service of the company and study the manner in which the market can be expanded in the future.

A subsidiary company would require the registration of a new affiliated company based on the laws of the foreign jurisdiction which would have all the rights of any similar company operating under the laws of the foreign jurisdiction in order to provide services, sale or the manufacturing of goods.

JOINT VENTURE

Most businesses, especially midsized to large businesses, determine that the joint venture is usually the preferred mode of entry into new and often risky markets. The investment risk is spread out reducing the chances of making cultural legal errors. Further, the partner in the foreign jurisdiction may have assets and strengths which will compliment the Canadian businessman including his familiarity with the political and economic environment and experience in doing business in the foreign jurisdiction. A foreign partner can often provide indispensable knowledge of the local market and companies that may be interested in the service or product offered. A foreign partner will usually contribute financially to the endeavour and most particularly and most certainly be involved in the management of the business in the foreign jurisdiction.

The legal considerations required when entering into a joint venture varies depending on whether one is entering into a technology oriented joint venture or a market oriented joint venture.

1. TECHNOLOGY ORIENTED JOINT VENTURE:

In many cases the main feature of contractual joint ventures is the transfer of technology and know how from a foreign to a local partner. The main types of these technology oriented joint ventures are:

a) Know how and patent licensing agreements.

b) Manufacturing contracts;

c) International sub-contracting

d) Production sharing and risk service contracts

e) Turnkey contracts

f) Management contracts

g) Technical assistance agreements

h) Franchise agreements

i) Leasing

j) shared research and development

k) Placing shared research contracts

2. MARKETING ORIENTED JOINT VENTURES

Marketing oriented joint ventures are becoming more and more common international business. These joint ventures are more than simple buyer / seller relationships as the partners work together, either continuously or for a defined period of time to achieve certain objectives. Some examples of the marketing oriented joint ventures are:

1. Buy back arrangements

2. Long term purchase contracts

3. Sales commission agreements

4. Consortia

5. Counter purchase

6. Procurement or marketing cooperation

7. Marketing tie-ups.

8. Third country marketing arrangements

9. Product exchange

KEY STAGES IN THE COLLABORATION PROCESS

Expanding into the Asia Pacific market can be a very simple process or a very complicated one. Concluding an agreement can take anywhere from six months to three years or more and success is largely based on ensuring that all stages of planning are taken into account. The key stages in the collaboration process include:

1. Identification of needs

2. Getting the format right

3. Structuring the search

4. Selection of a partner

5. Negotiations

6. Approvals

7. Implementation

8. Management

In order to proceed successfully in completing the above-mentioned stages, one must be familiar with the legal requirements of the foreign jurisdiction and their compatibility with the laws of Canada. Up to 70% of joint ventures fail due largely to the fact that the key stages in the collaboration process were not followed.

IDENTIFICATION OF NEEDS

It is of the utmost importance that both partners have a clear understanding of each others needs. There have been situations when two partners have each mandated their legal representatives to prepare the appropriate contractual agreement that would bind the parties without discussing with each other a manner in which this agreement could be accomplished by working together and not through duplication of effort. The practical result of two agreements being prepared has in most cases not only increased the length of time that an initial agreement could be concluded, but in most cases, has resulted in the ultimate failure of the joint venture.

It is therefore recommended that an understanding is entered into where the Canadian company or the host partner is mandated to prepare the initial agreement which is then reviewed by legal representatives of the other potential partner. When choosing a partner issues that must be considered include:

1. What do you expect your partner's profile to look like?

2. What is the logical way to proceed in this partnership?

3. Have you clarified your commercial objectives? Do you know what markets to penetrate with your products and what do you really need from a partner?

4. How have you performed in your past partnerships?

5. What are your partner's real needs?

6. What political and cultural problems exist in the foreign jurisdiction?

7. How will the partnership add value to your business in the sense of allowing you jointly to do things you could not do alone?

8. What do others tell you about your prospective partner's management strengths and strategic direction?

GETTING THE FORMAT RIGHT: ALTERNATIVES TO FORMAL JOINT VENTURES AND MERGERS

While many business people feel that joint ventures are the only way to go, alternatives often exist that could equally meet an enterprises objectives. Long winded legal contracts, extensive public relations efforts for a launch and other costly formalities may often not be required. For example, technical development, to improve a production process or product design, may be made more cost effective by hiring a technical consultant rather than starting a joint venture arrangement with another enterprise.

A lack of financial resources is not solved by joint venture arrangements. Better and less complicated options include securing term loans and/or equity financing from local and international financial institutions and venture capital companies.

With respect to export marketing, some options include tie ups with export houses and trading houses, arrangements with buying agents and export supply agreements.

FINANCIAL ELEMENTS TO CONSIDER IN PLANNING A JOINT VENTURE

The financial elements of a partnership are essential to ensure success. Partners should, between them, divide at least 15-25% of the total investment required, while the remainder could come from foreign or local sources of investment funds including local and international development finance institutions and venture capitalists.

Contributions by partners can be made in cash or in kind, including, land and buildings, machinery, raw materials, know how or provision of technical partners. This can allow the joint venture to go ahead without major cash outlays by the partners and these assets may be suitable as security for bank loans.

The capital structure of a joint venture company should provide for partners to adjust their level of investment in future years including an exit by one of them if necessary. Several classes of share capital may be needed to meet the requirement. These could include convertible or redeemable share capital, which permits a partner to realize his equity investment by converting it to debt, subject to the profitability of the business.

In order to ensure success in any joint venture you must know what resources you expect your partner to commit in relation to the resources you have available.

STRUCTURING THE SEARCH

If you have not gone through a systematic and structured partner search, you cannot be sure of maximizing your opportunities. You must identify your target market, technological requirements, financial requirements and complete a proper and detailed business plan.

Your proposal must be clear and simple so that your future partner, without any difficulty, understands your needs. Your proposal should include the following:

1. A concise general description of the project

2. A history of your firm and management

3. Projected market and market share

4. Technical feasibility, human resource and raw material requirements

5. Investment requirements, project financing and returns

6. Government issues

7. The expected time frame of the project

There are many different channels for identifying prospective partners:

1. Embassies: The commercial sector of our Canadian embassies around the world.

2. Ministries of industry and trade

3. Investment promotion bodies

4. Investment banks

5. Chambers of commerce

6. Lawyers and accountants

7. Venture capital companies

8. Corporate research laboratories

9. Business development units of large corporations

10. Patent agents and patent literature

11. Trade journals

12. Trade associations and professional societies

13. Trade directories

14. Computer data bases.

For companies seeking partners in the emerging economy of the Asia Pacific region there are a range of international institutions such as the United Nations Industrial Development Organization and the International Finance Corporation that can play a useful role in helping to identify suitable joint venture partners.

ENSURING A SUCCESSFUL PARTNER SEARCH

1. Attempt to identify more than one possible partner

2. Consult trade officials, other non competing companies, outside experts to verify your potential partner's reputation.

3. Assign highly capable, competent people to the task including at least two high level managers from your company who can work along with the lawyer or agent assisting in the matter. These managers must have a clear understanding of the technical, legal and financial aspects of the company in order to understand the enterprise as a whole.

4. Build the final agreement into the search method. You must be aware of the major financial aspect of your preferred legal agreement, such as capital structure, management policies and use them as a checklist when holding preliminary discussions with prospective partners. This approach will minimize unwanted surprises when the lawyers are drafting the proposed agreements.

TIPS ON HOW TO AVOID JOINT VENTURE HEADACHES

1. Anticipate every problem. Work with a professional agent or attorney who will plan with you for most contingencies right at the beginning.

2. Adopt a win-win attitude. Keep in mind that the joint venture is a partnership and both parties must profit.

3. Do not be afraid to say no. While negotiations require give and take, a set of firm priorities is imperative.

4. Remember that the host country is involved. Many governments offer joint ventures attractive financial incentives and can turn floundering joint ventures into successful operations.

NEW OBJECTIVES FOR LEGAL AGREEMENTS IN COLLABORATIVE MANAGEMENT

Legal contracts can prove to be the real stumbling block in international business relationships. While no international or other collaborative agreement should be without one, the negotiation of detail in a contract between people of different cultures is often difficult. Contract time is often the point at which a company's executives drop their cultural sensitivity. Contracts have to be a certain way; they have to fill pre-determined conditions; they have to satisfy the attorneys and yet they must be an extension of the cultural understanding that has gone into building a relationship rather than a cut off point. Failing to realize this in the international arena creates three major risk areas:

1. The need to make major concessions

2. Formulating a contract that makes the strategy unworkable

3. Partner conflicts

CROSS CULTURAL CONTRACTS: eight basic points for starting with the right context in mind

1. You do not have to know the other's culture, but at least have an understanding of what is typical in their approach to contracts;

2. Once you have established the standard practice of your partner's country, determine whether there is an absolute commitment to including these elements in the contract;

3. Ask yourself the same question, namely, are there areas of your contract that are outdated and may not be required;

4. Can you do business with old ideas?

5. Determine how strong is your temptation to concede contract points in order to maintain relationship quality;

6. What types of concessions are appropriate to build trust?

7. How do you build a balance between the level of detail you feel comfortable with and avoid the impression that you are criticizing your partner;

8. Does compromise feel like failure?

In order to ensure success in the international contract, individuals must try to "know where the other party is coming from". We must be aware that compromising basic cultural philosophy underlines our sense of trust and security. To ensure success, individuals must be willing to embrace the partner's cultural requirements which are often difficult.

THE INTERNATIONAL CONTRACT

I will now try to lay out a set of contract conditions which help make international collaboration more creative and liberated.

Negotiating legal agreements can often undo much of the valuable work that has gone into building a partnership. The agreement can destroy trust. The contractual relationship is essential and must be done without un-necessary concessions. One cannot throw away advantages just to be your partner's best friend. To the same extent, the "worst case scenario" style of contract is not suitable for collaborative agreements as it is often an insult to your new partner who develops a sense of insecurity as to your level of trust in the partnership.

Although Canadian companies' cultural values should be as important as your partner's, we are well aware of the example of the past ten years where it has been understood that "if you want to succeed in Japan you must learn the Japanese way". With time, as Asian countries do more and more business with North America, the balance of understanding each other's cultural values will come to the forefront.

TEN PRIORITIES TO INCLUDE IN THE INTERNATIONAL CONTRACT

1. Ensure ease of exit

2. Focus on the effect of practical managerial inputs on partnership quality

3. Look for imaginative ways of structuring fair and equitable control without taking the 50 - 50 options

4. Equitable net gain should involve extraordinary rewards

5. Explicitly prohibit profit margins on internal exchanges or supplies or services. Avoid exploitation

6. Tie the venture into normal communications structures

7. Make project evaluation part of the contractual relationship. Devise shared evaluation criteria

8. Use minimum outcome scenarios to help create realistic expectations

9. Imagine the future

10. Include the detective and external authority

ENSURE EASE OF EXIT

Since we know that at least as many joint ventures fail as those that succeed, it is important to ensure ease with exit. Lengthy dispute resolution procedures often signal the end of a relationship and are very costly. Loading a contract with compensation clauses and penalties is usually not the best approach in the international context.

Phase contracts to incorporate compensation clauses only once quality relationships have had an opportunity to evolve is usually the most effective way to proceed. Partners should not feel that they are bound in the first phase of the contract. The benefits of collaboration must be what holds the partnership together and not the potential penalties that would result from resolution. In later stages when both parties have invested more into the partnership, these type of penalty clauses or dispute resolution procedures can kick in and become effective as of that future date.

QUALITY AND THE EFFECTIVE PRACTICAL MANAGERIAL INPUTS

Make sure that detailed managerial tasks are factored into the contract. Joint executive meetings create the impression of managerial control without the substance. The most costly and stressful task is to coordinate and to ensure that deadlines are met, that quality criteria are defined in advance and such criteria are met, and that outputs reflect each parties expectations.

Make sure of an obligation to relate management responsibilities to clear quality criteria and guidelines. In today's climate it is legitimate to make quality issues contractual. This automatically implies a management infrastructure that can deliver quality.

FAIR AND EQUITABLE CONTROL

Look for alternatives to conventional control structures which are proportional to initial investment. In considering ownership and equitable control, options to consider include:

1. Introduction of a veto right for minority stakeholders;

2. Explore fully, each side's competence and interests in management and strategy development;

3. Create two-tier management structure;

4. Opt for two-tier ownership structure;

5. Negotiate long term against short term gains.

A two-tier management structure, typically divides management between control over day to day decisions and strategic planning; where the controlling board's votes are attached to shareholding and some form a veto is in place.

Some agreements deal with the majority shareholder issue by creating a two-tier profit structure, giving equal rights to profits at the end of each year, but a larger percentage of long term equity to the majority shareholder.

EQUITABLE NET GAIN AND EXTRAORDINARY REWARDS

Issues to consider include:

Can the partnership define an incentive and reward structure?

Contracts should therefore divide profits in proportion to financial inputs. A bonus and reward structure should also be included in the contract.

AVOIDING EXPLOITATION

One must consider whether either side is looking for a way of taking risk investment back in the short term?

Once must be aware of partners who load inefficiencies into overhead. Do not assume that a partnership will benefit from internally provided services or goods.

Internal charging needs to be handled by demonstrating that exploitation is not taking place, rather than simply assuming that the partnership is benefiting from internally provided goods or services. The contract must insure transparency avoid exploiting the venture and avoid internal recharging unless this can be done on a transparently supportive basis.

TYING THE PARTNERSHIP INTO NORMAL COMMUNICATION STRUCTURES

In order to ensure continuous support of the joint venture the contract must create strong communication links with parent organizations and integrate the venture into existing strategy development procedures.

DEFINING APPROPRIATE AND SHARED EVALUATION PROCEDURES

Evaluation must share criteria which focus on the efforts of both sides and include an evaluation not only in the area of cash flow and profitability, but also quality criteria and a comparison of performance to other similar enterprises in your industry.

USING MINIMUM OUTCOME SCENARIOS TO HELP CREATE REALISTIC EXPECTATIONS

A list of realistic expectations is an obligation for senior management to take direct control of negotiations.

IMAGINE THE FUTURE

Strategic flexibility must take into account the need for the joint venture to perform in certain areas that the partners could not perform by themselves. All contracts must allow for strategic changes by imagining and predicting future changes and needs.

THE DETECTIVE AND THE EXTERNAL AUTHORITY

In order to ensure success after the contract has been signed you will be through the consultation with professionals or agents and most importantly, external advisors who can ensure that the joint venture stays on track. The external advisor has two main functions. He must act as a detective in order to search out faults and the rationale either of the venture or of the management strategy. Providing the company with advice and correct errors will save considerable money.

The external advisor can also help managers take time out from their own enthusiasm to deal with the realities required to ensure that quality criteria are applied rather than being enforced by a lead partner. The external authority's role is to assist partners to interpret their obligations to each other.

It is important to keep your side of the bargain in an evolving partnership in employing an external authority to assist as a detective and advisor can ensure that you ask the same questions of your own organization that you would want to ask of your partners.

CONCLUSION:

It is therefore important that the above issues must be included in international contracts. Proper negotiation through legal representation in coordination with top management involvement as well as the preparation of a legal contract that will respond to future needs and yet respect the cultural differences of the parties involved is vital to ensure the success of the international collaborative joint venture.

NEW ARBITRATION PROCEDURES

When discussing legal issues to consider in the Asia Pacific region one must always deal with the possibility of legal disputes.

Disputes between joint ventures commonly arise as is in all projects when the parties expectations are disappointed and one of the parties is unable to accept the financial consequences. Dispute resolution procedures have to be integrated into a contract. This means the possibility of falling out has to be raised when good will is at its peak. Effective dispute resolution is essential. The contract must include where and under which law disputes will be resolved.

GOVERNING LAW

Making a selection of governing law is very important. Governing law can radically affect dispute resolution. Parties are naturally suspicious of each other's laws and therefore often compromise to use the law of a third country such as Switzerland, for example. This compromise is often costly however as legal representation from a third country is then required. In any event, governing law must be clearly outlined in the contract.

FORUM

As important as the type of dispute resolution is the place where it is to be held. Will dispute resolution take place in the Courts? At an administrative tribunal or in some other manner? Arbitration is an international procedure. However the laws of the country have an affect on the way the arbitration is conducted. Therefore the venue for hearing must clearly be outlined.

In addition to litigation and arbitration there are two other possibilities which need to be considered, alternative dispute resolution procedures and expert determination.

LITIGATION

In determining the courts of which ever country is chosen one accepts that their usual rules in order to resolve the dispute will apply. Both parties however tend to be suspicious and both would see the other's courts as probably being bias.

ARBITRATION

An alternative to litigation and often a more attractive resolution to the question of dispute resolution in joint ventures is international arbitration. It offers a neutral tribunal composed of either one arbitrator or three. The tribunal can meet and hold hearings in a neutral third country or by agreement anywhere the parties find convenient. The composition of the tribunal board is usually made up of an impartial party and in the case of three arbitrators, one from each country. Arbitration can be supervised and organized by an international body such as an international chamber of commerce or international arbitration board. Arbitration proceedings are generally private and in most countries there is limited scope to appeal to the court from arbitration awards/decisions.

ALTERNATIVE DISPUTE RESOLUTION

Alternative dispute resolution offers assistance to parties in negotiating; a settlement usually with the help of a neutral mediator. Some ADR clauses are now written into contracts stating that the parties have to try to resolve the disputes with the assistance of neutrals. A welcome feature of the ADR movement is a shift away from the aggressive culture of dispute resolution through litigation to a recognition that settlement is often in the interest of both parties.

EXPERT DETERMINATION

Expert determination is useful where there are identifiable valuation and technical issues that can be determined separately from issues involving mixtures of fact and law.

THE IDEAL ARBITRATION CLAUSE

There are eight elements in an ideal arbitration clause:

1. The arbitration clause must clearly refer disputes to arbitration;

2. It is essential to be clear where the arbitration is going to be held;

3. An appointing authority is vital;

4. It should be clear from the arbitration clause whether there is to be institutional supervision of the arbitration;

5. The arbitration clause must specify how many arbitrators there will be; Will the parties have the right to representation by lawyers;

6. The clause should specify the language of the proceedings;

7. It is desirable, though not essential, to provide that an arbitration be subject to some kind of rules;

8. It is advisable to enter into a specific agreement excluding appeals.

ARBITRATION PROCEDURE

The procedure to initiate arbitration must be clear in the contract and can be relatively informal by way of one party sending a letter to the other enclosing a notice.

Then there needs to be established a procedural frame work known as directions allowing each side to say what their case is and how they will prove it together with their comments on the case put forward by their opponents.

MANAGING A DISPUTE: SIX KEYS SKILLS OF A GOOD ARBITRATION LAWYER

Lawyers who advise clients involved in international arbitration need to have a number of talents:

1. Flexibility: They will need to be prepared to adapt to types of procedures that are found in international arbitration which are derived as much from other countries' systems as those of their own national courts.

2. Familiarity: The second is a familiarity with the procedures of other jurisdictions as well as their own.

3. Responsiveness Lawyers who conduct any dispute have to remember that their sole purpose is to improve their client's position in the case, or at least make sure that there is a successful damage limitation exercise.

4. Technical Competence: The fourth is an ability to absorb technical information. Often disputes have a heavy technical content.

5. Managerial efficiency: The fifth is management skills. This is essential to ensure that the case progresses smoothly without getting buried in large amounts of paper or subsidiary issues.

6. Persuasive advocacy: The hearings have to be addressed by a lawyer who is a skilled advocate.

CONCLUSION:

Arbitration is often the right choice of dispute resolution for international joint ventures. However the contract must clearly identify the arbitration clause and skilled lawyers are naturally needed both at this stage and to conduct the disputes.

It must be understood however that in many jurisdictions in the Asia Pacific region, enforcement of arbitration awards or other disputes resolved through traditional north american method is difficult. Settlement of disputes through negotiation and involvement of individuals of authority or for whom your partner may have respect will often be useful in the resolution of a dispute. To the same extent, enforcing ones right to their intellectual property may only be obtained in many Asia Pacific country through non North American traditional approaches. When the courts are ineffective, individuals must resort to intervention by political authorities or through other innovative manners.

I was recently told of a situation where a university student had been selling the intellectual property of a software program. In order to stop this infraction, it was determined that the courts would be of no use and therefore after great discussion and negotiation, it was discovered through the attorneys involved that the aunt of one of the attorneys at the office in the foreign jurisdiction was a professor at the university who spoke to the Dean and informed the infringing student that if he did not cease and desist from the sale of this protected software, that he would be removed from the university and disgraced by his involvement in this matter.

It is therefore important to be aware not only of the legal enforcement procedures available to the foreign investor as well as ensuring their proper creation of a secured contractual arrangement; but that in addition, flexible and innovative methods must be developed through working with experienced representatives to ensure ones success.

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