BEYOND WRECKING CHINESE DRYWALL: CONSIDERATIONS AND PROSPECTS OF LAW AND PRACTICES OF SOURCING FROM CHINA

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I. INTRODUCTION

China has emerged as the world’s largest manufacturer according to the United Nations, and China’s prevailing position in production is well instituted.1 In 2013, the value of China’s manufacturing on a gross value-added basis was 35.1% higher than that of the United States.2 In 2013, China’s gross value-added manufacturing was equal to 28.9% of its GDP, compared to 12.1% for the United States and 18.7% for Japan.3 With its enormous economic development and ambition to proliferate investment overseas,4 China has begun to seek greater returns from its

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3. See id.

4. See generally Jamil Anderlini, China to Become One of World’s Largest Overseas Investors by 2020, FIN. TIMES (June 25, 2015), https://www.ft.com/content/5136953a-1b3d-11e5-8201-cbd03d71480 (discussing how China’s outbound foreign direct investment has gone from virtually nothing to more than $100 billion a year over the past decade, and how Chinese investment requires a
manufacturing clout by pursuing both higher-end commercial activities and more diverse elements of the manufacturing value chain.\(^5\)

Moreover, current trends show manufacturing-value creation and product value chains, cornerstones of modern global-sourcing practice, have grown increasingly segmented\(^6\) and globally distributed as multinational corporations dominate with aggressive investments.\(^7\) Through this segmentation, key pillars and functions of global sourcing such as product design, production, intellectual property protection, innovation, technology transfer, and distribution services, have experienced rationalization and renovation with global implications.\(^8\)

This trend favors China, whose high supplier capacity, sophisticated logistics network, and strong infrastructure provide unique competitive

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\(^7\) See Federica Saliola & Antonello Zanfei, Multinational Firms, Global Value Chains and the Organization of Knowledge Transfer, 38 RES. POL’Y 369, 379 (2009) (proposing that value chain relationships become fundamental vehicles for knowledge transfer, which is a combination of efforts by both domestic and foreign firms for increasing local competencies and adapting technology to host market conditions).
advantages for both traditional manufacturing industries and new industries such as the high-tech sector. Chinese firms, especially original equipment manufacturers (OEMs), which initially took advantage of relatively humble initial positions in the value chain, have promptly stepped into more value-added undertakings with elevation of skills and capacities.

In the midst of evolving global-sourcing practice, China’s economic development and stronger rule of law have presented both Chinese and global-sourcing firms an unprecedented opportunity to reform the law regarding sourcing practice. Such reform has already occurred—legal issues in various areas have presented new challenges and prospects, such as the multinationals’ intra-group transfer-pricing arrangements. Simultaneous legal reform within China, such as recent anticorruption efforts, inevitably adds an extra layer of legal consideration for global-sourcing practice. The extent of all of this new development calls for a more detailed analysis on how global-sourcing practice may better coordinate and accelerate with China’s development.

The rest of this article is organized as follows: Part II introduces and discusses global sourcing and its recent development trends as background for later analysis. Part III describes the evolution of the manufacturing and product value chain, as well as how China may benefit from the globalization of sourcing practice. Part IV offers a concrete analysis and thoughts on legal issues relating to recent whereabouts and development of global sourcing, especially introducing the tax framework and transfer-pricing practice for sourcing and intragroup services, and China’s anticorruption undertaking including severe commercial bribes or kickbacks in the recent amendment of China’s legal framework.


12. See infra Part IV.

Criminal Law code. Part V concludes.

II. GLOBAL SOURCING AND TRENDS

A. Global Sourcing

“Global sourcing” refers to the practice of sourcing from the global market goods and services, then moving them across geopolitical boundaries. Global sourcing aims to fully exploit cross-border competences in securing delivery of quality product or services. Such conceived efficiencies usually involve labor-intensive production facilities, low cost of available but fine raw material, and other economic factors such as tax incentives and low-trade tariffs, although legal convenience and political stability are also often contemplated. The result is a practice that targets “low-cost countries” to invest in for sourcing purposes. In practice, low-cost country sourcing comprises the majority of the sourcing market, as global-sourcing practices are more sophisticated than stereotypical low-end, labor-intensive, and language-confined approaches. Multinational corporations today strive to harness the potential of global sourcing and benefit from cost reduction in all aspects, to the extent that global sourcing forms an integral part of most deliberate sourcing plans and procurement strategies. Global sourcing gradually becomes a fundamental strategy for multinational


15. See Parella, supra note 6, at 756.

16. See generally Sarfaty, supra note 14 (discussing the labor standard in supply-chain management in developing countries).


18. See Gereffi, supra note 6, at 452 (discussing the political and economic integration for small economies in terms of global value chain linkages).


20. See Parella, supra note 6, at 779–82 (discussing the tension between CSR and procurement practices with examples of Foxconn in China).
corporations, whereby a central sourcing hub pursues economies of scale and achieves risk minimization through corporation-wide calibration and benchmarking. Through these benchmarks, corporations proactively integrate and coordinate common items and materials, processes, designs, technologies, and suppliers across worldwide purchasing, engineering, and operating locations.

Perhaps surprisingly, the search for low costs apparently takes low priority with regards to global sourcing for most multinational corporations. Instead, global sourcing affords more intricate, multifaceted, and multi-layered opportunities, such as increasing business development in a potential market, pooling talent and valuable resources unavailable domestically, dominating competitive dynamics within the industry for alternate supplier sources, stimulating competitive edges by enlarging total supply capacity, developing innovation for licensing arrangements and technology transformation, and so on. On the other side of the coin, global sourcing prompts costs and complications that require detailed legal service and commercial monitoring, such as prolonged communication along product value chain, potentially compromised quality control and unsecured deliverables, exposure to various financial and political instabilities in jurisdictions of emerging and developing economies, increased legal risks of losing intellectual property ownership or copycatting, undue charges of labor abuse or environmental deterioration, increased management costs relative to domestic supply, and hidden overhead costs associated with diverse cultures and localization struggles.

Global sourcing involves participation, contribution and coordination

21. See id. at 807 (discussing how low-cost and short lead times, which may be abused by upstream suppliers, often are two factors contributing to violations of workers’ rights).


24. See id. at 501–03 (discussing potential and heightened risks to intellectual property in global sourcing which penetrates more core business functionalities).

25. See Itar-Tass Russian News Agency v. Russian Kurier, Inc., 153 F.3d 82 (2d Cir. 1998) (involving a copyright dispute in which the U.S. Court of Appeals for the Second Circuit adopted the “work-made-for-hire” doctrine to determine the initial ownership of the copyright in dispute).

of various players.\textsuperscript{27} Generally speaking, global sourcing impacts three of the most fundamental market segments: manufacturers or suppliers, product-marketing companies, and distributors.\textsuperscript{28} At the same time, international procurement organizations (IPOs) or sourcing agents may also be significant players in global-sourcing strategy for a multinational corporation.\textsuperscript{29} These procurement agents primarily identify, nurture, and maintain key global suppliers and vendors across sourcing categories, who in turn deliver substantial and adequate supplies to the whole multinational in a timely fashion. IPOs and agents are particularly essential for sourcing from large and resourceful countries such as China or a few major Southeast-Asian states, where a full range of sub-categorized markets compete and suppliers span the entire product value chain.

As a central module of globalization, well-orchestrated global-sourcing practice renders multinational corporations controversially robust opportunities to benefit from competitive advantages.\textsuperscript{30} Traditionally, global sourcing is severely criticized for contributing to worsened labor protection standards, unqualified working conditions, relatively low wages, abuse of underage staffing, and notorious environmental violations by farming overseas facilities and harvesting undue resources without consideration to exploitation in host countries.\textsuperscript{31} Domestic labor advocates and economic nationalists in developed countries also criticize global sourcing for its tendency to create job loss within established domestic industries.\textsuperscript{32} Although such labor-intensive production or relocation to emerging economies have attracted condemnation from human rights advocates internationally and economic nationalists domestically,\textsuperscript{33} global sourcing has contributed to enhanced mobility of capital, talent, and technology, and in turn stimulated economies that otherwise had limited opportunity for

\textsuperscript{27} See Gereffi, supra note 6, at 457 (listing five types of global value chain governance).
\textsuperscript{28} See generally OECD REPORT, supra note 7.
\textsuperscript{32} See generally e.g., LINDA LEVINE, CONG. RESEARCH SERV., OFFSHORING (OR OFFSHORE OUTSOURCING) AND JOB LOSS AMONG U.S. WORKERS (2011), https://fas.org/sgp/crs/misc/RL32292.pdf (discussing the impacts of global or offshore outsourcing on U.S. job market).
\textsuperscript{33} See generally, New Labor Contract Law Raises China’s Labor Costs, CHINASTAKES (Feb. 14, 2008), http://www.chinastakes.com/story.aspx?id=206. The small and medium-sized labor intensive enterprises surveyed in Jiangsu and Zhejiang province did not pay social security premiums for all their employees, which is clearly a substantial part of labor rights protection. \textit{Id}.}
Global sourcing also exports modern management and corporate governance skills as well as proprietary knowledge to host countries, which has proved to be successful in self-sustaining development and maintaining of technological advances in host countries.35

B. The Development of Global-Sourcing Strategies

Global sourcing is a syndicated undertaking of strategies that presents benefits for both multinational corporations and host countries.36 Generally speaking, global sourcing enhances the global logistical interaction between research and development activities, manufacturing, and marketing activities. Moreover, with regard to a legal perspective, global sourcing should clearly comprehend and escalate the impacts of product designers, engineers, branding managers, and purchasing agents in the product value chain and the decision-making process.37 Such interaction is a key factor in determining legal risks involved when defining a multinational’s global competitive strengths and, consequently, its market performance and edges.38

Global sourcing itself has developed progressively over the past three decades. For instance, the importance of currency-exchange rates and other cost determinations has diminished, in favor of pricing authority that considers assured quality and long-standing relationships with suppliers.39 It also benefits from a new competitive environment with excess global capacity, which catalyzes a transition from focusing on price and quantity to quality and reliability of products as determinative factors.40 Another external development that global sourcing has enjoyed is the innovation and restructuring of international trade infrastructure, through which advances in mechanical and operational features of international trade enable multinationals to solidify sourcing for strategic purposes.41 Moreover, development of global sourcing

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35. See generally Parella, supra note 6.
37. See id. at 424.
38. See id. at 400.
40. See id. at 125 (arguing that “the corporation should be able to make rational determinations to switch technologies that enhance its competitive position without being encumbered by inflexible pricing regimes”).
41. See Baldia, supra note 23, at 499 (“Advances in technology combined with increasingly stable foreign political climates and reduced trade barriers make it more compelling than ever for
further reinforced the irreplaceable role of purchasing managers and professionals play in crafting a global manufacturing industry and corporate approaches towards globalization.42

Global-sourcing strategy features the interplaying between a multinational’s competitive edges and the comparative advantage of various host countries when searching for suppliers and vendors.43 Accordingly, legal considerations for global-sourcing strategies are duly influenced by a multinational’s decisions regarding what activities and technologies merit its available investment and managerial resources.44 Moreover, legal considerations might be further implicated by the choice of which specific advantages should be exploited in different countries in terms of low-cost labor, resources, or geographical convenience.45 In addition to comparative advantages, global sourcing strives to cultivate and better the product value chain, which offers a general framework for the interrelated value-adding activities of a multinational on a global basis.46 From a legal perspective, the product value chain traditionally is divided into two major schools of activities or performance. The primary activities in the value chain include inbound logistics, manufacturing, outbound logistics, and after-sales service, while the supporting activities include human resource management, technology development, and financing activities.47 For improved performance of value chain activities, global-sourcing strategy simply improves the interaction between key functions such as intellectual property, manufacturing, and business continuity on a global

42. See Parella, supra note 6, at 763 (“Apple [Inc. ] ’contribute[s] market knowledge, intellectual property, system integration and cost management skills, and a brand name whose value reflects its reputation for quality, innovation, and customer service.”).


44. See Baldia, supra note 23, at 507 (noting that the “purpose and goal of the contract with respect to IP should be to fully assess and appropriately address the complexities and risks of owning, developing, and protecting the customer’s IP”).

45. See id. at 503–04 (“When it comes to the structure of a global sourcing transaction, one size does not fit all. There are three key structures: (i) sourcing through affiliated legal entities (wholly owned or majority ownership) in offshore locations, which can be thought of as ‘captive sourcing,’ (ii) contracting with unaffiliated offshore suppliers, or ‘third party sourcing,’ and (iii) partnering with local entities to share control of local operations used for delivery of sourced products or services, or ‘joint’ venture sourcing.”) (citation omitted).

46. See generally UNCTAD Analysis, supra note 5.

47. See Nagel & Van Blerkom, supra note 39, at 127 (noting that global sourcing “approach has many advantages, including: (1) ability to leverage technology and processes over diverse platforms and geographies; (2) improved productivity driven by more effective and efficient use of personnel and other resources that are spread across the globe; (3) associated natural hedging against geopolitical risks; and (4) support for, and even facilitation of, new business opportunities”).
basis, while logistics is to identify target markets and engineering needs for components.

Multinationals determine how to structure logistics internally or externally to manage the overseas market by analyzing import and export needs, engineering assembly services or utilizing semi-finished products, and delivering components of finished goods. Accordingly, such activities and functions should be coordinated and matched for setting up strategic alliances among all functions of value chain, considering transfer and usage of design and engineering technologies, and maintaining high ethical standards of integrity and compliance in daily management and operation. Given the complexity and subtlety of product value chain, a few major issues and considerations are prioritized by almost all multinationals when executing vigorous global-sourcing practices. Tax incentives or breaks, legal compliance culture, convenience of technology transfer, intellectual property protection, quality control system, anti-dumping policies, and international trade practices all should be deliberated in due course for such execution.

Partnered with cost considerations, transfer pricing from the international tax perspective is a key factor for perfecting global-sourcing practice, as unfavorable or failed tax policy regimes in host countries can easily swallow benefits generated through cost considerations. When developing strategy, corporations must identify

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49. See Parella, supra note 6, at 761 ("A U.S. firm . . . must decide between manufacturing in the United States and shipping the component to its customers in Asia—an option that involves long delays and considerable cost—or constructing an overseas plant next to its customers in Asia.").

50. See id. ("China can erect a massive operation in no time at all, staffed with compliant labour and with little concern about the impact of the factory on watersheds, air quality, and traffic.").

51. See Sarfaty, supra note 14, at 424 ("As multinational companies are becoming more dependent on global outsourcing, there is a need for regulation to ensure responsible supply chains.").

52. See Manley & Hobby, supra note 22, at 416–17 (quoting Zheng v. Liberty Apparel Co, 355 F.3d 61, 72–75 (2d Cir. 2003)) (introducing the six factor test under the Fair Labor Standards Act regarding the process and issues of various outsourcing phases).

53. See Gereffi, supra note 6, at 454 ("For developing countries, the trade, investment, and knowledge flows that underpin GVCs provide mechanisms for rapid learning, innovation, and industrial upgrading.").

54. See id. at 441–43.

55. See Sarfaty, supra note 14, at 449–50 (discussing challenges for executing due diligence).

56. See Baldia, supra note 23, at 501.

57. See id. at 501–03.

58. See Manley & Hobby, supra note 22, at 409–10, 419 (discussing the impact of outsourcing on employment and its balancing with U.S. international trade arrangement, which lacks a systematic regulatory framework to assure certainty and predictability).

59. See generally Benshalom, supra note 11.

60. See id. at 638.
and measure the risk of many different variables, including: tax policy framework, local market conditions, joint venture partnerships, tax holidays or breaks for foreign investment, and moral standing of local tax officials. Particularly, a successful transfer-pricing practice embodies the arm’s-length principle and cost-based pricing, together with a few key underlying considerations such as: general acceptance of foreign investment; market conditions of the host country; competition in the host country; expected reasonable margin for the foreign affiliate; income tax brackets; import and export restrictions; custom duties; pricing power controls, and foreign exchange controls.

Given the intricacy of the product value chain and density of evolving sourcing patterns, corporations that engage in global sourcing have gradually constructed a full-pledged practice of “countertrade” for adopting and executing non-traditional, non-cash compensation methods of financing. Sourcing from foreign jurisdictions is a balance of legal risks and business opportunities, and the resulting penumbra implies a thornier dichotomy between business motivations and duty to perform and abide by legal investigation. Usually, countertrade occurs in the forms of bartering, buy-back, and offset (rebate), however, such approaches often must answer to questions regarding the motivations to which they cater, such as dodging foreign exchange controls or lack of local currency, avoiding low country credit worthiness, stimulating sales volume increases, nurturing initial trust and long-term customer will, accessing new or difficult markets, and so on. Given the non-cash nature of countertrade methods, such measures require timely negotiations to fulfill upcoming orders and sourcing needs; however, countertrade is often blind to projecting information on future prices or repairs—and thus increased cost of sourcing activities—which is quite common for multinationals to swallow for initially stepping into a new

61. See id. at 641–48 (discussing the arm’s-length principle and related transfer-pricing issues).
62. See Nagel & Val Blerkom, supra note 39, at 133 (discussing pricing controls).
64. See Nagel & Val Blerkom, supra note 39, at 121 (noting a “customer’s finance and accounting or procurement function” is a part of the less “mature” field of the sourcing of business possesses).
66. For detailed analysis on the countertrade especially on the defences sector, see generally Schoeni, supra note 65.
67. See id. at 410 (“Marvelous offset policies limit the dimensions of the negotiation and, consequently, may cause ‘diseconomies of scale and scope.’ . . . [Therefore], a ‘more flexible’ policy, sometimes using offsets, ‘is preferable in most settings.’ “).
Global-pricing and anti-dumping practice is another important factor for successful global-sourcing execution and value chain management. Given intensified competition in host countries as well as surging local economies, the governments of developing and emerging economies often engage in measures and negotiation techniques such as protectionism and prohibition of unfair pricing of imported goods. Due to the relative lack of transparency and impartiality of judicial and legislative organs in host countries, global-sourcing activities are exposed to risks of anti-dumping actions and transformation of trading up, i.e., moving from low-value to high-value chains. As a result, multinationals may have to conduct “add-on” core service enhancement and set up strategic alliances with local partners to realize legal compliance in distribution and communication with authorities. This type of response is commonly called “variability consideration.” Moreover, in concert with transfer-pricing techniques, coordinating pricing models among different countries from a global perspective while making it feasible for internal management of margin realization is one of the most delicate challenges for global sourcing to resolve. In this context, corporations must include legal consideration as to the nature of competition, supply chain, and customers in host countries, as well as market integration and governmental control over pricing authority in certain industries, which could implicate initially unforeseen

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68. See id. at 403 (“[R]epairs and maintenances of defense hardware account for seventy percent of costs; [while] production is only seventeen percent. [Such] ‘distribution of cost shares raises ex post contractual hazards and increases the probability that the seller will engage in some form [of] opportunist behavior,’ and offsets present the potential for ‘an efficient, private-ordered solution.’”).

69. For a detailed discussion on anti-dumping and import law regarding sourcing, see generally International Sourcing, supra note 65.

70. See Simon Lester, The Role of the International Trade Regime in Global Governance, 16 UCLA J. INT’L L. & FOREIGN AFF. 209, 247 (2011) (“[S]ome [local] groups . . . simply want to promote domestic interests, whether they relate to goods, services or people. [Such] sentiment may be a combination of protectionism, national security concerns, and general patriotism. Nationalists harbour an ‘us versus them’ sentiment in various contexts, and some take this approach with regard to trade . . . [with] a fear of losing sovereignty to some sort of undemocratic world government.”).


72. See Nagel & Van Blerkom, supra note 39, at 128–29 (noting that in the global-sourcing pricing regime, whether the variability consideration is “expressed on a global basis or rather a regional or even country specific basis . . . depend[s] to a large extent on the nature of the delivery of the services,” for example, whether it is delivered on a central or virtual basis or on a local basis by actual “‘feet on the street’”).

73. See Benshalom, supra note 11, at 638–39.
III. THE EVOLVING PRODUCT SOURCING VALUE CHAIN IN CHINA

A. Global-Sourcing and Product-Value-Chain Renovation in China

China has risen as a key global economic development engine and player over the past three decades. One consequence of its great economic advances is China’s gradually escalating move from passively accepting norms to shaping policy in various international arenas such as international trade, energy consumption, tax coordination, manufacturing and production, and others. Echoing rigorous economic developments, product supply chains in China have evolved with more complexities and efficiencies. The stereotyped “low-end” and “lean-margined” Chinese consumer-product manufacturers have become increasingly sophisticated and able to achieve more “value-adding” deliverables or considerations of the product creation supply chain, and have upgraded from mere manufacturers to multifaceted, cross-functional suppliers with capable branding outreach. One way this change is illustrated is the way Chinese corporations have changed to incorporating an array of branding and production functions traditionally handled by international purchasing organizations (IPOs).

The past three decades have witnessed a disconnection or reconstruction of the manufacturing and product-development process, which has offered new possibilities that product companies have earnestly embraced. As the globalization process deepens and international trade regimes reshuffle, the evolution of core corporate values and global strategies of some product-marketing (brand) companies, traditionally headquartered in US and Europe, has been both intelligent and dramatic. Therefore, evolving legal measures are essential to safeguard interests of those companies, which will increasingly face and cope with threats to the value and leverage that a

74. See Sarfaty, supra note 14, at 451–52 (“Control over data may be a way for initiatives . . . to create a monopoly for their services in the upstream . . . market and crowd out competing programs.”).


77. See Renouf, supra note 29.

78. See Gereffi, supra note 6, at 449 (discussing the evolvement and development of value chain in Brazil).

79. See Parella, supra note 6, at 808–15 (discussing the shifting of corporate accountabilities from unilateral to bilateral).
multi-functional supplier brings into the landscape. As commonly accepted, manufacturers, product-marketing companies, and distributors are three fundamental components of the product value chain. Different legal orientations are attempted or tentatively fixed to regulate each player in the product value chain based on its function, due to the fundamental differences between each. For instance, manufacturers, which are historically focused on the “hard” essentials of field manufacturing, usually conduct and complete orders passively from the product-marketing companies. Product-marketing companies concentrate on the more subtle upstream and downstream facets of production, such as IP protection and envisioning, nurturing, and initiating products and brand lines. Comparatively, product distributors perform the last stride in the value cycle by aggressively—but swiftly—pushing product to end consumers. Due to such differences, legal measures and treatment for each of these value chain functional segments are traditionally designated for each traditional role through legislative, judicial, corporate managerial, and practical discourses.

However, realities tend to be knottier than theories. In practice, each of these presumptively delineated players categorically embodies a collection of occupations and functions. Significantly, a recent development is that Chinese product manufacturers have gradually expanded from their original rigid roles of “low-end,” lean-margined manufacturing to incorporating more branding and marketing features, and ultimately growing up as competitors to established global product-marketing companies and retailers. Smart thinking now considers Chinese suppliers as innovative contributors to collections of value-adding engagements that must be managed and coordinated through new legal discourse and framework, to effectively address the distinctive attributes of product sourcing and to upgrade Chinese manufacturing

80. See id.
81. See Gereffi, supra note 6, at 434–35.
82. See id. at 440 (noting for the “full range of activities that firms and workers perform to bring a specific product from its conception to its end use and beyond, the GVC approach provides a holistic view of global industries from two contrasting vantage points: top-down and bottom-up”).
83. See id. at 438–39 (“In producer-driven chains, the lead firms that to a large degree defined the structure of these industries were largely global manufacturers like General Motors, Ford, IBM and HP.”).
84. See id. at 456 (“Firms in emerging economies like China and Brazil are seeking to move to the head of GVCs . . . [and] can rely on global suppliers in their midst and on broader GVCs for a wide range of inputs and services, from design to production to logistics to marketing and distribution.”).
86. See Gereffi, supra note 6, at 453–56.
landscape. This article argues that the evolution of the Chinese suppliers through the models of Original Engineering Manufacturing (OEM) (suppliers that manufacture designs given to them), and Original Design Manufacturing (ODM) (suppliers that develop products and designs on their own) presents promising opportunities to both inbound investors into China and outbound investments initiated expansively by Chinese capitalists, and that the constantly reforming international trade regime and corporate governance of multinational corporations should expect and incorporate new frontiers of legal issues in earnest.

The discussion should begin by describing the evolution of the concept of the value chain over the past three decades by comparing roles played by each of the three components in the consumer-product value chain. In the past, there was little intersection and interaction in the functions of different supply chain players. Thirty years ago, brand companies were conceived of as key drivers of innovation who cultivated and nurtured their influences on and associations with retailers and consumers to foster each new generation of ripened series or established productions. Strategic roles, such as business development, product design, intellectual property protection, sample engineering and manufacturing, and clientele control were held as central commitments and calculated tasks that were coordinated internally by multinational corporations. Manufacturers in China back then conducted almost nothing more than basic engineering, such as fabricating accessories and source components, assembling product, and compiling key parts of final productions. Relatively speaking, at the very beginning of the value chain, the added value or improvement made by a Chinese manufacturer was narrow, and, as a result, profit margins from manufacturing were thin. At the other end of the value chain, retailers or lower-tiers of distributors were primarily accountable for end distribution and interacting with the end consumers.

Nowadays, Chinese suppliers and manufacturers engage in a diverse landscape and face an emerging horizon for bettering their capacities, which in turn presents a dynamic scheme for legal discourse to effectively address. In particular, product-marketing companies, or

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87. See generally Li-Wen Lin, Legal Transplants through Private Contracting: Codes of Vendor Conduct in Global Supply Chains as an Example, 57 AM. J. COMP. L. 711 (2009) (using China as an example of legal transplantation effects in supply chain).
88. See Gereffi, supra note 6, at 434–35.
89. See id. at 437–39.
90. See id.
91. See id. at 436.
92. See Parella, supra note 6, at 802 (“[O]ne of the advantages of [the] global value chain is that it delegates and distributes roles among several actors in a manner that avoids duplication of efforts, capitalizes on the functional advantages of the actors, and adds value through a progression of steps.”).
brand companies, materially engage matching manufacturers as new
products are initiated, designing and improving processes in order to
lower engineering costs and energize a nimbler transition to the
manufacturing fronts. Chinese suppliers or manufacturers have
embraced the opportunity for their increased involvement by
aggressively investing in engineering resources to meet customer needs.
Meanwhile, some Chinese product management companies, in pursuit of
targeted products with the motivation of improving margins, openly and
aggressively compete in global bidding for new products. By being
engaged earlier in the production process, Chinese suppliers evidently
have managed to sidestep the gamble of competing on mere lowest-cost
and labor-intensive manufacturing, rather improving margins by
leveraging the “value-base” approach rather than on the “cost-plus”
basis, which was a natural upshot of calculation from income tax
avoidance. Admittedly, the incorporation of Chinese manufacturing
suppliers or manufacturers into value-chain-building process has
resulted in truncated development and production lead times; however,
such early integration practice may expose to sourcing professionals the
risks of failing to locate the best-cost supplier. Particularly over the
past 10 years, the intertwined convergence of the three value chain
segments has gradually remodeled previous value chains and extended
influence from the brand company to the supplier. For instance, the
market has experienced the alliance of cross-industries retail sectors as
well as the goal of Chinese suppliers to escalate their margins and
protect local manufacturing leadership through creating extra and
exclusive ODM products. Moreover, brand companies now thrive
because they are more cost competitive through low-cost country
manufacturing.

In terms of consolidation of retail sectors, based on the advantages

93. See Li-Wen Lin, Corporate Social Accountability Standards in the Global Supply Chain: Resistance, Reconsideration, and Resolution in China, 15 CARDOZO J. INT’L & COMP. L. 321, 334–35 (arguing that in the buyer-driven commodity chains, “large retailers, branded marketers, and branded manufacturers play the pivotal roles in setting up decentralized production networks in a variety of exporting countries”).

94. See Nagel & Van Blerkom, supra note 39, at 131–32 (noting that “the gaming of pricing by a particular business unit or region to the detriment of other business units or regions within an enterprise [or the entire value chain]”).

95. See id. at 135 (noting the invoicing and related considerations for value chain pricing and arrangement).

96. See Lin, supra note 93, at 324 (“Manufacturers in developing countries . . . are usually small companies measured on an international scale[, and] . . . profit from the multinationals’ cost-reduction strategy . . . . Meanwhile, the product market in the developed countries has become so competitive that multinational companies are pressed to squeeze every penny out of their operations, including their supply chains.”).

97. See Dhruv Grewal et al., Retail Success and Key Drivers, in RETAILING IN THE 21ST CENTURY: CURRENT AND FUTURE TRENDS 28 (Manfred Krafft & Murali K. Mantrala eds., 2010); see
of Chinese OEMs and China’s expansive shipping industry, top retailer alliances increase margins through the development of “house brands” to supplement or compete with any given traditional supplier’s (brand companies’) offerings. Although consumers may initially treat such activity as competitive strategies or marketing incentives on an opportunistic basis, gradually consumers have modified their consumption patterns, and the “house brand” trend has become widespread for production lines covering hardware, clothing, and especially fast-moving consumer goods in groceries, while competing with and finally pushing out many brand companies.

The formidable OEM philosophy, i.e., exactly the same products with different trademark or labels, has increased manufacturer leverage through function consolidation, and retailers compete equally as an appealing alternative customer pool for Chinese manufacturers, creating a “win-win” scenario for both giant retailers and Chinese manufacturers to greatly increase their margins by competing with established IPOs or brand company agents. As a result, such coalition between retailers and Chinese manufacturers has further energized brand companies to lower prices and increase margins by shifting to the house-brand practice of engaging Chinese manufacturers earlier in the process and adopting a much more flexible approach to coordinating with OEMs in local Chinese talents market, or even finding alternatives in Southeast-Asian countries with conceivably lower costs yet unstable supply or uninsured quality.

Moreover, after two decades of swift progress and accrued learning, Chinese manufactures—especially OEMs—have accumulated enough resources to capitalize and invest in essential functions such as business marketing, graphic designing and engineering, project management, quality control, talent pooling, human resource management, and

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100. For example, in the outrageously competitive smartphone industry, the Chinese company Huawei has gradually won out as a big rivalry of the world-leading Apple Inc. and Samsung for designs and capacities and became a household name in the electric industry. See generally Holly Donging Zhu & Michael Jones, Huawei: An Exemplar for Organizational Change in a Modern Environment, J. INFO. TECH. EDUC.: DISCUSSION CASES, May 6, 2014, at 1, http://www.jite.org/documents/DCVol03/v03-01-Huawei.pdf.

101. See generally Keith E. Maskus, Observations on Innovation and Technology Use in the BRICS, 18 LAW & BUS. REV. AM. 537 (2012).
semifinished-goods monitoring, all of which enables them to cater to both retailers and brand companies. To further attract US and European customers and secure a solid stance in competition, many previously private or family-owned small companies or proprietorships in China have chosen to modernize their corporate governance and devote more funds to upgrade their services with better production equipment, financing, inventory, and warehousing. Over the past three decades, under the influential appeal resulting from accelerated Chinese economic development, many Chinese suppliers and OEMs have successfully paved ways to invest and outshine their peers in such reshuffling and rationalizing processes of global supply chain transformation, augmenting their share of and influence in global competition and increasing their margins if at all possible.

B. Legal and Commercial Implications of Product Value Chain

The global value chain for consumer products manufactured in or sourced from China has been progressively intertwined and mutually contingent among all facets of the chain. For instance, previously detailed categorizations of ownership of physical manufacturing assets, as well as traditionally clear delineation of intellectual property rights, have become more indistinct and antagonistic to many top established product management companies and brand companies. By balancing dual motivations of margin realization and ownership protection, value chain players in the US and Europe may have to swallow the reality that they must earlier engage with Chinese OEM involvements, which could always lead to unforeseen ambiguities over certain ownership and rights to manufacturing assets, loss of leveraging OEM-shopping privileges, and capital immobility. Although some top established brand


103. See Gary Herrigel et al., THE PROCESS OF CHINESE MANUFACTURING UPGRADE 109 (2013) (“UP”grading in China has been a historical success, that upgrading must be seen as a learning process and that current Chinese upgrading involves a transformation in industrial learning dynamics. During the initial export-oriented industrialization strategy, Chinese producers successfully upgraded by apprenticing themselves to their foreign customers and [they] learned through integration in transnational communities of practice.”).

104. For example, Chinese overseas direct investment has been increasing quickly over the past decades. See generally NORA BURGHART & VANESSA ROSSI, CHATHAM HOUSE, CHINA'S OVERSEAS INVESTMENT IN THE UK (2009), https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/International%20Economics/1209pp_china_odi.pdf.

105. See Baldia, supra note 23, at 503–09 (introducing the structural change of sourcing transactions and intellectual property transfer).

106. See Nagel & Van Blerkom, supra note 39, at 137 (noting this is particularly important for the
companies have the capacity to nimbly use global competitive sourcing advantages to realize low production costs and prices by outsourcing certain design engineering and manufacturing services to China and other Asian countries, an inevitable inadequacy or vulnerability to this tactic is the resulting prolonged supply chain and rigidity in dealing with ad hoc policy changes and customer service emergencies. Such vulnerability may expose these brand companies to fierce competition from hostile newcomers in the same or similar industries, given the current climate of detailed segmentation of customer services.  

This article argues that three decades of striving and struggling to hone proficiencies have educated many Chinese OEMs and manufacturers to undertake tailored and customized services and obligations when interacting with overseas customers. As a result these players have adopted a great number of innovative approaches such as positive customer profiling, service categorization, intensive technology or know-how transfer, securing local advantages, and diversifications of product portfolio, among others. Some ambitious Chinese OEMs or manufacturers are not even satisfied with the passive style of competition and have fashioned bold, yet well-received, self-designed brands with self-governing intellectual property rights and pursuits. Moreover, manufacturers from Asian countries, especially China, have struggled to find ways to stand out with enhanced roles and capabilities over the past three decades, and such change complicates or modifies traditional legal discourse and measures taken by Chinese OEMs or manufacturers. For instance, Chinese OEMs or local giant manufacturers gradually take advantage of leveraging their relative market size and global customer bonds, as well as heightening the perception of their importance in product value chain, to safeguard or even hunt new investments and business development. For example, after certain Chinese manufacturers have learned lessons from suffering sourcing pricing practice in terms of how to structure the cost and margin balance: “[g]iven the long-term nature of most sourcing transactions, as well as the evolving competitive landscape and business objectives for most customers, even the best of deals are often renegotiated or, at a minimum, restructured prior to the end of their initial term.”).

107. See Parella, supra note 6, at 787 (arguing that reform of the global value chain requires acknowledging the full spectrum of interests involved and designing incentives that speak to the various segments of the value chain).

108. See Sarfaty, supra note 14, at 431 (“Global supply chains frequently include multiple layers of suppliers, which may be difficult to trace and therefore regulate[, and] . . . comprehensive monitoring by the company may not be possible.”).

109. See id. at 458 (“[H]ome states must take greater responsibility for implementation of supply chain regulations, companies must recognize that they face a major compliance challenge that requires new tools and sustained investment in their internal culture . . . . [I]t will be essential for firms to create a culture of compliance featuring cooperation among multiple departments[, and] . . . they must enforce new relations with suppliers that will foster organizational learning around supply chain management.”).
judicial and business losses by following Chinese non-legal approaches of dispute resolution when dealing with overseas counterparties, they now have managed to engage a full set of cutting-edge local and international legal services to refine and reformulate manufacturing or outsourcing services and contracts to maintain competitive edges, safeguard their own interests, and, more importantly, to greatly improve and substantiate their due reputation in global trading.

Modern global-sourcing practice has privileged the large retailers who have managed to survive the past three decades’ market changes with unprecedented advantages of selecting suppliers of their choice: established brand companies or rising Chinese OEMs. To be sure, some retailers continue sourcing from brand companies, carry the benefit of cross-industry accesses, established client bases and notoriety, and certain quality-assurance mechanisms. However, Chinese manufacturers and OEMs increasingly provide exactly the same customer satisfaction and product engineering, but with lower costs and more customizable products. Modern product value chain has seen a consistently growing number of such retailers source substantial shares of immediate or potential orders directly from Chinese manufacturers, further squeezing product-marketing companies in the value chain and exercising more control in establishing benchmark prices for goods.

Brand companies progressively face a more sophisticated domestic and global business environment when seeking to maintain competitive edges and settling challenges arising therefrom. Limited by heightened coordination with and intensified dependence on Chinese OEMs and manufacturers, brand companies must work hard to isolate certain essential functions such as raw-material and inventory financing, talents pooling and retaining, and product designing. Eventually (or ideally) brand companies have to form coalitions with Chinese OEMs and manufacturers to tackle problems that are traditionally foreign to product-value-chain considerations, such as the volatility of energy and

110. See Maskus, supra note 101, at 545 (noting that China “enacted major changes in all forms of intellectual property in the wake of its entry into the WTO in 2001 and now has a legal framework for protection that is not much different from that in the United States”).

111. Id. (noting that legal reforms “are not very meaningful if the laws are enforced poorly or on a discriminatory basis . . . . China still faces considerable obstacles in achieving a transparent and effective IPRs regime”).

112. See Herrigel et al., supra note 103, at 111 (“Foreign customers apprenticed their Chinese suppliers by showing them how to meet ever more exacting manufacturing and commercial standards.”).

113. See id. at 112 (“Strategic uncertainty, unfamiliarity with new forms of production, lack of experience with product development and design, moreover, leads producers to both tolerate and even encourage experimentation.”).

114. See Nagel & Van Blerkom, supra note 39, at 133.

115. See Gereffi, supra note 6, at 456 (identifying that the entire value chain “assures ongoing involvement in leading-edge technologies, standards, and industry best practices”).
oil pricings, unforeseen foreign exchange manipulations, disagreements from twisted customer expectations, undue labor-abuse charges, intellectual property protection and countervailing efforts, and so on. However, brand companies may suffer a very unfavorable dilemma in their desire to stabilize margins and cope with aggressive tactics from inferior competitors during the product life cycle. Whether enticed by corporate governance myopia or by lower cost quotations, it is not unlikely that brand companies may partner with inferior suppliers and be dragged into legal trouble due to suppliers’ gross breach of managerial liabilities, inexperienced financing performance, or deliberately misleading quoting tactics.116

This article further submits that modern global-sourcing practices may run into complications due to inadequate value chain management practices, which are often heightened by the subtleness of mutual trust and vast geographical distance among the parties. Such complications in turn give rise to material issues on both business and legal grounds. For instance: ownership of intellectual property rights may become disputable between brand companies and proactive manufacturers based on distinctive protective measures provided by court systems in different jurisdictions;117 technology transfer and licensing arrangements may bring in unanticipated disturbance of services or supply due to regional prohibitive measures;118 local advantages of Chinese OEMs such as environmental protection and tax compliance might be abused;119 quality assurance and process might be disruptive between brand companies and Asian suppliers; and practical financing measures adopted by suppliers or Chinese OEMs for tooling, engineering, inventory and warehousing might be unable to provide security for firms striving to achieve positive margins both domestically and on an international scale.

Moreover, corruption and counter-corruption measures in China continue to be a major concern for suppliers, brand companies, and product management companies, all of which must be attentive and careful in managing supplies and sourcing from China. Suppliers or Chinese OEMs should be clear about their government relationships and public affairs management, to avoid falling into in existing and potential unethical business practices, political scandals, or economic crimes. For any violation of anticorruption practice, brand companies and product

116. See Parella, supra note 6, at 792 ("Host States often suffer from weak or non-existent regulatory capacity that prevents them from enforcing standards and ensuring compliance.").
117. See Balda, supra note 23, at 502.
118. See id. at 526.
management companies should be stern in upholding values and enforcing compliance principles,\textsuperscript{120} going so far as to employ tactics such as: punitive adjustment of profit share scheme; immediate cancellation of existing and potential orders; suspension of licensing arrangements or technology transfer; dissolution of business partnerships and alliances; and termination of all possible commercial liaisons.

In summary, for the past three decades, patterns, models, and mechanisms of global sourcing have undergone unprecedented changes. Traditional practices and standardized measures for handling Chinese manufacturers and OEMs should be modernized to adequately anticipate and avoid issues in the current reciprocally assimilated product value processing chain. Legal discourse and policy orientation should reflect reforms and variations matured in the past three decades, in terms of transforming from a pattern of distinct accountabilities of each party with a relatively narrow scope of deliverables, to encompassing a more generalized and multifaceted range of functions and obligations. The enumerated advances in global sourcing involving Chinese manufacturers and OEMs also reflect a rhetoric conversion in that more novel issues and concerns are addressed by protecting interests and investments of all parties, creating a “win-win” landscape for prospect development. Consequently, development in global sourcing also calls for innovative yet practical approaches to legal and policy reform to reinforce current low-cost strategies and steady supply of quality consumer goods, which best serve the interests of all parties in the product value chain.

IV. LAW AND PRACTICE OF GLOBAL SOURCING FROM CHINA

China, as the “World Factory” or “Inc. No. 1,” played a major role in the transformation of global-sourcing practices over the last three decades and established itself as an influential player in the international trade arena.\textsuperscript{121} Sourcing from China has been an intriguing phenomenon with mixed reviews over the years in that the supply of goods are either acclaimed or denounced for variance in quality and pricing.\textsuperscript{122} For developed or industrial economies, China is known for “processing trade” for its ability to offer a low-cost labor force, cheap raw materials


\textsuperscript{121.} See generally CHINA AS THE WORLD FACTORY (Kevin H. Zhang eds., 2006).

and a full-pledged logistics service system. Whether the goods are artless Christmas trees or Dell personal computers, or high-tech components for Boeing or millions of units of the Apple iPad Pro, a large chunk of Chinese exportation involves global sourcing or contract-manufacturing goods that are designed or invented elsewhere. “Processing trade” means China imports essential inputs or licenses key technologies, which are applied and assembled therein predominantly for exportation only. Elaboration and continuing maturity in global sourcing have positioned China with an irreplaceable status of contract-manufacturing terminus and hub. This in turn intrinsically associates its own success in developing its economy and legal system with the cooperation and incoming capital of its trading partners, who have periodically voiced complaints about threats from China.123

This part contends that the development of global-sourcing systems and the maturity of product value chains have interwoven with China’s recent accomplishments and grant China comparative advantages as one of the largest sources and vendors of manufacturing supplies. Multinational corporations should respect China as a unique destination for sourcing and realizing economic value scales. Debates and analysis are voluminous on the interactions among global-sourcing changes, Chinese OEMs, processing trade, developed economics, and so on. This part further contributes related thoughts on an array of legal issues involving compliance, due diligence and major areas of global sourcing, where interactions and mutual reassurance between global-sourcing practitioners and China were established. Such issues include workplace safety, labor standards and disputes, intellectual property protection, dispute resolution, tax incentives framework,124 anticorruption measures, and recent policy developments. However, due to mere space limitations, this part focuses primarily on sourcing-related jurisdictional issues on tax incentives and transfer-pricing framework, anticorruption efforts and updates, and due diligence and compliance review in China, which are the top-prioritized legal issues for multinational corporations. By no means does this article understate the significance of other relevant legal issues more briefly discussed herein.

123. See Gereffi, supra note 6, at 441 (“[C]hallenge of economic upgrading in [global value chains] is to identify the conditions under which developing and developed countries and firms can ‘climb the value chain’ from basic assembly activities using low-cost and unskilled labor to more advanced forms of “full package” supply and integrated manufacturing.”).

A. Global-Sourcing-Related International Tax Framework and Transfer Pricing

1. Tax Treaty Framework

Global-sourcing practice and product value chains are heavily colored by companies trying to coordinate comparative advantages of tax incentives, international tax policies, tax treaties, and transfer-pricing policies among all jurisdictions which provide value-added manufacturing services or implement technology and know-how transfer policies. For instance, China’s framework of tax treaty, tax incentives, and international tax policies has encouraged and accommodated foreign investment and global sourcing to great effect. One outgrowth of China’s great economic advances is its steadily escalating move from being a passive norm-taker to being a driver of discourse in various international arenas, such as China’s continual efforts in reforming its international tax policies and outreach. Since China concluded its first two tax treaties with Japan (1983) and the United States (1984), its tax treaty network has expanded to include ninety-nine tax treaties (as of 30 June 2013), and two arrangements with its own special administrative regions, Hong Kong and Macau.125

China’s tax treaty framework is profoundly impacted by different stages of growth and various developmental goals of the Chinese economy. China’s growth-friendly and revenue-oriented tax-treaty framework function to eliminate double taxation, redistribute tax revenues, and pledge economic benefits from the stance of a net-capital-importer state. Given its fiscal reform, international trade surplus, and foreign direct investment (inbound and outbound) to and within China, the evolution of Chinese tax treaties over the past three decades reflects a few notable patterns, especially with regard to synchronizing with global sourcing and product value chains.

First, Chinese tax treaties are characterized and inspired by the hybrid influence of the UN Model and Commentary thereon, the OECD Model and Commentary thereon, and China’s indigenous economic, cultural, and political features and priorities. On one hand, China has concluded different specific tax-treaty provisions with developed (typically OECD members) and developing countries (South American, African and Southeast Asian states). Even for various OECD member countries, China either designed or reserved certain provisions and adopted specialized approaches for specific relationships, especially in recent renegotiation. On the other hand, such hybrid influence goes beyond

125. See Guo Jia Shui Wu Zong Ju (国家税务总局) [State Administration of Taxation], http://www.chinatax.gov.cn (last visited on Nov. 3, 2016).
rigid inclusion of model provisions. Many principles, guidelines, and concepts borrowed therefrom have been embedded in treaty negotiation and practice. In this connection, global sourcing is deeply involved in adopting either the OECD Model or UN Model pending on specific advantages necessarily to be taken by China or its trading partners.

Second, the evolution of tax treaties between OECD member countries and China witnesses a broader scope of source taxation, especially comparing those with non-OECD developing countries or countries with less sophisticated tax regimes. This claim can be substantiated by provisions involving tightened compliance requirements, as well as the adoption of anti-abuse rules. This trend is worthy of closer observation. Moreover, China’s economic growth may promote tax-treaty practices in some senses. Based on approximately ¥11 trillion of tax revenue in 2013, China tends to be flexible yet aggressive in negotiating tax-treaty provisions.

Third, a general reevaluation of China’s treaty position has begun based on China’s emergence as a growing capital exporter rather than a mere capital receiver or importer. For example, Chinese manufacturers and OEMs have progressively transformed from mere manufacturing vendors to multifunctional commercial value providers, and such changes need immediate reflection in treaty renegotiation for the benefits of enlarged realizable margin. One driver behind this change is China’s substantial foreign exchange reserves, which invites the use of conduits for Chinese capital to be reinvested in China via overseas investments. Another force is that multinational enterprises invested or controlled by Chinese financial firms have started investing abroad in a myriad of enticing acquisitions and profitable businesses, putting China at the front of international tax policy negotiations. In terms of global sourcing, the majority of recent treaty renegotiations have

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128. See Nargiza Salidjanova, China’s Foreign Exchange Reserves and Holdings of U.S. Securities, USCC ECON. ISSUE BRIEF, Mar. 21, 2014, at 4 (noting that Hong Kong is the top destination for Chinese FDI, accounting for over half of the total outflows in 2012, which suggests that Hong Kong is being used as a conduit for Chinese seeking to invest abroad).
removed the tax-sparing clause and reduced the withholding tax rate on direct dividends, which likely would give Chinese investors more shares of margin based on arrangements of produce value chain.

Fourth, but not least, with China’s continuous reform in its system of tax law since 1994, especially after China became a WTO member country in 2001, and the enactment of the Enterprise Income Tax Law (EIT Law)\(^\text{129}\) in 2007, China’s tax treaties concluded thereafter exhibit striking differences from those agreed to in the 1980s and 1990s. For example, general anti-abuse rules, CFC rules, and the abolition or removal of certain tax incentives were all directly raised in recent tax treaty negotiations and implementations.\(^\text{130}\) Again, this trend has made an impact on global sourcing, especially with regard to how to structure a transfer-pricing model without arousing sensitive anti-abuse rules.

2. International Tax Policy Goals

In terms of global sourcing, the fundamental goals of China’s international tax policy focuses on economic margin expansion for Chinese OEMs and manufacturers, and in turn serve Chinese economic growth and fiscal collection.

First and foremost, the prevailing goal of any effort to reinforce revenue collection should be firmly sustained through product-value-chain arrangement, especially under worldwide tax competition for highly mobilized capital. This point is vital, as China labels itself a developing country and a capital receiver, and is gradually becoming a growing capital exporter. Second, tax treaties should eliminate international double taxation and double non-taxation to assure that income from sourcing is taxed only once. Third, tax treaties should reconcile contradictions or conflicts of interests between China and its treaty partners to properly distribute tax revenues arising from international sourcing activities. In this regard, the tax treaties more serve the function of redistributing tax revenues. Such reconciliation also factors in the negotiation and participation of other international treaties and protocols, such as those related to international trade.


\(^{130}\) For example, the recently concluded China–Netherlands tax treaty (effective as of Aug. 31, 2014) incorporates relevant consideration into clauses on permanent establishments, dividends, interests and royalties, and capital gains on shares, which makes the Netherlands one of the most favourable holding jurisdictions for investments from and into China. See generally DELOITTE, TAX AND INVESTMENT IN CHINA 2016 at 10–15, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-chinaguide-2016.pdf.
Fourth, but more noticeably, the implementation of tax treaties should be embedded efficiently—or, ideally, seamlessly—into China’s existing public administrative and judicial systems. This goal is strategically crucial because China has been prioritizing unilateral measures for Chinese manufacturers and OEMs, such as tax credits and tax exemptions, which target the largest possible reduction of double taxation.

The development of Chinese tax treaties originates from, and associates with the growth of, foreign direct investment into China for the “maturity process” of the whole tax system. Meanwhile, the general performance of foreign investment echoes and pressures global-sourcing practice and product-value-chain arrangements, as long as brand companies and Chinese OEMs are contracting parties encouraging cross-border investments and capital movement. Multinational corporations also take advantage of centralized management to arrange functional segmentation of resources and intra-firm sourcing strategy. Moreover, the patterns of tax treaties have heavily progressed over time, especially with regards to factoring in consideration for foreign direct investment, international trade turnover, and the balance of foreign trade and investment with particular trade partners or multilateral-treaty-contracting States. It is not at all surprising that the first few Chinese tax treaties were more a friendly gesture to foreign investors with receptive skeleton provisions. The economic and distribution functions of these tax treaties were aimed at attracting foreign direct investment and anticipating investment security for investors from developed countries, especially OECD member countries. For example, early investors from Japan and the United States expected to place their investments in a tax-safe, stable, and predictable environment, with known tax rates for investment profits, the existence of tax-sparing clauses, and relevant tax dispute-resolution options.

As China has gradually expanded its tax-treaty network to the other BRICS countries, transition economies, developing countries from Africa, Latin America, and Asia, and offshore financial centers such as

the Cayman Islands, Bermuda, and the British Virgin Islands, China has prioritized protecting its outbound foreign direct investment through certain tax-treaty provisions and mutual information exchange agreements. For example, Chinese international tax policy puts more thought into how to support Chinese OEMs and manufacturers transform into multifaceted, proactive providers, complete with value-added functions. A recent pattern is that earlier tax treaties with some OECD member countries have been renegotiated by incorporating stricter source-taxation rules and GAAR provisions.135 Accompanying such efforts, China’s State Administration of Taxation (SAT), the highest Chinese tax authority, has circulated key interpretative guides and made official rulings on tax-treaty provisions. In addition, in the past five years, China has rushed into a few tax treaty amendments with major offshore financial centers (tax havens) to address information exchange, mainly due to fevered outbound Chinese capital flow through international securities markets and the related frenzied flow of money, in order to curb unjust enrichment from the appreciation of Chinese currency and the distortion of the real estate market.

3. Management of Transfer Pricing Relating to Global-Sourcing Practice

For global-sourcing-related policies on transfer pricing, Chinese tax treaties generally follow Article 9 of the OECD Model codifying the arm’s-length standard. The two main regulations governing transfer pricing are the Implementing Regulations for the Enterprise Income Tax Law136 and the Detailed Rules for the Implementation of the Administration of Tax Collection Law.137 In addition to a few SAT circulars dealing with specific aspects of transfer pricing,138 the SAT...
Trial Measures for Special Tax Adjustment\textsuperscript{139} are in the form of a circular, but have meaningful legal force in China.\textsuperscript{140}

Regarding pricing power and product-value-chain arrangement on margins, transfer pricing is uniquely important on interpreting details of the arm’s-length principle, which is codified in Article 41 of the EIT Law.\textsuperscript{141} Where a transaction between an enterprise and its related parties is not based on the arm’s-length principle, i.e., sourcing price designed by Chinese OEMs and overseas branding companies to take advantage of tax rates and source rules, thereby reducing the taxable income of the enterprise or its related parties, the tax authorities are authorized to make reasonable adjustments to the taxable income of the enterprise or its related parties. Apart from the system of allocation based on the arm’s-length principle, the EIT Law permits the SAT to use “other reasonable methods” in certain circumstances. Article 44 of the EIT Law provides that the tax authorities are authorized to assess the income of a taxpayer with regard to transactions with associated enterprises if the taxpayer fails to provide information on such transactions or provides false or incomplete information, in order to reflect the “true” circumstances of such transactions.\textsuperscript{142} Article 115 of the EIT Regulations allows the assessment to be based on any of the following methods: level of profit of the same or similar enterprises; costs of the enterprise plus reasonable expenses and profit margin; allocation of the overall profit of the corporate group in accordance with a reasonable ratio; or any other reasonable method.\textsuperscript{143}

Furthermore, there is no clarification in the EIT Regulations concerning what ratio of allocation is considered reasonable, what

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\textsuperscript{139} See generally \textit{Beginning of a New Era}, supra note 138.

\textsuperscript{140} The legal validity of SAT circulars has been questioned by scholars. See generally Wei Cui, \textit{What is the “Law” in Chinese Tax Administration?}, 19 \textit{ASIA PAC. L. REV.} 73 (2011) (respectfully arguing that, given the context of the current Chinese tax administration, the legal force of SAT circulars still dominates tax practice and the administration on transfer pricing).


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factors may be used in determining the ratio or whether the profit of the corporate group is limited to that earned in China.

Transfer-pricing rules apply to all forms of related-party transactions, such as product value chain within a multinational company, but questions exist whether the thin-capitalization rule is part of the transfer-pricing rules. In practice, tax authorities are authorized to reassess a taxpayer’s income by using either the arm’s-length principle or the thin-capitalization rule. Transfer-pricing rules are thus instrumental in determining the amount of taxable income of a taxpayer, and they are also regarded and used as specific anti-avoidance provisions.

Transfer-pricing audits are challenging for multinational corporations that engage in global sourcing. Bilateral and multilateral transfer-pricing audits in China generally relate to determination of the amount paid or cost in transactions among associated enterprises or Chinese manufacturers. The newly released SAT Bulletin 6 on Special Tax Investigation Adjustment and Mutual Agreement Procedures (SAT Bulletin 6), effective as of May 1, 2017, offers the latest official interpretative aid when reviewing transfer-pricing issues in China.

For example, the 2009 SAT Circular on Transfer Pricing instructs provincial tax authorities to focus audits on situations where overseas losses are being shifted onshore and onshore profits are being shifted to tax havens. For losses, under Article 29 of the Special Tax Adjustment Measures, enterprises that report losses in two or more consecutive years or companies that consistently expand their operations in China while maintaining low profits or sustaining losses will trigger transfer-pricing audits.

Chinese auditors may also inspect and gather information through Chinese embassies or consulates in foreign countries, or conduct a field audit in a foreign jurisdiction. For timing issues, Article 53 of the EIT

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Law requires enterprises in China to adopt the calendar year as their taxation year. Many enterprises have their audited financial report finalized only in the first quarter of the following year.

4. Transfer Pricing for Intra-Group Services

Multinational corporations dynamically engage intra-group services for establishing transfer-pricing arrangements and increasing cross-border capital mobility for achieving additional margins. In this connection, SAT has implemented more stringent requirements and issued a draft Circular titled “The Discussion Draft on The Implementation Measures of Special Tax Adjustments” (the Draft Circular) in September 2015, which affirms the threshold for Chinese taxpayers or affiliates of multinational corporations to prepare three-tier, contemporaneous transfer-pricing documentation: a master file, a local file, and a country-by-country file as needed.

For the key requirement of the local file, SAT expects it to disclose the following: more detailed and rigorous analysis on valuation chain creation analysis on related intercompany transactions; overall business operation flow; product and cash flow of multinational corporations; consolidated financial statements and all individual financial statement for each entity participating in the overall business transaction within the multinational group; allocation methods and result of global profits; and information on FDI and equity transfer within a multinational corporation’s group.

More important, multinational corporations involved in intra-group services, cost-sharing agreements, or thin-capitalization schemes must prepare a “special issues” file for intra-group services, especially processing trade and global-sourcing services. Accordingly, multinational corporations should be able to complete a whole package of tasks, including: disclosing copies of relevant intra-group services agreements; delineating the covered services and billing details; identifying and allocating service costs; selecting specific transfer-

pricing methods to prove validity of the pricing; and revealing information about any cost sharing arrangement and thin capitalization.

Accordingly, the focused issue of intra-group services is whether the service fees paid and/or received by Chinese subsidiaries should follow the arm’s-length method. A further issue to tackle is whether management fees and service commissions should be charged because Chinese subsidiaries may benefit from such services. As a result, the benefit test or necessity test should be applied to determine whether such services are truly needed by the Chinese subsidiary, and whether such services are remunerated through transfer-pricing policies already established with related party transactions.

For global-sourcing practice and product value chain, there are a few special issues to watch for to better implement the new Draft Circular. First, global-sourcing practice within a multinational corporation should pass a validation requirement known as an authenticity test to ensure the reasonableness of allocation schemes that SAT finds hard to verify or is unlikely to fully accept evidence of substantiation provided by subsidiaries. Moreover, SAT recommends disclosing in the Master File the global transfer-pricing policies, methods, and amount assigned to each subsidiary as comparable. Second, global product-value-chain arrangements must provide clarity regarding intra-group payments for royalties or technical services fee, in that technology licensing arrangements may incorporate service terms of technical assistance, which requires different tax treaty interpretation. Third and more important, product value chain should disclose the value creation process and contribution scheme for SAT’s review and confirmation. Therefore, in addition to traditional OECD guideline methods, the new SAT Draft Circular recommends a value contribution allocation method (VCAM) which is in line with value creation approach under OECD’s Base Erosion and Profit Shifting Action Plan. 150  Multinational corporations should submit reasonable formulae to calculate the impact of value-creation activities on overall revenue, such as assets, cost, revenue, headcount, and consistency.

For intra-group transfer-pricing audits, the issues center on definition of cost pools, consistency between business reality, and inter-company agreements. Therefore, for companies employing a product value chain, the selection of allocation methods and transfer-pricing policies receives more attention, especially when service fees may be reclassified as royalty payments leading to significant withholding tax and corporate income tax adjustments under tax treaties. At present, it is still unknown

whether the lack of reliable comparable companies in developing countries gives an edge to SAT to potentially allocate more profits to Chinese entities than to other benchmarking companies.

B. Anticorruption Considerations of Global-Sourcing Practice

1. The New Wave of Anticorruption Campaign in China

Corruption in commercial and foreign investment areas is by no means a newfangled challenge plaguing public faith and hindering integrity in the Chinese business environment. It is a modest, inescapable reflection of a social climate which has flourished alongside China’s focus on market-economy construction and encouraged overseas investment. Different from other sectors, detriments of corruption in commercial and investment areas are widespread and hideous, and greatly undervalue returns and investments for the long-term nourishment of society.

Global-sourcing practice has been a notorious hotbed for corruption for decades, mostly through the manipulation of classic countertrade approaches with non-cash compensation and by conspiring with government officials for undue benefits. The political and social environment since 2013 has imposed maneuvers and controls as part of a nationwide anticorruption crusade advanced by Central Commission for Discipline Inspection (CCDI) and China’s central leader, President Xi Jinping.\textsuperscript{151} Since Xi assumed Communist Party of China (CPC) core leadership in November 2012, Xi initiated waves of anticorruption campaigns, particularly against government officials who have considerable discretion over determinants of economic activity and resource allocation. In the most recent round of anticorruption campaigns, Xi advocated that authorities—especially CCDI—chase “tigers” (high-level officials) and beat “flies” (low-level officials)\textsuperscript{152} to demonstrate the seriousness of the central leadership’s commitment to fight corruption. Chinese policymakers and central leadership also share a consensus that corruption embedded in various hierarchical levels constitutes a formidable obstacle to government accountability and hurts continued economic growth, the percentage of which has plummeted to 6.9% annual growth in 2015, the lowest annual improvement since the


In China, corruption is generally perceived as the abuse of public office or privileges for private gains. However, the interpretation of just what constitutes “corruption” in the modern Chinese context is conceptualized in different approaches as a definitional issue. In China, the most common notions of corruption are *fubai* and *tanwu*. The former is broader and translated into English as “rotten,” or “decaying,” while the latter is common to economic or westernized senses and refers to actual rule breaking, such as bribery and embezzlement, which might be more evident in global-sourcing practice. As opposed to other countries, Chinese authorities target not only allegedly corrupted officials or entrepreneurs, but also their relatives, and label extramarital affairs or sex-based bribes as instances of corruption in China.

A central dilemma for almost all jurisdictions looking to secure a healthy and robust environment for investment and commercial activities is the balance of combatting corruption while maintaining power. Before Xi took over, periodic anticorruption campaigns launched in China against corrupt officials displayed a similar pattern: a few low-profile, local officials were selectively penalized with heavy sentences to warn other incumbent officials. Therefore, a close watch over the development of balance between corruption and countermeasures since the late 1970s reveals that China’s rapid transformation from planned, centered economy to market, open economy stimulated the emergence of corruption. Economic reforms and experimental policies provided ample opportunities for corruption and profiteering to flourish while institutional, administrative, and legal fundamentals lagged to certain extents. Previous cycles of crackdowns on corruption largely resolved into cosmetic hype, and failed to provide meaningful deterrence and punishment.

Particularly, in the most recent round of anticorruption efforts, CCDI, as China’s highest graft-buster, has been tasked and assigned with the
broad mandate to conduct investigations and disseminate stationed investigative teams to various ministries including large state-owned enterprises such as Sinopec or PetroChina.\footnote{159. See Dingding Chen, China’s Anti-Corruption Campaign Enters Phase Two, DIPLOMAT (July. 2, 2015), http://thediplomat.com/2015/07/chinas-anti-corruption-campaign-enters-phase-two/\/.} A tough yet popular approach undertaken by CCDI is the *shuanggui* scheme, through which suspects of corruption, especially government officials, are summoned and interrogated for confession at designated time slots and locations.\footnote{160. See Keith Zhai, Communist Party Seeks to Reform Its “Shuanggui” Anti-corruption Investigations, SOUTH CHINA MORNING POST (Nov. 21, 2013), http://www.scmp.com/news/china/article/1361851/communist-party-seeks-reform-anti-corruption-investigations (discussing rampant movement on anti-corruption).}

Additionally, CCDI also must deal with the complicated issue of who investigates or monitors CCDI if it abuses power or becomes corrupted. Meanwhile, CCDI issued and strictly enforced a series of new regulations and protocols against extravagant practices and lifestyles. An evident indicator is the sharp decline of sales and importation of luxury items, known to be popular as gifts in exchange for official favors or personal gains, and even the gambling revenue in Macau has sharply decreased.\footnote{161. See Chow, supra note 152, at 688.} Moreover, a forceful tenet of Xi’s anticorruption campaigns is to embrace transparency and accountability through educational programs for the public, especially Internet users. For example, CCDI set up and publicized a designated website to encourage the anonymous reporting, accusation, and exposure of suspicious corruption or corrupted officials.

In summary, the recent anticorruption campaign advocated and enforced by Xi and CCDI used diverse methods to achieve increased transparency and efficiency. First, China has promulgated a series of new laws and regulations to buttress and cultivate the judicial prong of anticorruption efforts, in addition to enhancing administrative quality of government bureaucracies and promoting a social atmosphere against corruption. Second, enforcement of those new laws, regulations, and detailed CPC discipline protocols has been austere and stern. The enforcement protocols swept through almost every significant governmental sector, as well as industries for economic development such as banking, capital markets, higher education, finance, food safety governance, healthcare, real estate, and resources and energy. Third, the CCDI through media of all forms made it clear that officials should remain vigilant, honest, and independent in performing and executing duties, as authorities intend to severely punish those committing corruption in the height of crackdown,\footnote{162. See generally Tianlong Lawrence Hu, The Politics of the Drive Against Corruption, U. WORLD NEWS (Jan. 8, 2016),} including senior officials,
leaders of public universities, and senior intellectuals or faculty, who in some senses are looped into the party system and therefore are subject to CCDI jurisdiction.

This progress signals China’s commitment to combating corruption in all sectors. Detailed interpretation and enforcement of new laws and regulations also signals improved transparency. It is expected that that incumbent senior management of multinational corporations would subscribe to stricter behavior codes with awareness of China’s anticorruption goals of improving transparency and solidifying political stability.

2. Strengthened Legal Measures for Anticorruption

Even as the post-2013 unparalleled toughness of anticorruption crackdown in China is unprecedented, the recent wave of anticorruption crusade should not be considered merely a political purge that will ebb once the current leadership loses power. Moreover, despite criticism of the certain selective approach to enforcement and charges of lacking judicial transparency, this article praises Chinese leaders’ grit, will, and determination in curbing corruption. It also submits that such anticorruption efforts improve the rule of law in China, which is also reflected in President Xi’s reform agenda.163

The legal framework of anticorruption is a comprehensive and multifaceted undertaking by the Chinese government, and legal flexibility of anticorruption enforcement is quite broad. To illustrate, a wide variety of bribery-related activity is punished: bribes to government officials; bribes to or given by a natural person; bribery in exchange of improper benefits; bribe taking; bribes to non-government officials; bribes to or given by legal persons, such as companies, associations, or other entities; and bribery in exchange of business opportunities and competitive advantages. The legal consequence of such strong anticorruption is voluminously covered in China’s legal code system, as well, and liabilities imposed therein are extensive.164 In particular, criminal liability includes imprisonment of individual offender or executives of an offending enterprise, and there are no limits on the amount of criminal fines in addition to criminal sanctions. Administrative liability covers administrative fines, forfeiture of

http://www.universityworldnews.com/article.php?story=20160105132631220 (discussing the area of higher education to which the CCDI paid unprecedented attention).


unlawful profits generated from bribery activities, and administrative sanctions. Moreover, a corruption conviction carries with it other consequences such as prohibition from government procurement, reputation damage, and other collateral litigation.

The National People’s Congress of China recently passed and released the ninth amendment (Ninth Amendment) to the Criminal Law of the People’s Republic of China 2015 (2015 Criminal Law), labeling and toughening-up anticorruption rules to be among the strictest in the world. Various judicial and administrative authorities also have issued or updated new rules to advance executive procedures, compliance, accountability, reasonable disclosure, record keeping, de-administration, transparency, and interagency communications, covering both official bribery and commercial bribery, both of which relates to global sourcing to large extents. In particular, in addition to increasing the criminal fines applicable to individuals, the 2015 Criminal Law criminalizes the act of giving bribes to retired officials of influence, as well as to persons who are not themselves serving or retired government officials but who may be in a position to exert influence thereon. Further, the 2015 Criminal Law restricts the circumstances in which sentences for bribery offenses can be mitigated or exempted for self-reporting.

Previously, bribe payers could alleviate penalty or be discharged from criminal liability if they voluntarily admitted their crimes before being prosecuted. However, under the Ninth Amendment, eligibility for

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166. See Chow, supra note 164, at 1017–18.

167. See Article 390A of Criminal Law of People’s Republic of China, effective as of November 1, 2015, stipulating that “whoever, for the purpose of seeking illicit benefits, offers bribe to any close relative of an employee of a state functionary or any other person who has a close relationship with the said employee of the state authority, or any dismissed employee of a state authority or any of his or her close relatives or any other person who has a close relationship with the said employee shall be sentenced to imprisonment of not more than three years or criminal detention in addition to a fine; if there is any serious circumstance or any serious loss has been caused to the national interest, shall be sentenced to imprisonment of not less than three years but not more than seven years in addition to a fine; or if there is any other especially serious circumstance or any especially serious loss has been caused to the national interest, shall be sentenced to imprisonment of not less than seven years but not more than ten years in addition to a fine.” Zhong Hua Ren Min Gong Ge Guo Xing Fa Xiu Zheng An (Jiu) (中华人民共和国刑法修正案(九)) [Amendment (IX) to the Criminal Law of the People's Republic of China] (promulgated by Standing Comm. Nat'l People's Cong., Aug. 29, 2015), art. 46, http://www1.lawinfochina.com/display.aspx?id=19864&lib=law (China) [hereinafter Amendment IX].

168. See Article 390 of Criminal Law of People’s Republic of China, effective as of November 1, 2015, (“The briber who actively confesses to his or her crime before being prosecuted may be given a lighter or mitigated penalty. Whoever commits a relatively minor crime and plays a crucial role in resolving an important case or has any major meritorious performance may be given a lighter penalty or be exempt from penalty.”). Amendment IX, supra note 167, art. 45.
reduced penalties presumes that the offense must be relatively inconsequential, and the bribe payer must either confess crucial information leading to a successful investigation of others in a significant case or contribute to the investigation in a meaningful way.\textsuperscript{169} Also, prior to the Ninth Amendment, criminal bribery fines were prescribed principally against corporate offenders, instead of individuals. However, the Ninth Amendment expanded the application of criminal fines for the offense of giving a bribe to include certain individual offenders: individuals bribing non-government officials (Article 164); individuals bribing government officials (Article 390); and individuals brokering bribery to government officials (Article 392).\textsuperscript{170}

While it has been a crime to receive a bribe since 2009, the 2015 Criminal Law for the first time criminalizes bribing a person who may exert influence on a current or former government official. The Ninth Amendment aims to thwart nepotism exercised by government officials, incumbent or retired, from accepting or soliciting bribes through their “inner circle” of relationships. In particular, for an official bribery offense where offenders intentionally provide property to a “state work official” in return for improper gains or benefits, the amount involved therein should exceed certain prescribed threshold. Penalties in this connection range from temporary criminal detention up to life imprisonment in addition to confiscation of illegal gains.\textsuperscript{171} The 2015 Criminal Law empowers local courts with extensive discretion in sentencing individuals since it fails to delineate a scheme for fines calculation. Accordingly, the range of criminal fines imposed on an individual bribe payer is quite unpredictable and potentially consequential.

In addition to the general upgrading of criminal law and measures, a few of China’s judicial authorities and industry regulators have issued

\textsuperscript{169} See id.

\textsuperscript{170} Paragraph 1 of Article 164 of the Criminal Law was amended to read: “Whoever gives any property to a staff member of a company, an enterprise or any other entity for any illicit benefit shall be sentenced to imprisonment of not more than three years or criminal detention in addition to a fine if the amount of property is relatively large; or be sentenced to imprisonment of not less than three years but not more than ten years in addition to a fine if the amount of property is huge.” Amendment IX, supra note 167, art. 10. Paragraph 1 of Article 392 of the Criminal Law is amended to read: “Whoever introduces bribery to any employee of a state authority shall be sentenced to imprisonment of not more than three years or criminal detention in addition to a fine if the circumstances are serious.” Id. art. 10.

\textsuperscript{171} For example, according to Article 383(3) of the new Criminal Law, “If the amount involved in the corruption is especially huge or there is any other especially serious circumstance, the convict shall be sentenced to imprisonment of not less than ten years or life imprisonment in addition to a fine or forfeiture of property; or if the amount involved is especially huge and especially material losses have been caused to the interests of the state or the public, the convict shall be sentenced to life imprisonment or death penalty and a forfeiture of property. Id. art. 44.
rules for improving government record-keeping, tightening interagency communications, enabling background checks, and increasing transparency. These efforts will further clarify the uniformity and transparency elements of the upgraded rule of law. In particular, China’s Supreme People’s Procuratorate issued the Provisions of the Supreme People’s Procuratorate on Bribery Case File Inquiry 2013, which publicizes criminal records of those convicted of bribery.\textsuperscript{172} The State Administration for Industry and Commerce (SAIC) issued the Interim Provisions on the Disclosure of the Information on Administrative Punishments concerning Industrial and Commercial Administration 2014, which requires the basic information of parties and their corruption offenses to be uploaded to the SAIC’s newly launched online platform within 20 working days after an SAIC administrative penalty is released.\textsuperscript{173} In addition, China’s top healthcare authority, the National Healthcare and Family Planning Commission, promulgated the Regulation on the Establishment of Commercial Bribery Records in Medical Device and Pharmaceutical Sales and Purchase Areas 2013, which obliges local healthcare regulators to preserve bribery records of business operators who receive criminal or administrative penalties for giving bribes to healthcare institutions, and bans convicted business operatives from selling products to public-financed or state-owned hospitals.\textsuperscript{174}

Through new legislation and strict enforcement that deals specifically with official graft and corruption from both demand and supply sides, there is no doubt that greater transparency is expected in corruption crackdown, which will only fortify the public’s confidence in its officials. The central government also makes clear through social propaganda its firm intention to further punish government corruption.\textsuperscript{175} Moreover, new legislation such as the Ninth Amendment

\begin{itemize}
\item \textsuperscript{175} See generally China President Plans to Strengthen Anti-Corruption Campaign, JURIST (Jan. 6, 2017), http://www.jurist.org/paperchase/2017/01/china-president-plans-to-strengthen-anti-corruption-campaign.php.
\end{itemize}
provide detailed and tailored explanations of legal terms and thresholds which are not covered in prior legislation.

One problem with the new system is the dual track of CCDI and judicial systems which handle two different types of cases. On one hand, cases involving commercial stakes or slight fines usually are handled by the judicial system, such as the recent GSK case; on the other hand, cases entailing high-level government officials are first screened or filtered by CCDI before they are moved for due criminal procedure. It is without merit to conduct anticorruption cases in this dual-track manner. On one hand, it reduces public attention to certain low-profile cases; on the other hand, CCDI may have too much discretion and flexibility in furthering investigation against some high-profile cases.

Most importantly, however, the anticorruption movement enforced by Chinese central government signals its commitments to constructing a rule of law. As President Xi Jinping called for the rule of law and comprehensively established reform, the fourth plenary session of the eighteenth CPC Central Committee adopted Major Issues Concerning Comprehensively Advancing Rule of Law, showing that the legal system supports the government’s political authority. The principles and tenets of anticorruption should be enshrined in a jurisprudential manner, honoring the rule of law. The very measures the CPC and CCDI promote in corruption crackdown—such as transparency, independence, uniformity, and procedural justice—all unify the same mandates of the rule of law: certainty, consistency, equitability, and clarity. Moreover, focus on anticorruption reinstates the general public’s faith in the government’s uniformity, impartiality, and commitment to due process. Crackdown on corruption echoes a CPC ideology of the importance of the “rule of virtue” in solidifying political legacy and proclaiming fair competition, creditability, self-respect, and cooperation with government. Without doubt, anticorruption upholds the “rule of virtue” and justifies the ideology of rule of law—a concept fundamental from ancient Chinese customs which used rhetoric of the

176. See generally Chow, supra note 152 (discussing in detail commercial corruption and the impact of the GSK case to multinational corporations operating in China).


178. See id. (describing major goals: “to improve the socialist system of laws with Chinese characteristics, at the heart of which is the Constitution, and strengthen the implementation of the Constitution; to thoroughly advance the administration of government on the basis of the law and accelerate our efforts to build a rule of law government; to ensure judicial impartiality and improve judicial credibility; to strengthen the notion of the rule of law among all Chinese people and drive forward the development of a rule of law society; to raise the level of competence of rule of law professionals; and to strengthen and improve the Party’s leadership over efforts to comprehensively advance the law-based governance of the country.”).
rule of law to legitimize government. In similar fashion, anticorruption from both central and marginal approaches substantiates traditional and modern rule of law conceptions.

C. Due Diligence for Global-Sourcing Practice

Conducting due diligence on contractual manufacturing is a basic yet far-reaching element of global-sourcing practice. Each of the three components of product value chain would not generate margins without a competent due diligence and robust understanding of the whole sourcing process. When sourcing from Chinese manufacturers and OEMs, brand companies and product management companies may face entirely distinctive challenges or rewards with respect to due diligence. In terms of gradually strengthening straightforward review and outlining requirements for legal compliance, monitored by Chinese government for curbing corruption and cultivating commercial integrity, there are various goals that multinational corporations should set and accomplish.

First, a sourcing agent or multinational corporation should tailor itself as a local customer when conducting sourcing due diligence. For the most part, fraudulent suppliers or vendors would be reluctant to take the risks of cheating a local Chinese company in the same industry, especially due to the much lower costs for a local plaintiff to sue for deceitful behavior. More importantly, Chinese suppliers are much less willing to be entangled in lawsuits in their home market because losses derived from ruined business reputation usually outweigh short-term, petty benefits earned therefrom. The motivation behind this appears economic, but actually carries fundamental legal implications in that it proactively dodges possible lawsuits arising from involvement with inferior suppliers.

Second, a competent global-sourcing practice would hold back complete trust in any counterparts before making meaningful moves, such as baiting suppliers with small orders or free trial of services. Legal counsel plays a key role here, as counsel represents clients up front, conducting due diligence following a thorough and standardized process. Moreover, it is quite important and worthwhile to build up experience and understanding of scenarios potentially involving fraud; staging the buyer as the seller is a good technique to do so. Given over three decades of reform of business registration and compliance in China, global-sourcing practice should trust and credit government resources by default, in part due to legal counsels’ freedom to fully access and use public records.

Third, it would be legally wise to adopt lessons from competitors or follow settled precedents when dealing with Chinese manufacturers and
OEMs. Although it is well known that foreign sourcing activities usually receive preferential judicial protection at the national level, the formulae and rationales employed in judicial precedents in local jurisdictions would be of special reference value for remedying losses or averting risks.

Fourth, but not least, global sourcing due diligence proponents should concentrate on obtaining as many paper records of operations of Chinese OEMs and manufacturers as possible, and to think twice about their contents. This does not mean discredit the trustworthiness of legitimate documents in general or any due legal protection; rather, this practice anticipates the shortage of accurate methods of measuring suppliers’ sales or productivity. In many cases, companies should engage a trading agent in China. Trading agents in China are engaged for commissions and offer the advantage of familiarity with local practices, but their behavior and history should be closely monitored for any unauthorized subcontracting or buried lawsuits.

V. CONCLUSION

The development of global-sourcing practice and the evolution of global product value chains are in a critical stage with unprecedented issues posed by global segmentation of manufacturing and intra-group services within multinational corporations. China has gradually solidified a dominant position as the largest mass-production country and eventually seeks to expand its engagement to higher-end and more value-added services. It, therefore, is an essential partner for companies engaging in global-sourcing and product-value-chain planning. On one hand, global-sourcing development needs a soft landing by compromising interests and conflicts of all sources, which demand a modern sourcing regime. On the other hand, after two decades of development, product-value-chain creation and evolutions have entered into a new stage that requires rechecking and regrouping of all business functions, while original initiatives of strengthening fixed stereotypes will likely not properly serve the global need for capital mobility and cross-border infrastructure renovation.

China’s ambition to expand overseas investment and to improve its international position from a passive norm-taker to being a driver of the discourse in various international arenas encourages more forceful reforms in many fields to better serve legal solutions of new issues in global sourcing. These reforms include transfer-pricing arrangements, China’s anticorruption efforts, due diligence review, intellectual property protection, technology transfer, and workplace safety and labor protection. Such efforts in discovering and resolving new legal issues
again continue to be one of the focal areas for multinational corporations and Chinese legislators. Indeed, the international framework of global-sourcing coordination and multi-jurisdictional cooperation create further layers of incentives and necessity for China to fine-tune its domestic sourcing-related legal framework, ranging from promotion of free-trade zones, renegotiation of outdated tax treaty articles, more active participation in consequential overseas investments, and acknowledging international dispute resolution.