

CASE 18

NES China: Business Ethics (A)

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By April 1998, it had been almost a year since the Germany-headquartered multinational company NES AG had first submitted its application to the Chinese government for establishing a holding company in Beijing to co-ordinate its investments in China. The application documentation had already been revised three times, but the approval by the government was still outstanding. Lin Chen, government affairs co-ordinator at NES AG Beijing Representative Office, came under pressure from the German headquarters and had to find a way to obtain approval within a month.

During the past year, Chen had almost exclusively worked on the holding company application. In order to facilitate the approval process, she had suggested giving gifts to government officials. But her European colleagues, Steinmann and Dr Perrin, disagreed because they thought such conduct would be bribery and would violate business ethics. Confronted with the cross-cultural ethical conflict, Chen had to consider possible strategies that would satisfy everybody.

IVEY

Xin Zhang prepared this case under the supervision of Professor Joerg Dietz solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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COMPANY BACKGROUND

NES and NES AG

NES was founded in Germany in 1881. Over the following 100 years, by pursuing diversification strategies, NES had grown from a pure tube manufacturer into one of the largest industrial groups in Germany, with sales of US\$14 billion in 1997. NES built plants and heavy machinery, made automotive systems and components, manufactured hydraulic, pneumatic and electrical drives and controls, offered telecommunications services and produced steel tubes and pipes.

NES was managed by a holding company – NES AG – that implemented value-oriented portfolio management and directed its financial resources to the areas with the greatest profit potentials. In 1997, NES AG owned NES's 11 companies in four business segments: engineering, automotive, telecommunications and tubes. These companies generally operated independently and largely at their own discretion, as NES AG was interested in their profitability and not their day-to-day operations.

NES had always been committed to move along the road of globalization and internationalization. Headquartered in Germany, NES had businesses in more than 100 countries with over 120,000 employees. In the process of globalization and internationalization, NES established a business principle that demonstrated its responsibilities not only to shareholders, employees and customers, but also to society and to the countries where it operated. As an essential part of the company's corporate culture, this principle pervaded the decentralized subsidiaries worldwide and guided the decision-making and conduct of both the company and its employees.

NES China operations

NES's business in China dated back to 1889, when it built the flood barrages for the Canton River. In 1908, NES supplied seamless steel tubes for the construction of a waterworks in Beijing. Through the century, NES continued to broaden its presence. From the mid-1950s to 1997, NES supplied China with an enormous 5.2 million metric tons of steel tube and 1.6 million tons of rolled steel.

Since China opened up to foreign trade and investment in the late 1970s, NES's presence had grown dramatically. From 1977 to 1997, NES had completed more than 40 technology transfer and infrastructure projects. It had also set up 20 representative offices, six equity joint ventures and three wholly owned enterprises.

In developing business links with China, NES adhered to its business principle. Most NES enterprises in China had highlighted this principle in their codes of conduct in employment handbooks (see Exhibit 1). These codes required employees to pursue the highest standards of business and personal ethics in dealing with government officials and business customers, and to avoid any activities that would lead to the involvement of the company in unlawful practices. Instead of tendering immediate favors or

EXHIBIT 1 Excerpt from the Employment Handbook of One of the NES's Enterprises in China

Article 3 Employment and Duties

- 3.1 The Company employs the Employee and the Employee accepts such employment in accordance with the terms and conditions of the Employment Contract and this Employment Handbook
- 3.6 The Company expects each Employee to observe the highest standards of business and personal ethics, and to be honest and sincere in his/her dealings with government officials the public, firms, or other corporations, entities, or organizations with whom the Company transacts, or is likely to transact.
- 3.7 The Company does business without favoritism. Purchases of materials or services will be competitively priced whenever possible. An Employee's personal interest or relationship is not to influence any transaction with a business organization that furnishes property, rights or services to the Company.
- 3.8 Employees are not to solicit, accept, or agree to accept, at any time of the year, any gift of value which directly or indirectly benefits them from a supplier or prospective supplier or his employees or agents, or any person with whom the Company does business in any aspect.
- 3.9 The Company observes and complies with all laws, rules, and regulations of the People's Republic of China which affect the Company and its Employees. Employees are required to avoid any activities which involve or would lead to the involvement of the Company in any unlawful practices and to disclose to the proper Company authorities any conduct that comes to their attention which violates these rules and principles. Accordingly, each Employee should understand the legal standards and restrictions that apply to his/her duties.
- 3.10 All Employees are the Company's representatives. This is true whether the Employee is on duty or off duty. All Employees are encouraged to observe the highest standards of professional and personal conduct at all times.

Article 13 Discipline

- 13.1 The Company insists on utmost discipline. The Employee's misconduct or unsatisfactory performance will be brought to the attention of the responsible Head of Department or Member of the Management when it occurs and will be documented in the Employee's file.
- 13.2 Some offences are grounds for immediate dismissal and disciplinary procedures will apply to other offences.
- 13.3 Offences which are grounds for immediate dismissal include:
 - (i) Breach of the Company's rules of conduct
 - (j) Neglect of duties, favoritisms or other irregularities.

Source: Company files

rewards to individual Chinese officials and customers, NES relied on advanced technology, management know-how and top quality products and service as a source of its competitive advantage. NES emphasized long-term mutual benefits and corporate social responsibility. Since 1979, NES had trained more than 2,000 Chinese engineers, master craftsmen, technicians and skilled workers in Germany. It had also offered extensive training programs in China. Moreover, NES was the first German company to adopt the suggestion of the German federal government to initiate a scholarship program for young Chinese academics to study in Germany. As a result, NES had built a strong reputation in China for being a fair business partner and a good guest company.

NES Beijing representative office

In 1977, NES was the first German company to open its representative office in Beijing. Along with NES's business growth, the Beijing Representative Office continued to expand. In 1997, it had 10 German expatriates and more than 40 local staff in nine business units. One unit represented NES AG. This unit was responsible for administrative co-ordination and office expense allocation. The other eight units worked for the German head offices of their respective NES companies in the engineering, automotive and tube segments.

Chinese legal restrictions severely limited the activities of the Beijing Representative Office. It was allowed only to engage in administrative activities, such as conducting marketing research for the German head offices, passing on price and technical information to Chinese customers, and arranging for meetings and trade visits. Moreover, it could not directly enter into employment contracts with its Chinese employees. Instead, it had to go through a local labor service agency designated by the Chinese government and consult with the agency on almost all personnel issues including recruitment, compensation and dismissal. As a result, the German managers of the Beijing Representative Office found it difficult to effectively manage their Chinese employees. In the absence of direct employment contracts, the managers had to rely on an internal reporting and control system.

CURRENT SITUATION

Establishing a China holding company

In early 1997, NES AG had decided to establish a holding company in Beijing as soon as possible after carefully weighing the advantages and disadvantages of this decision. Establishing a China holding company was advantageous because, unlike a representative office, a holding company had its own business licence and could therefore engage in direct business activities. In addition to holding shares, a holding company could co-ordinate many important functions for its enterprises, such as marketing, managing government relations, and providing financial support. As a "country headquarters," a holding company could also unite the NES profile in China and strengthen the good name of NES as a reliable business partner in the world's most populous country. Moreover, it could hire staff directly and thus retain full control over its own workforce. In light of these advantages, NES AG expected substantial time and cost efficiencies from the China holding company.

Several disadvantages, however, potentially outweighed the advantages of a China holding company. First, Chinese legal regulations still constrained some business activities. For example, a Chinese holding company could not balance foreign exchange accounts freely and consolidate the taxation of NES's Chinese enterprises, although this might be permitted in the future. Second, the setup efforts and costs were high. To establish a holding company, NES had to submit a project proposal, a feasibility study, articles

of association and other application documents to the local (the Local Department) and then to the central trade and economic co-operation departments (the Central Department) for examination and approval. Third, there was only a limited window of opportunity for NES AG. Once the China holding company had received its business licence, within two years, NES AG would have to contribute a minimum of US\$30 million fresh capital to it. The Chinese regulations prescribed that this capital could be invested only in new projects, but otherwise would have to remain unused in a bank account. NES currently was in a position to invest the capital in its new projects, but the company was not certain how much longer it would be in this position.

Working team

NES AG authorized the following three individuals in the Beijing Representative Office to take up the China holding company application issue:

Kai Mueller, 58 years old, had worked for NES in its China operations since the 1970s and had experience in several big co-operative projects in the steel and metallurgical industries. He would be the president of the holding company.

Jochen Steinmann, 30 years old, was assigned to Beijing from Germany in 1996. He would be the financial controller of the holding company.

Dr Jean Perrin was a 37-year-old lawyer from France who had an in-depth understanding of Chinese business laws. He would work as the legal counsel. His previous working experience included a professorship at the Beijing International Business and Economics University in the 1980s.

The trio had advocated the idea of a China holding company to NES AG for quite some time and were most happy about NES AG's decision, because the future holding company would give them considerably more responsibilities and authority than did the Beijing Representative Office.

Considering the complexity and difficulty in coping with the Chinese bureaucratic hurdles, Mueller decided in March 1997 to hire Lin Chen as a government affairs co-ordinator for the working team. Chen, a native Chinese, was a 28-year-old politics and public administration graduate who had worked four years for a Chinese state-owned company and was familiar with the Chinese way of doing business. Mueller expected that Chen would play an instrumental role in obtaining the holding company approval from the Chinese government. He also promised that Chen would be responsible for the public affairs function at the holding company once it was set up.

Chen's view of doing business in China

Chen officially joined the Beijing Representative Office in June 1997. She commented on doing business in China:

China's economy is far from rules-based; basically, it is still an economy based on relationships. In the absence of an explicit and transparent legal framework, directives and policies

are open to interpretation by government officials who occupy positions of authority and power. In such circumstances, businesspeople cultivate personal *guanxi* (interpersonal connections based implicitly on mutual interest and benefit) with officials to substitute for an established code of law that businesspeople in the Western society take for granted.

In building and nurturing *guanxi* with officials, gifts and personal favors have a special place, not only because they are associated with respect and friendship, but also because in today's China, people place so much emphasis on utilitarian gains. In return for accepting gifts, officials provide businesspeople with access to information about policy thinking and the potentially advantageous interpretation of the policy, and facilitate administrative procedures. Co-operation leads to mutual benefits.

Although an existing regulation forbids government officials to accept gifts of any kind,¹ it remains pervasive for businesspeople to provide officials with major household appliances, electric equipment, "red envelopes" stuffed with cash, and overseas trips. There is a common saying: "The bureaucrats would never punish a gift giver." Forbidding what the West calls bribery in a *guanxi*-based society where gift giving is the expected behavior can only drive such under-the-table transactions further behind the curtain.

While sharing benefits with officials is normal business conduct in China, it is interpreted as unethical and abnormal in the West. Faced with their home country's ethical values and business rules, Western companies in China cannot handle government relationships as their Asian counterparts do. They often find themselves at a disadvantage. This dilemma raises a question for a multinational company: Should it impose the home country's moral principles wherever it operates or should it do what the Chinese do when in China, and, if so, to what extent?

Different opinions on bribery

When Chen started working in June 1997, Mueller was sick and had returned to Germany for treatment. Steinmann and Dr Perrin told Chen that NES had submitted the holding company application to the Local Department in April 1997 and that the Local Department had transferred the documents to the Central Department at the end of that month. But nothing had happened since then. Chen felt that she had to fall back to her former colleague, Mr Zhu, who had close personal *guanxi* with the Central Department, to find out first who had the authority in the Central Department to push the processing and what their general attitudes towards the application were.

In July, Chen reported her findings to Steinmann and Dr Perrin:

The approval process at the Central Department is difficult. Because holding companies are a relatively new form of foreign investment in China, the officials are unsure whether they are a good idea for China. They have been very prudent to grant approval. Hence, we don't have much negotiating leverage, although we are a big company and have products and technologies that China needs. The officials say that they will consider a holding company's application within 90 days of its submission. They issue approval however, only when the application is deemed "complete and perfect" (in that all issues have been resolved to the Central Department's satisfaction). The Central Department is under no real obligation to approve any holding company application. They can always find some minor issues. So the approval procedure may be lengthy. The legal basis for establishing holding companies is provided by the Holding Company Tentative Provisions, Supplementary Rules and some

unpublished internal policies. This provisional and vague status allows the officials to be flexible in authorizing a holding company. In such circumstances, maintaining close connections with the responsible officials is absolutely critical.

Chen suggested:

The quickest and most effective way to build such connections is to invite the responsible officials to dinner and give gifts. It won't cost the company too much. But what the company will gain in return – efficiency in obtaining approval and flexibility in the interpretation of the wording within the scope permitted by law – is worth much more

Upon hearing Chen's report and suggestion, Steinmann was shocked:

That would be bribery. In Germany bribing an official is a criminal offence for which both the briber and the bribed are punished. NES is a publicly traded company with a board of directors that reports to shareholders and monitoring authorities in Germany.

We have met the criteria for setting up the holding company. What we should do now is organize a formal meeting with the officials and negotiate with them. This is the way we have done it in the past, and it has always worked. I am not aware that we ever had to use bribery. NES does not have a history of wrongdoing.

Knowing how critical it was to follow China's customary business practices in tackling such issues, Chen argued:

Yes, it is correct. NES did not have to give gifts of this kind in the past. But don't forget: virtually all of NES's projects or joint ventures in the past were approved by agencies responsible for specific industries or local governments that were very keen on having access to NES's technology. As a result, NES always has had considerable bargaining power. It is different this time: we need to found a holding company, and we have to deal with the Central Department that we have never contacted before. Even Mueller does not have relations in this department. Moreover, our contacts at the industrial and local levels won't help much because they have very limited influence on the Central Department and, hence, the holding company application issue.

Moreover, you can't equate gifts with bribes. The approval letter doesn't have predetermined "prices" and no one forces us to pay. We give gifts just to establish relationships with officials. We develop good relationships, and favorable consideration of these officials comes naturally. According to Chinese law,² to give gifts to government officials and expect them to take advantage of their position and power to conduct *illegal* actions is bribery. Our intent is to motivate officials to handle our application legally but without delay. I see no serious ethical problem.

In some ways it's also hard to blame officials for feathering their nest because they are poorly paid. Whether they process our application quickly or slowly has absolutely no impact on their US\$200 monthly income. Then, how can we expect them to give our case the green light? They are not morally wrong if they accept our gifts and don't create obstacles for us in return.

Negotiation doesn't help much. Unless we have close relationships with them, they will always find some minor flaws in our documents. After all, they have the authority for interpreting the regulations. Therefore, we have to be open-minded and get accustomed to the Chinese way of doing business.

Chen hoped that Dr Perrin would support her, as she had a feeling that the French were more flexible and less ethically sensitive than the Germans. Dr Perrin, however, shared Steinmann's view. Perrin said:

We should not give officials anything that has some value, with the exception of very small objects (pens, key holders, calendars and the like) given mainly for marketing and advertisement purposes. I also think that these officials should not accept any gifts. It's unethical and illegal. If we think it is unethical, we should combat it and refrain from it

Nonetheless, Dr Perrin understood the importance of *guanxi* as an informal solution to Chinese bureaucracies. So he agreed that Chen could invite one of the two responsible officials to dinner through Mr Zhu and present a CD player to this official as an expression of respect and goodwill, although he thought it went too far and was approaching bribery.

On a Saturday evening in July, Chen met the official at one of the most expensive restaurants in Beijing. At the dinner, the official promised to work overtime the next day on NES's documents and give feedback as soon as possible.

The following Monday, Chen got the government's official preliminary opinion demanding a revision of 16 clauses of the application documents. Steinmann and Dr Perrin found it difficult to understand this. NES had drafted the documents with reference to those of another company, whose application had been approved by the Central Department a few months ago. Why didn't the Central Department accept the similar wording this time? Chen again contacted her former colleague Zhu, who told her:

You should never expect to get things done so quickly and easily. It takes time to strengthen your relationships. I can ask them to speed up the procedure without changing too much of the wording. But you'd better offer them something generous to express your gratitude since they would consider it a great favor. RMB3,000 (US\$360) for each of the two will be OK. Don't make me lose face anyway.

Steinmann and Dr Perrin thought it was straightforward bribery even if gifts were given through a third party. If they agreed to do so, they would run high personal risks by violating the corporate business principle and professional ethics. As controller and lawyer, they were expected to play an important role in implementing strict control mechanisms in the company and keeping the corporate conscience. Moreover, they were worried that the potential wrongdoing might damage the strong ethical culture of the Beijing Representative Office and the good corporate image among the Chinese employees of the office, although it likely would not affect the whole company because NES was so decentralized.

However, Chen thought that *renqing* (social or humanized obligation) and *mianzi* (the notion of face) were more important and that NES's business ethics and social responsibility could be somewhat compromised. In Chen's eyes, Steinmann and Dr Perrin were inflexible and lacked knowledge of the Chinese business culture. Steinmann and Dr Perrin told Chen that she needed to learn Western business rules and values in order to survive in a multinational company.

Recent developments

In August 1997, the vice-president of NES AG led a delegation to visit China. Chen arranged a meeting for the delegation with a senior official of the Central Department. It turned out just to be a courtesy meeting and did not touch upon the details of the holding company approval issue.

In November, Steinmann and Dr Perrin met the two responsible officials in hopes of negotiating with them such that the officials would allow NES to leave some clauses unchanged. But the officials insisted on their original opinion without giving a detailed explanation of the relevant legal basis. The negotiation lasted only half an hour, and Steinmann and Dr Perrin felt that it accomplished nothing.

Because of the limited window of opportunity (that is, new investment projects required an immediate capital injection), they felt that they had no choice but to modify the documents according to the officials' requirements. Modifying the documents was an administrative struggle with NES AG, because due to company-internal policies, the German headquarters had to approve these modifications. The application was resubmitted at the end of November. When Chen inquired about the application's status in December, the officials, however, said that the case needed more consideration and then raised some new questions that they said they failed to mention last time. This happened once again three months later in February 1998.

WHAT NEXT?

In April 1998, Steinmann, Dr Perrin and Chen submitted the newest revision of the application. As NES AG could not defer funding the new projects, it demanded that the Beijing working team obtained approval within a month so that NES AG could use the China holding company's registered capital of US\$30 million. Otherwise, NES AG would have to re-evaluate the China holding company and might abandon it all together. In that case, Mueller, Steinmann and Dr Perrin would miss opportunities for career advancement. As for Chen, she was concerned about her job because the Beijing Representative Office would no longer need her position.

Being very anxious about the current situation, Mueller decided to come back to Beijing immediately. Chen wanted to be able to suggest a practical approach that would gain the co-operation of the bureaucrats while conforming to the German moral standards. Chen also contemplated some challenging questions. For example, what constituted bribery? When ethical values conflicted, which values should people follow? How could these differences be resolved? To what extent should a multinational company like NES adapt to local business practices? Should the future China holding company develop special ethical codes to recognize the Chinese business culture? The answers to these questions were very important to Chen, because she expected to face similar ethically sensitive issues in the future.

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Notes

- 1 The China State Council Order No. 20 promulgated on 1988.12.01. Article 2 Any State administrative organization and its functionary shall not give and accept gifts in activities of domestic public service. The China State Council Order No. 133 promulgated on 1993.12.05. Article 7 Gifts accepted in activities of foreign public service shall be handled properly. Gifts above the equivalent of RMB200 (about US\$24) according to the Chinese market price shall be handed over to the gift administrative department or acceptor's work unit. Gifts of less than RMB200 belong to the acceptor or to the acceptor's work unit. P. R. China Criminal Law (revised edition) promulgated on 1997.03.14. Article 394 Any State functionary who, in his activities of domestic public service or in his contacts with foreigners, accepts gifts and does not hand them over to the State as is required by State regulations, if the amount involved is relatively large, shall be convicted and punished in accordance with the provisions of Article 382 and 383 of this law. (Article 382 and 383 regulate the crime of embezzlement.)
- 2 The China State Council Order No. 20 promulgated on 1988.12.01. Article 8 Any State administrative organization and its functionary who give, accept or extort gifts for the purpose of securing illegitimate benefits shall be punished in accordance with relevant state law and regulations on suppression of bribery. The P. R. China Criminal Law (revised edition) promulgated on 1997.03.14. Article 385 Any State functionary who, by taking advantage of his position, extorts money or property from another person, or illegally accepts another person's money or property in return for securing benefits for the person shall be guilty of acceptance of bribes. Article 389 Whoever, for the purpose of securing illegitimate benefits, gives money or property to a State functionary shall be guilty of offering bribes.