Case Study

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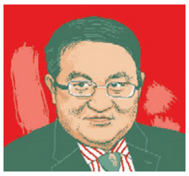
Should a German-Chinese joint venture follow the ethical rules of the parent company or the country of operation? *by Katherine Xin and Wang Haijie*

Culture Clash in the Boardroom

The Experts



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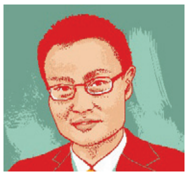

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HBR's fictionalized case studies present dilemmas faced by leaders in real companies and offer solutions from experts. This one is based on a teaching case at China Europe International Business School in Shanghai.

The room was already packed when Liu Peijin walked in. His flight from Shanghai to Chongqing had been delayed, and he had fretted about missing the training. But fortunately he'd gotten there in time. Liu knew his presence was important. As the president of Almond China, he wanted to show his Chongqing colleagues how much he cared about the topic under discussion: ethical business practices.

Taking his seat, Liu nodded at the head of HR, who was running the training. The two went way back: Both had been with their German parent company, Almond Chemical, since 1999, when it first established operations in China. Since then Almond China had set up two joint ventures with local partners—the only way foreigners could do business in chemicals in the country. Almond controlled 70% of the stock in one of them. The other was a venture with Chongqing No. 2 Chemical Company, in which Almond had a 51% stake and the Chinese directors were very active.

Liu sat next to Wang Zhibao, the vice president in charge of sales for the Chongqing joint venture. Wang looked skeptical. He was good at his job, having closed several key deals that had kept the business afloat during its early years. But he was also at the center of a conflict between the venture partners: The Chongqing executives were increasingly vocal about how difficult it was to operate according to European standards, particularly the rules against gifts and commissions. Such incentives were commonly accepted in China and routinely employed by Almond's competitors. Trying to do business without them, Wang argued, was foolhardy. "This is China, not Europe," was his refrain.

But the line between these practices and breaking the law was a fine one. Almond was headquartered in Munich and listed on the New York Stock Exchange as well as the Frankfurt Stock Exchange, meaning it was required to adhere to the U.S. government's Foreign Corrupt Practices Act, which specifically forbade the bribing of foreign government officials by U.S.-listed companies.

Liu kept an eye on Wang as the HR director explained Almond's ethics regulations and the legal consequences of business bribery. Liu knew the rules made sales more difficult, but Almond's policy was clear, and he wanted to make sure that every member of the sales team understood it.

He had taken the same hard line on safety and environmental practices. The production facilities in Chongqing had been built according to German national standards, and all the safety equipment—helmets, shoes, and protective clothing—had come from Europe. The Chinese partners had called these investments "wasteful" and "frivolous"—"luxurious expenditures" that the young venture couldn't, and shouldn't, afford. But, with backing from the head office, Liu had stood firm. Similarly, he'd insisted that the factory's MDI (methylene diphenyl diisocyanate) waste be treated as a dangerous substance and processed with a special cleaning agent, in accordance with European standards, even though Chinese law didn't mandate it. His partners had been dismayed at the millions of yuan this would cost. But Liu refused to compromise, because he had witnessed the consequences of lesser standards firsthand. Years before, when he was working for another Chinese chemical company, an affiliate's chlor-alkali plant had suffered an explosion, injuring 200 staff members and residents of the surrounding area and halting production for more than a month.

The training was reaching its end, and the HR director signaled to Liu that it was his turn to speak. Liu hesitated slightly as he looked at his Chongqing colleagues. "At Almond, ethics are nonnegotiable," he said. "We need to remember these laws as we go about our business. We are not just a Chinese company; we're a global one." Solemn, blank faces stared back at him.

As he left the room, he couldn't help feeling that his remarks had fallen on deaf ears.

"We Cannot Concede"

Two weeks later, Liu was back in Chongqing for the second-quarter board meeting. As he walked into the lobby of the Hilton, he ran into George Ho, the finance director for the joint venture. Ho looked flustered.

"Are you all right?" Liu asked in English. Ho was from Hong Kong and didn't speak fluent Chinese. He held a unique position: He reported to the general manager of the joint venture but also to the finance director at Shanghai headquarters.

"I'm worried about this meeting, Liu," Ho said. "I had a disturbing conversation with Wang last week."

> "We are not just a Chinese company," Liu said. "We're a global one." Blank faces stared back at him.

Liu nodded, not surprised.

Ho continued. "Wang is close to making a huge sale—30 million yuan—but the customer's purchasing manager is insisting on a 1% commission. He says that's what he's being offered by other companies."

"We can't do that," Liu said.

"That's what I said. But Wang was insistent. He said that if we can't do that, we should at least be able to offer the manager a trip to Europe, a visit to Almond headquarters."

"What did you say to that?" Liu asked.

"No—of course," Ho replied. "But he accused me of jeopardizing the venture. He said that we 'foreigners' have so much money, we don't care about the performance of the business."

"You did the only thing you could do," Liu said.

"I can't believe Wang thought that suggestion would fly, especially after the training," Ho said. He walked down the hall toward the boardroom. Liu followed.

The meeting had barely begun when Chen Dong, the chairman of the joint venture and a Chongqing No. 2 Chemical executive, raised the commission issue. (His leadership position was one of the many concessions Almond had made to lure his company into the joint venture.)

That was fast, Liu thought. He sat quietly while Dolf Schulman, the vice chairman of the venture and Almond Chemical's senior vice president of business development, fielded the question.

"Chen, we cannot concede on these issues," Schulman said. "There are no exceptions to be made. Almond must be a law-abiding corporate citizen—as should every Almond employee."

Ho looked up and nodded at Liu. But Chen was not ready to end the discussion. "To the best of my knowledge," he said, "many foreign-owned companies reward Chinese customers for their business. Some companies organize overseas visits, some provide management training, some arrange golf outings. This is good business practice in China. We need to be flexible in order to compete. If we can't provide the commission, let's at least consider a visit to Munich headquarters."

This was typical behavior for Chen. He had a tendency to develop very strong opinions but keep them to himself until the board met. Schulman waited for the translator to finish; then he hesitated, trying to come up with a suitable response. Liu knew he needed help.

"Commission or trips, it's all the same thing: business bribery," Liu said. "We can get orders without these tactics."

Chen picked up the Q2 financial statement that had been distributed at the beginning of the meeting and said, "Orders? What orders? We made only 60% of our target for this quarter. When we set up this joint venture, we assigned our very best people to it—our best technicians, best salespeople, best managers. Why? Because we believed we could manufacture some of the best chemical products in the world and, in turn, get more orders. But look at this." He threw the statement down on the table. "Our performance is sinking fast. This joint venture has done

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nothing but hurt us. We have yet to see any return at all."

Chen paused to let the translator catch up but then thought better of it. "All you do is make us spend, spend, spend—on German goggles, unnecessary waste processing, and ridiculously high salaries." He turned to Ho, who looked bewildered. "And now I hear rumors that you are planning to launch SAP's ERP software to synchronize with headquarters. When will the spending stop?"

Chen continued, his voice rising. "We need a tighter control on costs. We can't possibly meet our profitability target when our expenses are so high. We want to choose the finance director going forward, so we can give this venture a real chance at succeeding. We see no other option."

He sat back in his chair and crossed his arms. Schulman was squirming in his seat. Ho was pale with shock. Liu wasn't sure what to say. He was astonished that Chen had brought up the safety standards—he'd thought that issue was settled long ago—and astounded by the slap at Ho. But he needed backup if he was going to oppose the joint venture's chairman.

Finally Schulman spoke. "Chen, thank you for being honest about your concerns," he said. "At this point I think all these issues are still open for discussion."

Liu almost choked. What was Schulman thinking? Seeing Liu's expression, Schulman looked at his watch and said, "Should we take a 15-minute break?" With that, he stood up.

"This Venture Is Critical"

As Liu walked out of the room, Schulman grabbed his elbow and steered him toward a smaller meeting room down the hall. Once the door was closed, Schulman's shoulders slumped.

"Liu, what should we do?" he asked. "Do you think we should concede to these demands? This venture is critical for us—you know that."

Liu did understand how high the stakes were. China accounted for only 3% of Almond's current business, but the company was depending on the country for future growth. The Chongqing operation was supposed to prove that Almond could expand further in China, and the company was already planning additional acquisitions. But Liu was shocked that Schulman would even consider bending the company's standards regarding ethics and safety.

"We need to stand strong," Liu said, "not give in." He was thinking about Almond's reputation as well as the future in China. He had joined the century-old German company not only because it boasted the world's leading chemical-production technology, but also because of its values, management approach, and safety ethic, which he'd hoped would serve as a model for Chinese industry.

"But we shouldn't annoy them," Schulman said. "We need Chen. And he's right about the numbers. We could be in trouble without Wang's sale. Besides, where do we draw the line? Is a golf game bribery? We do that in Germany all the time."

Liu realized that Schulman wasn't asking for his opinion. He was asking for permission to give in. Suddenly Liu felt like a kid stuck between two warring parents. The break time was almost up. They needed to get back to the meeting and respond to Chen's demands.

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What should Liu Peijin do?

See commentaries on the next page.

The Experts Respond

Xu Shuibo is the former CEO of TNT Mainland China's subsidiary TNT Hoau.

I EMPATHIZE with Liu and the others in this case. Devising an operations strategy that is suitable for, and successful in, the Chinese market is difficult. At TNT Hoau we are up against several of the same challenges: Many of our competitors have dubious business practices, such as offering kickbacks. As a globally traded company, should we follow suit? Can we still get orders if we don't? How can we respond to the pressures on our salespeople?

We have learned two lessons that Liu might heed. One: There is no room for compromise on ethics. Two: Creating standardized processes allows you to outperform the competition.

In regard to ethics, we accept that we may lose some clients because of our refusal to give kickbacks. But we also know that ethics can be good for business. In fact, one of our clients asked our Shenzhen branch for a 10% kickback. The branch general manager declined, saying, "We are now wholly owned by TNT, a *Fortune* 500 company. We will never offer bribes." The client excitedly responded, "At last I've found a company that refuses." He then placed an order worth millions of yuan.

Almond should focus, as we have, on gaining target customers, such as large international firms, that share its values, and not go after companies that insist on bribes and commissions.

The second lesson for Liu is the role of standardized processes in beating the competition. He was right to fight for higher safety standards. We have succeeded in large part because we implemented processes that have long been used in Europe and the United States but are still relatively uncommon in China. For example, very few domestic road-transportation companies guarantee timely delivery. We are able to do that because we adopted time standards for each step in our process: loading, client notification, and so on.

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Almond needs to lead the way by setting the standards for safety and ethics. A company may achieve short-term success if it bows to hidden rules, but in the long term it will eventually fail. The business environment in China is very different from what it was 30 years ago, and it will continue to evolve. Over the next 10 years we can expect to see more regulation and the development of new criteria for doing business in China. It will pay to be ahead of that curve.

To resolve this specific conflict, Liu needs to identify other areas of compromise. For example, if the joint venture's products are for export, the high German standards should be upheld. But if the products are for domestic sale only, guidelines that comply with Chinese law may suffice. Or, if SAP is too expensive, the joint venture can implement cost-effective software as long as it is compatible with the global Almond system.

Both sides are right in these debates. The Chinese should not be faulted for their pursuit of profits, and the Germans should not be faulted for standing up for their values. Both profits and values matter. The key is to find a solution that compromises neither.

WHAT WOULD YOU DO?

SOME ADVICE FROM THE HBR.ORG COMMUNITY

IF GIFT giving is an integral part of Chinese business practice, why shouldn't Almond embrace it? Liu should reconsider his stance. Perks like golf games, fishing trips, and foreign getaways don't constitute bribes when they are separate from the negotiation or sales process. Participating in this practice will strengthen Almond's local identity, and exceeding China's safety and environmental standards will safeguard its global one.
Sartaj Anand, *junior fellow, Melton Foundation BMS*

LIU NEEDS to remember that decisions made at the local level could have negative consequences for the larger company. His job is to further the interests of the company's shareholders, not to secure deals by any means necessary. Compromising Almond's ethics or safety standards may affect its ability to secure contracts in the future.
Jose Di Geronimo, *V-22 stress engineer, Boeing*

THE VENTURE should market itself as holding high ethical standards. It can then use its reputation as a clean company to woo customers that respect and appreciate those standards. To do this, Liu will need to convince his sales team that sacrificing short-term targets for long-term gains is worthwhile.
Tanmay Pandya, *cofounder, Bridgedots*

Zhang Tianbing is the global vice president and the director of the China Research Center at A.T. Kearney.

JOINT VENTURES are never easy and need to be set up properly from the start. The kind of misunderstanding and mistrust that have erupted in the Chongqing venture can be avoided by establishing reasonable expectations of future investment and return early on.

Liu fills an important role as the president of Almond China. His position requires him to serve as a liaison and interpreter for the two sides. He can help both parties to the joint venture better understand their differences of opinion. As a Chinese national, he should clearly explain to Schulman what is behind the Chinese side's thinking, while making it explicit to the Chinese what underlies headquarters' insistence on German practices.

Both the Chinese and the foreign managers need to be more open-minded about the other side's perspective. Their problems will not be solved if everyone focuses on what his side stands to gain. The two sides should figure out together what is best for the venture as a whole, over the long term.

The business environment in China is changing fast. Many Chinese manufacturing companies have begun to standardize production processes, but most of them still think standardization is unnecessary when it comes to safety. However, as Liu remembers well, only one mishap can undo a company. Now there is greater pressure on companies to consider environmental protection and safety issues. I think companies like Almond are right to adopt higher standards than Chinese law mandates, because in the long run the costs will be much greater if problems become serious. Environmental protection is a necessity in China. And without adherence to safety protocols, China's economic success cannot be sustained.

Ethical issues should be treated the same way. In China, because there are no explicit laws regarding bribery, foreign companies typically have three choices: They can do what domestic companies do; they can strictly adhere to Western rules; or they can navigate the gray areas by offering a variation of the typical kickback. In deciding which route to take, joint ventures need to impose higher standards on themselves. Since the 2008 financial crisis, surveillance over foreign-listed companies has become stricter, and China, like most other countries, has paid greater attention to business ethics. Liu must be sure that the Chongqing venture does not gain short-term benefits at the expense of its long-term reputation.

To move forward, Liu needs to help the parties communicate better with one another. Because they come from different cultures, they have distinctive approaches to work and cooperation. The Chinese believe in "emotion, reason, and law," whereas the Europeans tend toward "law, reason, and emotion." The Chinese establish relationships by getting to know one another's families, for example. Europeans believe work relationships are limited to work. Neither side knows how to relate effectively with the other. Liu can advise the Germans to build up personal trust with the Chinese before talking about the reasons for the standards. In order to establish a functional relationship, each party needs to communicate in a way that makes the other feel respected and comfortable.

If Liu remembers that he must persuade the Chinese side with emotion and the German side with reason, his job of mediating a resolution will be far easier.

If Liu persuades the Chinese side with emotion and the German side with reason, his job of mediating a resolution will be far easier.

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