AREA DEVELOPMENT

Challenges of Moving Manufacturing Out of China

When moving manufacturing out of China, there's a lot to consider, e.g., employment contracts, retrieval of tooling and molds, IP protection, and taxes and fees.

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There is plenty of manufacturing capability around the world for consumer goods, PPE, testing equipment, medical devices, consumer goods, and other industrial products. So why are companies reshoring their manufacturing operations now?

The Tax Reform Act of 2017 helped. The 301 China penalty tariffs gave a little push. But the global pandemic made executives acutely aware of their global supply chain risks and vulnerabilities and provided an opportunity to rethink their global manufacturing strategy. New strategies typically include at least some capacity for manufacturing and sourcing critical goods in America.

{{RELATEDLINKS}} Pharmaceutical manufacturers were among the first to consider reshoring in an attempt to reduce America's dependence on basic ingredients coming from China and India. Other industries are now actively following, including automotive, plastics, and machinery. But how easy is it to extract your manufacturing from China or end your relationships with suppliers and contract manufacturers?

It's not so easy.

Global Supply Chains Sourcing from China
Global supply chains are part of the problem. Much of the production in China includes consumer products, finished goods, and parts that go into other finished goods around the world. This is because, over the past 20 years or so, China has become the low-cost production leader, particularly for high-touch, high-labor-content processes such as electronics assembly and sewing. This production cost profile (high-touch, high-labor-content) is well suited to low-cost countries such as China, Vietnam, Bangladesh, Mexico, and others.

From a market economy perspective, this is appropriate. But strictly economic decisions have not served the markets very well in this pandemic emergency, with so many human lives at stake. Having no capacity for producing products such as PPE, medical devices, and pharmaceuticals in our home country leaves us vulnerable and completely dependent on China.

The global pandemic made executives acutely aware of their global supply chain risks and vulnerabilities. The pandemic has been a wake-up call and a catalyst for reshoring, or at least for considering a multi-country manufacturing strategy. The U.S. government has also started to consider an industrial policy that supports critical industries and may even offer incentives for reshoring. But leaving China to return production to the U.S. is likely to be complicated and expensive.

Leaving China
Even if some industries are deemed critical and incentives are provided, there are still difficult hurdles in leaving

China and redirecting supply chains to a third country or toward reshoring to America. Companies cannot expect to simply pack up shop, lock the doors, turn out the lights, and move back to the U.S. It's complicated.

The decision to leave China isn't an easy one. With nearly 350 million people in China's middle class and growing, China is likely to be a company's biggest target market over the next 20 years. As the Chinese middle class grows, so do its disposable income and the desire for all kinds of products, particularly those with Western brand names. To serve this market, many manufacturers are deciding to leave at least some of their production in Asia.

Further, America's relationship with China has deteriorated significantly over the past four years. Not only has the anti-China rhetoric ramped up in America, but also the anti-America rhetoric is equally as bad in China. The Chinese government and the Chinese Communist party have made no secret of their unhappiness with American trade and sanctions policy. They aren't going to make it easy for companies to move manufacturing out of China.

Let's examine the various facets of the Chinese operation:

- The Chinese Employees — In China, most workers are hired under employment contracts lasting one to two years. If a company closes its factory in China, the expectation is that all employees will be paid until the end of their contract. This is often a costly surprise to Western companies. Before deciding to leave China, companies should carefully check their responsibilities outlined in their employment contracts.

  It's best to consult with an attorney familiar with Chinese employment law — perhaps one with offices in the U.S. as well as China. In-country local Chinese law firms may not have your best interest in mind. It's best to use a multinational law firm with deep China experience.
- Tooling and Molds — Packing up and shipping or trying to retrieve tools and molds from a Chinese manufacturing site can also be problematic. In the past, a Western manufacturer would send machine tools or molds to a Chinese original equipment manufacturer (OEM), or to their own Chinese manufacturing site. These tools and molds, sometimes worth hundreds of thousands of dollars, are needed to produce products.

  Leaving China to return production to the U.S. is likely to be complicated and expensive. If a company does not take steps to clearly identify ownership — and signs an agreement to that effect, including serial numbers positively identifying each item — it may never see the tools and molds again. This is because the Chinese believe that they have been given the equipment, and it becomes part of the plant's assets and infrastructure. The Chinese government may not allow the machines, tooling, and molds to be exported. Your contract, that you thought clearly defined ownership, may not be honored in a Chinese court.

  Blueprints and molds that are made in China for your production line are yet another issue to consider. If a Chinese manufacturer has your blueprints and they outsource the mold-making to a subcontractor, it's a sure bet that they will continue to produce your goods long after you are gone. The Chinese mold-maker is likely to claim ownership of the mold, even though you paid to have it made. In fact, the Chinese company may have registered your brand and logo in China without your knowledge.
- Manufacturing Methods Intellectual Property — When a company leaves China, it also leaves behind its manufacturing intellectual property if the Chinese have been taught confidential production methods. We've all heard the horror stories about IP protection, copying, and counterfeiting in China.

  To protect their IP, most Western companies now register their patents and brands in China. But production methods and raw materials aren't always as well protected. A company may have taught the Chinese factory how to make its product — methods the Chinese factory is likely to continue to use to produce the same product under a different name. In addition, the Chinese factory now knows all of your raw materials and parts suppliers and potentially could source the same materials from the same suppliers after you are gone.
- Taxes and Fees — In addition to paying out employment contracts, there may be other regulations that must be considered. China's Commerce Department has issued guidelines for withdrawal from China by foreign investors. China's law requires that foreign investors inform creditors of the closing, settle all outstanding taxes, pay all pending debts, liquidate property, and de-register the business. In addition, companies may be

required to pay closure taxes. All this takes time and money, and often comes as a surprise to Western companies in the process of reshoring.

Obtaining a permit to leave may be yet another hurdle. Depending on your industry, the Chinese government may not want you to leave the country. High-tech companies, in particular, may be subject to extended exit permit times. Anything that would be considered a strategic industry or strategic technology is likely to experience delays in the permitting process.

To serve the growing Chinese market, many manufacturers are deciding to leave at least some of their production in Asia **The Way Forward**

There is a lot to consider when designing a new global manufacturing strategy. Many things are now in flux, including the global trade wars, domestic industrial policy, and incentives. With the U.S. presidential election of Joe Biden and Kamala Harris, changes in policy will affect global relationships. Katherine Tai has been nominated as the next U.S. Trade Representative, and with her significant background in China relations and negotiations, the U.S. relationship with China is likely to improve. But so much damage has been done during the past four years that improving and changing the China-America relationship now is a daunting task that will surely take time.

So many companies make the mistake of simply comparing labor costs when determining their reshoring pathway. But there is so much more to a reshoring decision, especially within the context of a global pandemic and the resulting global recession. There is no sweeping correct answer applicable to all enterprises in all countries. Microeconomics of the firm will drive the final decision to reshore or not.