R&P 方旭 CHINA LAWYERS

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LEGAL BRIEFING

# Foreign Investment Opportunities

# Taking Control of Distribution

## Hot Topics



## Legal Articles

R&P 方旭 CHINA LAWYERS

asialaw LEADING LAWYERS

Asialaw Leading Lawyers recommends:

**MAARTEN ROOS**

**ROBIN TABBERS**

**CHEN YUN**

**KATHLEEN CAO**

**VICTORIA LEI**

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## New Office for R&P Beijing

This summer, R&P Beijing moved to its new office at the Kunsha Center, conveniently located in Beijing's Central Business District (CBD). Since its opening last year February, R&P Beijing has experienced steady growth and this new office allows it to continue expanding its business.

This expansion facilitates R&P China Lawyers to continue assisting its foreign clients throughout China from its key regional offices in the country's two economic centers: Shanghai and Beijing. For more information and support in Beijing, please contact our usual R&P contact or our Beijing office directly:

**New address:**

9/F, 909, Building 2, Kunsha Center, No. 16 Xinyuanli, Chaoyang District, 100027, Beijing, P.R. China

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## R&P in Asialaw Profiles and Asialaw Leading Lawyers

In the 2016 rankings by Asialaw Profiles of Asia-Pacific's leading domestic law firms, R&P China Lawyers was recommended in three categories: Corporate / M&A, Dispute Resolution, and Labour & Employment. In the review, emphasis was given to the "good combination of Chinese expertise and European understanding" that we provide our clients.

A number of individuals were also singled out. Maarten Roos and Robin Tabbers were mentioned for their expertise supporting European and American clients across a number of practice areas, while senior associate Kathleen Cao was described by a client as "very professional and dedicated".

Asialaw Leading Lawyers recommended Maarten Roos, Robin Tabbers, Chen Yun, Kathleen Cao and Victoria Lei.

## Reminding on R&P Practice Areas (see p.9 for detail)

| | |
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| Corporate/M&A | Commercial & Trade |
| FDI & Registration | Employment |
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| Intellectual Property (IP) | Private Client Services |


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# Foreign Investment Opportunities Continue Despite China's Economic Downturn

*By Maarten Roos & Robin Tabbers*

**Our firm recently received many queries from business contacts in Europe and the US: is the Chinese miracle over? China's stock-market has crashed, and the whole world is now concerned about economic growth in China. What kind of impact are we noticing? Does China still offer sufficient opportunity for foreign investors to develop their business? Or are we starting to see foreign investors closing shop to focus on other markets?**

*By Robin Tabbers and Yang Linfeng*

China's stock-market woes are certainly having an impact. For more than a year, the stock-market was a favorite topic for dinner-table conversations, but since June China's middle classes have shifted focus. Many retail investors stepped in late and saw some of their capital base dissolve, however perhaps surprisingly, this seems not to have led to much pessimism. The explanation may be simple: compared to just a few years back most Chinese are still much better-off, and they have more freedom than ever before to spend their money on things they care about, whether it is online fresh fruit, a new I-Phone or international travel.

So what about the Chinese economy? Whether it grows with 7% or 6% or even less, the key point to understand is that the Chinese economic is currently in the midst of a shift from construction-, manufacturing- and export-led growth to a more balanced economy based more on consumer-spending and services. This shift can only be gradual, which is tempering the growth rate. But the developments noticeable all around us, and this gives a lot of confidence.

As such, that there are plenty of opportunities for a foreign business that can create for itself a niche in China's new economic structure. A look at the business of some of our clients illustrates some of the challenges that foreign investors are facing, as well as their ambitions for the near future.

1. Projections for car sales have taken a nose-dive over the past 6 months, which is leading to decreased orders for our clients in the **automotive industry**. One client in particular is currently under pressure to cut costs and terminate redundant workers. On the other hand, China's car market is among the biggest in the world, with continued demand for internationally-branded cars. The current re-

organization should ready the company for the years to come.

2. A client in the **furniture industry** has decided to continue operating its main workshop in Beijing, but political meddling, stricter environmental rules and increasing costs are pushing the company to concurrently seek new models. For example, an increasing amount of low-skilled work is outsourced to suppliers in Vietnam. Another client in the same industry is reducing a traditional reliance on (decreasing) sales orders from Europe by setting up a local sales team to target multinationals in China.

3. **Organized care for the elderly** is still in its infancy in China, but three factors combine for a bright future: a culture of filial piety, a wish of children to become more independent of their ageing parents, and plenty of money to spend. One of our clients is partnering with Chinese real-estate companies and insurers to build and operate senior care projects all over the country. On the other end of the spectrum, **babies and infants (child) education** is a fast-growing market as well: one client has responded to demand by offering international-curriculum education to Chinese kindergartens and elementary schools, while yet another is helping the Chinese Society of Education to develop a Montessori curriculum with Chinese characteristics.

4. The demand for internationally-branded goods remains very high among China's middle-class consumers. A client in the **fast-fashion business** is on route to establish fifty new branches this year alone. It is important to cover first- and second-tier markets across the country, but in many tertiary markets it is benefiting considerably from a first-mover advantage.

5. The shift from a manufacturing base to a full-grown sales market has forced many companies to change their business models. Several clients are currently building factories to produce goods in China for sales in the Chinese domestic market. Transportation fees, import duties as well as long delivery times are accelerating the shift of **manufacturing high-quality products and machinery in China** as opposed to the Western home base.

6. Increased labor costs and the economic slowdown are also pressuring foreign and domestic companies alike to become more distinctive compared to their competitors. International niche players in **multimedia marketing** for example are investing in China in response to a growing demand for existing clients to come up with integrated marketing solutions that are not yet available from domestic companies.

7. Amidst daily food scandals and with a growing middle class, the demand for high quality international brands in F&B is rising exponentially. Several of our clients are active in the **beverage industry** in China, where the sales potential is enormous and so far few foreign players have made much of an impact.

A look at our firm's business is illustrative as well. Over the past decade, we have supported many international businesses to establish manufacturing bases for export to Europe, the United States, Canada and Australia, or to organize the sourcing of products from China. In recent years however, we have seen a strong shift towards manufacturing, trade and services *for the Chinese market*.

Already in 2013 China became the world's largest luxury market and largest e-commerce market. With continuing urbanization and urban incomes poised to rise by 15% per year, one international consultancy expects the number of China's middle class consumers to reach 630 million by 2022, and 1.4 billion by 2030. This goes a long way to explain the optimism among many foreign investors despite the current economic downturn.

# Taking Control of Distribution in China

*By Maarten Roos*

*By. Maarten Roos & Victoria Lei*

In international media, one of the leading economic stories in recent years has been the slowing growth of the Chinese economy. Indeed, China's GDP officially grew by only 7.4% in 2014, slipping from 7.7% in 2013. However, this is not making China less interesting as a target for international business. Heavy industries may be suffering, but the demand for consumer goods and services from China's consumers, for example, is booming. Modern shopping malls are rising across China including in smaller cities, China has taken over as the world's largest car market, and the Chinese have become the biggest buyers of international tourism and education abroad.

For many international businesses, this means a renewed focus on China, and how to reach a middle-class which is growing larger than those of Europe and North America combined. This requires a commercial plan, combined with some crafty legal structuring.

Traditionally, many international brands have outsourced sales in China to distributors in China. A Chinese (incl. Hong Kong) company was deemed more familiar with consumption practices in China, could build and maintain close relationships with customers (incl. state-owned ones), and was even willing to share in some of the cost and risk. In all kinds of sectors from fashion to medical devices, to equipment and to F&B, international businesses relinquished control over distribution in China. Recent trends show that many businesses are eager to take back control over their Chinese distribution channels.

In the remainder of this article, we focus on some of the legal challenges that international companies face when restructuring distributor relationships: how to build self-owned distribution channels, how to terminate distribution contracts, the importance of ensuring IP / trademark ownership, and managing product registrations.

**1. Building Self-owned Distribution Channels**

Although many international companies have been taking advantage for years, for others it will be news: China allows, and in fact encourages, foreign investors to establish self-owned distribution companies. Over the past two decades, most economic sectors have been opened to foreign investment, with restrictions remaining for only a few sectors that are deemed of national interest. Chinese-registered companies solely invested by foreign businesses (so-called wholly foreign-owned enterprises, WFOE in short) can thus engage directly in the domestic and international trade of all kinds of products. They also have the choice of opening retail outlets to reach individual consumers.

It is no longer difficult to establish a WFOE in trading or retail. Procedures are inevitably more complicated than in “lighter” jurisdictions such as Hong Kong, but there are plenty of good lawyers that can help to navigate China’s bureaucracy. Minimum investment requirements have mostly been abolished, while companies have much freedom to determine their own corporate governance structures. The new *PRC Foreign Investment Law*, which is currently in draft and may be promulgated later this year, is another step to make life easier for international businesses to set-up shop in China.

It is also important to remember that a subsidiary established in one location can do business all over the country. If it makes sense commercially, it can open subsidiaries, branches or liaison offices to have people on the ground in other cities, for example to conduct sales or support local customers. And local partners can be engaged to provide support in building and maintaining relationships with special customers, such as government departments. But from a legal perspective, all trade can be organized through and financially consolidated in the one Chinese entity.

**2. Terminating Existing Distribution Contracts**

One legal challenge that many companies will face, is to terminate relationships with existing distributors. In some cases this is easy: if the distribution agreement was properly drafted, termination clauses should provide clear and unabridged guidance how to manage termination, and at what cost.

Where the distribution contract is not exclusive, another choice may be to let it run parallel to self-owned channels. Or perhaps it is beneficial to directly acquire the Chinese distributor or its distribution network – as is permitted under Chinese law. A detailed due diligence will be needed, but if it can be implemented then it will allow for a flying start to further developing the business. The best distribution agreements may already foresee in such an option, though in the end this will usually be a matter of negotiation.

International businesses may face tougher residence if the distribution agreement is exclusive, and does not include any termination clauses, while the Chinese counterpart refuses to deal. A choice will have to be made between breaching the exclusivity term and building a parallel structure, or terminating the distribution agreement without cause and risking claims for damages. A legal analysis will have to be made on a case by case basis, but in practice loopholes can often be found to minimize the risks to potential claims for damages. It is good to remember that filing claims in Chinese courts can be a difficult and cumbersome process for your opponents, acting as a natural barrier to all but the strongest of legal claims.

**3. Ownership of trademarks / intellectual property**

A key part of any distribution strategy, is to establish the ownership of relevant brands in China. Risking limited contractual claims is one thing, but making large investments without brand security may prove to become an insurmountable hurdle to overcome. Some particular issues in the Chinese setting:

- China’s system for protection of trademarks is modeled on international standards, which means that trademarks must be registered in China (either directly or through the international Madrid system) to be protected in China.

By applying the first-to-file rule, China does not offer specific protection to international trademark owners who are late to register their trademarks. As a result, trademark squatting by business partners (incl. distributors) and third parties is very common.

- In the context of a distributor relationship, international businesses often discover late that their Chinese distributor has taken the initiative to register relevant brand names – if not the international company name and brand names for specific product lines, then at least the Chinese equivalents thereof. This can result in a major dispute. If registered in bad faith, the international owner may have the legal grounds challenge the trademark registration of a distributor, but this will take time and success is not guaranteed. Meanwhile, the distributor continues to hold the trademark rights, and can threaten legal action if the international brand owner tried to enter China directly.

Even international brand owners that are not (yet) contemplating a change to their business model should review whether they own exclusive trademark rights in China; and if they do not, should develop a strategy to either obtain such rights (whether through legal action or friendly acquisition) or build new brand names (e.g. in Chinese) that they control. Even with a less-than-perfect reputation for legal protection of IP rights, it is not advisable to roll out a distribution strategy while being under constant threat of seizures and lawsuits.

**4. Managing Product Registrations**

Another focus point that deserves attention, is that of product registrations. Many categories of goods are not subject to special licensing, which means that a Chinese trading company (including one with foreign investment) can import such goods and then sell them in China without obtaining specific product registrations or approvals. Other categories of goods, however, *are* subject to special supervision and/or approvals, and this includes certain food and feed products, medical devices, health products, pharmaceuticals and active pharmaceutical ingredients, cosmetics and ingredients, and even various electronic goods (which are subject to CCC certification).

Product registrations are usually very bureaucratic and therefore take a lot of time to complete, while existing certifications from foreign countries generally do not count for much. As a result, product registrations are very valuable, and so where possible companies should avoid placing distributors in charge of product registrations. Examples abound where distributors take advantage of their powerful position in the distribution chain to extort their international counterparts. If using distributors in product registrations is unavoidable (for legal or for commercial reasons), then the acquisition or renewed filing of product registrations will become an important part of the strategy to take over distribution through a wholly-owned entity in China.

# Chinese-Australian Free Trade Agreement

*By Robin Tabbers*

**On 17 June 2015, the Chinese-Australian Free Trade Agreement (ChAFTA) was signed to promote the growth of Sino-Australian trade, which accumulated to a total trade revenue of around AUD160 billion in 2013-2014. The deal also implements a new set of trade regulations, providing better access for a myriad of Australian-originated products in the Chinese market, by ensuring that 95% of Australian products exported to China will become duty-free.**

The current (non-official) Chinese Tax Tariff commitments would ensure that the majority of Chinese tariffs imposed Australian goods would be reduced to 0% within 5 years.

Although most products will receive duty-free treatment over a given period of time, the remaining 5% of products would continue to be taxed at base fare (Category D). These exported products of Australian Origin include some of the following:

| HS Code | Base Rate (%) | Description of Product |
|---|---|---|
| 11022000 | 40 | Maize (Corn) Flour |
| 17019910 | 50 | Granulated Sugar |
| 24022000 | 20 | Cigarettes containing Tobacco |
| 31052000 | 50 | Mineral or chemical fertilizers containing the three fertilizing elements nitrogen, phosphorus & potassium |
| 48195000 | 7.5 | Packing containers (including record sleeves), nes, of paper or paperboard |
| 51051000 | 38 | Carded Wool |

## Most Top Export Products Exempted

In 2013-2014, the top Australian exports to China included iron ores and concentrates (AUD 57.0b), coal (AUD 9.3b), gold (AUD8.1b) and copper (AUD 2.1b). With the exception of SOME coal related products, these exports of Australian Origin will be placed under the A-0 category and would receive duty-free benefits immediately.

## Will ChAFTA stimulate Australian exports to China?

For certain products, the ChAFTA will result in immediate or gradual lowering of duties. It is foreseeable that the Australian export of these products will increase in the coming years; whether the products are priced more competitively or come with higher margins, Australian exporters will double their efforts to reach the Chinese market!

# Our Practice Areas

## Corporate/M&A

- Acquisition/Sale of Equity or Business Assets
- M&A Advisor, Deal Structure, DD
- JV Contract / Negotiations / Buy out
- Reconstructing / Reorganization
- Loans & Corporate Financing
- Private Equity and Venture Companies

## FDI & Registration

- FDI Company Incorporation & Liquidation
- Set-up of branches all over China
- Registration of chances to capital, business scope, director, investor, legal rep, address
- Risk Management Systems Development
- Corporate Governance Systems Development
- Real Estate Development

## Dispute Resolution (Litigation & Arbitration)

- Negotiate Disputes with Chinese Buyers/Sellers
- Demand Letters
- Police Filings
- Litigation (Chinese Court)
- International Arbitration
- IP Enforcement
- Compliance, Corruption, Fraud
- Government Complaints / Issues

## Intellectual Property (IP)

- Trademark Matters
- Patents / Copyright Matters
- IP Protection, Investigations & Enforcement
- Customs & Trade Fair Infringement Actions
- Administrative Action
- Cease & Desist Letters
- Civil Law Suits
- Non-Disclosure Agreements
- Licensing Agreements

## Commercial & Trade

- Import, Export, Trade Contracts
- Processing Manufacturing Trade
- Contract Negotiations
- Trade & Export Financing
- Distribution Contracts
- Contract Management
- Avoiding & Resolving Disputes

## Employment

- Draft Employment Drafts
- Create Employment Handbooks
- Employment Matters in M&A Transaction
- Internal Governance
- Safe-Keeping of Stamps and Licenses
- Firing Senior Management
- Layoff, Reconstructing, Reorganizations
- Take-over / Raid Offices
- Employment Termination
- Labor Arbitration

## Compliance

- Commercial Bribery
- Officials Bribery
- Corruption, FCPA/UK Bribery Act
- Internal Control System
- Codes of Conduct
- Entertainment Policies
- Data Privacy Protection
- Responding to Government Investigations
- Fraud, Self-Dealing, Sexual Harassment
- Accounting Fraud, Channel-Stuffing
- Compliance Training
- Internal Investigation/Audit
- Ombudsman (Serving As)

## Tax, Forex and Customs

- International Tax Structure
- China Corporate Tax
- Individual Income Tax
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- Customs Issues
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- Government Action

## Private Client Services

- China Exit Restrictions
- Detention
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- Employment Disputes
- Personal Income Tax