R&P 方旭 CHINA LAWYERS

Volume VIII|001

January 2018

LEGAL BRIEFING

Selling in China

LEGAL DEVELOPMENTS

LATEST NEWS

"R&P focuses on advising foreign medium-sized private companies and small to mid-sized multinationals on their Chinese investments and cross-border deals"

"Maarten Roos is vastly experienced in advising European and American companies on their China-bound investment and corporate activities"

"A Shanghai boutique, well equipped to advise on a wide range of issues"

Koen Naber Appointed Vice President Of The Benelux Chamber Of Commerce In China

We hereby proudly announce that Koen Naber, Director of R&P China Lawyers, was appointed Vice President of the Benelux Chamber of Commerce in China. Representing the nation states of Belgium, Netherlands and Luxembourg, the Chamber is the prime platform for the Benelux business community to get together and share an active interest in developing trade and business in China. As a member of the Beijing Board of Directors, Koen advises the daily management of the Chamber on a broad range of issues and assists with regard to the Chamber's strategic direction.

R&P Supports Nutriad Group on Sale

Nutriad Group, a global feed additives producer and a long-time client of R&P, was recently sold to French multinational Bluestar Addisseo. Nutriad has multiple interests in China including two subsidiaries, and so R&P China Lawyers acted as Nutriad's PRC legal counsel on this transaction.

R&P's team was led by managing director Maarten Roos and partner Kathleen Cao, Allen & Overy in Paris and DLA Piper in Amsterdam were also involved in the transaction. For more information on this deal, please go to https://nutriad.com/2017/12/bluestar-adisseo-anounces-nutriad-acquisition/

One of R&P's oldest clients, Nutriad is typical in that it retains the firm's support across a broad range of practice areas including Chinese corporate / M&A, commercial work, compliance, employment, tax and dispute resolution. For more information on how we can support in M&A transactions, please email roos@rplawyers.com or your usual contact at the firm.

R&P China Lawyers is a boutique Chinese law firm headquartered in Shanghai, providing high-end legal services to foreign businesses active in China.

R&P Legal Briefing is written to inform clients and friends of the latest developments in Chinese law and practices.

For more on our experience or the services that we have on offer, or to read more articles on Chinese legal topics, please visit our website: www.rplawyers.com

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Reaching 1.4 Billion Consumers:

Sales Channels For International Retailers And Brands In China

By Maarten Roos & Robin Tabbers

"Ambitious companies will usually want to combine their own physical store retail network including at least one or more flagship stores with at least one major e-commerce channel to allow cross-exposure."

1. Introduction

Despite China remaining the sourcing capital of the world, most companies nowadays enter China to *sell* their products, rather than to source (or produce) them. This is not surprising given China's demographics: for example, it is already the world's largest luxury market as well e-commerce market, and according to one study it could have 630 million middle class consumers by 2022 (McKinsey).

As the landscape is developing so quickly, it is time for a comparison between the different sales channels available to foreign companies today. No doubt, China's e-commerce opportunities are getting the most press but in fact it is *not* just about e-commerce: the best strategy is made with an understanding of *all* the opportunities, and based on the model that fits best with your products, your prospective market, and the resources that you want to invest in making your China strategy a success.

We will share with you the (good and bad) experiences of 100+ international retailers and brands that we have assisted to (try to) conquer the Chinese market, providing you with a useful framework for your China entry decision-making process, based on the entry models that we see most.

2. Selling via an import agent or distributor

A classic and low entry-barrier option is cooperating with a Chinese import agent or distributor, who will be responsible for the sale of the products in China. A distributor will buy your products and sell them on the Chinese market on its own account, while an import agent is normally involved when you already have an end-buyer for your products.

Nangjing Lu, the premier retail street in Shanghai

These methods are very common when a company intends to distribute the product quickly and inexpensively, albeit ones that have several disadvantages as well.

Choosing the right distributor can be problematic, which some of our clients have learnt the hard way: (i) there is a lot of competition for the best distributors, (ii) most distributors tend to have their own agenda, which means that their interests often do not fully align with yours, (iii) most distributors will want exclusivity in return for access to their China-wide network, will promise huge sales but are unwilling to commit and, in the end, may well under perform. Giving exclusively should always be subject to clear conditions and restrictions (geographic, industry, market segment, minimum sales volumes, term, etc).

The proper structuring of sales, agency and distribution contracts is therefore key, and you must get legal advice before you end up like many before you did: having committed to a non-performing distributor without the option to terminate and either appoint a new distributor, or pursue other sales channels. Other disadvantages to watch for: profit margins of this channel will generally be small, while you will have limited control (if any) over marketing and branding.

3. Cross-border e-commerce or domestic e-commerce

E-commerce has taken China by storm. The statistics speak for themselves; online retail sales in China reached 5.16 trillion yuan ($752 billion) in 2016, representing a 26.2% growth from 2015—more than double the growth rate of overall retail sales according to China's National Bureau of Statistics. When talking about e-commerce in China the first thing that comes to mind is Alibaba. TMall, the B2C platform owned by Alibaba, had a staggering 54.6 % market share in 2016, and was followed by JD.com with 24.7 %.

Taking TMall and JD as examples, we see that they offer two options for retailers and brands: TMall Classic and JD are for companies that are established in China (*domestic e-commerce*), while Tmall Global and JD International give companies that are set up abroad the option to sell into China (*cross-border e-commerce*). Setting up a cross-border store seems like an attractive option for foreign companies because they do not need a physical structure in China, however there are several significant downsides and challenges. First, operating a store on a cross-border platform is quite expensive, with yearly operating fees of easily $10,000, a commission on every sale which varies between 3-6 % and a one-time fee of around $25,000. Add to this the fixed and commission fees of service providers who create, design, and operate your store, and margins will be limited. Moreover, cross-border sales only account for a very small percentage of the total China e-commerce market (some estimate around 5%). Finally, when operating from abroad, companies tend to refrain from or do not know how to engage in relevant marketing activities tailored to the Chinese consumer.

Operating a domestic e-commerce channels has many advantages. The main drawback is the requirement to set up a subsidiary in China to enlist with a platform, and sell goods domestically in China. A secondary issue, at least for some categories of products (e.g. cosmetics), is that the goods to be sold must meet local requirements. Overall, and unless certain local restrictions prevent domestic sales in China, most companies now tend to use cross-border e-commerce as a stepping stone, or they skip it altogether and directly **focus on domestic e-commerce channels through a newly-established Chinese subsidiary.**

4. Local China office to manage customers, distributors, franchisers, retailers, and e-commerce

Increasingly, companies decide to set up a China office to manage their sales channels more directly and effectively, while retaining various levels of involvement with and control over marketing, branding, customer data, pricing, distribution, and brand proposition. A China entity offers the opportunity to hire permanent local staff, who can gather local knowledge and share this with headquarters, for a step-by-step development of the optimal sales channels and an overall China strategy. Some companies may still start with growing existing customer and distributor business, while opening new channels with retail, franchise, and e-commerce.

5. Brick-and-mortar retail stores

In the long-term, the most profitable channel - but also the costliest to run – seems still to be the brick-and-mortar, physical retail network. Traditionally foreign retailers and brands have often used a franchise model (less control over the marketing, branding, customer base, pricing, and brand proposition) or they set up joint ventures that will invest and help them in the process. But in recent years, many well-known international brands have focused on setting up a 100% Wholly Foreign-Owned Enterprise (WFOE) to open physical stores.

While the downside of this channel is obviously the high investment and operational costs, there are several distinct advantages. First, the profit margins in retail are high (especially if the products are manufactured or sourced in China), as this means saving on transportation, import duties, and taxes. Furthermore, the retailer is in full control of sales, marketing, branding, pricing, brand proposition, and its omni-channel China operations. Moreover, it presents companies with a unique opportunity to understand the Chinese market and its customers, and use this for a long-term approach to become an established brand in China. Some retailers invest heavily in obtaining brand recognition, and a critical mass (G-Star, Under Armour), while others choose strategic, affordable locations, and take time to grow their brand (Victoria's Secret). With its middle class ever growing and a clear appetite for foreign products and brands, China is already a mature sales market that can hardly be ignored by Western retailers and brands.

6. Conclusion

There are plenty of ways to approach the market. Ambitious companies will usually want to combine their own physical store retail network including at least one or more flagship stores, usually combined with at least one major e-commerce channel to allow cross-exposure. More cautious approaches are to find the right distributor that will do the work for you, setting up a local company for domestic e-commerce, or taking an omni-channel approach. For those companies that cannot yet sell into China the cross-border e-commerce model may be the first step, but even then, they are wise to invest in structure, so that they can expand into domestic sales promptly when the time is opportune

Retail alternative: How To Establish A Franchise In China

By Yang Limeng & Robin Tabbers

"Regarding the ways of operating a franchise business in China, there are two business models… A foreign franchisor may directly sign a franchise contract with Chinese franchisees or set up a WFOE in China to operate the franchise business."

1. Introduction

Franchising is a popular business model used extensively in China as well as the rest of the world by many international retailers and brands to achieve business success. This article explores how to establish a franchise in China while highlighting the most important considerations unique to this market.

2. Barriers To Entry

The term "franchise" in the Chinese Regulation on the Administration of Commercial Franchises refers to business operations by which an enterprise owning a registered trademark, enterprise mark, patent, know-how, or any other business resource (hereafter the "franchise resource") confers or licenses the said franchise resource to any other business operator through a contract. The franchisee undertakes business operations under a uniform business model as stipulated by the contract and pays franchising fees to the franchisor.

This definition is common and recognized worldwide; in other words, most foreign franchise models can be used in China through ways analysed below. Nevertheless, it does not mean there are no obstacles to overcome. Chinese authorities have set preconditions on franchise businesses that apply to both foreign and domestic franchisors. In detail, the preconditions are:

1. A franchisor engaging in franchise activities shall possess a mature business model and the ability to provide long-term business guidance, technical support, business training, and other services to the franchisee.

2. A franchisor engaging in franchise activities shall have at least two direct sales stores, and shall have undertaken the business for more than a year (the so called"2+1" requirement). For a foreign franchisor, is it not required that such direct sales stores are located in China. In other words, two direct sales stores abroad qualify as well, however the franchisor has to provide a business certificate of the direct sales store (including a Chinese translation) notarized by the local agency and accredited by the local Chinese embassy or consulate.

3. Two Common Business Models

Regarding the ways of operating a franchise business in China, there are two business models. In accordance with the Chinese WTO Schedule of Specific Commitments on Services, restrictions on franchise have been withdrawn since Dec 11, 2004. Therefore, there are currently two available models: cross-border supply and commercial presence. A foreign franchisor may directly sign a franchise contract with Chinese franchisees or set up a WFOE in China to operate the franchise business.

The foreign franchisor may choose either model based on its specific conditions and commercial strategy. Both ways have their advantages and disadvantages. Please refer to the table below:

	Cross-border supply	Commercial presence (WFOE)
Advantages	Foreign franchisor can quickly establish a franchise by directly signing a franchise contract with one or each domestic franchisee, which will limit the time and the costs. The foreign franchisor can meet the“2 + 1” requirement if it has two foreign sales stores.	It is more convenient for the franchisor to train and supervise the franchisee, to expand business, and to protect its IP. It is easier to be adapted to the local cultural and trade customs. According to most recent information, the WFOE does NOT have to meet the “2 + 1” requirement before it can operate a franchise business as long as its investor meets this requirement.
Disadvantages	This model is not suitable for rapidly expanding the market as the marketing costs are high and communication between franchisor and client is difficult. It is difficult and costly to train and supervise the franchisee. One cannot easily appoint one master franchisee, since he may not immediately qualify to act as franchisor (2+1).	Establishing and operating a WFOE requires time and investment.

4. How To Establish A Franchise

4.1. Registration

In accordance with Regulation on the Administration of Commercial Franchises, a franchisor shall apply for archival filling to the local commerce authority within 15 days after it signs a franchise contract with a franchisee within China for the first time.

When applying for registration, the following files shall be submitted:

- copy of the business license and the original and photocopy of yearly check certificate, or other original subject qualification certificate with the photocopy;

- WFOE shall submit the original and photocopy of Approval Certificate extra. When the registered items of business license have changed, an Alteration Certificate issued by the Industrial and commercial bureau shall be submitted;
- original and photocopy of registration certificate of business resources such as the trademarks, enterprise mark, patent and know-how;
- approval of related competent department, if the franchised products or services need to be permitted according to the related laws and regulations;
- original and photocopy of ID card of the legal representative;
- application form;
- contact sheet;
- distribution of the direct sales stores;
- distribution of the partner shops;
- market plan of the franchisor;
- franchisor's commitment signed and sealed by the legal representative;
- specimen of the franchise contract;
- operation manual.

Notice:

- In case a franchisor fails to do so, penalties will be imposed. In detail, the local commerce authority will impose a fine of at least 10,000 RMB but no more than 50,000 RMB, to be paid within a certain time limit. If the franchisor fails to do so within the time limit, it will be fined at least 50,000 RMB but no more than 100,000 RMB, and a public announcement will be made. Nevertheless, failure to meet the 2+1 requirement or complete the filing process with the commerce authority does not necessarily nullify the franchise contract. In that case local court will judge the effectiveness of the franchise contract based on specific circumstances.
- Franchisor shall apply for alteration to the relevant authorities within 30 days when the following information registered has changed:
  - industrial and commercial registration information;
  - franchise resource;
  - distribution of the direct sales stores run by the franchisee.

4.2. Contract requirement

A franchisor engaging in franchise activities should sign a franchise contract with the franchisee in written form. The contract shall include the following contents:

- basic information of the franchisor and the franchisee;
- contents and duration of the franchise;
- type, amount and payment method of franchising fees;
- specific contents and methods for business guidance, technical support, business training and other services to the franchisee;
- quality, standard request and warranty measure for products or services;
- sales promotion and advertising for products or services;
- consumer protection and compensation for damage in the franchise business;
- alteration, dissolution and termination of the franchise contract;
- responsibility of default;
- solution of the dispute;
- other matters franchisor and franchisee agreed upon;

Notice:

- Franchisor should offer a manual including the operation of a franchise business to the franchisee and provide business guidance, technical support, business training and other services to the franchisee continuously according to the content and manner of the franchise contract.
- Franchising products and services shall conform to the laws and regulations.
- If a franchisee pays the fee before making a contract, an explanation about the use and the way of refunding should be stated in written form by the franchisor.

- franchisee shall not transfer the franchise to others without permission. Disclosing and allowing others to use the franchise resource is also forbidden.

5. Disclosure Of Information Required

Chinese law states that, for the purpose of protecting the franchisee's interest, the franchisor is required to provide the following information to the franchisee at least 30 days before both parties execute the franchise contract:

- the name, domicile, legal representative, registered capital, business scope of and basic information about the franchised operations of the franchisor;
- the basic information about the registered trademark, enterprise mark, patent, know-how and business model of the franchisor;
- type, amount and payment method of franchising fees (including whether and how a deposit would be charged and refunded);
- prices and requirements for providing products, services and equipment to the franchisee;
- specific contents, methods and implementation plans for continuously providing business guidance, technical support, business training and other services to the franchisee;
- specific measures for guiding and supervising the business activities of the franchisee;
- investment budget for franchise network;
- number, distribution and business evaluation of current franchisees within the territory of China;
- digests of the financial statements and audit reports as audited by the accountant firm for the recent two years;
- conditions about franchise-related lawsuits and arbitration for the recent five years;
- whether the franchisor or its legal representative has ever conducted major illegal business operations; and
- other information prescribed by the commercial administrative department of the State Council

If a franchisor hides any of the information listed above or provides false information, the franchisee may terminate the franchise contract. If the information provided by the franchisor has undergone any major change, notification should be delivered to the franchisee.

6. Termination Right Of Franchisee

According to Chinese law, the franchisor and the franchisee shall stipulate in the franchise contract that the franchisee may unilaterally terminate the contract within a certain period after the franchise contract has been concluded.

This is the so called "free termination right" granted to a franchisee. This right gives the franchisee a cooling-down period to avoid risks such as being inexperienced or acting on impulse. There is no uniform period regulated by law, and the franchisor may set it based on the specific situation of the franchise. We advise a "free termination right" period that expires before the franchisor hands over the franchise resource.

When the franchisee terminates the franchise contract by this right, it shall be free of any liabilities based on breach of contract, and the paid fees, such as the deposit or loyalties, shall be refunded if franchisee has not used the franchise resource yet. Nevertheless, if such termination causes direct loss to the franchisor, the franchisor may claim damages against the franchisee.

Tariff Reductions To Impact Foreign Sales To Chinese Consumers

Starting from 1 December 2017 new reduced import tariffs apply in China. It is the fourth time China has reduced its import tariffs since 2015. This is positive news for foreign companies that are already selling in the PRC and for companies that are pondering entering the Chinese market, as this newest measure will significantly reduce the cost of selling certain imported goods to Chinese consumers.

187 different product categories are affected by the changes, with most of the tariffs having been reduced by at least 50%. The most eye-catching tariff reductions:

- baby formula: from 20% to 0%
- diapers: from 7.5% to 0%
- retail packaged infant food: from 15% to 2%

Other notable products that are affected by the reductions are:

- 27 kinds of medicines (like penicillin and ampicillin)
- certain kinds of coats, suits and textile and leather materials
- 20 different personal hygiene and beauty products, such as eye shadow, lipstick, toothbrushes and shampoo
- 8 various seafoods (like salmon, crabs and shrimp)
- 30 categories household appliances (like washing machines, coffee machines, air conditioners toasters)
- 21 different foodstuffs including cheese, meat and pasta
- 4 categories of drinks

Consumer spending has quickly become the engine of Chinese economic development, and so this newest measure is a clear effort to encourage domestic spending and therefor economic growth.

Secondarily, this reduction will also incentivise Chinese from buying in China rather than spending abroad – a trend that was started by high net-worth individuals but is becoming popular with the middle class as well. The regulation could also adversely affect the so called dàigòu (代购) business model – Chinese agents that purchase goods overseas, and send or peddle them back to China.

"The reduction also signals that the PRC government acknowledges the strong preference that Chinese consumers have for foreign consumer products"

The reduction also signals that the PRC government acknowledges the strong preference that Chinese consumers have for foreign consumer products. Very often, these are still seen as superior to domestically produced items, especially in the health and beauty segments. This round of tariff reductions therefore presents new opportunities for foreign companies that want to sell in China.

Cross-border E-commerce

Interestingly, this measure may also put pressure on companies that only use the cross-border E-commerce model to sell into China. Under this model, goods are marketed on international online platforms such as Tmall Global and when purchased, items are shipped directly from bonded zones to Chinese individual buyers without having to pay duties. The latest developments will make it more attractive for international businesses to set up entities in China directly, import the goods against the now reduced tariffs, and then sell them on local online platforms (e.g. Tmall) to reach a much broader audience.

R&P Speaks At Shopping Today

On 21 September 2017 Robin Tabbers was invited as an expert by Thuiswinkel to give a presentation on selling in China at the Shopping Today conference. Since Robin is an expert in Shopping Tomorrow's China e-commerce work-group, he was asked to explain all the legal and commercial ins and outs of the different channels used for e-commerce in China.

Thuiswinkel is a Dutch interest group for e-commerce that represents Dutch sellers on a national and international level. Shopping Tomorrow is its digital research platform for all e-commerce professionals. Every year they organize the Shopping Today conference where the industry's leading professionals get together and discuss recent developments in the field of e-commerce, with almost 2000 participants in 2017.

R&P Again Recommended by Chambers

For the 6th year in a row R&P China Lawyers has been recommended by Chambers Asia Pacific Guide 2018 as one of China's leading domestic law firms for Corporate / Commercial work (Band 2).

In its review, R&P is described as:

"A Shanghai boutique, well equipped to advise on a wide range of issues incorporating foreign direct investment, corporate restructuring, joint venture establishment and liquidation. Standout expertise in the media and retail sector, assisting international companies with their investments and operations in China."

Clients appreciate the turnaround speed of the firm, noting: *"We expect to get service in a timely manner and they deliver that."*

Another client, who engages the team frequently, says that *"they have a practical approach, very open-minded in coming up with ideas."*

We are pleased to be recommended by the market for what we do best, and proud to be ranked among the country's top Chinese law firms. We look forward to continue supporting international businesses to develop their activities in China.

R&P 方旭 CHINA LAWYERS

Individual Recognitions Asialaw Leading Lawyers 2017

asialaw LEADING LAWYERS

We are thrilled to announce that once again, five of R&P's professionals are listed in the latest, 2017 edition of Asialaw Leading Lawyers – the guide to Asia-Pacific's leading lawyers in private practice at national and regional law firms:

Maarten Roos

Corporate and M&A; Intellectual property Dispute resolution & Litigation

Robin Tabbers

Corporate / M&A, Labour & Employment

Chen Yun

Banking & Finance

Victoria Lei

Corporate / M&A

Kathleen Cao

Corporate / M&A