LEGAL UPDATES

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Top Eight Legal Issues Regarding Entering The China Market

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China has rebounded from the recession and is again developing at a rapid rate. With the domestic consumption expanding fast, experts predict enormous market growth in China over the next decade. In our practice, we have seen a growing trend for exports to China by small to medium-sized companies in the Midwest. We are frequently called upon to answer the legal questions arising in the process of distributing goods in China. Our China Law Brief provides a summary of eight key issues that we consider to be of most importance. A company selling goods in China may not encounter all these issues, but chances are several will arise and one may delay or derail the transaction if the issue is not properly addressed. This list does not cover all the details and nuances of the issues identified, but provides a guide to assist companies in preparing for a business arrangement in China.

Issue 1: Form of Representation

A U.S. company needs some form of representation in China before it can distribute its products. The company should evaluate the following questions to determine the most suitable mode to achieve its objectives:

a. What is the most effective way to enter the Chinese market?

b. Is the structure of the representation allowed by local law?

c. What costs and resources are required?

d. What potential liabilities exist?

For example: Clients frequently ask, “Can I hire a salesperson in China?” or “What about a sales rep who is an independent contractor?” In China all activities by foreign companies must squarely come within the scope that is permitted by local law regulating foreign companies. Unfortunately, without first registering a legal entity in China, a foreign company is not allowed to hire an employee in China and chances are you won't get away with calling this person an independent contractor either.

The most straightforward and relatively easy way to arrange for representation is to find a distributor in China. If you want more control, you can set up your own entity, but setting up an entity in China requires approval by the Chinese authority and can be time consuming and costly. A representative office by a foreign company is easier to set up than a separate legal entity, but it cannot engage in sales activities, which sometimes defeats the purpose.

Depending on the distribution structure, there may be tax consequences under both U.S. and Chinese law. It is important for any U.S. company to understand these and other potential liabilities associated with the structure.

Issue 2: Registration, Certification and Licensing Requirements
Many products must be registered, certified or licensed by the relevant Chinese authority before they can be sold in China. Products concerning human health and safety, or products which are deemed potentially hazardous to human, animal or environmental health and safety, usually have certification or registration requirements. We recommend that you check the regulations with the State Administration of Quality Supervision, Inspection and Quarantine, the Certification and Accreditation Administration, and the relevant authority of your industry (for example, the Ministry of Health is your relevant authority if you manufacture medical equipment) to confirm if a registration, certification or license requirement applies to a specific product.

In addition, China passed a new Food Safety Law in 2009, which requires all foreign food manufacturers to register with the relevant authority before food products can be imported into the country.

Issue 3: Business Scope
In China, each company has a specific scope of business that is set forth in the company's business registration documents. This is the scope of commodities and/or services that the company is legally allowed to produce or provide. There are two contexts in which this issue could come into play for a U.S. company. First, if you are setting up an entity in China, its business scope must be carefully drafted to ensure that future operations will not be deemed outside the approved business scope. The description still needs to be specific, however, because the Chinese authorities will not approve any business scope that is too broad or too general. It can be a challenging task to draft the business scope because it must closely track the Classification of National Economic Industries (an official publication that divides business operations into categories) and also practically encompass all the activities that the entity plans to undertake.

Second, if you will be using a distributor, you should verify the distributor's business scope to ensure the distributor is authorized to import goods and distribute the types of products that you intend to sell in China.

Issue 4: Intellectual Property Protection

It should be no surprise that intellectual property protection made our top list for doing business in China. Chinese law offers comprehensive protection of patents, trademarks, trade secrets and copyrights, however, there is widespread violation and ineffective enforcement of law. So, the key for any company seeking to sell products in China is to create and implement a practical and effective action plan. Several seemingly obvious, but often overlooked, action items include:

a. Evaluate what intellectual property is important to the company

b. Review the company's product portfolio and take action to register the patents and marks that have not been properly registered in China (subject to eligibility standard under Chinese law)

c. Register both the English and Chinese versions of the marks

Also consider whether the company anticipates on-line business and whether it should register its domain name in China.

More importantly, a company should take precautionary measures within its organization and that of its Chinese business partner to protect its intellectual property. For example, restrict access to sensitive information and develop protocols to protect it from unintended disclosure or misappropriation. Utilize confidential agreements when appropriate, and properly train employees who will come into contact with the sensitive information. Creating a comprehensive and meaningful process to protect intellectual property at the outset is a critical component to safeguarding a company's intellectual property rights.

Issue 5: Foreign Exchange Regulations

China has relatively strict foreign exchange regulations. Moving currency in or out of the country often triggers a settlement, registration or approval requirement, depending on the type of transaction. For example, a loan agreement between a foreign lender and a Chinese borrower must be approved by the State Administration of Foreign Exchange or its local branch to be legally effective. For a distributorship arrangement, in order for the local distributor to obtain the foreign currency required to compensate its foreign seller, the contract, invoice and certain customs documents must be submitted to a designated bank for verification that foreign currency is required to meet a valid contractual obligation. A U.S. company should evaluate if the foreign exchange regulations in China have any implications on the planned transaction based on the structure of the transaction.

Issue 6: Local Tax and Import Duties
Depending on the structure of the transaction, a U.S. company may incur tax liability under Chinese law. For example, a U.S. company may be subject to China's enterprise income tax for certain China-sourced income such as interest, royalties, capital gains, etc. In addition, revenue generated from a licensing arrangement is subject to a business tax in China. The income tax paid in China will be eligible for the foreign tax credit provided under the U.S. tax law, but the business tax may not be similarly eligible.

In addition, import duty and value-added tax (usually 17 percent) will apply to all imported goods. Although these taxes are often the importer's responsibility, they can significantly impact the deal economics and the parties' cash flow or profits. Therefore, it is important for a U.S. company to understand these issues beforehand. Local tax and import duty issues can be quite complex and the results vary depending on the specific arrangement. We strongly recommend that companies confer with legal and tax advisors to determine how these impositions may impact the contemplated transaction.

Issue 7: Dispute Resolution
When a business arrangement involves two parties in two countries, the inevitable question is: In the event of dispute, at what location will the parties resolve the dispute and what method of dispute resolution will the parties use? A U.S. company may think having the Chinese party submit to exclusive jurisdiction in a U.S. court is the ideal solution. The problem with this approach is that no treaty exists between the two countries to enforce foreign judgments. Even if the U.S. party wins the case in a U.S. court, unless the Chinese party has substantial assets in the U.S., the U.S. party will still have to seek to enforce the judgment in China. A Chinese court is not obligated to enforce such judgment.

When contemplating a contractual relationship between a U.S. company and a Chinese company, an arbitration clause is a more effective means to provide certainty to the dispute resolution process. The U.S. and China are both parties to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York" Convention), which provides for an effective means to enforce arbitral awards. However, the arbitration clause needs to be properly drafted to be enforceable both in the U.S. and China. Careful thought should also be given to which arbitration institution and rules to choose, where to locate the arbitration, which language will be used, and which governing law will control. These are often heavily negotiated provisions in the contract. Both parties may need to compromise in order to reach a position that is fair and acceptable to both sides.

Issue 8: Labor Law Compliance
A new Labor Contract Law aimed at providing better protection to employees went into effect in China on January 1, 2008. The law applies to both domestic and foreign-owned firms hiring

employees in China. A U.S. company with employees in China, usually through its Chinese subsidiary, should acquaint itself with the mandatory requirements of this new law, which are very different than what is customary for a U.S. employer.

The law requires that an employer enter into a written employment contract with all employees and significant penalties can be levied against employers that fail to do so. The familiar "at will" employment concept has no place under the Chinese Labor Contract Law. The law only allows three types of contracts: fixed term, open-ended and project-based. An open-ended contract has no termination date and the employer can only terminate the employee under the specific grounds enumerated in the law. A fixed-term contract has an agreed-upon termination date, but an employee retained after two fixed-term contracts have expired is deemed to have an open-ended contract. The law also requires a mandatory open-ended term contract in certain situations where the employee has worked for the employer for more than ten years. A project-based contract's term is based on the project's length.

Furthermore, a non-competition clause is only valid if it meets certain statutory requirements and compensation is required to be paid to the employee during the non-competition term.

What This Means To You

China is an attractive market for many companies seeking to expand its distribution network and there are many reasons to pursue opportunities in that country. However, as with any new venture, careful planning and preparation are required to launch a successful expansion strategy. The topics discussed in this summary are among the most critical and often misunderstood or overlooked. A company seeking to do business in China should consider the issues carefully and discuss them further with legal counsel.

Contact Information

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