



Distribution in China – Legal Issues

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Introduction

In 2012, China surpassed the United States to become the world's largest destination for foreign investment, marking another milestone in China's unprecedented growth and development. As the benefits of China's extraordinary economic development expand, the rise of the Chinese consumer has become the latest opportunity for many domestic and multinational corporations.

Foreign companies looking to sell their goods to Chinese businesses and the increasingly affluent Chinese consumer do so either directly or indirectly. The direct method requires a company to establish a presence in China and undertake the import or manufacture and subsequent distribution of its goods. The indirect method involves either selling the goods to a Chinese buyer that resells the goods in China, or appointing a commercial agent in China that introduces prospective buyers to the foreign company.

As the market for selling into China becomes more saturated, companies are already shifting their strategies. Foreign companies are venturing further downstream and either participating in retail distribution and franchising, or engaging in direct selling to the Chinese market. The rise of e-commerce and internet sales also has had a significant impact on models and structures for distributing goods and services, and provides new opportunities for a variety of distribution models.

Many foreign companies manufacture goods within China—mainly through foreign-invested enterprises (FIEs)—then sell the goods wholesale. Some FIEs are wholly foreign-owned enterprises (WFOEs), a business form that can only operate in China with certain restrictions. With the appropriate licenses and permits, however, a WFOE can distribute a range of goods in China. Typically this distribution is done at the wholesale level, but some WFOEs distribute at the retail level.

Business Models for Distribution in China

IMPORTING

Foreign companies have been exporting products directly to buyers in China for a long time. Chinese buyers that did not wish to obtain the associated import and export licenses¹ would hire a Chinese-registered foreign trade agent to undertake all necessary import formalities.

Import and export in China is generally regulated by China Customs and the People's Republic of China General Administration of Customs in China (GACC).² Of the three levels of customs authorities in China, the GACC is at the top of the hierarchy.

¹ A foreign trade license issued by customs is different from trading rights under the business scope of a company under China laws. A foreign trade license issued by customs entitles the license holder to deal with customs formalities by itself, so that it is not necessary to engage a customs broker. The trading rights within a company's business scope indicate that the company is legally permitted to engage in the business of trading.

² Zhonghua Renmin Gonghe Guo Haiguan Fa (中华人民共和国海关法) [Customs Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., July 8, 2000, effective Jan. 1, 2001) art. 3.

The customs clearance procedure for importing goods into China involves essentially three steps that are jointly performed by the provincial and local customs offices: documentation, inspection and release of goods. Businesses typically engage a customs broker, which assists in processing the declaration. Customs brokers must be registered as lawfully established declaration entities, and they have different potential roles depending on the nature of the customs clearance.

The importer or customs broker first completes the customs declaration in writing. An authorized entity in the local customs office then transmits the data electronically through the Electronic Data Interchange system to the “electronic data examination center,” which checks the format of the data, then transfers it to different customs officers according to the types of goods that were declared. The customs officers check the valuation and classification of each entry, and that data is released and sent back to the local customs house. The importer or customs broker then provides the customs officer at the local customs port with the paper declaration form, together with all other required documents.

Next, the local customs office determines whether a physical examination is necessary and, if so, how it should be completed. Depending on the product, circumstances or particular program of inspection determined by the customs office, the entire shipment may be inspected. China Customs will either examine all of the goods or take samples for inspection. The examination can be undertaken at an examination station, a customs facility or, if appropriate arrangements are made, the importer’s premises. Other border agencies, such as the State Administration on Quality Supervision Inspection and Quarantine, may also inspect certain goods, such as food, agricultural products, measuring instruments and medicines.

Finally, if all customs duties and import taxes are paid, the imported goods will be released. In some circumstances, goods can be released prior to the completion of customs formalities if the importer provides a guarantee.

COMMERCIAL AGENTS

Another means of penetrating the China market is the use of a commercial agent in China to import and distribute products. There are, however, legal limitations on what a local commercial agent can do. A commercial agent might be a representative office of a company based in Hong Kong or a domestic mainland Chinese entity with links to regional or multiregional (rarely national) distribution networks. A commercial agent in China typically does not hold an import and export license, and therefore pays a commission to such a license holder to facilitate the importation of foreign products.

Commercial agents promote products, introduce buyers and facilitate sales in China, but normally do not act as a true “agent” with the power to sign contracts and legally bind the foreign supplier. At the same time, commercial agents are not true distributors, because they do not purchase the product and resell it. Most commercial agents do not want to take on the risk—or do not have the capital—to buy and resell a foreign supplier’s products.

The use of a commercial agent generally is not regarded as the best mechanism for medium or large foreign corporations to distribute their products in China. Commercial agents may not have the experience, expertise or interest necessary to ensure that the trademark and its goodwill are properly protected, the product reaches

the market in the timeframe and manner required, and marketing is carried out professionally as envisaged. There also may be concern that much of the brand's goodwill might be directed to the local agent and not to the foreign supplier. Nevertheless, if a foreign exporter is prepared to invest in careful selection, proper training and constant communication with its commercial agent, it may be able to obtain adequate market representation from a commercial agent.

TRADING COMPANIES

Another method adopted by foreign companies is the formation of an FIE with a business scope that encompasses trading. These FIEs can obtain trading rights to import and export goods, and can later even obtain a permit allowing them to engage in downstream distribution. Foreign-controlled Chinese companies—such as FIEs—that are registered and have RMB 1 million³ in paid-up capital can obtain an import and export trading license. This is particularly true if an FIE manufactures goods in China.

Since 2005, companies that are foreign-invested commercial enterprises (FICEs) have been able to engage in distribution and trading if they have been approved by the relevant authorities. FIEs (including WFOEs) that engage in manufacturing can now also obtain approval to expand the scope of their business to include distribution and trading, but normally only with respect to the goods that they manufacture. Approvals for distribution and trading within China for FIEs and FICEs are primarily granted by China's provincial agencies.⁴

WHOLESALE DISTRIBUTION

There are many Chinese companies that act as distributors for foreign suppliers. Typically such distributors purchase and resell products to smaller Chinese distributors or retailers.

For foreign undertakings, an increasingly common route to the Chinese market is to establish independent wholesale distribution in China. There are numerous legal challenges related to wholesale distribution of goods in China, even if the goods are developed or manufactured in China. Chinese law includes limitations on how long a company can operate and requirements for annual approvals that entail an annual examination of the undertaking's operations by the Chinese authorities. In addition to the rules specific to wholesale distribution, foreign undertakings must comply with a complex system of legal requirements, most notably regulations related to tax, company law, urban planning, contracts, antitrust (competition) rules, employment, advertising and foreign exchange.

A foreign investor can establish an FICE, in the form of a WFOE, to conduct wholesale distribution activities. This kind of entity is commonly referred to as a "wholesale FICE." China's Regulations for the Administration of Foreign Investment in the Commercial Sector (Commercial Sector Regulations) enable an FICE that has been duly established under China's Company Law to engage in the wholesale distribution of

³ Approximately US\$160,000.

⁴ Shangwubu Guanyu Xiafang Waanishang Touzi Shangyeqiye Shenpi Shixiang de Tongzhi (商务部关于下放外商投资商业企业审批事项的通知) [Notice of the Ministry of Commerce on Delegating the Matters Concerning the Examination and Approval of Foreign-Invested Commercial Enterprises] (promulgated by the Ministry of Commerce, Sept. 12, 2008, effective Sept. 12, 2008).

goods to “retailers and industrial, commercial, institutional and other users, or to other wholesalers, and related ancillary services.”⁵

With limited exceptions in sectors such as oil, salt, tobacco and fertilizers, a wholesale FICE can distribute as a wholesaler without the involvement of third party agents or organizations by taking the following actions:

- Buying and selling goods through a Chinese company, including through another FIE, and issuing value-added tax (VAT) invoices and offset VAT
- Engaging in the buying and selling of goods with a foreign company and directly undertaking customs clearance and procedures
- Conducting general after-sales services, repair and maintenance, as well as buying or selling parts and components incidental to after-sales services

In practice, the registered capital requirements for setting up a wholesale FICE can vary depending on the individual requirements of the local government where the entity is registered. Before the wholesale outlet can be established and commence trading, certain procedures must be followed, and detailed information and documentation must be provided. Approval and business licenses are required from the Ministry of Commerce (MOFCOM) and the local Administration for Industry and Commerce (AIC), respectively.

A wholesale FICE is prohibited from dealing in agricultural chemicals, salt or tobacco. There are also special requirements if the business deals in products subject to import and export quotas, or deals in pharmaceuticals, books, newspapers or other periodicals, gas supply or automobiles.⁶

RETAIL DISTRIBUTION

There are several large, well-known foreign retail outlets operating in China, primarily in the large cities in the eastern part of the country. Since December 2004, foreign companies have been able to establish FICEs in the form of WFOEs and engage in retail distribution. These entities are commonly referred to as “retail FICEs.” A retail FICE may undertake the following activities in China:

- Retailing
- Importing merchandise that it sells
- Sourcing and procuring goods for export, if they are produced in China
- Telemarketing, mail order sales, internet sales and vending machine sales
- Conducting related ancillary services

There is a minimum registered capital requirement for establishing a retail FICE. In practice, the amount varies according to the individual requirements of local governments.⁷ Approvals and business licenses must

⁵ Waishang Touzi Shangye Lingyu Guanli Banfa (外商投资商业领域管理办法) [Administrative Measures on Foreign Investment in the Commercial Sector] (promulgated by the Ministry of Commerce, Apr. 16, 2004, effective June 1, 2004) art. 3, § 2.

⁶ Administrative Measures on Foreign Investment in the Commercial Sector, *supra* note, 5 at art. 17.

be obtained from MOFCOM and the local AIC, respectively.⁸ However, provincial approval is required for applications intended for distribution or sale by means other than television, telephone, mail order, internet or vending machines when the retail outlets are located in the same provincial administrative region as the FICE.⁹

In addition to allowing the establishment of new wholesale or retail FICEs, the Commercial Sector Regulations allow foreign investors with existing FIEs other than wholesale or retail FICEs to expand the business scope of their FIEs to engage in wholesaling, retailing, franchising and agent commission-based businesses.

FRANCHISING

Franchise agreements are increasingly used in China as a method to distribute goods. Franchising generally involves the franchisee (a reseller) selling products with specific characteristics through a particular method of sales. This method involves the use of trademarks, and the franchisor often provides commercial or technical assistance (proprietary know-how).

The licensing of intellectual property (IP), such as trademarks and proprietary know-how, normally involves payment of a franchise fee for the use of the particular business method and other IP rights. A franchise agreement usually contains restrictions on competition, such as non-compete or exclusive distribution clauses that include obligations to purchase certain products or services only from the franchisor or from a person designated by the franchisor.

In China, franchising is governed principally by the Regulations on the Administration of Commercial Franchise Operators¹⁰ (Franchising Regulations), the Contract Law, the Anti-Monopoly Law (AML) and other antitrust-related laws. China's Franchising Regulations apply to "commercial franchising operators," which are defined as "an arrangement whereby a franchisor, by contract, authorizes a franchisee to use its operational resources, such as its trademark, tradename, patent, proprietary know-how; and the franchisee conducts business in accordance with the franchisor's standardized business model and pays franchising fees in accordance with a franchising agreement."¹¹

A franchise agreement must be the subject of a written contract containing provisions dealing with a list of items, including the nature of the franchise, fees, protection of consumer rights and liability for breach. There

REQUIREMENTS OF A FRANCHISOR:

- Be an enterprise
- Be capable of providing the franchisee with long-term guidance and support with training
- Have at least two directly operated stores for one year
- Have a well-established operation model

⁷ Administrative Measures on Foreign Investment in the Commercial Sector, *supra* note 5, at art. 7.

⁸ See generally Administrative Measures on Foreign Investment in the Commercial Sector, *supra* note 5.

⁹ Administrative Measures on Foreign Investment in the Commercial Sector, *supra* note 5, at art. 10, § 3.

¹⁰ Shangye Texujingying Guanli Tiaoli (商业特许经营管理条例) [Regulations for the Administration of Commercial Franchising] (promulgated by the State Council, Feb. 2, 2007, effective May 1, 2007); Order 485 of the State Council promulgated Feb. 2007 and effective 1 May 2007.

¹¹ Regulations for the Administration of Commercial Franchising, *supra* note 10, at art. 3.

are several mandatory provisions protecting the franchisee that must be included in the contract, as well as a number of pre-contractual disclosure requirements.

China has introduced additional administrative measures based on the Franchising Regulations that deal with the filing of a franchise contract and records with MOFCOM, as well as a long list of detailed “information disclosure” requirements.¹² The franchisor must comply with the information disclosures by providing the relevant information to the franchisee at least 30 days prior to the franchisee’s signature of the franchise agreement. These disclosures must also be made at least 30 days before the renewal of such an agreement, unless the renewed franchise agreement is on the same terms as the original. Failure to make the disclosure or providing false information to the franchisee, even if done unintentionally, entitles the franchisee to rescind the franchise contract.

DIRECT SELLING

Direct selling is defined under Chinese law as a “method of distribution whereby a direct salesperson recruited by a direct sales enterprise promotes its product, outside any fixed place of business, directly to an ultimate consumer.”¹³ Direct selling is taking hold in China, with some well-known multinational companies using this method to reach the Chinese consumer. The Regulations for the Administration of Direct Selling (Direct Selling Regulations)¹⁴ and the Regulations on the Prohibition of Pyramid Selling (Anti-Pyramid Regulations)¹⁵ are the primary regulations that govern direct selling in China.

China’s Direct Selling Regulations stipulate that a direct seller may only sell products that the direct seller, its parent companies or its parent’s holding companies have produced. The law is ambiguous about whether products produced by other affiliated companies of direct sellers can be sold through direct selling.

Direct sellers are subject to licensing requirements. To become a licensed direct seller, the following conditions must be satisfied:

- The investors must have a good commercial reputation and must have no record of a major violation of Chinese (and perhaps also other countries’) laws in the five years immediately preceding the license application.

ALLOWED FOR DIRECT SELLING:

- Cosmetics
- Health instruments and devices
- Health foods
- Cleaning products
 - Personal hygiene
 - Daily use products
- Small kitchenware

¹² Zhixiao Guanli Tiaoli (直销管理条例) [Regulations on Administration of Direct Sales] (promulgated by the State Council, Aug. 8, 23, 2005, effective Dec. 1, 2005) art. 2.

¹³ Zhixiao Guanli Tiaoli (直销管理条例) [Regulations on Administration of Direct Sales] (promulgated by the State Council, Aug. 8, 23, 2005, effective Dec. 1, 2005) art. 3.

¹⁴ Zhixiao Guanli Tiaoli (直销管理条例) [Regulations on Administration of Direct Sales] (promulgated by the State Council, Aug. 8, 23, 2005, effective Dec. 1, 2005).

¹⁵ Guowuyuan Jinzhi Chuanxiao Tiaoli (国务院禁止传销条例) [Regulations on the Prohibition of Pyramid Selling] (promulgated by the State Council, Aug. 23, 2005, effective Nov. 1, 2005).

- If the investor is a foreign investor, it must have at least three years experience in direct selling activities outside of China.
- Registered capital of no less than RMB 80 million¹⁶ must have been paid into the FIE.
- A bond of RMB 20 million¹⁷ must have been paid in full at a designated bank at the time of incorporation.¹⁸
- Information and disclosure systems must have been established in accordance with the law.¹⁹

MOFCOM must approve any establishment of a WFOE that is engaged in direct selling,²⁰ and the WFOE must establish a branch in any province in which it wishes to directly sell, unless the enterprise itself is already registered in that province. A service outlet must also be established in each such province. The purpose of the service outlet is to provide information to customers regarding pricing, return policies and after-sale services. Each branch office and service outlet must meet the requirements of its local government.²¹ When a direct seller or branch thereof recruits a direct salesperson, it must execute a sales promotion contract with the salesperson and ensure that the salesperson engages in direct selling activities only in a region where a service outlet has been established.²²

ELECTRONIC COMMERCE

In 2012, China had more than 214 million internet shoppers, a number that has grown at an annual rate of approximately 50 percent since 2008.²³ The China E-Business Research Center estimates that total online sales in China exceeded RMB 800 billion²⁴ in 2011.²⁵ These online sales accounted for 4.32 percent of China's total retail sales in 2011.²⁶

A foreign investor wishing to sell its own products using its own online platform is required to register the online platform. In China, a license will be required if the company has an online platform that allows third parties to set up online shops selling their respective products.²⁷ However, a foreign-controlled entity has never been granted a license to establish an online platform that enables third parties to have online shops selling their respective products, and in one case MOFCOM required the acquirer of such an online platform to stop the service or transfer the license to a Chinese-controlled entity.²⁸

¹⁶ Approximately US\$12.9 million.

¹⁷ Approximately US\$3.2 million.

¹⁸ Regulations on Administration of Direct Sales, *supra* note 13, art. 29.

¹⁹ Regulations on Administration of Direct Sales, *supra* note 13, art. 7.

²⁰ Regulations on Administration of Direct Sales, *supra* note, art. 9.

²¹ Regulations on Administration of Direct Sales, *supra* note 13, art. 10.

²² Regulations on Administration of Direct Sales, *supra* note 13, art. 16.

²³ "E-Shopping Fuels Domestic Consumption," *China Daily*, August 20, 2012.

²⁴ Approximately US\$128.5 billion.

²⁵ "Rise of the Online Titans," *Caixin Online*, August 16, 2012.

²⁶ "Online Carnival," *People's Daily Online*, December 3, 2012.

²⁷ MOFCOM 2010 Notice on the Sale by Foreign Invested Enterprises of Products Through the Investment and Vending Machines, Article 1(3).

²⁸ MOFCOM Announcement [2012] No. 49 – Conditional Approval of Acquisition of Equity in Niu Hai Holdings (Yihaodian) by Wal-Mart Stores Inc., August 13 2012.

Foreign companies attempting to sell products on Chinese e-commerce portals are likely to face difficulties if they have not established a presence in China. A “presence” can be a subsidiary, a joint venture (JV), a wholly owned entity, or a local distributor or agent. Few Chinese e-commerce portals are able or willing to deal with the customs clearance and after-sales service issues associated with imported goods. Chinese portals rely heavily on the foreign companies whose products they sell or promote to handle import, customs, logistics and fulfillment issues. Thus the effectiveness of local distribution can be crucial to a foreign company’s successful e-commerce sales in China.

The rules and procedures for customs and transportation related to internet sales by foreign companies are becoming increasingly restrictive. In April 2012, China introduced new customs rules for online purchases of overseas goods and imposed restrictions on collaborations between Chinese domestic logistics and postal companies and their overseas counterparts.²⁹ Under the new rules, logistics providers are required to go through a special customs channel to monitor compliance and enforcement of the new rules. In addition, goods for personal use that are valued at more than RMB 5,000³⁰ carry a 10 percent import duty in addition to VAT.

Structures for a Distribution Business

Before discussing in detail the structures available to foreign investors for the distribution of goods and services, it should be noted that government involvement in the Chinese economy is much greater than in many other countries. While China is often referred to as a market economy with Chinese characteristics, the government still owns and controls many large state-owned enterprises (SOEs) and appoints the members of those SOEs’ boards of directors.³¹ Many large SOEs continue to hold monopolies in key industries, including public utilities; transportation; telecommunications; and the manufacturing of strategically important products, such as coal, petroleum and steel.

It should also be noted that support from national and regional governments plays a significant role in establishing, developing and operating a distribution business in China. This support is often the key to determining market access for products as well as any regulatory or commercial risks. A distribution business seeking to enter the Chinese market needs to have a very good understanding of all levels of the government and their constituent institutions.

Foreign suppliers can sell directly to distributors in China or can establish subsidiaries, representative offices, branch offices or partnerships in order to operate their business in China. A subsidiary usually takes one of the following forms: equity joint venture (EJV), cooperative joint venture (CJV) or WFOE. EJVs and

²⁹ “Policy Shift to Crimp Fast-Growing Overseas Online Buying,” *China Daily*, April 4, 2012.

³⁰ Approximately US\$800.

³¹ *Zhonghua Renmin Gonghe Guo Gongsifa* (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 68.

WFOEs are independent legal entities with limited liability under the Company Law.³² A CJV can also be a limited liability corporate entity, or can be established and operated through a cooperation agreement between the joint venture parties without a separate legal entity.

DIRECT SALES – COMPANIES WITHOUT A PERMANENT ESTABLISHMENT IN CHINA

Some foreign suppliers have no permanent establishment in China. Such suppliers sell directly to their distributors in China using a Hong Kong or other offshore company as an intermediary. Under this structure, sales are made by the offshore company to unrelated distributors in China.

Foreign suppliers may frequently send representatives and staff to meet with the distributors in China. These visits typically include advising and assisting the distributors with marketing, training the distributor and staff, liaising with and monitoring distributors, assessing the market, and assisting with after-sales service and warranty claims. Suppliers might have their own foreign staff or locally engaged contractors or staff involved in such visits, assistance and monitoring.

This structure must be carefully limited in action and scope in order to avoid legal liabilities. The conduct of the staff, representatives and contractors, as well as the number and duration of the visits, are all factors that the government uses to assess the nature of the structure. If these factors show a more permanent and expansive presence, the structure may be deemed a “service” permanent establishment or a “fixed-place” permanent establishment, leading to significant tax liabilities. Further, if the foreign supplier’s staff and representatives engage in direct sales activities, such a structure could be deemed to be conducting business activities without proper authorization or registration, leading to penalties by the local branch of the State Administration for Industry and Commerce (SAIC).

REPRESENTATIVE OFFICE

Setting up a representative office is probably the quickest and simplest method for most foreign suppliers to conduct business in China. However, it should be noted that a representative office is not allowed to engage in direct business activities and is restricted to performing liaison activities, information gathering and market research.³³

The establishment of a representative office does not require government pre-approval for most industry sectors, and it is normally necessary for the representative office to register only with the local branch of the

³² Company Law, *supra* note, 31 at art. 3 and 4; Zhonghua Renmin Gonghe Guo Zhongwai Hezi Jingying Qiye Fa (中华人民共和国中外合资经营法) [Sino-Foreign Equity Joint Venture Enterprise Law of the People’s Republic of China] (promulgated by the Nat’l People’s Cong., Mar. 15, 2001, effective Mar. 15, 2001) art. 4; Zhonghua Renmin Gonghe Guo Waiziqiye Fa Shishi Xize (中华人民共和国外资企业法实施细则) [Detailed Implementing Rules of the Wholly Foreign-Owned Enterprise Law of the People’s Republic of China] (promulgated by the State Council, Apr. 12, 2001, effective Apr. 12, 2001) art. 18.

³³ Waiguoqiye Changzhu Daibiao Jigou Dengji Guanli Tiaoli (外国企业常驻代表机构登记管理条例) [Administrative Regulations on the Registration of Permanent Representative Organizations of Foreign Enterprises] (promulgated by the State Council, Nov. 19, 2010, effective Mar. 1, 2011) art. 13 and 14.

SAIC.³⁴ For certain specially designated industries, such as shipping, aviation and securities, pre-approval must be obtained from the administrative authority having jurisdiction over the industry before the representative office can be registered.³⁵

BRANCH OFFICE

A foreign company can set up a branch office in China. However, for distribution activities, this option is only available to foreign companies in a very limited scope of industries,³⁶ such as commercial banking³⁷ or oil exploration.³⁸

If a foreign entity has established a Chinese subsidiary, such as an EJV or WFOE, the subsidiary may set up its own branch office within China, which will allow the subsidiary to conduct activities in different Chinese locations. The branch office of such a Chinese subsidiary will not be a separate legal entity, and liability for such a branch office will be borne by the Chinese subsidiary. However, in contrast to representative offices, branch offices are permitted to engage in revenue-generating activities.³⁹

³⁴ Administrative Regulations for the Registration of Permanent Representative Offices of Foreign Enterprises *supra* note 33 at art. 4 and 5.

³⁵ See Waiguo Zhengquan Lei Jigou Zhuhua Daibiao Jigou Guanli Banfa Zheng Jian Jigou Zi [1999] 26 Hao (外国证券类机构驻华代表机构管理办法 证监机构字[1999] 26号) [Administrative Measures for China-Based Representative Offices of Foreign Securities Institutions [1999] No. 26] (promulgated by the China Securities Regulatory Commission, Apr. 21, 1999, effective Apr. 21, 1999) art. 2, 4; Waiguo Hangkong Yunshu Qiye Changzhu Daibiao Jigou Shenpi Guanli Banfa Zhongguo Minyong Hangkong Zongju Ling Di 165 Hao

(外国航空运输企业常驻代表机构审批管理办法 中国民用航空总局令第 165 号) [Administrative Measures for Examination and Approval on Foreign Air Transport Enterprises' Permanent Representative Organizations in China Order No. 165 of the Civil Aviation Administration of China] (promulgated by the Civil Aviation Administration of China, Apr. 3, 2006, effective May 3, 2006) art. 3; Zhonghua Renmin Gonghe Guo Guoji Haiyun Tiaoli Zhonghua Renmin Gonghe Guo Guowuyuan Ling Di 335 Hao (中华人民共和国国际海运条例

中华人民共和国国务院令 第 335 号) [Regulations of the People's Republic of China on International Maritime Transportation Decree No. 335 of the State Council] (promulgated by the State Council, Dec. 11, 2001, effective Jan. 1, 2002) art 34.

³⁶ Administrative Measures on Registration of Foreign (Offshore) Enterprises Engaging in Production and Business Activities in China art. 2 and 3.

³⁷ Zhonghua Renmin Gonghe Guo Waizi Yinhang Guanli Tiaoli (中华人民共和国外资银行管理条例) [Administrative Regulations of the People's Republic of China on Foreign-Invested Banks] (promulgated by the State Council, Nov. 11, 2006, effective Dec. 11, 2006) art. 2.

³⁸ Zhonghua Renmin Gonghe Guo Duiwai Hezuo Kaicai Lushang Shiyou Ziyuan Tiaoli (中华人民共和国对外合作开采陆上石油资源条例) [Regulations of the People's Republic of China on Sino-Foreign Cooperative Exploitation of Onshore Petroleum Resources] (promulgated by the State Council, Sept. 30, 2011, effective Nov. 1, 2011) art 17.

³⁹ Zhonghua Renmin Gonghe Guo Gongsidi Dengji Guanli Tiaoli (中华人民共和国公司登记管理条例) [Regulations of the People's Republic of China on Registration Administration of Companies] (promulgated by the State Council, Dec. 18, 2005, effective Jan. 1, 2006) art. 46.

WHOLLY FOREIGN-OWNED ENTERPRISE

WFOEs are limited liability companies that are independent legal entities entirely owned by foreign investors.⁴⁰ A WFOE is the most commonly used foreign investment vehicle in China.

Compared to other legal entities, a WFOE is relatively easy to set up. WFOEs give foreign investors the ability to have complete managerial control over the WFOE and its assets. As a result, it is generally easier to have more control over a foreign investor's IP, such as the use of trademarks, patents and trade secrets. Because of the high incidence of infringement of IP rights in China,⁴¹ the degree of control over an entity's IP can be an important consideration for distribution activities where brands, trademarks and trade secrets are critical to the products sold.

WFOEs, however, are not permitted to engage in all activities and in all sectors. China's Foreign Investment Industrial Guidance Catalogue (Foreign Investment Catalogue) and sector-specific rules must be consulted in order to determine whether a WFOE or JV can be used for a particular business.⁴² The Foreign Investment Catalogue sets out "encouraged," "restricted" and "prohibited" activities and sectors. Any activity or sector not expressly listed in one of these three categories generally falls within the "permitted" category. Currently, wholesale and retail activities (with some restrictions) are classified as either "encouraged" or "permitted."⁴³ Direct selling, mail ordering and internet selling are classified as "restricted" activities. Limited foreign investment is allowed in such restricted activities and is subject to approval at higher levels of government, which can be more difficult to obtain.⁴⁴

EQUITY JOINT VENTURE

An EJV is an independent legal entity with limited liability.⁴⁵ Investors contribute capital and enjoy rights to a percentage of the profits equal to their contributed capital. Capital contributions may be in cash or in kind, such as land use rights, buildings, intangible assets or equipment. In general, the ratio of equity interest held by the foreign investor(s) in an EJV is at least 25 percent.⁴⁶ During the term of the EJV, the parties cannot withdraw their contributions to the registered capital or either transfer or assign their equity interests without

⁴⁰ Implementing Regulations for the PRC Wholly Foreign Owned Enterprise Law *supra* note 32, at art. 18; Zhonghua Renmin Gonghe Guo Waizi Qiye Fa (中华人民共和国外资企业法) [Wholly Foreign-Owned Enterprise Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 2000, effective Oct. 31, 2000) art. 2.

⁴¹ See, e.g., China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy, Inv. No. 332-519, USITC Pub. 4226 (May 2011) available at <http://www.usitc.gov/publications/332/pub4226.pdf>.

⁴² The Foreign Investment Catalogue identifies sectors and industries for which a Chinese partner is required. In some instances, it also states that the Chinese partner must have either a controlling interest or a relative controlling interest.

⁴³ Foreign Investment Catalogue.

⁴⁴ Foreign Investment Industrial Guidance Catalogue; Regulations on Administration of Direct Selling art. 7 and 9; Notice of the General Office of the Ministry of Commerce on Issues Related to Examination, Approval and Administration of Online Sales and Vending Machine Sales Projects of Foreign-Invested Enterprises art. 1(2).

⁴⁵ Zhonghua Renmin Gonghe Guo Waihezi Jingying Qiye Fa (中华人民共和国中外合资经营企业法) [Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China] (promulgated by Nat'l People's Cong., Mar. 15, 2001, effective Mar. 15, 2001) art. 4.

⁴⁶ Sino-Foreign Equity Joint Venture Enterprise Law *supra* note 45, at art. 4.

prior government approval.⁴⁷ Any transfer of equity interests is also subject to the consent of the other EJV partners.⁴⁸

The board of directors is the highest authority in the management of an EJV.⁴⁹ Either the chairman of the board, other board members or a general manager can be the EJV's legal representative, who may be a Chinese or foreign national. Potential drawbacks of an EJV are that it can be time consuming to negotiate the establishment of an EJV and that there may be a risk of loss of control over IP and confidential information.

COOPERATIVE JOINT VENTURE

A CJV is often established as a company with its own independent legal identity and with limited liability. It can also be an entity with no separate legal personality and without the protection of limited liability.⁵⁰ It should be noted that although it is legally possible to set up a CJV without establishing it as a separate legal entity, in practice it may be difficult to obtain government approval to do so.

China's legal regime allows a certain amount of flexibility in the structure of a CJV. The profit-sharing ratio does not necessarily have to reflect the ownership interest ratio of each investor; instead, it may be decided by the investors based on their joint venture contracts.⁵¹ The parties may also provide "conditions of cooperation" instead of capital contributions to the CJV.

The highest authority in the management of a limited liability CJV is the board of directors. If a CJV does not have a separate legal personality, its highest authority is a joint management committee. There must be at least three members on the board of directors or the joint management committee, each of which can be made up of Chinese citizens or foreign nationals.⁵²

FOREIGN-INVESTED PARTNERSHIP

Foreign investors can also conduct business in China through a partnership.⁵³ A foreign-invested partnership (FIP) is a general or limited partnership established in China by foreign investors and Chinese investors.⁵⁴

⁴⁷ Zhonghua Renmin Gonghe Guo Waihezi Jingying Qiye Fa Shishi Tiaoli [Implementing Regulations for the Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China] (promulgated by the State Council, July 22, 2001, effective July 22, 2001) art. 19.

⁴⁸ PRC Sino-Foreign Equity Joint Venture Enterprise Law *supra* note 45, at art. 4.

⁴⁹ Implementing Regulations for the PRC Sino-Foreign Equity Joint Venture Enterprise Law *supra* note 47, at art. 30.

⁵⁰ PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 45, at art. 2; Implementing Regulations for the PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 47, at art. 4 and 50.

⁵¹ PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 45, at art. 21; Implementing Regulations for the PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 45, at art. 44.

⁵² PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 47, at art. 12; Implementing Regulations for the PRC Sino-Foreign Cooperative Joint Venture Enterprise Law *supra* note 45, at art. 25.

⁵³ *See generally*, Waiguo Qiye Huozhe Geren Zai Zhongguo Jingnei Sheli Hehuo Qiyeguanli Banfa

(外国企业或者个人在中国境内设立合伙企业管理办法) [Measures for the Administration of the Establishment of Partnership Enterprises in the Territory of China by Foreign Enterprises or Individuals] (promulgated by the State Council, Nov. 25, 2009, effective Mar. 1, 2010).

Foreign investors may also join existing domestic partnerships, which will be converted into FIPs. An FIP may be established following approval by the SAIC and its local counterparts.⁵⁵

An FIP provides flexibility in terms of capital contribution and profit distribution. Partners can make capital contributions to the partnership in cash or in kind, such as labor, IP, land use rights, buildings or other property rights. Foreign investors may make their contributions either in exchangeable foreign currencies or in legally acquired RMB.⁵⁶ Profit distribution can be arranged according to the partnership agreement, and the ratio of the distribution does not have to correspond to the partners' respective capital contributions.⁵⁷ Existing restrictions on foreign ownership in certain industries apply equally to FIPs.

Taxation and Foreign Exchange

APPLICABLE TAXES

Any applicable taxes will be assessed against the party legally responsible for paying the tax concerned; that party may be either the supplier or distributor. Therefore, while there is no requirement on parties to include any contractual provisions in a distribution agreement concerning tax payments, the inclusion of such provisions can be useful for avoiding misunderstanding.

Customs Duty

Customs duty is applied to the customs value or “dutiable price” of the goods or materials imported. The “dutiable price” is calculated on the basis of the transaction price of such goods and includes freight and related expenses, as well as insurance premiums incurred before the unloading of the goods at the entry point within China. Dutiable price is subject to examination and final determination by China Customs. Customs duty rates vary depending on the tariff codes of the particular goods imported. Royalty payments may also be subject to customs duties if the royalty fee is relevant to the goods imported (*e.g.*, payment of royalty fees constitutes the conditions for sale of such goods).⁵⁸

Value-Added Tax

In China, foreign and domestic businesses must pay turnover taxes, including VAT, business tax (BT) and consumption tax (CT). VAT is assessed on sales and importation of goods as well as on processing, repairs

⁵⁴ Waishang Touzi Hehuo Qiye Dengji Guanli Guiding (外商投资合伙企业登记管理规定) [Administrative Regulations for the Registration of Foreign-Invested Partnership Enterprises] (promulgated by the General Administration for Industry and Commerce, Jan. 29, 2010, effective Mar. 1, 2010) art. 11.

⁵⁵ Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals *supra* note 53, at art. 5 and 12.

⁵⁶ Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals *supra* note 53, at art. 4.

⁵⁷ PRC Partnership Law Art. 33; Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals *supra* note 53, at art. 3.

⁵⁸ Zhonghua Renmin Gonghe Guo Guowuyuan Ling Di 392 Hao (中华人民共和国国务院令 第 392 号) [Regulations of the People's Republic of China on Import and Export Duties Decree No. 392] (promulgated by the State Council, Nov. 23, 2003, effective Jan. 1, 2004) art. 19(5).

and replacement services normally related to goods. In some locations, including Shanghai and Beijing, the provision of certain services (*e.g.*, R&D and technology, information technology, cultural creation, logistics support, leasing of tangible goods, assurance and consulting) and logistics are also subject to VAT. VAT is collected on most goods imported⁵⁹ into the customs territory of China (import VAT) and on most goods that are sold within China. The standard VAT rate is 17 percent, with certain goods taxed at 13 percent, and a few items subject to an even lower VAT rate. Both the import VAT, paid by the importer or agent at import at the applicable rate, and the input VAT, paid on a domestic purchase, can usually be credited against the output VAT of a Chinese enterprise qualified as a “general VAT taxpayer.”

Business Tax

BT is assessed on the provision of major services, the transfer of intangible assets and the sale of immovable property within China. BT is payable by service providers that receive income from providing BT-taxable services, and is generally 5 percent on gross income. However, different BT rates, ranging from 3 percent to 20 percent, apply to different types of services. Service providers located outside of China must pay BT as long as the service recipient is located in China. The service recipient pays BT by withholding a portion of the amount payable—normally 5 percent, but the applicable rate varies depending on the nature of the service. Under the pilot VAT program commenced in Shanghai, Beijing and other designated cities, the Chinese government has expanded the scope of VAT to replace the imposition of BT on certain service and logistics industries.⁶⁰

Consumption Tax

CT, similar to an excise duty in other countries, is imposed on entities that produce, entrust third parties with processing, or import certain specified “luxury” consumer goods, such as tobacco, alcoholic beverages, cosmetics, gasoline and automobiles. CT is usually calculated according to statutorily defined formulas that take into account the price of the goods sold, the quantity of goods sold or, in respect to some limited items (*e.g.*, white spirits), both the price and quantity of the goods sold.⁶¹

⁵⁹ Except for some statutorily exempted goods, such as certain R&D equipment and devices imported by foreign-invested R&D companies, most imports are subject to import VAT.

⁶⁰ Caizhengbu, Guojia Shuiwu Zongju Guanyu Shanghaishi Kaizhan Jiaotong Yunshuye He Bufen Xiandai Fuwuye Yingyeshui Gaizheng Zengzhishui Shidian de Tongzhi Cai Shui 111 Hao (财政部、国家税务总局关于在上海市开展交通运输业和部分现代服务业营业税改征增值税试点的通知财税[2011]111号) [Notice of the Ministry of Finance and the State Administration of Taxation on Implementing the Pilot Program for Replacing Business Tax with Value-Added Tax in the Transportation Industry and Some Modern Service Industries in Shanghai [2011] No. 111] (promulgated by the Ministry of Finance and the State Administration of Taxation, Nov. 16, 2011, effective Jan. 1, 2012) art. 1.

⁶¹ Zhonghua Renmin Gonghe Guo Xiaofeishui Zanzheng Tiaoli Di 539 Hao (中华人民共和国国务院令 539号) [Interim Regulations of the People’s Republic of China on Consumption Tax Order No. 539 of the State Council] (promulgated by the State Council, Nov. 10, 2008, effective Jan. 1, 2009) art. 5.

Enterprise Income Tax

This tax is imposed on enterprises and is similar to company taxes in other countries. Under the unified Enterprise Income Tax (EIT) Law, there is an overall 25 percent EIT rate with several exceptions, or preferential treatment. One of the exceptions is for qualified small-scale and thin-profit companies, which pay EIT at a rate of 20 percent.⁶²

Many countries have signed double tax treaties with China that provide certain treaty benefits and allow for the avoidance of double taxation for resident enterprises of one country doing business in, or with a party of, another country. For example, reduced withholding income tax on dividend income, interest income or royalty income that is repatriated from a resident undertaking in China to another country may be applicable pursuant to such treaties. There may also be an exemption to the creation of permanent establishment, a prerequisite to EIT liability, by an undertaking of one country doing business in China because of certain circumstances. Generally, non-Chinese-resident businesses must apply or negotiate with local Chinese tax authorities to obtain the benefits provided by such double tax treaties.⁶³

Stamp Duty

Stamp duty is generally levied on companies and individuals who conclude or receive any of the following documents:

- Documents issued for purchase and sale transactions, process contracting, property leases, commodity transportation, storage and custody of goods, loans, property insurance, technology contracts, engineering project assessment and design contracts, construction and installation project contracts, and other contractual situations
- Documents involved in the transfer of property by purchase, sale, inheritance, gift, exchange or division
- Documentation of rights or licenses
- Other documents declared to be taxable by the tax authorities

Stamp duty is calculated at a fixed rate according to the relevant contract amount,⁶⁴ or at a fixed amount per document. Specific stamp duty exemptions may be available for certain types of contracts or documents.⁶⁵

⁶² Zhonghua Renmin Gonghe Guo Zhuxi Ling Di Liushisan Hao (中华人民共和国主席令 第六十三号) [Law of the People's Republic of China on Enterprise Income Tax Order No. 63 of the Chairman of the People's Republic of China] (Promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 28.

⁶³ Fei Jumin Xiangshou Shuishou Xieding Daiyu Guali Banfa (Shixing) Guoshui Fa [2009] 124 Hao (非居民享受税收协定待遇管理办法 (试行) 国税发[2009]124号) [Administrative Measures for the Application of Tax Treaties to Non-Resident (Trial Implementation) [2009] No. 124] (promulgated by the State Administration of Taxation, Aug. 24, 2009, effective Oct. 1, 2009) art. 3.

⁶⁴ Ranging from 0.005 percent to 0.1 percent depending on the nature of the taxable documents, *e.g.*, 0.05 percent for sales agreements.

⁶⁵ Zhonghua Renmin Gonghe Guo Yinhuashui Zaxing Tiaoli Guowuyuan Ling [1988] Di 011 Hao (中华人民共和国印花税法暂行条例 国务院令[1988]第 011 号) [Interim Regulations of the People's Republic of China

(continued...)

TYPICAL TAX CONSEQUENCES OF DIFFERENT LEGAL STRUCTURES WITHIN CHINA

It is useful to consider the tax consequences of the business models and legal structures used for a distribution business within China. For example, when a foreign company establishes a Chinese company headquarters (HQ) within China and would like to operate in a jurisdiction different from that of the HQ, the company could set up either a subsidiary company (Subsidiary Model) or a branch company (Branch Model) in the local jurisdiction where the business operations will be conducted. These two entity types (subsidiary or branch companies) may differ significantly in matters such as establishment procedures, capacity for assuming tax and other liability, and tax filing methods.⁶⁶

From a China tax perspective, under the Subsidiary Model, a subsidiary would pay EIT to its local-level tax authority independently from its HQ. Under the Branch Model, an HQ with one or more branch companies would follow a central (or consolidated) filing method for EIT, and the overall EIT payable may be split and paid among different local-level tax authorities in different local jurisdictions.

Each model has benefits and disadvantages. Under the Subsidiary Model, if either the HQ or its subsidiaries sustain losses in the current year, the current loss may not be used to offset the current profit made by another entity in the same year. However, because the subsidiary's EIT is paid exclusively to the local-level tax authority, the subsidiary is likely to be favored by the local government authority, which could lead to possibly higher local tax or financial incentives. In contrast, under the Branch Model, the total EIT payable is split and paid to different local-level tax authorities in different jurisdictions according to a preset calculation, and thus the branch company may be treated less favorably by the local government, as compared to a subsidiary.

Further, a branch company can be established as either a non-tax-paying branch company or a tax-paying branch company. From an EIT perspective, whether a branch company is tax paying or not depends upon whether the branch company in question conducts "primary business functions" and whether it pays VAT/BT locally in respect of its activities.⁶⁷

If a branch conducts "primary business functions" (for example, manufacturing or sales activities) or pays VAT/BT for its activities in its local jurisdiction, the branch company would likely need to pay EIT to the local-level tax authority. Conversely, if a branch company engages in internal or auxiliary functions (*e.g.*, R&D and logistical support) but does not conduct "primary business functions" and does not pay VAT/BT

on Stamp Tax Decree No. 11 of the State Council] (promulgated by the State Council, Aug. 6, 1988, effective Oct. 1, 1988) art. 4.

⁶⁶ See generally *Waiguo Qiye Changzhu Daibiao Jigou Dengji Guanli Tiaoli Guowuyuan Ling Di 584 Hao* (外国企业常驻代表机构登记管理条例 国务院令 第 584 号) [Administrative Regulations on the Registration of Permanent Representative Organizations of Foreign Enterprises Decree No. 584 of the State Council] (promulgated by the State Council, Nov. 19, 2010, effective Mar. 1, 2011).

⁶⁷ *Kuadiqu Jingying Hui Zong Na Shui Qiye Suo Deshui Zhengshou Guanli Zanxing Banfa Guoshuifa* [2008] 28 Hao (跨地区经营汇总纳税企业所得税征收管理暂行办法 国税发[2008]28号) [Interim Measures for the Collection and Administration of Consolidated Payment of Enterprises Income Tax on Trans-Regional Operation [2008] No. 28] (promulgated by the State Administration of Taxation, Mar. 10, 2008, effective Mar. 10, 2008) art. 9 and 11.

locally, the branch company would likely not be deemed a tax-paying entity. However, it must be noted that the above rule might not apply when an HQ and its branch company are both located in the same province. In that case, local tax rules in the particular province would apply; for example, there may be a different EIT allocation method for the HQ and branch company.⁶⁸

From a VAT perspective, if goods are internally transferred between an HQ to its branch company for sale (which means that the branch company will in the future either issue invoices to, or receive payment from, its end customers), then the internal transfer could be taxed immediately. When the branch eventually sells the goods to its end customers, the future sales would also be subject to output VAT, but the branch may be able to claim input VAT credits under the aforementioned VAT credit system.⁶⁹

FOREIGN EXCHANGE RESTRICTIONS

In China, there are restrictions on transferring money out of the country and on exchanging foreign currency into and out of China's currency, the renminbi.

A Chinese distributor typically must exchange and remit foreign currency overseas⁷⁰ in order to pay a foreign supplier or parent company. Before the distributor can do so, it must register with the relevant branches of the State Administration of Foreign Exchange (SAFE). The registration requirement applies whether the payment is for goods or services supplied, license fees, royalties, commissions or other such fees.

Before funds for payments associated with imported goods can be remitted overseas, a Chinese importer (including a distributor if the distributor is also the importer) must present to its bank all the documentation, such as shipping documents and customs declarations, required by SAFE. For payments on imported goods, all businesses must report to SAFE within 30 days of payment any overseas payments or receipts that are prepaid or received more than 30 days in advance of the date shown on the import declaration form; paid or received more than 90 days from the date shown on the import declaration form; or paid or received using a letter of credit with a payment term that exceeds 90 days. Generally, the prepayment amount cannot exceed 25 percent of the total payments that the company made for all imports in the previous 12 months. If prepayment exceeds this amount, SAFE may exercise its discretion to conduct an onsite investigation of the company.⁷¹

⁶⁸ Kuadiqu Jingying Huizong Nashui Qiye Suodeshui Zhengshou Guanli Zanzing Banfa Guoshuifa [2008] 28 Hao (跨地区经营汇总纳税企业企业所得税征收管理暂行办法 国税发[2008]28号) [Interim Measures for the Collection and Administration of Consolidated Payment of Enterprises Income Tax on Trans-Regional Operation [2008] No. 28] (promulgated by the State Administration of Taxation, Mar. 10, 2008, effective Mar. 10, 2008) art. 39.

⁶⁹ See generally Zhongguo Renmin Gongheguo Guowuyuan Ling Di 538 Hao (中华人民共和国国务院令 第538号) [Interim Regulations of the People's Republic of China on Value-Added Tax Order No. 538 of the State Council] (promulgated by the State Council, Nov. 10, 2008, effective Jan. 1, 2009).

⁷⁰ "Overseas" for the purposes of this article refers to jurisdictions outside of China, which include Hong Kong, Macau and Taiwan.

⁷¹ Detailed Rules for the Implementation of Pilot Guidelines on Management of Foreign Exchanges in Goods Trade.

In addition, only certain designated banks can exchange foreign currency for renminbi and vice versa. Current account items (such as interest on foreign currency loans, insurance premiums or construction expenses payable in foreign currency) may be converted relatively easily if they do not exceed US\$100,000. Foreign currency for capital account items—such as the principal on foreign currency loans or the pre-establishment expenses of a WFOE that are remitted into China by the foreign investor—may be converted to renminbi only with the approval of SAFE.⁷²

These restrictions can result in cash being “trapped” in China when it might be more efficiently used elsewhere. Early planning of a distribution network and structure, such as the use of shareholder loans, can be crucial to reducing the risk of “trapped” cash.

It should be noted that a WFOE (or other FIE) can only use converted renminbi for purposes within the WFOE’s defined business scope. For example, renminbi might only be used to purchase land for a distribution warehouse for the WFOE’s own use. If the WFOE’s business scope does not include the purchase of shares in any entity, that same tranche of renminbi cannot be used to purchase shares in a wholly owned subsidiary that in turn purchases the land with the warehouse for the WFOE’s use.

If a sale of goods or services is between businesses and individuals in China, the sale price must be in renminbi and may not be priced in a foreign currency.⁷³ Foreign businesses selling into China may price their goods or services in foreign currency, as may Chinese businesses selling their goods and services to buyers outside of China.

Appropriate clauses to minimize delays and disruptions for payments overseas for the purchase of products, prepayments, commissions, fees and royalties can be included in a distribution contract. Some suppliers stipulate that failure to obtain and maintain the necessary licenses or permits is grounds for automatic termination of a distribution agreement.

Key Relevant Laws for Distribution in China

Compared to many other countries, there are significant differences in the legal restrictions on distribution contracts in China. For instance, restrictions on pricing, resale price maintenance, exclusive supply arrangements, exclusive purchase arrangements, retailer fees, attempts to limit the supplier’s or distributor’s liability, and the use of standard form contracts are controlled, to a greater or lesser extent, by different aspects of Chinese law.

The following sections discuss many of the most significant issues that are likely to be raised in negotiation or to be of particular concern when

COMPANY A WILL BE PRESUMED DOMINANT AND UNDER GREATER LEGAL RESPONSIBILITY IF:

- A has 50 percent market share
- A and B together have a more than 66 percent market share (unless A alone has less than 10 percent)
- A, B and C have 75 percent market share (unless A alone has less than 10 percent)

⁷² Notice of the State Administration of Foreign Exchange on the Adjustment of Foreign Exchange Administration Policies for Current Accounts and Regulations of the People’s Republic of China on Foreign Exchange Control.

⁷³ Regulations of the People’s Republic of China on Foreign Exchange Control.

drafting or implementing a distribution contract in China. These issues will also be relevant to the ongoing business of a supplier or distributor in China. Addressing these issues early and in the proper fashion will help reduce violations of the law (and the ensuing fines and claims for damages) and will reduce the inclusion of unenforceable terms in an agreement.

Entities should be aware that success brings greater legal responsibilities. Success in the China market leading to a “dominant market position” will immediately entail greater restrictions on the conduct of a successful company. Such success will usually require a thorough revision of the company’s practices and procedures in the market.⁷⁴ This is because a *non*-dominant business can legally engage in certain conduct, such as refusal to supply or exclusive dealing, but if the business becomes dominant in the market, the same conduct can amount to an abuse of the business’ market dominance prohibited by the Anti-Monopoly Law.

CHINA’S CONTRACT LAW

The Contract Law provides legally enforceable rules on agreements between Chinese and foreign parties. China’s Supreme People’s Court has also released “interpretations” on several key issues concerning the application of the Contract Law. These interpretations are not a part of the “law,” as may be the case in a common law jurisdiction. Nonetheless, they play an important role in dispute resolution because Chinese courts use them when adjudicating disputes.

In addition to setting forth the various technical requirements for contracts, China’s Contract Law delineates a number of instances where a document that appears to be an enforceable contract can be void, voidable by one or both parties, invalid or unenforceable within China. Significantly, in China a lack of fairness and violation of social norms—which may not be significant factors in other countries—can render a contract void or unenforceable.⁷⁵

“Fairness” and “Good Faith”

The Contract Law requires that parties to the contract adhere to the principle of “fairness” or “equity.” A Chinese judge or arbitrator would generally have discretion to decide what is “fair,” the standard of which need not be the same as that customarily used by the parties. The fairness principle appears to go beyond the concept of contracting in good faith that is present in many of the continental European jurisdictions. By way of comparison, China’s Contract Law requires that parties observe the principle of “good faith” in exercising their rights and fulfilling their obligations, in addition to abiding by the principle of “fairness.”⁷⁶ If a contract lacks such “fairness” or “equity,” a court or arbitration panel may rescind or alter the contract.⁷⁷

⁷⁴ Zhonghua Renmin Gonghe Guo Fanlongduan Fa (中华人民共和国反垄断法) [Anti-Monopoly Law of the People’s Republic of China] (promulgated by the Standing Committee of the Nat’l People’s Cong., Aug. 30, 2007, effective Aug. 1, 2008) art. 19.

⁷⁵ Zhonghua Renmin Gonghe Guohe Guo Hetong Fa (中华人民共和国合同法) [Contract Law of the People’s Republic of China] (promulgated by the Nat’l People’s Cong., effective Oct. 1, 1999).

⁷⁶ Contract Law, *supra* note 75, at art. 5 and 6.

⁷⁷ Contract Law, *supra* note 75, at art. 54.

Standard contracts, also known as “adhesion contracts” or “form contracts,” are required to be fair to the party that cannot negotiate the terms of the contract.⁷⁸ For standard contracts, it is considered unfair to exempt oneself from liability or to increase the liability of the other party in circumstances where the other party is not given the opportunity to negotiate the terms of a standard form contract. This applies equally to business-to-business contracts and consumer contracts.

ANTI-MONOPOLY LAW (ANTITRUST/COMPETITION RULES)

China’s AML came into effect in August 2008 and performs substantially the same role as the European Union’s competition law and U.S. antitrust laws. The AML immediately made headlines around the world when it was used in early 2009 to block Coca-Cola’s US\$2.4 billion bid for Huiyuan, a Chinese bottled drinks producer. The AML’s stated goals are to prevent and restrain “monopolistic” conduct, protect fair market competition, enhance economic efficiency, safeguard the interest of consumers and the interests of society as a whole, and promote the healthy development of China’s economy.⁷⁹

“Monopolistic conduct” is defined as including agreements, decisions or other concerted behavior that eliminates or restricts competition; abuse of a dominant market position; and concentrations such as mergers, acquisitions and joint ventures that may have the effect of eliminating or restricting competition.⁸⁰

A breach of the AML can result in fines of up to 10 percent of a company’s annual revenues, confiscation of illegal gains and private damage actions in the courts.⁸¹ There is also the possibility that an agreement contrary to the AML may be declared invalid and unenforceable.⁸² Since coming into force, numerous cases have been brought by both the AML enforcement authorities and private parties. The AML is a key consideration for businesses that operate in China or that have a component of their business in China.

ANTI-UNFAIR-COMPETITION LAW

China’s Anti-Unfair-Competition Law (AUCL) was enacted in 1993. The stated goals of the law are to encourage and protect fair competition, discourage unfair competitive acts, and protect the lawful rights and interests of business operators and consumers.⁸³ The AUCL operates together with the AML, the Price Law and other laws to regulate the ways that businesses are allowed to compete with each other. The AUCL regulates matters such as the protection of business secrets, commercial bribery, predatory (below cost) pricing, bid rigging, false advertising and other similar commercial matters. The AUCL can have an important impact on distribution because it places limits on what a distributor can do with respect to, for example, prices, advertising, promotions and prizes, and the bundling or tying together of goods and

⁷⁸ Contract Law, *supra* note 75, at art. 39.

⁷⁹ Anti-Monopoly Law, *supra* note 74, at art. 1.

⁸⁰ Anti-Monopoly Law, *supra* note 74, at art. 3.

⁸¹ Anti-Monopoly Law, *supra* note 74, at art. 46–50.

⁸² Contract Law, *supra* note 75, at art. 52(5).

⁸³ Zhonghua Renmin Gonghe Guo Fanbuzhengdangjingzhen Fa (中华人民共和国反不正当竞争法) [Law of the People’s Republic of China Against Unfair Competition] (promulgated by the Standing Committee of the Nat’l People’s Cong., Sept. 2, 1993, effective Dec. 1, 1993) art. 1.

services.⁸⁴ Breach of the AUCL can result in confiscation of illegal gains and fines by the enforcement authorities, as well as private civil actions for damages in the courts.⁸⁵

PRICE LAW

China's Price Law was enacted in 1998. The Price Law's stated goals are to standardize price behavior in order to encourage the rational disposition of resources, stabilize the general market price level, protect the rights and interests of consumers and business operators, and promote the healthy development of the socialist market economy.⁸⁶ The Price Law restricts, for example, a supplier, distributor or both from the following:

- Any collaboration to control prices "to the great detriment of the lawful rights and interests of other business operators or consumers"
- The dissemination of information relating to proposed price increases in order to raise the price of goods or services to excessive levels
- Discriminatory pricing to different customers for the same merchandise or service under the same conditions⁸⁷

The Price Law is also important because it is the principal means through which the government imposes and adjusts price controls such as price ceilings, fixed prices or price guides. Failure to comply with the Price Law can result in fines, confiscation of illegal gains, orders to cease operations and revocation of the offender's business license.⁸⁸

ANTI-CORRUPTION LAW

Generally, foreign companies in China must pay attention to three sets of anti-corruption laws. Under China's legal system, the laws governing commercial and governmental corruption fall under two categories:

- Administrative regulations, such as the AUCL and the Interim Provisions on Banning Commercial Bribery
- Criminal laws, mainly forbidding bribes to government officials

Secondly, foreign companies frequently also must follow the anti-corruption laws of their home countries. Finally, where applicable, foreign companies should take steps to comply with the far-reaching U.S. and UK anti-bribery laws, which, if breached, have the potential to create extensive liability for most multinational corporations.

⁸⁴ AUCL, *supra* note 83, at art. 9, 11, 12 and 13.

⁸⁵ AUCL, *supra* note 83, at art. 20 and 24–28.

⁸⁶ [Price Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Dec. 29, 1997, effective May 1, 1998) art. 1.

⁸⁷ Price Law, *supra* note 86, at art. 14.

⁸⁸ Price Law, *supra* note 86, at art. 40.

The Legal Impact of the Status of Each Party

DOMINANT SUPPLIERS AND DOMINANT DISTRIBUTORS

A dominant supplier or distributor bears additional legal duties because of its position as a dominant player in the Chinese market. A supplier or distributor's position of dominance in the relevant market is also critical for determining the liability for abuse of such dominance. Failure to comply with the additional legal duties to avoid abuse of a dominant market position can result in fines, confiscation of illegal gains and private damage claims for the abuse of dominance.

There is a presumption of dominance, and therefore additional legal duties, in the following situations:

- The supplier or distributor's market share is 10 percent or more, and the supplier and two other undertakings together have 75 percent or more of the market.
- The supplier or distributor's market share is 10 percent or more, and the supplier and one other undertaking together have 66.6 percent (two-thirds) or more of the market.
- The supplier or distributor's market share is 50 percent or more.⁸⁹

Further, if a supplier or distributor declares publicly that it is dominant or has a market share in which the presumption of dominance arises, China courts will assume that the supplier or distributor is in fact dominant. In such cases, the burden shifts to the supplier or distributor to prove that it is not dominant.⁹⁰

Examples of additional legal duties imposed by the AML on a dominant supplier or distributor include the prohibition, without justification, of the dominant undertaking from refusing to trade with a trading party, restricting a trading party to trading only with the dominant supplier or dominant distributor, or discriminating in pricing or other treatment between customers.⁹¹

RETAILERS AND LARGE RETAILERS

There are specific rules in China regarding arrangements between large retailers and their suppliers. These are included in the Administrative Measures on the Sales Promotions of Retailers (Retailer Promotion Measures).⁹² These Retailer Promotion Measures are applicable to all retailers that are either enterprises and their branches, or sole proprietors registered in the AIC that sell products to consumers.⁹³ These Retailer Promotion Measures therefore apply to almost all retailers regardless of their size or revenue. The Retailer Promotion Measures contain strict rules on how sales promotions can be conducted.

⁸⁹ Anti-Monopoly Law, *supra* note 74, at art. 19.

⁹⁰ [2012] Provisions of the Supreme People's Court on Certain Issues Relating to Cases Involving Civil Disputes Arising out of Monopolistic Conduct, art.10.

⁹¹ Anti-Monopoly Law, *supra* note 74, at art. 17.

⁹² Lingshoushang Cuxiao Xingwei Guanli Banfa (零售商促销行为管理办法) [Measures on the Administration of Sales Promotions Conducted by Retailers] (promulgated by the Ministry of Commerce, *et. al.*, Sept. 12, 2006, effective Oct. 15, 2006).

⁹³ Measures on Sales Promotions, *supra* note 92, at art. 3.

There are also specific Administrative Measures for Fair Transactions Between Retailers and Suppliers (Fair Retail Transaction Measures)⁹⁴ that apply only to larger retailers. These Fair Retail Transaction Measures only apply to enterprises and their branches that are registered with the AIC and that sell directly to consumers and have annual sales (aggregated chain store sales) of RMB 10 million or more (large retailers).⁹⁵

The Fair Retail Transaction Measures impose strict requirements on the way large retailers deal with their suppliers. A large retailer is severely limited as to what provisions it can agree to with its suppliers, including with regard to fees, product returns, refunds, removal of products from displays and sales to other retailers.⁹⁶ Therefore, large retailers and their suppliers must take these requirements into account in their agreements and dealings.

SUPPLIERS TO LARGE RETAILERS

In addition to restricting large retailers in their conduct, the Fair Retail Transaction Measures give rights to, and place limitations on, suppliers that deal with large retailers. For example, the supplier to a large retailer can refuse the latter's return of a product that has been destroyed, expired or spoiled, even if the supplier bears no loss as a result of such return.⁹⁷ At the same time, under the Fair Retail Transaction Measures, a supplier to a large retailer cannot restrict the large retailer's sale of product supplied by other suppliers.⁹⁸

When negotiating distribution arrangements for China, large retailers and suppliers to large retailers must take into account the additional legal restrictions imposed by the Fair Retail Transaction Measures.

The Distribution Contract

PRE-FORMATION ISSUES

Pre-Formation Memorandums of Understanding and Letters of Intent

Under Chinese law, there is a cause of action for a breach of "pre-contract." For example, if a letter of intent or memorandum of understanding is entered into and states that a sales and purchase contract will be formed within a certain period, then one party may bring a cause of action against the other party if the other party refuses to enter into that sales and purchase contract.⁹⁹

Refusal to Deal

A dominant undertaking in the Chinese market is prohibited from refusing to trade with another trading party without justification.¹⁰⁰ This prohibition includes both refusing to engage in new transactions with trading

⁹⁴ Lingshoushang Gongyingshang Gongpingjiaoyi Guanli Banfa (零售商供应商公平交易管理办法) [Administrative Measures for Fair Transactions By and Between Retailers and Suppliers] (promulgated by the Ministry of Commerce, *et al.*, Oct. 12, 2006, effective Nov. 15, 2006)

⁹⁵ Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 94, at art. 3.

⁹⁶ *See generally*, Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 94.

⁹⁷ Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 94, at art. 9.

⁹⁸ *See generally*, Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 94.

⁹⁹ 2012 Interpretation of Supreme People's Court.

¹⁰⁰ Anti-Monopoly Law, *supra* note 80, at art. 18.

counterparties and delaying or interrupting existing transactions without justification.¹⁰¹ This prohibition can affect undertakings with relatively low market shares, since an undertaking having a market share as low as 10 percent can be presumed to be in a dominant market position. In addition, there is a presumption of dominance for a group of three undertakings if the three undertakings combined have 75 percent of the market and each of them has at least a 10 percent market share.¹⁰²

A dominant undertaking is also prohibited from refusing, without justification, to give its trading counterparties access (under reasonable trading conditions) to necessary utilities if those trading counterparties require the utilities for manufacturing or “operating” activities.¹⁰³ While it is unclear what the scope of this provision may be, it could conceivably apply not only to electricity, gas and water, but also to the distribution of internet access or network technology (software), as well as other specialized inputs that might be characterized as “utilities” necessary for manufacturing and other operating activities.

The SAIC has indicated some factors that it will take into account when assessing any justification for conduct that may be regarded as an abuse of dominance. One factor is whether the practice is conducted on the basis of “ordinary operating activities” and “ordinary interests.” Another factor is how the practice will affect economic efficiency, public interest and economic development.¹⁰⁴

The National Development and Reform Commission (NDRC) has also issued a regulation providing that a dominant undertaking must not, without justification, refuse to deal with a trading party in a “disguised” manner by fixing an excessively high sale price or an overly low purchasing price.¹⁰⁵ However, the NDRC has also indicated that in such circumstances, there are several acceptable justifications for refusing to trade, including the following:

- An extremely bad credit record or a continuous deterioration in operations that may cause great risk to “more secure commerce”
- The ability of the trading counterparties to purchase the same kinds of products or substitute products from others at reasonable prices¹⁰⁶

Agency and the Authority to Enter into a Contract

THE LEGAL REPRESENTATIVE

China’s Contract Law provides that if the legal representative or the person in charge of an organization exceeds the limits of her or his power in entering into a distribution contract, “the act of representation shall be effective unless the counterpart is aware or ought to be aware of the excess of the limit of power.”¹⁰⁷

COMPANY “CHOP” OR SEAL

¹⁰¹ SAIC Regulation 54 of 2010, art. 4.

¹⁰² Anti-Monopoly Law, *supra* note 80, at art. 19.

¹⁰³ SAIC Regulation 54 of 2010, art. 4.

¹⁰⁴ SAIC Regulation 54 of 2010, art. 8.

¹⁰⁵ NDRC Regulation 7 of 2010, art. 13.

¹⁰⁶ NDRC Regulation 7 of 2010, art. 13.

¹⁰⁷ Contract Law, *supra* note 81, at art. 50.

If a contract is for the cross-border sale of goods, and the U.N. Convention on International Sale of Goods, which China ratified in 1998, applies, a binding contract is formed at the moment of acceptance of the offer to sell.¹⁰⁸ This acceptance can be made by a statement or other conduct of the offeree that indicates assent to the offer.¹⁰⁹ Frequently this is done by signing a document that sets out the terms of sale.

Chinese law acknowledges that a contract can also be formed by oral agreement. In addition, the Contract Law provides that where “the parties enter into a contract in the form of a contract instrument, the contract is executed at the time when both parties place their signatures or affix their seals onto the instrument.”¹¹⁰ Affixing to a contract the corporate seal or “chop” is therefore sufficient to legally bind the company to the contract. However, it is normal business practice to also require the signature of a legal representative or other corporate office holder of the contracting Chinese company.¹¹¹ When contracting between or among individuals, it is not unknown for individuals to execute the contract by affixing a fingerprint to the contract, rather than a signature. It is now clear that a contract bearing only the individual’s fingerprint will be equivalent to one having the individual’s signature under seal.¹¹²

In China, the corporate seal or chop is frequently required to lodge documents with various authorities, including customs, tax and corporate regulators. The seal or chop is also often required to enter into contracts in China. Therefore, business can come to a standstill if the chop is controlled by a recalcitrant or obstructive general manager, director or employee.

The corporate chop should be strictly controlled and only accessible to a very limited number of trusted individuals. Under normal circumstances, a distributor should never be given access to a supplier’s chop, because the chop can be misused, either deliberately or mistakenly, to create an assumption of agreement to enter into a binding legal relationship. There is at least an assumption that a contract has been validly entered into if the distributor’s chop appears on a contract, even if misused or applied mistakenly. In addition, if the distributor fails to return the chop, it can be extremely difficult to conduct business without it, because it can take weeks to have a replacement registered with the authorities in China.

CORRUPTION AND BRIBERY

In China, gifts and payments to government officials and employees of SOEs are of great concern. A 2012 publication of the Commercial Service of the U.S. Department of Commerce stated bluntly that “Corruption remains endemic in China.”¹¹³ In the health sector, bribery has become so common that the Ministry of Health has issued draft guidelines that may require both patients and doctors to sign a mutual non-bribery agreement before hospitalization.¹¹⁴

¹⁰⁸ The U.N. Convention on International Sale of Goods came into force in China on January 1, 1988: International Sales Law, Enderlein and Maskow (Oceana Publications Inc., New York, 1992), page 4.

¹⁰⁹ United Nations Convention on Contracts for the International Sale of Goods (1980), art. 18.

¹¹⁰ Contract Law, *supra* note 81, at art. 32.

¹¹¹ Contract Law, *supra* note 81, at art. 50.

¹¹² Note 5, 2009 Explanation of Supreme People’s Court on Questions Arising Under the PRC Contract Law.

¹¹³ U.S. Commercial Service, “Doing Business in China: 2012 Country Commercial Guide for U.S. Companies,” 92.

¹¹⁴ “No-Bribery Agreement to Be Signed in Hospitals,” *China Daily* (Aug. 2, 2012).

The giving of gifts, cash or items of value by either a supplier or distributor can give rise to administrative or civil liability. In a worst-case scenario, such actions may even cause criminal liability under Chinese and foreign laws, such as the U.S. Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act.

Under Chinese law, the giving of incidental gifts such as mooncakes,¹¹⁵ bottles of wine, dinners and other relatively small gifts is normally deemed legal if it is for promotional purposes. However, gifts of cash or anything of value for an improper purpose, such as obtaining or retaining business, will generally be regarded as bribery and considered illegal. It should be noted that both the bribe offeror and the offeree commit an offense under Chinese law.¹¹⁶

Under Chinese law, “official” bribery is an offer of property to a state functionary in return for a benefit or assistance in obtaining an improper benefit. Significantly, “state functionary” includes doctors or medical workers in a state hospital, as well as employees of an SOE. Under Chinese law, not all employees of an SOE are regarded as government officials. Article 93 of the Criminal Law defines “state functionary” as “employees of state-owned companies, enterprises, institutions and people’s organizations who are engaged in public services, and persons who are appointed and sent by state organs, state-owned companies, enterprises and institutions to non-state-owned companies, enterprises and institutions and mass organizations to engage in public services, and other persons who are engaged in public services according to law.”

The U.S. FCPA defines a “foreign official” as “any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or departments, agency, or instrumentality.” U.S. enforcement agencies generally consider employees of SOEs that are major players in primary sectors, such as banking, energy, telecommunications, and oil and gas, to be “foreign officials” regardless of title, rank or position. Interactions with such personnel will therefore be governed by the anti-bribery provision of the FCPA. FCPA risks in China are complicated by this broad definition of a “foreign official.”¹¹⁷

Those who facilitate bribery also commit an offense under Chinese law and may be punished as principal offenders. Because a distributor and its employees or other representatives might be regarded as a facilitator of a bribe, the supplier and the distributor itself would be prudent to include a clause in a distribution agreement that explicitly requires the distributor and its employees, agents and representatives to refrain from engaging in any conduct that would or might be regarded as bribery. Immediate termination of the distribution agreement for breach of such an anti-bribery provision is appropriate.

Commercial Bribery

In China, there is also a crime of “commercial” bribery, punishable under both the Criminal Law and the Commercial Bribery Regulations. Commercial bribery is the offering of “property or other means” by a

¹¹⁵ A Chinese bakery product traditionally eaten during the Mid-Autumn Festival.

¹¹⁶ Zhonghua Renmin Gonghe Guo Xing Fa (中华人民共和国刑法) [Criminal Law of the People’s Republic of China] (promulgated by the Nat’l People’s Cong., Mar. 14, 1997, effective Oct. 1, 1997), art. 93.

¹¹⁷ See discussion, *infra*.

business person to an entity, company or individual in order to sell or purchase merchandise. There is no requirement for the involvement of a state entity or state official. The definition of “property” includes cash or material objects, including those disguised as promotional fees, service charges, consultancy fees, commissions, financial support or reimbursements. However, the Commercial Bribery Regulations exclude from the definition of “property” small promotional gifts given according to business customs. Note also that giving “off-the-books” or secret commissions, discounts or rebates may be considered commercial bribery. Both the offeror and offeree are criminally liable for commercial bribery. As previously discussed, civil liability for such conduct can also arise under the Anti-Unfair Competition Law.

A distribution agreement should include strict requirements on the proper recording of transaction documentation and correspondence, any negotiated discounts, rebates, commissions, fees, reimbursement of travel or accommodation expenses, or other payments or property provided to a customer, employee or representative of another entity or company.

The FCPA and the UK Bribery Act

The FCPA prohibits a multitude of parties¹¹⁸ from making corrupt payments to foreign officials for the purpose of obtaining or retaining business. There have been numerous investigations and a number of convictions in the United States, as well as very heavy settlement “fines” paid by U.S.-listed companies that arose out of their operations in China. Settlements of FCPA enforcement actions in the United States indicate that smaller penalties are likely if the company has a significant compliance program.

Companies with a presence in the United Kingdom (not only UK-registered companies) must comply with the UK Bribery Act. This act makes it a criminal offense to fail to prevent bribery of foreign officials by a person “associated” with an organization or company. An associated person is one who performs services for or on behalf of the organization or company. The UK Bribery Act allows for an “adequate procedures” defense, which limits liability for companies that have instituted compliance programs to prevent bribery. Therefore, a compliance program that includes agents and distributors could be critical for defending a company against a charge of bribery and reducing any penalties that might arise out of either the UK Bribery Act or the FCPA.

Given the broad scope of offenses under the FCPA and UK Bribery Act, a best practice that could be instituted by any business under the jurisdiction of these two laws is to institute an anti-bribery compliance program for its Chinese operations. In addition, businesses should consider including appropriate provisions in their distribution agreements to better ensure that the compliance program is implemented, monitored and followed.

Because of the statutory protection of, and incentives provided to, whistleblowers, there is always a possibility of investigations against multinationals by the Chinese, U.S. or UK authorities on the basis of a whistleblower’s report. Serious consideration should therefore be given to drafting a distribution agreement with provisions that require the distributor to take the following actions, for example:

¹¹⁸ Including U.S. companies and their employees and agents; U.S. citizens; any companies that are listed in the United States and their employees or agents; and any companies or their employees or agents, whether U.S. or not and whether listed in the United States or not, that commit a violation while in the territory of the United States.

- Refrain from any questionable conduct and report such conduct to the supplier
- Assist in the design or implementation of an anti-bribery compliance program
- Actively cooperate in any audit or investigation
- Confirm, prior to payment, that the identity of any holder of an account for the payment is the intended recipient
- Confirm that no part of any payment to the distributor will be paid illegally, either directly or indirectly, to a state functionary or government official

The Chinese authorities have been known to inform U.S. authorities if they become aware of conduct that is potentially in breach of the FCPA. Further, disgruntled employees in China are increasingly using the threat of an FCPA violation to obtain benefits they might not otherwise receive.

GENERAL CONTRACT ISSUES

Standard Form Contracts or “Contracts of Adhesion”

Particular care must be taken in China when using a standard form contract with numerous distributors or franchisees, or when incorporating standard forms or clauses into a distribution contract. China’s Contract Law provides that the party making use of a standard form contract must use reasonable means to clearly highlight to the other party the provisions in the contract that limit or eliminate the liability of the party providing the standard form, and on request must provide explanations to such provisions.¹¹⁹

Further, certain types of provisions are not valid in a standard form contract, including those that exclude the user from any liability, increase the liability of the other party or exclude important rights of the other party.

Confidentiality and State Secrets

If a supplier or its distributors are dealing with an SOE, particular care should be taken when either gathering what might be regarded in other countries as market information about an SOE, or transferring, disclosing or using commercial and technical information related to an SOE or the markets in which an SOE operates.

China’s State-Owned Assets Supervision and Administration Commission and the State Council introduced new rules in 2010 that re-categorize a “commercial secret” of an SOE as a “state secret.”¹²⁰ These new rules mean that the traditional trade secrets of an SOE, such as business and technical information, may now be considered state secrets and subject to China’s State Secrets Law and the Criminal Law.

Disclosure or use of a state secret is potentially a criminal offense, so disclosure or use of information previously categorized as an SOE’s commercial secret can potentially lead to criminal liability. Once any information in a document is deemed a state secret, then the information should not be reviewed, copied, circulated or removed. If a supplier anticipates that its distributor will have dealings or compete with an SOE, it should ensure that there are appropriate contract clauses in its distribution agreement to address this issue.

¹¹⁹ Contract Law, *supra* note 81, at art. 39.

¹²⁰ Art. 3 and 11 of the Interim Provisions on Protection of Commercial Secrets of Centrally Administered SOEs.

For example, a distribution agreement might include in a confidentiality clause a guarantee from an SOE that no documents provided by the distributor will include any state secrets.

Exclusion of Liability

In China, a contractual provision is invalid if it purports to exclude liability for physical injury to the other party, or excludes liability for gross negligence or intentional damage.¹²¹ As mentioned above, standard contract clauses formulated in advance by a party for repeated use and not as the result of negotiation with the other contract party are also invalid if the party providing the standard clauses excludes itself from liability or imposes greater liabilities on the other party.¹²²

Dispute Resolution

Unless a distribution agreement has some “foreign” aspect¹²³ to it, a dispute must be settled in China, in the Chinese language, by the Chinese courts or an official Chinese arbitration body (arbitration commission). If the distribution agreement has a foreign aspect, then arbitration outside China is likely acceptable, and an award by a foreign arbitration tribunal is enforceable in China.¹²⁴ However, if an FIE in China is involved in a dispute, the status of the FIE is not deemed as a foreign aspect. There must be some other foreign aspect. If a Chinese party has limited dispute resolution experience outside China, arbitration in Singapore or Hong Kong using the Singapore International Arbitration Centre, United Nations Commission on International Trade Law, International Chamber of Commerce or Stockholm Arbitration Rules would likely be agreeable to a Chinese party.

If the dispute concerns the use of the supplier’s trademark and there is no arbitration provided for in the trademark license, a consultation procedure must be followed before court proceedings in China can be commenced. For trademark disputes, there is also an alternative to court proceedings enabling any interested party to submit the dispute to the AIC for settlement. Thereafter, court proceedings can be commenced if a party is dissatisfied with the AIC decision.¹²⁵

Termination Compensation

China has no requirement mandating payment of any compensation or indemnity to a commercial agent or distributor upon termination or expiry of the agreement. If the agreement provides for compensation upon termination or expiry, the Contract Law will apply. Care should be taken, however, to ensure termination has been properly and clearly exercised and communicated to the terminated distributor.

¹²¹ Contract Law, *supra* note 81, at art. 53.

¹²² Contract Law, *supra* note 81, at art. 39, 40.

¹²³ *E.g.*, there is a clause for supply of equipment or grant of a license to use proprietary knowledge provided by a non-Chinese entity from outside China.

¹²⁴ China has ratified the New York Convention on Recognition and Enforcement of Arbitral Awards.

¹²⁵ Zhonghua Renmin Gonghe Guo Shangbiao Fa (中华人民共和国商标法) [Trademark Law of the People’s Republic of China] (promulgated by the Standing Committee of the Nat’l People’s Cong., Oct. 27, 2001, effective Dec. 1, 2001) art. 53.

RESTRICTIVE CONTRACT CLAUSES

This section considers contract clauses often included in a distribution agreement that will be of concern under China's antitrust rules and trade mark and product liability laws. For example, depending on the circumstances, many of these clauses might be regarded as a breach of the AML and therefore be prohibited. The clauses might also be illegal under the AUCL, the Price Law, or the Fair Retail Transaction Measures.

Clauses that restrict one or more of the parties in the way that they conduct business, or that restrict with whom or under what conditions a party may do business, can to a greater or lesser degree restrict competition in the market. If restrictions in competition appear in a distribution agreement, particular care must be taken not to infringe the AML. Conduct prohibited by the AML has recently become a focus of the antitrust enforcement agencies in China, with the imposition of fines of hundreds of millions of yuan in the last quarter of 2012 and first quarter of 2013.¹²⁶

The AML, which was introduced in August 2008, is largely modeled on the competition law of the European Union. The AML enforcement authorities frequently look to EU competition law to compare the approach taken by the European Commission and are clearly influenced by EU precedents concerning restrictions of competition.

Exclusive Supply/Exclusive Distribution Clauses

Exclusive supply or exclusive distribution normally involves an agreement that the supplier will sell products to one distributor only. An agreement is also one of exclusive supply when there are agreed-upon incentives that cause the supplier to concentrate its sales predominantly with one distributor.¹²⁷ As a result, a competing distributor cannot purchase the product from the supplier, and the supplier supplies to one distributor exclusively.

In China, the AML provides that if a supplier is dominant in the market, it cannot refuse to trade with a distributor without justification. To do so may result in fines of up to 10 percent of annual revenues and claims in the courts by those suffering damage, as well as confiscation of illegal gains.¹²⁸ If a clause in a distribution agreement requires a dominant supplier to supply exclusively to one distributor only, the supplier in such a case would have to refuse to trade with any other competing distributors. However, any refusal to trade by a dominant supplier, without justification, could be regarded as a prohibited abuse of dominance contrary to the AML.

¹²⁶ For example, see two cases from the end of 2012 and early 2013: "Six LCD Panel Manufacturers Fined CNY 353 Million for Price Cartel" and "Maotai and Wuliangye Fined CNY 449 Million for Vertical Price Fixing" in *China Competition Bulletin* (Jan/Feb 2013) pp. 4–5, available at http://jjs.ndrc.gov.cn/gzdt/t20130117_523205.htm and <http://finance.sina.com.cn/chanjing/b/20130222/164314620476.shtml>, accessed March 16, 2013.

¹²⁷ Compare EU Commission Guideline on Vertical Restraints OJ 2010 C/130/1 at para. 192.

¹²⁸ Anti-Monopoly Law, *supra* note 80, at art. 47, 50.

If a distributor is dominant, it cannot require a supplier, without justification, to trade exclusively with that distributor or with an undertaking designated by the distributor.¹²⁹ To do so would be an abuse of the distributor's dominance and, unless justified, is prohibited by the AML.

Furthermore, China's AUCL imposes strict regulations on suppliers possessing "monopoly status." A "monopoly" supplier cannot restrict the distributor in purchasing a product only from the monopoly supplier or undertakings designated by such a monopoly supplier.¹³⁰ The AUCL does not define "monopoly status," although it appears to refer to those entities that enjoy "exclusive production and sales" in China for particular products.¹³¹ As such, the AUCL is likely to refer to those SOEs that enjoy such a status.

"Non-Compete" and Exclusive Purchase Clauses

A non-compete clause is one that prevents the distributor from selling, reselling, manufacturing or purchasing products that compete with products of the supplier. A non-compete clause can have the same effect as an exclusive purchase clause.¹³² In effect, a non-compete clause means that the distributor can purchase and resell products only from the supplier. If the distributor buys or manufactures and then sells products that compete (*i.e.*, are substitutable) with those supplied by the supplier, the distributor will be in breach of the non-compete obligation. If the supplier is dominant it cannot require, without justification, that the distributor deal only with the dominant supplier or with others designated by the dominant supplier.¹³³

Specifically, SAIC regulations prohibit a dominant supplier, without justification, from requiring its distributors (*i.e.*, the trading counterparty) to trade exclusively with the dominant supplier or those designated by the dominant supplier, and from restricting its distributors from trading with the dominant supplier's competitors.¹³⁴

According to SAIC regulations, when assessing whether there is sufficient justification for a dominant supplier's refusal to deal with distributors, the SAIC must take into account whether the conduct is on the basis of ordinary operating activities and "ordinary interests," and how the conduct will affect economic efficiency, public interest and economic development.¹³⁵ Unfortunately, no guidance or examples are available on the practical application of this provision.

A non-compete or exclusive purchase clause would also require the distributor to refuse to deal with any competitor of the supplier. If the distributor is dominant, under the AML a refusal to purchase from competitors of the supplier without justification is equally prohibited.¹³⁶

¹²⁹ Anti-Monopoly Law, *supra* note 80, at art. 17.

¹³⁰ AUCL, *supra* note 89, at art. 6.

¹³¹ Anti-Monopoly Law, *supra* note 80, at art. 7.

¹³² See section 7(d)(i) on "Exclusive Supply."

¹³³ Anti-Monopoly Law, *supra* note 80, at art. 17(4).

¹³⁴ SAIC Reg. 54/2010 art. 5.

¹³⁵ SAIC Reg. 54/2010 art. 8.

¹³⁶ Anti-Monopoly Law, *supra* note 80, at art. 17(3); SAIC Reg. 54/2010 art. 4(3) and 5.

With regard to the unjustified prohibitions against non-compete or exclusive purchase clauses when a supplier or distributor is dominant, it is important to note that in China, a market share as low as 10 percent can amount to dominance in some circumstances.

It should also be noted that there are special rules for sales to large retailers whose aggregate annual sales (including those of all chain stores) are RMB 10 million¹³⁷ or more.¹³⁸ If a large retailer is restricted to purchasing a certain type or range of products from a single supplier, that retailer cannot purchase, and thus cannot resell, products that could have been supplied by others. If a supplier (whether dominant or otherwise) restricts the large retailer's ability to sell goods purchased from other suppliers, this restriction is likely to be contrary to the Fair Retail Transactions Measures.¹³⁹

Territorial Restrictions

A territorial restriction is one where the distributor agrees to only resell the supplier's product in a specified geographic area. Under such a clause, a distributor cannot resell product in territories exclusively allocated to another distributor. In China, a dominant supplier is prohibited from imposing "unreasonable restrictions on the territory of sales" without justification.¹⁴⁰ If the supplier is dominant, it is unclear under Chinese law what would be regarded as an "unreasonable" territorial restriction and what is sufficient to justify such an unreasonable territorial restriction. In determining whether there is sufficient justification under the AML for an unreasonable territorial restriction imposed by a dominant supplier, the applicable SAIC regulations require the SAIC to consider whether the practice (territorial restriction) is conducted on the basis of ordinary operating activities and ordinary interests, and how the territorial restriction will affect economic efficiency, public interests and development of the economy.¹⁴¹ The SAIC has issued no decision or guidelines that may be of assistance to further clarify these aspects of the regulations.

Customer Restrictions

Rather than allocate distributors to an exclusive territory, a supplier may agree to sell its products to a distributor for resale only to a particular group of customers. For example, the supplier of a high-technology product may agree to supply only one distributor for sales to corporate customers, and reserve sales to small businesses and individual customers for itself. The distributor would then be restricted to making sales only to its allocated customer group, which in this example would be corporate customers.

Under Chinese law, these customer restrictions are problematic if either the distributor or the supplier is dominant in its respective market. This is of particular concern given that in some circumstances "dominance" is presumed to exist when an undertaking's market share is as low as 10 percent.

SAIC Regulation 54 provides that a dominant supplier (or dominant distributor) must not impose "additional unreasonable restrictions on . . . customers targeted" or impose "other trading conditions irrelevant to the

¹³⁷ Approximately US\$1.5 million.

¹³⁸ Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 100, at art. 4.

¹³⁹ Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 100, at art. 18(2).

¹⁴⁰ SAIC Reg. 54/2010 art. 6(3).

¹⁴¹ SAIC Reg. 54/2010 art. 8.

items traded” without justification.¹⁴² Entities that impose these restrictions without justification are abusing their dominance and violating the law.

Further, if the dominant supplier refuses to sell to a distributor because the distributor is reselling or proposes reselling outside of its allocated customer group, such refusal to trade, without justification, could equally be regarded as an abuse of dominance. If the distributor is dominant and must refuse to trade with a customer outside of its allocated customer group because of the distribution agreement, such a refusal to trade could, without justification, be an abuse of dominance and be prohibited by the AML.¹⁴³

Minimum Stocking and Shelf Space Allocation

A clause requiring a distributor to use all or almost all of its stock capacity or available shelf space exclusively for the supplier’s product can amount to a requirement to deal exclusively or almost exclusively with the supplier. Such a clause can therefore have an effect similar to a non-compete clause and could, if the supplier is dominant in the market, be a breach of the AML. A violation of the law could occur if a minimum stocking or shelf allocation obligation was so onerous as to restrict a retailer’s sales of other suppliers’ products, particularly if the supplier is dominant.¹⁴⁴ In such a case there would be limited or no space left for competing suppliers.

A minimum stocking or shelf space obligation could, if very high, also amount to a breach of the Fair Retail Transaction Measures. These Fair Retail Transaction Measures apply to retailers with aggregate sales of RMB 10 million or more, whether the level of sales is reached in a single store or aggregated across all sales in the same chain of stores. The Large Retailer Measures provide that no supplier to a large retailer may “restrict the retailer’s sale of products of other suppliers.”¹⁴⁵ It remains to be seen at what level a high stocking or shelf space obligation will be deemed as a restriction of the retailer’s sale of the products of other suppliers.

Tying/Bundling

In China, a supplier cannot require a distributor to unwillingly buy another product along with the product that the distributor seeks to purchase.¹⁴⁶ According to China’s AUCL, this prohibition on tying, also commonly referred to as “bundling,” applies regardless of the market share or market power of the supplier or the distributor.

There is also a provision in China’s AML providing that a dominant company is prohibited from engaging in the tying of sales as described above unless some justification exists. Unlike in the European Union, in China, even if the supplier is not dominant or has a good justification for engaging in tying, a company could still be in breach of the AUCL if it has tied sales of different products.

¹⁴² SAIC Reg. 54/2010 art. 6.

¹⁴³ See discussion, *supra* of non-compete clauses.

¹⁴⁴ SAIC Order 54, 2010 art. 5(3).

¹⁴⁵ Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 100, at art. 18(2).

¹⁴⁶ AUCL, *supra* note 89, at art. 12.

Post-Termination Non-Compete Clauses

In China, the legal position in respect to a post-termination non-compete clause is unclear. Such a clause would require the distributor not to compete with the supplier or its other distributors following the termination or expiration of the distribution agreement.

If the supplier is dominant, there is the possibility that an overly restrictive post-termination non-compete clause may be considered an “unreasonable trading condition” unless justification exists. The SAIC regulations prohibit the imposition by a dominant supplier (for example) of “unreasonable restrictions for the contract period” without justification, and the imposition of trading conditions “irrelevant to the trading objectives.”¹⁴⁷ While both of these terms are rather vague and have not been the subject of a judicial or public SAIC decision, if the supplier is dominant, there is a real possibility an overly restrictive post-termination non-compete clause could be prohibited.

At the same time, the AUCL provides that a business operator must not use trade secrets in violation of an agreement not to use or disclose the secrets, including as a competitor of a supplier.¹⁴⁸ It would therefore likely not be prohibited for a dominant supplier to prevent use by a terminated distributor of its IP rights or trade secrets post-termination. This would likely be true even if it meant that the terminated distributor could not continue trading without the suppliers’ IP or trade secrets.

PRICING, DISCOUNTS, REBATES AND FEES

Resale Price Maintenance

A supplier may want to control the resale price at which a distributor sells products to consumers or downstream users. In China, unless an exemption under the AML applies, such resale price maintenance (RPM) is generally prohibited. The AML specifically prohibits undertakings from fixing the resale price or restricting the minimum price of resale.¹⁴⁹

Despite these prohibitions, restrictions on resale prices have not been unusual in China, but that will undoubtedly change, because the NDRC imposed a fine of RMB 449 million (approximately US\$73.5 million) early in 2013 on two producers of liquor for restricting minimum resale prices.¹⁵⁰

There is no prohibition against issuing recommended resale prices or agreeing with a distributor on the maximum resale price. However, care should be taken that a “maximum” price or “recommended” resale price is not, in effect, a fixing of the resale price.

There is an argument that RPM is permissible in China if it can be shown that the RPM does not restrict competition. A 2012 judgment of the Shanghai Intermediate Court suggests that if there is not sufficient

¹⁴⁷ SAIC Reg. 54/2010 art. 6(2) and 6(4).

¹⁴⁸ AUCL, *supra* note 89, at art. 10.

¹⁴⁹ Anti-Monopoly Law, *supra* note 80, at art. 14.

¹⁵⁰ “Maotai and Wuliangye Fined CNY 449 Million for Vertical Price Fixing,” *China Competition Bulletin* (Jan/Feb 2013) China Competition Research Centre, pp. 4–5, available at <http://finance.sina.com.cn/chanjing/b/20130222/164314620476.shtml>, last accessed March 16, 2013.

evidence to show that the RPM clause restricts competition, a clause restricting the minimum price of resale is not necessarily prohibited.¹⁵¹ It remains to be seen whether such an argument will be successful on appeal. The Chinese enforcement authorities, notably the NDRC, seem to have taken the view that RPM is *prima facie* contrary to China's AML.¹⁵²

In addition, article 14(1) of China's Price Law requires that undertakings must not "work collaboratively to control market prices to the great detriment of the lawful rights and interests of other undertakings or consumers." There is an argument that the NDRC could also rely on this article 14(1) to find that a supplier has collaborated with a distributor to control the downstream consumer market price through the fixing of the resale price. If such "collaboration" between a distributor and supplier is determined to be detrimental to the rights and interests of consumers, there could also be a violation of the Price Law.

"Unfair" Pricing

In China, sales at unfairly high prices and purchases at unfairly low prices are prohibited if either the seller or the buyer is dominant in the market. Such unfair pricing is considered to be an abuse of a dominant market position.¹⁵³ If the supplier is dominant in the market, it is prohibited from selling at unfairly high prices. If the distributor is dominant in the market, it is prohibited from buying at unfairly low prices and from selling at unfairly high prices. Unlike other forms of abuse of dominance, such unfair pricing is prohibited even if there might be justification for it. The key test on this issue is determining when a price is so excessive that it is "unfair."¹⁵⁴

SOME FACTORS THE NDRC USES TO DETERMINE UNFAIR PRICING:

- Is the price markedly higher or lower than similar products?
- Does a change in price exceed the normal range?
- (Dominant seller) Does a price increase markedly exceed an increase in cost?
- (Dominant buyer) Does a decrease in purchasing price markedly exceed the reduction in costs of the seller?

The fixing of an excessive sale price or an overly low purchase price by a dominant undertaking, if it amounts to a "disguised" refusal to trade, is also prohibited unless justified.¹⁵⁵

Under the Price Law, a business operator (whether dominant or not) must not "seek exorbitant profits in violation of laws and regulations," or in a "disguised way, raise or lower prices at irrational ranges by

¹⁵¹ See Johnson & Johnson case in *China Competition Bulletin*, edition 17, Jan/Feb 2012, page 3.

¹⁵² NDRC Reg. 7/2010 art. 8; *see also* *China Competition Bulletin* Jan/Feb 2013 China Competition Research Centre, pp. 4–5, and <http://finance.sina.com.cn/chanjing/b/20130222/164314620476.shtml>, last accessed March 16, 2013; and the case of the NDRC demanding that book distributors remove restrictions on their resale price, *China Competition Bulletin*, China Competition Research Centre, September 22, 2010.

¹⁵³ Anti-Monopoly Law, *supra* note 80, at art. 17(1).

¹⁵⁴ NDRC Reg. 7/2010 art. 11.

¹⁵⁵ NDRC Reg. 7/2010 art. 13; *see also* Refusal to Trade, *infra*.

artificially raising or lowering grades of merchandise or services.”¹⁵⁶ There have been no recent cases to clarify what these two provisions may mean in practice, but it seems likely that the NDRC will enforce the more modern AML rather than rely on the Price Law. At the same time, it should be noted that the NDRC has applied both the AML and the Price Law concurrently in the same case since the introduction of the AML.¹⁵⁷ Therefore, companies must take care that the terms of a distribution agreement do not breach the Price Law’s provisions.

In respect to predatory pricing, under the AUCL, subject to certain exceptions, sales by a supplier or distributor (whether dominant or not) below cost are a breach of the law.¹⁵⁸ The Price Law and implementing regulations also provide that it is illegal for a supplier or distributor (whether dominant or not), intending to exclude competitors or to monopolize the market, to sell below cost, with certain exceptions, notably that the goods are at the end of season, are near the end of their shelf life or are sold because of financial distress, such as bankruptcy.¹⁵⁹

“English Clause” – Match Most Favorable Offer

The so-called “English clause” is used in a distribution agreement in order for the supplier to have an equal opportunity to sell to the distributor if better offers are made by competing suppliers. Such a clause requires the distributor to report any better offer to the supplier and only allows the distributor to accept such better offer if the supplier does not match it.

In China, there is no guidance on whether and under what circumstances an English clause would be prohibited. Under the AML, if a dominant supplier always matches a better offer, thereby effectively requiring the distributor to deal only with the dominant supplier, this would be prohibited unless the dominant supplier could justify such conduct.¹⁶⁰

Retailer Fees

Chinese law provides particular protection to entities that supply products directly to medium-sized and large chain stores and hypermarkets. Medium-sized and large retailers¹⁶¹ in China have legal restrictions on the fees that they can charge their suppliers. These large retailers cannot charge fees, including in any “disguised” form, for the following:

- The signing or renewal of a contract
- An in-store bar code (as long as a state-approved bar code is used by the supplier)

¹⁵⁶ Price Law, *supra* note 92, at art. 14(6) and (7).

¹⁵⁷ See, e.g., Rice noodle case and Fuyang Paper Association case; see also 16 Industry Associations Release Agreement Calling on All Companies to Not Collude in Order to Fix Prices *available at* http://www1.china.com.cn/economic/txt/2010-12/09/content_21505790.htm.

¹⁵⁸ See discussion, *infra*, on predatory pricing.

¹⁵⁹ Price Law, *supra* note 92, at art. 14(2), and Decree No.2 of the State Development Planning Commission (now NDRC) on Curbing Predatory Pricing of March 8, 1999, Regs. 2 & 6.

¹⁶⁰ SAIC Order 54/2010 art. 5.

¹⁶¹ Medium and large retailers are those with annual revenues equal to or greater than RMB 10 million, approx. US\$1.5 million.

- A bar code fee exceeding the actual cost of the in-store bar code
- A decoration or ornament fee charged at the time of redecoration of a store but not used for the sales area of the supplier's product
- Festivals, business anniversaries, store openings, store reopenings, listing of the enterprise, mergers, and so forth, without providing the supplier with promotion services
- Fees that are unrelated to the sale of the supplier's product and are either required to be paid by the retailer itself or charged by the retailer without the corresponding provision of any services to the supplier¹⁶²

Up-front Access and Shelf Space Fees

Up-front access payments are fees the supplier pays to distributors so that the supplier can have access to the distributor's distribution network and as remuneration for services provided to the supplier by retailers. Such up-front access payments are also used to pay for shelf space in retailer outlets and can be important in gaining (and maintaining) access to the market.

In China, considerable care must be taken so that up-front access payments are not considered to be a form of commercial bribery. Any up-front payment must be transparent, not secret and recorded accurately in the books and accounts.¹⁶³ If the payment is not made in such a way, the fees could readily be regarded as commercial bribery in much the same way that discounts and rebates might be in similar circumstances.

If a distributor or retailer is dominant in the market, it cannot add "unreasonable fees" to the price in trading. While it has not been the subject of a decision, the wording of the applicable NDRC regulation could be interpreted to mean that adding up-front access fees or shelf space fees may be considered as adding "unreasonable fees to the price in trading" and may potentially be an abuse of dominance. Unless the fees can be justified, there is a risk that they may be prohibited if the distributor or retailer is dominant.

Discriminatory Access Fees

If the distributor or retailer is dominant, it cannot discriminate in its prices or trading conditions. The distributor or retailer therefore must also take care that the up-front access fee is not different for different suppliers in the same circumstances.¹⁶⁴ Even if the distributor or retailer is not dominant, care should be taken that different up-front access fees do not amount to discrimination in the price of goods or services under the same trading conditions, contrary to the Price Law.¹⁶⁵

Up-front access fees and shelf space fees are of particular concern to medium-sized and large retail chains, because China has introduced special rules on fees and payments in this sector.

¹⁶² Administrative Measures for Fair Transactions By and Between Retailers and Suppliers, *supra* note 100, at art. 13.

¹⁶³ AUCL, *supra* note 89, at art. 8.

¹⁶⁴ AUCL, *supra* note 89, at art. 17.

¹⁶⁵ Price Law, *supra* note 92, at art. 14(5).

Rebates and Discounts

In China, particular care must be taken when granting a rebate or giving a discount. This is not only an issue under the AML and AUCL, but the Price Law also can potentially have an impact on rebates and discounts.

Differential Discounts and Rebates

Under China's Price Law, regardless of whether a business operator is dominant, it must not engage in price discrimination for the same kinds of products under the same trading conditions. Such activities could easily be considered "abnormal" price behavior.¹⁶⁶ Rebates and discounts that differentiate between distributors in the same circumstances can be regarded as "abnormal" price behavior, and care should be taken as to how they are granted.

If a business operator is dominant, according to the NDRC and SAIC regulations that implement the AML, the business operator is prohibited from discriminating in treatment without justification, including through the application of a preferential discount.¹⁶⁷ When determining the "justification" for a preferential discount, the SAIC will consider whether the discount was given on the basis of "ordinary business activities and ordinary interests."¹⁶⁸ So far, there have been no published cases that provide guidance on what this may mean in practice.

Dominant Players and Rebates

In China, granting discounts or rebates is prohibited unless justified if the intent or effect is to restrict a counterparty to dealing only with a dominant supplier, or to only deal with undertakings designated by the dominant supplier. Possible justification for such discounts or rebates includes ensuring product quality and safety, maintaining brand image or improving service quality, or significantly improving efficiency and enabling consumers to share the benefits thereof.¹⁶⁹

Commercial Bribery

China's AUCL also has special rules on rebates and discounts. For example, the AUCL provides that if a supplier offers "an off-the-books rebate or discount in secret" to another business or individual, such behavior is deemed to be "offering bribes." Acceptance of such a rebate or discount is deemed to be "taking bribes."¹⁷⁰ Note that no government official, agency or government enterprise need be involved. The illegal bribe can arise in a transaction involving only private parties and often is called "commercial bribery" to distinguish it from government-related bribery. In order for a rebate or discount to be lawful, it must be recorded in the

¹⁶⁶ Price Law, *supra* note 92, at art. 14(5).

¹⁶⁷ SAIC Reg. 54/2010 art. 7; NDRC Reg. 7/2010 art. 16.

¹⁶⁸ SAIC Reg. 54/2010 art. 8.

¹⁶⁹ NDRC Reg. 10/2010 art. 14.

¹⁷⁰ AUCL, *supra* note 89, at art. 5; Guanyu Jinzhi Shangye Huilu Xingwei De Zanxing Guiding

(关于禁止商业贿赂行为的暂行规定) [Interim Provisions on Prohibition of Commercial Bribery] (promulgated by the State Administration for Industry and Commerce, Nov. 15, 1996, effective Nov. 15, 1996).

books and accounts and must not be made in secret. Rebates or discounts that are made on a cash basis and not entered clearly in the accounting books as a “rebate” or “discount” but, for example, are recorded as petty cash entail a certain amount of risk, because such behavior may be deemed commercial bribery.

“Predatory Pricing” – Sales Below Cost

In China, subject to limited exceptions, under the AUCL and Price Law, neither a supplier nor a distributor may sell at a price below cost for the purpose of excluding competition.¹⁷¹ This applies whether or not the supplier or distributor is dominant in the market.

CAN BE SOLD BELOW COST:

- Perishable or Live Products
- Products Near the Expiration Date
- Seasonal Sale Products
- Products Sold for Debt Liquidation or Change of Business

The Price Law prohibits undertakings from engaging in below-cost pricing in order to eliminate competitors or dominate the market “and disrupt normal production and operations to the great detriment of State interests or the lawful rights and interests of other undertakings.”¹⁷²

The relevant NDRC provisions provide a list of exceptions, including the following:

- Overstocked goods
- End-of-season or out-of-season sales
- Products nearing the end of their shelf life or validity period
- Perishables that are near the end of their shelf life
- Sales to pay off debts or related to bankruptcy, changing operations or suspending business operations in accordance with the law¹⁷³

Further, under the AML, if the supplier or distributor is dominant in the Chinese market, there is a prohibition against sales below cost unless such sales are justified.¹⁷⁴ Acceptable justifications are similar to those provided in the Price Law.¹⁷⁵

Discriminatory Pricing

China’s Price Law provides that an undertaking must not “discriminate in terms of prices for the same kinds of goods or services offered by undertakings under the same trading conditions.”¹⁷⁶ This applies to all distributors and suppliers regardless of their market share and irrespective of whether or not they are dominant in the market concerned.

¹⁷¹ AUCL, *supra* note 89, at art. 11; Price Law, *supra* note 92, at art. 14(2).

¹⁷² Price Law, *supra* note 92, at art. 14(2).

¹⁷³ NDRC (then SDPC) Provisions on Curbing Predatory Pricing Activities Decree 2/1999 art. 6.

¹⁷⁴ Anti-Monopoly Law, *supra* note 80, at art. 17(2).

¹⁷⁵ SAIC Reg. 54/2010.

¹⁷⁶ Price Law, *supra* note 92, at art. 14(5).

A dominant undertaking is prohibited from applying differential prices (and other transaction terms) to its trading counterparties with “equal standing”¹⁷⁷ or “under equal conditions” without justification.¹⁷⁸

Regardless of whether a supplier or distributor is dominant in the market, any contractual clauses that would suggest discriminatory pricing should be avoided in a distribution arrangement.

Announcements and Timing of Price Increases

Recent experience indicates that suppliers should be careful about how they communicate price increases to the market. Because of the provisions of the Price Law and the NDRC’s interpretation of the same, it may be prudent to include appropriate wording in a distribution agreement that limits the risk of a violation.

Article 14(3) of the Price Law prohibits undertakings from “fabricating and spreading information about price hikes, forcing up prices and thus stimulating excessive commodity price hikes.” The Price Law Penalty Regulations state that undertakings are prohibited from engaging in conduct that amounts to “fabricating and disseminating information on price increases to disrupt market and pricing order” in order to cause a surge or an excessive increase in the prices of commodities.¹⁷⁹

In a recent case, a large foreign supplier was sanctioned for giving notice of price increases to its distributors through widespread public announcements. The company was found by the NDRC to have breached Article 14(3) of the Price Law. According to the NDRC, the company indicated in public announcements that it intended to increase prices for specified products by 10 percent in April 2011 because of rising costs. The public announcements for this increase were “widely disseminated.” The announcements stated that “the household and personal care products industry has entered into a price hike cycle” and “the process of raising prices have to be made gradually in order to see if [our] competitors would follow suit,” and “if our competitors don’t follow suit, it would be a disaster for us and therefore we should only raise prices gradually.” The announcements allegedly caused widespread panic buying, as consumers began to purchase the company’s various household and personal care products in large quantities in specified cities around China. In early May 2011, after the NDRC’s intervention, the supplier announced that it was not going to implement the price increases for some of the relevant products and apologized to consumers for causing the widespread panic.

Pursuant to the Price Law Penalty Regulations, business operators in breach of the Price Law face fines of up to five times their illegal gains or up to RMB 3 million (in the absence of illegal gains). In the case described above, the NDRC decided to impose a fine of RMB 2 million after it took into account the supplier’s apology and suspension of price increases as mitigating factors.

The case demonstrates that care must be taken when giving distributors notice of price increases or when making price announcements. It is likely that the NDRC will take into account the extent to which such announcements either have or could “disrupt the market order” before determining if the conduct is illegal.

¹⁷⁷ Anti-Monopoly Law, *supra* note 80, at art. 17(6).

¹⁷⁸ NDRC Regulation 7/2010, art. 16.

¹⁷⁹ Price Law Penalty Regulations Article 6(1).

For instance, if price announcements cause consumers to panic and purchase certain goods or services in large quantities within a short time frame, this could very well be regarded as a disruption of “the market and pricing order.” Such disruption would be contrary to the Price Law.

Further, while the AML does not prohibit price signaling, it prohibits price fixing and, depending on the facts of the case, certain price signaling behavior could be taken to be a precursor of—or could even be sufficient evidence to prove—concerted price fixing conduct between competitors. This is an additional reason to be careful with price increase communications in China.

PRODUCT QUALITY AND LIABILITY

Product Liability

China’s Product Quality Law imposes strict liability on a manufacturer of a product for damage or injury to persons or property caused by a manufacturing or design defect.¹⁸⁰ Negligence does not need to be shown in such cases. Strict liability applies regardless of whether the manufacturer is a foreign company or domestic Chinese company. However, unlike for the manufacturer, it is unclear whether a distributor will be strictly liable for such defects or must be shown to be negligent.

China’s Tort Law provides for compensation to be paid for negligence causing damage or injury. This includes compensation for damage and injury when a company appears to be the manufacturer because, for example, it has allowed its name or logo to be placed on the negligently manufactured product. A number of suppliers have their distributors do final processing or packaging of a product (before supply to a retailer or customer in China), but leave their own trademark or logo on the product. Doing so attaches strict liability under China’s Tort Law. Insurance is typically used to minimize the risk.

Given China’s still-developing insurance market, a foreign manufacturer or supplier may prefer taking out its own insurance and reflecting the insurance cost in the price, rather than relying on a contract clause requiring the Chinese distributor to take out insurance coverage for liability in negligence or for strict liability under the Product Quality Law.

Product Quality

Under China’s Product Quality Law, a manufacturer is responsible for ensuring the goods that it supplies pose no unreasonable danger to individuals or property, meet all applicable national and industry standards, are fit for their intended purpose except when defects clearly indicate otherwise (*e.g.*, second-hand or obviously partly damaged goods), and are in conformity with the standards on the packaging and labeling of the goods.¹⁸¹

¹⁸⁰ Zhonghua Renmin Gonghe Guo Chanpin Zhiliang Fa (中华人民共和国产品质量法) [Law of the People’s Republic of China on Product Quality] (promulgated by the Standing Committee of the Nat’l People’s Cong., July 8, 2000, effective Sept. 1, 2000).

¹⁸¹ Product Quality Law, *supra* note 223, at art. 26.

If the seller is a distributor only (and not also the manufacturer), the seller must, amongst other things, take the following actions:

- Adopt measures to maintain the quality of the products that it sells
- Implement an examination and acceptance system for the purchase of inventory to ensure that the inventory includes the required product quality certificates
- Examine the packaging of products sold to ensure information concerning product specifications, warnings and facility location are included¹⁸²

Products that fail to meet mandatory standards are prohibited from being manufactured, sold or imported.¹⁸³ If a supplier or distributor does so, it can be subject to fines, confiscation of goods and, in serious cases, criminal prosecution.¹⁸⁴

INTELLECTUAL PROPERTY

Trademark Licensing

Trademark licensing is a common means through which foreign companies conduct business in China. Licensing can help the parent company retain ownership of the mark and control the use of it. Licensing can also help its local partner obtain proper authorization to use the mark.

According to China's Trademark Law, trademark rights are regional, and only the owner of a trademark successfully registered in China is entitled to the exclusive right of that trademark. Therefore, even if a company's trademark is well known internationally, if the trademark was not properly registered in China, it would still be difficult for the company to obtain protection for the trademark. A prominent example of the problem that can arise is Apple's reported settlement payment of US\$60 million to capture the "iPAD" trademark registration in China.¹⁸⁵

Most companies entering the Chinese market would be well advised to register their own marks in China, especially their core trademarks and home logo. The Chinese agency in charge of trademarks is the Trademark Office (TMO), which is affiliated with the SAIC.

A distribution arrangement may grant the distributor a right to use the trademark either through a separate trademark license agreement or through the inclusion of a provision in the distribution agreement. In China, if there is an exclusive trademark license, it is likely that exclusive distribution would be deemed to exist since an exclusive trademark license would have the same effect as giving exclusive distribution rights in China for the licensed products.

¹⁸² Product Quality Law, *supra* note 223, at art. 33–37.

¹⁸³ Zhonghua Renmin Gonghe Guo Biaozhunhua Fa (中华人民共和国标准化法) [Standardization Law of the People's Republic of China] (promulgated by the Standing Committee of the Nat'l People's Cong., Dec. 29, 1988, effective Apr. 1, 1989) art. 14; Product Quality Law, *supra* note 128, at art. 8.

¹⁸⁴ Standardization Law, *supra* note 228 at art. 20; Standardization Rules art. 32–36.

¹⁸⁵ *Apple v. Proview Technology* (Shenzhen): "Apple 'Settles China iPad Trademark Dispute for \$60m'" (July 2, 2012) available at www.bbc.co.uk/news/business-18669394, last accessed March 16, 2013.

There are two models of exclusive trademark licensing. One is the traditional “exclusive” license, under which only one licensee has the right to use the trademark under license within a certain scope of use and during a certain period. Another model is a “sole” license, under which both the licensee and the trademark owner have the right to use the trademark. The primary difference between an exclusive license and a sole license under China’s Trademark Law is whether the trademark owner will or might be deprived of the right to use the trademark.

A trademark license may include the right to sub-license. However, careful consideration should be given to the scope of any allowed sub-license—for example, whether the right is limited to granting only non-exclusive, non-assignable and non-transferable sub-licenses for limited purposes. Consideration should also be given to whether the trademark license should cover use of the trademark in any internet domain name.

In a distribution agreement or separate trademark license agreement, it is often prudent to include provisions such as the following:

- The distributor may use the trademark only as authorized and only to the extent necessary to perform the terms of the agreement.
- The distributor does not have and obtains no rights regarding the trademark by engaging in distribution activities.
- All goodwill associated with the trademark belongs exclusively to the foreign trademark holder.
- The distributor is not to use the trademark in conjunction with any other trademark.
- The distributor is not to change, distort or improperly use the trademark, or to register or use any trademark similar to that of the licensor’s trademark.
- The distributor is to notify the licensor if it becomes aware of infringement or potential infringement of the trademark.

The trademark license agreement should be recorded with the TMO within three months of the date that the agreement is signed.¹⁸⁶ Recording the agreement at the TMO facilitates payments associated with the trademark license. Payments pursuant to the trademark license are of particular concern with respect to license agreements that involve foreign parties. Remitting payments outside of China requires a TMO “record” certificate confirming that the trademark license has been recorded at the TMO. If the trademark license agreement has not been recorded with the TMO, problems may arise when making such payments. SAFE will normally request a copy of the notice the licensor was issued by the TMO showing that the trademark license has been recorded before it will approve remittance of a license fee to a foreign licensor.

According to the regulations on recording a trademark license in China, an application to record a trademark license will not be approved if the license term of the trademark is longer than the trademark’s period of

¹⁸⁶ Zhonghua Renmin Gonghe Guo Shangbiao Fa Shishi Tiaoli (中华人民共和国商标法实施条例) [Detailed Implementing Rules of the Trademark Law of the People’s Republic of China] (promulgated by the State Council, Aug. 3, 2002, effective Sep. 15, 2002) art. 43.

validity.¹⁸⁷ Further, the regulations provide that the following provisions are required to be included in a trademark license agreement:

- Information on the trademarks under license, including the marks, registration number, and the specific goods or services that are the subject of the grant of the license
- That the licensor has the right to supervise the quality of the products of the licensee that use the trademarks, and the licensee ensures the quality of the products that use the trademarks
- That the licensee indicates its own company name and the place of origin of such products on the products that use the trademarks
- That the licensee does not change any word or device of the trademarks or the combination thereof without permission, and does not use the trademarks beyond the scope of the approved products.¹⁸⁸

Trade Secrets

The AUCL protects against infringement of trade secrets.¹⁸⁹ When drafting distribution, franchise or other arrangements (*e.g.*, trademark licenses) that include the grant of an exclusive right to use trade secrets, consideration should be given as to whether the licensee/distributor should be able to act unilaterally when enforcing infringement of trade secrets in the Chinese courts.

If a distributor is granted a license to use trade secrets on an exclusive basis—for example, as part of a master franchise or distribution agreement—the owner/licensor of the trade secrets may want to limit the power of the exclusive distributor/master franchisee to unilaterally take legal action for unlawful disclosure of a trade secret.

In 2007, the Supreme People's Court issued an interpretation stating that if a distributor/franchisee has an exclusive license to use a trade secret, such distributor/franchisee may, without the intervention or knowledge of the owner of the trade secret, unilaterally bring an action for infringement of the trade secret.¹⁹⁰ In practice however, a licensor/owner of a trade secret typically will want to be notified of the infringement of its trade secret before any court action is taken, and may also want to restrict the exclusive distributor/franchisee to only bring legal proceedings with the consent of, or jointly with, the owner of the trade secret. This typically happens because the licensor/owner wants to ensure that its rights and interests are taken into account in any legal proceedings (or settlement thereof) for infringement of the trade secret.

¹⁸⁷ Shangbiao Shiyong Xuke Hetong Beian Banfa (商标使用许可合同备案办法) [Measures for Record-Filing of Trademark License Contract] (promulgated by the State Administration for Industry and Commerce, Aug. 1, 1997, effective Aug. 1, 1997) art. 11.

¹⁸⁸ Trademark Law, *supra* note 139, at art. 40.

¹⁸⁹ AUCL, *supra* note 89, at art. 10.

¹⁹⁰ Zuigao Renmin Fayuan Guanyu Shenli Buzhengdangjingzheng Minshi Anjian Yingyong Falü Ruogan Wenti de Jieshi (最高人民法院关于审理不正当竞争民事案件应用法律若干问题的解释) [Interpretation of the Supreme People's Court on Certain Issues Concerning the Application of Law in the Trial of Civil Cases Involving Unfair Competition] (promulgated by the Supreme People's Court, Jan. 12, 2007, effective Feb. 1, 2007) art. 15.

EMPLOYMENT LAW

China's labor laws must be taken into account not only when drafting a distribution contract, but also when considering an appropriate distribution business model. In some sectors, foreign entities distributing products in China have used what is often called an "indirect labor" or "dispatch" model. Under this model, the foreign company hires a human resources company, which in turn hires the sales people to meet the foreign company's distribution needs by placing these indirect hires in (typically larger) retail outlets, such as supermarkets and hypermarkets. Using an outside human resources company has worked well for companies with limited experience dealing with Chinese employees or Chinese labor laws.

Proposed changes in China's Labor Contract Law¹⁹¹, however, may change the way in which foreign entities structure their employment needs. The "indirect labor" or "dispatch" model may no longer be feasible if proposed changes to the labor dispatch rules are introduced. Key changes proposed in the employment relationship include the following:

- A "dispatched" employee would be prohibited from having a contract that exceeded a six-month term.
- An entity would only be allowed to hire dispatched employees in non-key-operation positions.
- Dispatched employees could only be hired when permanent employees were in training or on leave.¹⁹²

New business models will likely be needed to adapt to these changes. One possibility is for the individual providing services to both the distributor (or retailer) and the supplier to enter into an employment contract with the distributor rather than the supplier. This would be coupled with an agreement between the distributor and supplier that the distributor would provide specified services to the supplier through its contracted employees. Such an approach requires careful assessment and could create new exposure to liability.

Whatever legal relationships are available to be used when the services of individuals are required, entities should recall that Chinese law in many areas focuses on substance over form. Chinese courts have been known to take the approach that the beneficiary of services (provided by an employee of a distributor) may be liable if issues arise in respect of the employment relationship between the distributor and its employee, particularly if there is no written employment contract between the distributor and the employee. While there is no guarantee a court or regulatory agency will follow any provision in a distribution agreement concerning the legal relationship between, for example, the employee of a distributor and the recipient of services provided by the employee (such as a supplier or downstream retailer), the inclusion of an appropriate clause in the distribution agreement can give a court or regulator greater clarity on the intention of the distributor, supplier or retailer with regard to such employee.

¹⁹¹ Laodong Hetong Fa Xiuzhenan (Caoan) Taiowen (劳动合同法修正案 (草案) 条文) [Labor Contract Law Draft Amendments].

¹⁹² Labor Contract Law Draft Amendments, *supra* note 237.

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