Trend in China: Taking Control of Distribution

~ Maarten Roos

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

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

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

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

1. Building Self-Owned Distribution Channels

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

If you own or have a significant stake in such a business, know that it is no longer difficult to establish a WFOE in trading or retail. Procedures are inevitably more complicated than in "lighter" jurisdictions such as Hong Kong, but plenty of good lawyers can help you navigate China's bureaucracy. Not only have minimum investment requirements been all but abolished, but companies now have greater freedom to determine their own corporate governance structures. The new People's Republic of China Foreign Investment Law, which is in draft and may be promulgated later this year, is another step that will make it easier for international businesses to set up shop in China.

If you have established a subsidiary in one location, you can now do business all over the country. If it makes sense commercially, your business can open subsidiaries, branches, or liaison offices to have people on the ground in other cities (e.g., to conduct sales or support local customers). And you can engage local partners to provide support in building and maintaining relationships with special customers, such as government departments. But from a legal perspective, you can organize and financially consolidate all trade into one Chinese entity.

2. Terminating Existing Distribution Contracts

One legal challenge that your company may face is the termination of relationships with existing distributors. Sometimes this is easy: if the distribution agreement was properly drafted, termination clauses should provide clear and unabridged guidance on how to manage termination, and at what cost.

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

International businesses may face tougher resistance if their distribution agreements are exclusive and include no termination clause, while their Chinese counterparts refuse to deal. In such cases, businesses must choose between breaching the exclusivity term and building a parallel structure or terminating the distribution agreement without cause and risking claims for damages. However, you can mitigate the risk of damage claims where the distribution agreements contain certain exceptions. Remember that filing claims in Chinese courts can be a difficult and cumbersome process for your opponents, acting as a natural barrier to all but the strongest of legal claims.

3. Ownership of Trademarks/Intellectual Property

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

- China's system for protection of trademarks is modeled on international standards, so trademarks must be registered in China (either directly or through the international Madrid system) to be protected in China. By applying the first-to-file rule, China does not offer protection to international trademark owners late in registering their trademarks. Trademark squatting by business partners (including distributors) and third parties is common.
- In a distributor relationship, international businesses often discover too late that their Chinese distributor has registered brand names—if not the international company name and brand names for product lines, then at least the Chinese equivalents thereof. This can cause a major dispute. If a Chinese distributor has registered such brand names in bad faith, the international owner may have the legal grounds to challenge the trademark registration of a distributor, but this will take time, with no guarantee of success. Meanwhile, the distributor continues to hold the trademark rights and can threaten legal action if the international brand owner tries to enter China directly.

If you own an international brand and have not (yet) contemplated a change to your business model, review whether you own exclusive trademark rights in China; and if you do not, develop a strategy to either obtain such rights (whether through legal action or friendly acquisition) or build new brand names that you control. Even though China may have a less-than-perfect reputation for legal protection of intellectual property rights, it is not advisable to roll out a distribution strategy while your company is under constant threat of seizures and lawsuits.

4. Managing Product Registrations

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

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

Hot Topic in China: Compliance for Foreign Businesses

~ Robin Tabbers & Maarten Roos

Until recently, many Western managers accepted the need for flexibility on legal issues to thrive in the complex Chinese legal environment. Practices to strengthen relationships, such as luxurious dinners and karaoke evenings, sponsored travel, and red-pocket money, have often been part of the local culture: the best—and sometimes the only—way to do things, just as paying out part of salaries and bonuses against fapiao (legal invoices) to reduce the burden of individual income tax (IIT) was seen as a good way to stay financially competitive.

But reality has set in. On the one hand, China is sending a clear message that noncompliance will not be tolerated, as, for example, with the GlaxoSmithKline (GSK) scandal (CNY 3 billion in bribes), with Chinese officials at every level (tigers and flies) under arrest, with an active Public Security Bureau seeking to expel foreigners who do not have the right papers, with dawn raids by tax officers and the labor department, and with an increase in customs checks. Foreign governments, such as those of the United Kingdom (UK Bribery Act), the United States (Foreign Corrupt Practices Act), and Canada (Corruption of Foreign Public Officials Act), are increasingly pursuing and penalizing corrupt practices of their foreign subsidiaries, including those in China. We are even seeing managers of Chinese subsidiaries being expelled to appear in investigative hearings in their home countries.

Are foreign companies being singled out in China? This is the general impression. And in specific industries, it is becoming next to impossible for foreign businesses to remain competitive. In practice, though, it has seemed that foreign-invested companies (and their foreign managers) have always had a tougher time staying under the radar. Large companies such as GSK are juicy targets for setting an example, and many international businesses are sensitive to bad press. The Chinese government's current anti-corruption campaign is targeting Chinese officialdom. There are those who are already drawing conclusions about the lasting impact of this campaign on the business environment, which in the long run should benefit Chinese and foreign businesses.

For international companies, the lessons are clear: whether you are a large multinational or a small- to medium-sized business, you must pursue a high level of compliance to operate successfully in China. If you own or operate a business in China, here are issues you should watch out for:

Employment Taxes

Many companies traditionally sought to save on the cost of IIT and social insurance contributions by paying parts of their salaries (and bonuses!) as reimbursements against valid legal invoices (fapiao). However, an employee complaint to the Labor Department or local tax officer may trigger an inspection, which could trigger back payments, late fees, and fines. If the amounts of evaded taxes are large enough, these practices could even lead to criminal liability (though this is not common).

Corporate Taxes

Recently, a local district tax office in Shanghai pursued companies for failure to pay withholding taxes on intercompany expenses booked in the previous year. Tax offices are improving their systems, and many are becoming more assertive at initiating inspections and monitoring compliance. Campaigns focusing on certain kinds of activities (such as affiliated party transactions, in 2014) are causing havoc to companies that do not play strictly by the rules.

Tax Evasion and Bribery (Commercial and Official)

Some companies receive income off the books and then use some of these funds to pay illegal commissions (kickbacks) to promote sales, win projects, or obtain licenses. If this is even an occasional practice in your company, know that not only does this expose your company and managers to liability for accounting fraud and tax evasion, but it can also result in administrative, civil, and criminal liabilities for commercial or official bribery under the People's Republic of China laws. Even in industries where such practices are common, foreign businesses may be the first to get caught—with life-altering consequences for the business and its managers.

Business Scope Restrictions

China continues to restrict foreign investment in certain sectors, or it subjects businesses to special licenses that are difficult to obtain. Examples in the service industry are recruitment (joint ventures only, unless the investor is CEPA (Closer Economic Partnership Arrangement)-

qualified), labor dispatch (licenses difficult to obtain), legal services (closed to foreign investment), accounting and auditing (joint ventures only), and certain forms of education (subject to restrictions or licensing). Many foreign investors avoid such restrictions by establishing a Wholly Foreign-Owned Enterprise. But doing so leaves your business exposed and could lead to fines and even revocation of your business license. As part of a long-term strategy, as a foreign investor, also consider alternatives, such as trying to obtain the required licenses, relocating to a pilot area that allows this type of business (e.g., the Shanghai Free Trade Zone), using a variable interest entity structure, or entering into a joint venture with a local partner.

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