

## Entering the China Market: Top 10 Legal Issues

By: Fang Shen

With more than 30 years' rapid growth, China has become an enormous market that many American companies simply cannot afford to overlook. In particular, there seems to be a growing trend of exports, joint ventures and purchasing from China by companies in the Midwest. Here are the 10 most important legal issues in these transactions.

### Issue 1: Form of Presence

To determine the most suitable arrangement in entering China, a U.S. company should evaluate the following questions:

- What is the most effective way to enter the Chinese market?
- Is the structure allowed by local law?
- What costs and resources are required
- What potential liabilities exist?

Clients frequently ask "Can I hire a salesperson in China?" In China, all activities by foreign companies must squarely come within the scope that is permitted by local law regulating foreign companies. Without registering a legal presence in China, a foreign company is not allowed to hire an employee in China. The common arrangements used to enter the China market include: contractual arrangements (such as a distributorship), a Representative Office, a Joint Venture with a Chinese company or a Wholly Foreign-Owned Enterprise. Under some circumstances, a U.S. company is required to set up an entity in China to accomplish certain goals, although Chinese law is not clear on when activities of foreign companies necessitate the set-up of a Chinese entity. The general view among practitioners is if a U.S. company will have employees, have a physical presence, or open a bank account in China, the company is required to set up an entity or a Representative Office.

The following table summarizes the key features of the above modes of entry:

Form of Market Entry	Is it an entity separate from the U.S. company?	Does it have the protection of limited liability?	Is governmental approval required to set up?	Is there limitation on the scope of business?
Contractual arrangement	The Chinese company is separate from the U.S. company and the parties' rights and obligations are governed by the contract.	Yes. Ordinarily the U.S. company will not be responsible for the Chinese company's debt and liabilities.	No.	The Chinese company can conduct any business within its business scope.
RO	RO is an office of the parent company, not a separate legal entity.	No.	Yes, but is somewhat easier.	Not allowed to directly engage in operational activities, and may only engage in non-profit-making activities such as market research and liaison activities.
WFOE	Yes.	Yes.	Yes.	Within the business scope approved by the authority.

JV	Yes.	Yes.	Yes.	Within the business scope approved by the authority.
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## Issue 2: Registration, Certification and Licensing Requirements

Many products must be registered, certified or licensed by the relevant Chinese authority before they can be sold in China. Products concerning human health and safety, or products which are deemed potentially hazardous to humans, animals or the environment usually have certification or registration requirements. Businesses should check the regulations of the State Administration of Quality Supervision, Inspection and Quarantine, the Certification and Accreditation Administration and the relevant industry authority (such as the Ministry of Health when manufacturing medical equipment) to confirm if such a requirement applies to a specific product.

## Issue 3: Business Scope

In China, each company has a specific scope of business that is set forth in the company's business registration documents. This is the scope of activities that the company is legally allowed to engage in. There are two contexts in which this issue could come into play for a U.S. company. First, when setting up an entity in China, its business scope must be carefully drafted to ensure future operations will not be deemed outside the business scope. However, the description still needs to be specific because the Chinese authorities will not approve a business scope that is too broad. Second, if planning to use a distributor, verify the distributor's business scope to ensure it is authorized to import goods and distribute the products intended for sale in China.

## Issue 4: Intellectual Property Protection

China's written law offers comprehensive protection of IP rights, however, there is widespread violation and ineffective enforcement of the law. The key is to create and implement a practical and effective action plan. Three seemingly obvious, but often overlooked, action items include:

1. Evaluating what intellectual property is important to the company;
2. Registering company patents and trademarks in China;
3. Registering both the English and Chinese versions of trademarks.

More importantly, a company should take precautionary measures within its organization and that of its Chinese business partner: restrict access to sensitive information and develop protocols to protect it from unintended disclosure or misappropriation; utilize confidential agreements when appropriate; and properly train employees. Creating a comprehensive and meaningful process to protect intellectual property at the outset is critical.

## Issue 5: Foreign Exchange Regulations

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

## Issue 6: Local Tax and Import Duties

Depending on the structure of the transaction, a U.S. company may incur tax liability under Chinese law. The company may be subject to China's enterprise income tax for certain China-sourced income such as interest, royalties, capital gains, etc. In addition, revenue generated from a licensing arrangement is subject to a business

tax in China. Income tax paid in China would be eligible for the foreign tax credit provided under U.S. tax law, but business tax may not be similarly eligible.

In addition, import duty and value-added tax (usually 17 percent) will apply to all imported goods. Although these taxes are often the importer's responsibility, they can significantly impact the deal economics and the parties' cash flow or profits. Therefore, it is important for a U.S. company to understand these issues beforehand.

### **Issue 7: "Owning" Real Estate in China**

How does a foreign company occupy land and buildings in China, where the state and local collectives own all land? Private parties have the right to ownership of all property except land. To enable private parties to use and develop land, since the 1980s Chinese law has granted land use rights that usually last for 50 years for commercial and industrial uses, and up to 70 years for residential purposes. The Property Law of the People's Republic of China, also known as the New Property Law, which became effective October 1, 2007, addresses the renewals of land use rights as follows:

- For residential property, land use rights will automatically renew at the end of its term. The New Property Law is intentionally silent on the term of that extension and whether a fee will be required. Many believe local and regional governments will have the power to require additional payments.
- For non-residential property, the New Property Law leaves it to future laws and regulations that are effective at the time of expiration of such right. With regard to the houses built on the land and other real property related, if there is an agreement, the relevant agreement shall be abided by. Or, if there is no such agreement, the regulations then in effect shall be followed. There is the promise that terms of renewal will be developed and enacted prior to the expiration of the current term, which may be more than 20 to 30 years away. Many believe the new term of renewal may not be an additional 40 or 50 years, but possibly much shorter, and subject to careful reevaluation by the government.

### **Issue 8: Labor Law Compliance**

China's Labor Contract Law requires that an employer enter into a written employment contract with all employees, and significant penalties can be levied against employers that fail to do so. The familiar "at will" employment concept has no place under the Chinese Labor Contract Law. The law only allows three types of contracts: fixed term, open-ended and project-based. An open-ended contract has no termination date and the employer can only terminate the employee under the specific grounds enumerated in the law. A fixed-term contract has an agreed-upon termination date, but an employee retained after two fixed-term contracts have expired is deemed to have an open-ended contract. The law also requires a mandatory open-ended term contract in certain situations where the employee has worked for the employer for more than 10 years. A project-based contract's term is based on the project's length.

### **Issue 9: Dispute Resolution**

When a business arrangement involves two parties in two countries, the inevitable question is: how to best resolve a dispute? A U.S. company may think having the Chinese party submit to exclusive jurisdiction in a U.S. court is the ideal solution. The problem with this is that no treaty exists between the two countries to enforce foreign judgments. Even if the U.S. party wins a case in a U.S. court, they will still have to enforce the judgment in China, unless the Chinese party has substantial assets in the U.S. A Chinese court is not obligated to enforce such judgment.

An arbitration clause is a more effective means to provide certainty to the dispute resolution process. The U.S. and China are both parties to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York" Convention), which provides for an effective means to enforce arbitral awards. However, the clause needs to be properly drafted to be enforceable in both the U.S. and China. Careful thought should also be given to the arbitral institution and rules, location, language and governing law of the arbitration.

## **Issue 10: Local Formalities**

It is so easy to overlook local formalities, which may seem to carry no major significance, but if not followed, may delay or derail a business deal at the last minute. Here are a few examples:

- Contracts are required to be signed by the legal representative (a position registered with the government authority in China) of a Chinese company and to bear the company's seal to be legally effective.
- When submitting official applications to the Chinese government, the documents have to be signed in a precise color of ink and printed on a precise size of paper.

To avoid surprises, check with the local agencies about these details before finalizing any application.

For many reasons, China is an attractive market for companies seeking to expand their distribution networks. However, as with any new venture, careful planning and preparation are required to launch a successful expansion strategy.

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