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LEGAL BRIEFING

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RECENT NEWS

Brand new office for R&P Shanghai

To support the firm's expansion, R&P Shanghai has moved to brand-new, premium premises at Central Towers, connected to the Renaissance Hotel:

17/F Central Towers Tower A,
555 Langao Road, Shanghai

Mr. Koen Naber Joins R&P in Beijing

Koen spent many years working for Baker & McKenzie, in Amsterdam and then in Beijing. From R&P's Beijing office, he will be assisting international clients with business interests in China, representing them in negotiations with Chinese business partners and advising them on investments, contracts, restructurings, tax and dispute resolution. Koen has a special focus on China's retail market, supporting international brands and shopping malls on every aspect of their operations in China, including company formation, governmental licenses, lease agreements, employment contracts and brand protection.

R&P Hosts Annual General Meeting of Ally Law in Shanghai

On 11-14 May, R&P Shanghai hosted the Annual General Meeting of the International Alliance of Law Firms (Ally Law). Ranked by Chambers and Partners as a leading global network, Ally Law was established in 1990 and has 58 member firms in 38 countries across the United States, Europe and Asia, giving its members and their clients a unique global reach. R&P is the exclusive member for Mainland China, and took this opportunity to showcase China to the 80 delegates that attended the business meetings and social events.

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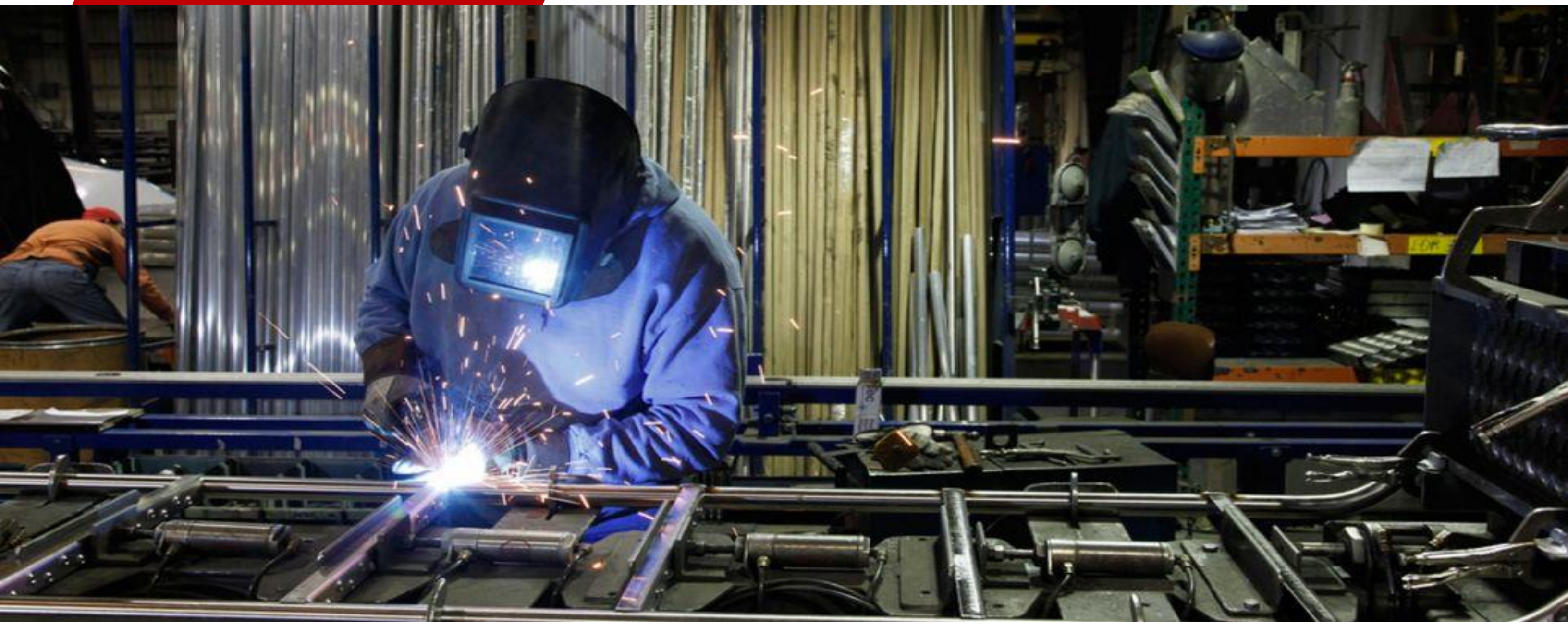

Manufacturing & Sourcing: in China for China

By Maarten Roos & Robin Tabbers

Many international companies are considering options to organize their sales into the Chinese market of China-sourced product, for example by establishing their own manufacturing or trading entity in China.

Companies have long sourced a broad range of products from China. In recent years, increasing wages in China have made Bangladesh, Vietnam, Mexico and even countries in Eastern Europe more attractive for sourcing low-cost goods, with the new phenomenon "re-shoring" gaining some popularity as well. Nonetheless, the availability of global supply chains combined with high skills, good logistics and the abundance of workers (even if no longer the cheapest) will ensure that China remains the **primary destination for global sourcing managers** for many years to come.

A new trend, however, is changing the way sourcing is being organized from a legal-structure perspective. China is becoming a major market for many of the goods that were once manufactured for export only. Western-branded products in particular are discovering a huge market in China, both for industrial and for consumer goods. Since most "international" products are actually made in Chinese factories, the question is often asked: what legal structures are available for an international company to source manufactured products in China, and then sell these in the Chinese market?

<u>Manufacturing in China for China</u>

Some international companies engage in manufacturing directly. If they already have a Chinese manufacturing entity, then they can use this entity to sell directly to Chinese customers – while also exporting goods to other countries.

Some international manufacturers that have not yet relocated manufacturing to China are now doing so. The growing Chinese market is driving decisions by international businesses to establish new manufacturing operations in China, so that they can ensure the quality- and price-advantages that are required to lead in a competitive market.

Larger companies may establish different manufacturing facilities for a better geographical reach, but from a legal perspective this is not strictly necessary: a manufacturing company in (say) Shenzhen is free to sell goods to customers all over China. Businesses that need sales staff or customer service representatives in other cities can establish branches or even hire them directly.

Sourcing in China for China

Other international companies rely on third-party factories or trading companies in China to manufacture their products. For international markets, they may choose to use an offshore trading company (e.g. in Hong Kong) to source goods from China and then sell them on to international affiliates or directly to customers all over the world.

For goods to be sold in China, on the other hand, these companies generally have the following options:

Option A: Export / Re-import

The offshore company can directly source product from China, and then re-sell these to Chinese customers or distributors. While simple and bypassing the need for a local Chinese entity, this structure is expensive: goods must first be exported and then re-imported, resulting in both logistics costs, additional VAT, and (in many cases) customs duties. These costs weigh heavily on margins that are generally very competitive in the Chinese market – especially in sectors where competing (local and international) goods are in abundance.

Option B: Domestic Trading Agent

A third-party Chinese trading company / agent may also be used to purchase from the Chinese factory, sell the goods to the Chinese customer, and after deducting costs and commissions remit the margin abroad. The commission will hurt margins, but this could still weigh positively against the cost of running an independent subsidiary. On the other hand, this structure brings a number of challenges that are difficult to overcome, such as:

- (i) to find a very reliable domestic agent (since they will be holding your money),
- (ii) to ensure financing (the agent will not want to take financing risk),
- (iii) to smoothly coordinate suppliers and customers, and
- (iv) to find a (-cost-) efficient means for repatriation of the margin.

Option C: Domestic Distributor

Some companies rely on one or more distributors to purchase and then sell the goods to Chinese customers independently, for example subject to a licensing fee to the international brand owner. While convenient, this comes with several risks, including:

- (i) your distributor will acquire intimate knowledge of your products and may compete or infringe on your IP,
- (ii) you would be completely dependent on your distributor

which makes entering the market yourself or appointing another distributor in the future more challenging,

(iii) your distributor may make promises to customer that cannot be fulfilled, hurting your reputation in the market, and

(iv) your distributor may not tolerate your involvement with marketing activities in China, which again means dependence without the guarantee that this will also lead to a lot of business.

Option D: Wholly-owned Subsidiary

The most direct approach is to establish a wholly-owned trading subsidiary in China. Such an entity can purchase goods from Chinese suppliers and then sell to Chinese customers – leaving the margin as profit to be repatriated (via dividends or service fees). Establishing a wholly-owned subsidiary is no longer very complicated and maintenance can be easily outsourced to a dependable law firm or corporate service provider; the main issues are the time to establish and get the company operational (usually 3-6 months), and the cost of establishment and maintenance.

Comparing these main options, importing the goods from and then re-exporting the goods to China (Option A) is often only for a one-time deal. In contrast, using an agent (Option B) can be quick and is particularly common in situations where sales are uncertain or expected to be sporadic, or if volumes are too small to warrant the cost of setting up in China. Using a distributor (Option C) may be suitable for companies that are not (yet) interested in the Chinese market, or simply for not want to allocate the resources at this moment. For companies authorizing a distributor to take charge, the key is to retain sufficient legal leverage to take back control China becomes a key focus in the future.

<u>Benefits to Establishing a Wholly-Owned Subsidiary</u>

An increasing number of companies are deciding to directly establish a subsidiary, which in the long run will offer many international companies the most value, with the following considerations:

- It is much easier than before to establish a wholly-owned subsidiary in China. Requirements on minimum capitalization have recently been abolished, while the few (licensing) restrictions left in place apply mainly to sensitive industries. Zones such as the Shanghai Pilot Free Trade Zone have adopted policies to become particular attractive to investors who prefer a lean organization. With costs and risks transparent, it has become easy for an international business to weight the benefits and drawbacks of a subsidiary as part of their China-strategy;

- Despite recent concerns over growth, China is already the second largest economy in the world, and its domestic market is continuing to develop very quickly. But there is also a lot of competition. An important consequence is that investment – in a stable structure as well as in marketing – is becoming increasingly worthwhile and is likely the only way get sufficient traction with Chinese customers in the long run;

- Through a Chinese subsidiary, the foreign investor can directly hire employees in China, for example to engage in local sales, marketing (incl. online) and customer service, quality control, logistics etc. In many industries it is crucial to have local Chinese-speaking staff on the ground; using agents and third parties to hire own staff is far from ideal and often comes at a cost;

- A subsidiary in China is multi-purpose. It not only allows for the purchase and sale of goods, but also can engage in other activities. For example, goods can be warehoused before they are sold on, and goods purchased for export can be sold directly to international customers rather than via affiliates. Some companies may also be interested to import certain international products and spare parts for sale in China. These are all activities that a simple Chinese trading entity can engage in.

Conclusions

For companies from North America and Europe that operate internationally, it is no longer a question of whether to engage in China, but how. Some continue to rely on China mainly as a source of products, preferring to target other markets. Many others have turned to China as the next big market, and are looking for ways to reach Chinese customers.

Serving Chinese customers is never easy. Products may have to be adapted to Chinese tastes, and competition in the Chinese market can be grueling. On the other hand, the products of Western brands and Western quality can usually be sold at a premium, even if they are made in China. The Chinese domestic market is so big and continues to grow so fast that it is difficult for most companies to ignore its potential.

International companies that do wish to target the Chinese market need to consider the optimal structure. If the goods were produced in China to begin with, then the most popular long-term solution is to establish a wholly-owned subsidiary to trade between Chinese suppliers and customers.

Enforcing Intellectual Property Rights in China

By Robin Tabbers & Michael Wilder

In recent years, China has continued its commitment to improving the protection of intellectual property, while filings for IP registrations have exploded. For example, the National Intellectual Property Strategy was designed to improve China's ability to protect and administer IP. Yet despite these advancements challenges still exist for foreign businesses with commercial activities in China.

Establishing Your IP Rights

Intellectual property falls under a few broad categories, and we will touch on each one briefly:

a. **Trademarks** (™): Trademarks must be registered to enjoy protection and are relevant to the widest range of businesses, and are simply a distinctive mark or brand that companies use to identify that the product or services with which the mark appears is from a unique source.

b. **Patents**: China recognizes three types of patents for 1) industrial designs; 2) utility models; 3) inventions. While industrial design patents protect the form of an object, utility and invention patents are for protecting unique technical solutions. All patents must be registered to enjoy protection.

c. **Copyright**: Copyright can be thought of as a "natural right" that is automatically born when an original work of literature, art or science is created. Commonly known for following books, photos, paintings, audio/video recordings, etc., increasingly copyrights are recognized for the design of utilitarian goods. While registration is not required, it is possible and its registration in China could lower the burden of evidence in lawsuits.

d. **Domain Names**: China has the largest number of internet users in the world and a rapidly increasing amount of commerce is being conducted online. Domain names ending in [.cn] and domain names in Chinese language should be a part of any foreign company's IP protection strategy here.

e. **Trade Secrets**: Chinese law includes both criminal and civil liability for the infringement of trade secrets. As one might expect, trade secrets cannot be registered, however companies can still claim technical or business information as long as certain conditions are met.

<u>Locate Infringers</u>

Finding out who or which company is infringing on your IP is a tricky business, as all too often by the time a case is discovered the damage to brand reputation or public image has already been done. Companies in China should be actively monitoring online, digital and physical infringement. While it can be challenging to obtain a full view on the scope of infringements let alone collect sufficient evidence to take legal action, one way to do so is to instruct one employ or retain a law firm with an IP department to monitor online infringements regularly, while you should consider hiring an investigation firm to find out more details about counterfeit traders and manufacturers.

<u>IP Enforcement Options</u>

a. **Cease and Desist Letters:** Many IP owners prefer first to make an attempt to pressure the infringer to stop or negotiate a deal. Usually this involves a lawyer sending a cease and desist letter which is often called a "Lawyer's Letter" in China. The effectiveness of these letters is varied and depends on circumstances of each case.

b. **Administrative Action:** China has many administrative departments and which one has jurisdiction depends on the kind of IP right involved. For trademarks, the State Administration for Industry and Commerce (SAIC); for patents, the State Intellectual Property Office (SIPO); for copyrights, it's the National Copyright Administration (NCAC). If the infringement is on products imported or exported, the General Administration for Customs (GAC) should be engaged.

c. **Civil Lawsuits:** When administrative action is not enough, companies can go one step further and begin civil litigation. The main advantage of this next stage is being in more control of the process and the possibility of receiving compensation. Usually this type of litigation is similar to general litigation and dispute resolution, albeit more specific and defined rules and strategies.

d. **Criminal Lawsuits:** In fact the least common could result in the best outcome; criminal enforcement of IP infringement is similar to other criminal cases. One challenge of this type of prosecution is the burden of evidence often required to convince the Public Security Bureau to investigate. Not all IP infringements qualify for criminal prosecution, while generally larger scale or high value product infringements do.

<u>Determining your Enforcement Strategy</u>

Deciding on a strategy should follow a simple pattern: for small infringers, start with a formal

Cease and Desist Letter sent by an experienced PRC law firm. Often times as soon as the small infringer sees this attention and involvement, they are more willing to comply.

For mid-sized cases of IP infringement, companies should start by engaging a law firm to visit the appropriate administrative body in China depending on the specific IP involved. Since trademarks are the most common form of IP in China, the AIC is a familiar and often involved department in such cases.

Large IP infringers deserve swift and strong legal action, to squash any dream of continuing such counterfeiting. Depending on the evidence available, the nature of the infringement, locale, etc. companies - along with their legal counsel - should decide the civil or criminal route.

Conclusions

Foreign companies with commercial or investment interests in China should always take the necessary steps to maximize their IP rights protection. This includes registering trademarks, brand logos, Chinese domain names, and patents, while making appropriate arrangement to protect their copyrights and trade secrets. If your IP is protected under Chinese law, owners have a range of options to enforce these rights including Cease and Desist Letters, administrative action, civil lawsuits and criminal prosecution.

By having a comprehensive IP protection and enforcement strategy for your business, companies can have better peace of mind when operating in China.

R&P´s PRACTICE AREAS

- Corporate/M&A
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- Intellectual Property (IP)
- Commercial & Trade
- Employment
- Compliance
- Tax, Forex and Customs
- Private Client Services

HR Compliance Matters: What You Need to Know

By Maarten Roos & Michael Wilder

With news of imminent mass layoffs in China, it is important for business managers to keep in mind the fragility of these proceedings. There are big challenges ahead for HR managers from affected industries in China. Knowledge of redundancy and restructuring options – and their consequences – is crucial.

As China transitions from an export-driven hub for cheap manufacturing to a domestic base of value-added consumerism, while at the same time experiencing a multi-year economic slowdown, companies are being forced to make difficult choices.

On February 29, Yin Weimin, the minister for human resources and social security, announced that China expects to lay off 1.8 million workers in the coal and steel industries, which employ a total of 12 million people.

Other sectors, however, are feeling the strain as well. According to the *2016 China Business Climate Survey* by the American Chamber of Commerce in Shanghai, 20% of American manufacturers presently operating in China are planning to let go of employees in 2016. Other developments in the last 12 months included Tesla announcing that it would cut nearly a third of its 600-strong workforce in China after a year of weak sales in mainland China; Yahoo cutting between 200 and 300 of its mainland staff; and Lenovo pledging to reduce 10% of its non-manufacturing workforce – roughly 3,200 people.

The Chinese government has significant influence on the process of firing workers through its numerous rules and regulations, and employees themselves are highly protected by Chinese labour laws. Therefore, the wrong approach by HR managers can lead to costly problems, such as workplace disruptions, labour disputes, and refusals from government officials to support a company in its hour of need.

Labour Contract Law of the PRC

Article 41 of the Chinese Labour Contract Law (amended 2012) details the laws around redundancy of employees for economic reasons. Employers can use this ground as long as they terminate either 10% or more of the total workforce, or at least 20 employees. In order to be eligible, the law requires employers to meet one of the following specific conditions, which are meant to protect employees:

- The company must have serious problems restricting its production or business;
- the economic circumstances on which the finalisation of a labour contract was based have undergone significant changes and, as a result thereof, the labour contract can no longer be performed;
- the company undergoes restructuring according to the requirements of the *Enterprise Bankruptcy Law* of the PRC;
- or the company undergoes a change of production, significant technological reform, or change of mode of operation and, upon variation of labour contracts, there is still a need for cost-cutting.

Qualification for Economic Redundancy

When downsizing on a large scale in China, it is important for companies to follow a strict schedule as outlined below:

1. Announce the situation to the relevant labour union, or all staff, 30 days in advance of the planned downsizing;
2. seek out the opinions of the labour union or the employees;
3. implement a schedule for enacting the redundancy;
4. communicate the redundancy schedule to government labour administrative authorities;
5. and announce the formal schedule of economic redundancy to all staff, terminate labour contracts with laid-off staff, and settle their severance payments.

The conditions of eligibility for executing an economic redundancy are very general. To minimise the risk that a redundancy programme will be challenged by individual employees in labour arbitration, it is key to obtain support in advance from the supervising labour administrative authorities at a local level. In practice, many companies start with step four (above), and get an informal green-light to proceed. Also important to note are the regional differences in the local officials' willingness to support mass layoffs; for example, Shanghai is unofficially known to be much more lenient and expeditious than Beijing.

Alternatives to Economic Redundancy

Where support is not forthcoming, an alternative approach may be considered. Companies may terminate not for economic redundancy but on other legal grounds, such as with mutual consent (subject to higher payments). The biggest practical disadvantage to economic redundancy is that employees must be notified well in advance, which means that they have more opportunities to be disruptive to the business. Therefore, some companies choose to bypass the economic redundancy altogether, and directly negotiate a termination of the employment contract with employees – as a group or individually.

In any case, companies should expect heightened emotions involved in the process of terminating 20 or more people from the payroll. Security should be prepared (physical security along with digital and cyber-related) and precautions taken well in advance of any announcement as upset employees may seize assets. A plan to approach key employees beforehand can lead to a smoother process.

What it means for HR professionals

Close coordination with staff – both the ones who will remain employed and those being terminated – will produce the smoothest-possible transition for restructuring. HR professionals should be sensitive to the following:

- When terminated, employee livelihood is under threat. Before any steps are taken, employees should be categorised by job title, salary, and time spent with the company, so that correct calculations can be made on possible costs to the termination, especially with regards to severance packages.
- The HR department is the first to employees and the last to see them on their way out. HR professionals should be prepared with the key message and important questions that need to be addressed.
- Terminations should be done swiftly and be tightly managed, in a way that aligns with the urgency of change as well as the focus of the company.
- Timing is essential in large terminations. Often, companies give notice on a Friday, late in the day or before a holiday, believing that the staff will be in good spirits, and hence, less upset with the news. This is not always true. Moreover, disruptions during the weekend are less likely and not as intrusive.

Handling the remaining workforce

Seeing a large number of colleagues suddenly disappear may well affect the morale of the employees who still have jobs. Moreover, these employees may start to doubt their own job security, fearing that the next round of terminations is just around the corner. The following are few more ideas for managing the sentiment of those left standing:

- Provide training that will fill the skills gaps left by those now gone;
- minimise the risk of burnout, so no one feels overwhelmed;
- boost morale, by proactively fielding questions and concerns;
- and set a solemn, respectful tone in the workplace immediately after the termination by not making any superfluous expenditures, such as having a party or redesigning the office.

Conclusions

Companies need to prepare for the courses of action that proceed economic redundancy and implement plans and strategies that ensure smooth transitions from both a legal and a practical standpoint.