

Legal Handbook



June 2019

I.C Contractual Options

Scan to follow us on WeChat



CONTRACTUAL OPTIONS

01

DISTRIBUTION ARRANGEMENTS

Foreign investors can enter into distribution arrangements with Chinese distributors who already have distribution networks in China. Drafting carefully your distribution agreement with your Chinese distributor is essential as there are significant and varied legal restrictions on distribution agreements in China, as compared to other countries.

EXCLUSIVE DISTRIBUTION

- WHAT IS AN EXCLUSIVE DISTRIBUTION AGREEMENT?

Exclusive distribution involves an agreement stipulating that the distributor will distribute to one distributor only. The exclusivity also relies on agreed-upon incentives that cause the supplier to concentrate its sales predominantly with one distributor.

- WHAT IS A NON-EXCLUSIVE DISTRIBUTION AGREEMENT?

If the distributor is a non-exclusive distributor, the supplier can appoint other distributor for the same products within a specific territory.

- TO WHAT EXTENT DOES THE ANTI-MONOPOLY LAW APPLY IN EXCLUSIVE DISTRIBUTION AGREEMENTS?

The Anti-Monopoly Law provides that if a supplier is dominant in the market, it cannot refuse to trade with a distributor without justification or conclude agreement fixing the price of goods; therefore, specific attention shall be paid to the exclusive agreement's drafting.

ESSENTIAL CONTRACT STIPULATIONS

- **Non-compete clause:** prevents the distributor from selling, reselling, manufacturing or purchasing products that compete with products of the supplier;
- **Territorial restrictions:** the distributor may agree to only resell the supplier's products in a specific geographic area;
- **Customer restrictions:** rather than designate 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 suppliers of a high-technology product may decide to only supply its products to one distributor for sales to corporate customers, and to reserve for itself sales to small businesses or individuals;
- **Confidentiality:** when drafting a distribution contract including the grant of an exclusive right to use trade secrets, special attention shall be given as to whether the distributor should be able to act unilaterally when enforcing infringement of trade secrets before Chinese courts;
- **Taxes:** withholding taxes will apply when payments are carried out from an onshore payer to an offshore party. The withholding taxes shall be paid

Contractual arrangements appoint Chinese partners as distributors, or trading or sourcing agents. It is an appropriate option for foreign investors who do not want to set up permanently in China, but who are still looking to manufacture, sell and distribute their products in China, while monitoring the operations from abroad. Moreover, those arrangements do not require approved/license except otherwise required by competent authorities.



by the onshore payer before the remittance. It is important to stipulate that the amount remitted to the offshore party after withholding taxes shall be equivalent to the invoiced amount;

- **Post-termination non-compete clause:** the distributor would be required not to compete with the supplier or other distributors following the termination or expiration of the distribution agreement.
- **Reserve of ownership:** reserve of ownership can be stipulated in a sales contract in China. However, the seller cannot claim for restitution if 75% or more of the price has been paid.
- **Independent contractors:** to ensure that the distributor will be responsible for its own actions, the agreement shall contain provisions indicating that the distributor is an independent contractor rather than an employee of the supplier.
- **Online/offline sale clause:** supplier may require that the distributor or e-commerce intermediaries do not sell products outside the assigned territory. With the major evolution of online sale in China, specific requirements may be stated to request to the distributor to provide more reports as to sales by territory, and some distribution systems have a specific fee or 'invasion fee' for sales out of its authorized territory.

INTELLECTUAL PROPERTY

- DOES THE FOREIGN INVESTOR NEED TO REGISTER HIS TRADEMARK BEFORE ENTERING IN A DISTRIBUTION AGREEMENT?

Generally, Distributors will require the Chinese trademark registration certificate before signing any distribution agreement with a foreign investor. In consequence, a foreign investor should register his trademark in China and wait for the issuance of the certificate before entering a distribution agreement. The duration of the procedure of Trademark registration is between **15 to 18 months** (from the date the file is accepted by the Trademark Office in China).

- WHAT ARE THE CHARACTERISTICS OF A TRADEMARK LICENSE AGREEMENT?

A trademark license agreement will grant the distributor the right to use the supplier's trademark. There are three models of trademark licensing:

- **The exclusive license:** under which a trademark owner licenses the use of the registered trademark to one licensee only, within a certain scope of use and within a certain period and the trademark owner to be prohibited under the agreement from using that registered trademark;
- **A sole license:** under which a trademark owner licenses the use of the registered trademark to one licensee only, within a certain scope of use and within a certain period and but prohibited thereunder from licensing the use of that registered trademark to others.
- **Non-exclusive license:** under which a trademark owner licenses the use of the registered trademark to others, within a certain scope of use and within a certain period and the owner to be permitted both to use that registered trademark and to license the use to others.

Moreover, a trademark license agreement may include the right to sub-license, careful attention shall be given to the scope of use. Consideration must also be given to whether the trademark license agreement also covers the use of the trademark in any internet domain name.

- HOW CAN THE DISTRIBUTOR USE THE SUPPLIER'S INTELLECTUAL PROPERTY RIGHTS?

The distribution agreement shall imply a license for the distributor to use the supplier's intellectual property rights but solely for the purpose of performance of the distributor's obligations under the distribution agreement.

However, in practice, it is advised to clarify the intellectual property rights' licensing through a separate agreement.



MANUFACTURING ARRANGEMENTS



Manufacturing agreements or **Original Equipment Manufacturer (OEM) agreements** are contracts providing for the terms and conditions of the relationship between one company, and a manufacturer which manufactures products to be distributed under the previous company's name and branding. Such relationship needs to be carefully managed with special consideration given to intellectual property issues.

INTELLECTUAL PROPERTY

- WHY SHOULD SPECIAL ATTENTION TO INTELLECTUAL PROPERTY BE GIVEN IN OEM AGREEMENTS?

Patents, trademarks, copyrights, know-how and trade secrets will be used by the manufacturing company to manufacture your products, and those intellectual property rights shall be carefully granted through license agreements. Indeed, you want to ensure that the manufacturer does not sell your products behind your back under your trademarks, nor do they copy or steal your tooling.

- WHAT SHOULD BE PROTECTED UNDER INTELLECTUAL PROPERTY CLAUSES?

Molds and tooling are essential because without them you cannot make the products immediately with another manufacturer if necessary. Protecting your ownership and intellectual property can help to avoid dramatic situations where the manufacturer uses the molds and tooling to hold you hostage. A detailed list of all of your molds and tooling shall be accounted for in the OEM in order to assert your ownership. A list of liquidated damages shall also be included in the OEM in case the molds and tooling are not returned by the manufacturer.

Registrations of trademarks, patents or copyrights can prevent the export of counterfeit goods and can prevent a competitor from registering your intellectual property. It is common that a **trademark license agreement** is signed separately from the OEM agreement.

A specific section of the OEM contract shall also be dedicated to the protection of trade secrets and know-how.

- HOW TO OBTAIN AN INJUNCTION TO MAKE THE CHINESE MANUFACTURER STOP MAKING YOUR PRODUCT?

Such **injunction** shall be only obtained from a Chinese court. If your OEM contract stipulates for the competence of an arbitration commission, you may apply to the arbitration commission for injunction, following which the arbitration commission shall, according to relevant provisions, submit such application of injunction to the competent court.

PRODUCT QUALITY CONTROL

- WHY SHOULD THE OEM AGREEMENT STIPULATE FOR AN INSPECTION CLAUSE AND WHAT SHALL THIS CLAUSE STIPULATE?

Attention should be paid to **quality control** to avoid defective products and quality issues upon delivery. Therefore, the **inspection clause** is essential, and the inspection process shall be carried out both before and after delivery. Also, the content of the inspection shall be clearly defined.

- WHAT IS THE BILL OF MATERIALS (BOM)?

The BOM is a **list of components** used in fabricating the product. It helps to prevent the manufacturer from substituting in cheaper materials. With a detailed BOM, risks of product defects and recalls are reduced.

OTHER ISSUES

- WHAT IS THE NORMAL PERIOD OF A WARRANTY CLAUSE?

The normal period for a **warranty clause** is two years from the date of shipment except otherwise stipulated under laws and regulations of the PRC, because the assumption is that the product will be sold sometime in the first year after shipment from China. The warranty clause shall stipulate its implementation, and also which party shall pay for returns.

- WHY SHOULD THE OEM CONTRACT STIPULATE FOR LIQUIDATED DAMAGES?

Liquidated damages are damages whose amount is decided between the parties during the formation of the contract. Those liquidated damages will encourage the parties to comply with terms and conditions in the contract, especially shipping terms and dates and quality requirements.



VARIABLE INTEREST ENTITIES (VIE)

The interest for VIE structures came from the **constraints imposed by the Chinese government** regarding foreign investment structures. Indeed, in some sectors, it is made mandatory by the Foreign Investment Catalogue, Negative List and sector-specific regulations, to establish a business with a Chinese partner. Moreover, many joint ventures set up in the past faced many difficulties with their Chinese partners.

Therefore, where an investment is subject to restrictions, foreign investors have used a **VIE structure to access to the Chinese market**.

The VIE structure was adopted especially in the sectors of e-commerce, direct sales, and telecommunication that require certain approvals from authorities. Well-known listed companies are using a VIE structure, such as the online media company Sina Corp., or internet companies such as Alibaba (delisted from the HKEx in 2012), Baidu, Ctrip, Youku and Tencent for examples.

In accordance with the New Foreign Investment Law promulgated on 15 March 2019, the VIE structure might be considered as a «foreign investment enterprise» and consequently shall abide by the rules promulgated under the New Foreign Investment Law.

CHARACTERISTICS

- WHAT IS THE VIE STRUCTURE?

The VIE structure is a **contractual option** where a wholly or partially foreign-owned entity enters into contracts with a Chinese company operating in PRC in the sector subject to foreign-investment restrictions or prohibitions, with the adequate business scope and licenses.

- HOW IS THE VIE STRUCTURE ORGANIZED?

The VIE structure is organized by three main elements:

- The **domestic company** with necessary licenses and adequate business scope to operate in China in the sector in which the foreign investment is restricted or prohibited;
- A **consulting WFOE** with the foreign investor as the sole shareholder;
- **Contractual elements** enabling the foreign investor to monitor the activities of the domestic company, to recover the profit made by the domestic company through the consulting WFOE, and to protect itself against any actions by which the nominee would try to get out of his purely passive role.

Examples of agreements granting effective control over the VIE: call option agreements, voting rights agreement or proxy, loan agreements.

- IS THIS STRUCTURE APPROVED BY THE AUTHORITIES?

The VIE structure is **tacitly approved by the Chinese authorities**. However, the **new Foreign Investment Law** plans to legally recognize the VIE structure, and already existing VIE structures may have to register to the MOFCOM for approval.

As that VIE structure was designed in the first place to circumvent the Chinese government restrictions on foreign investment in certain industries. The PRC Contract Law does not address the VIE structure directly, however, it clearly provides that the court may declare a contract void **“when a lawful form is used to conceal an unlawful purpose”**.

MAIN RISKS AND HOW TO LIMIT THEM

- WHAT ARE THE MAIN RISKS OF A VIE STRUCTURE?

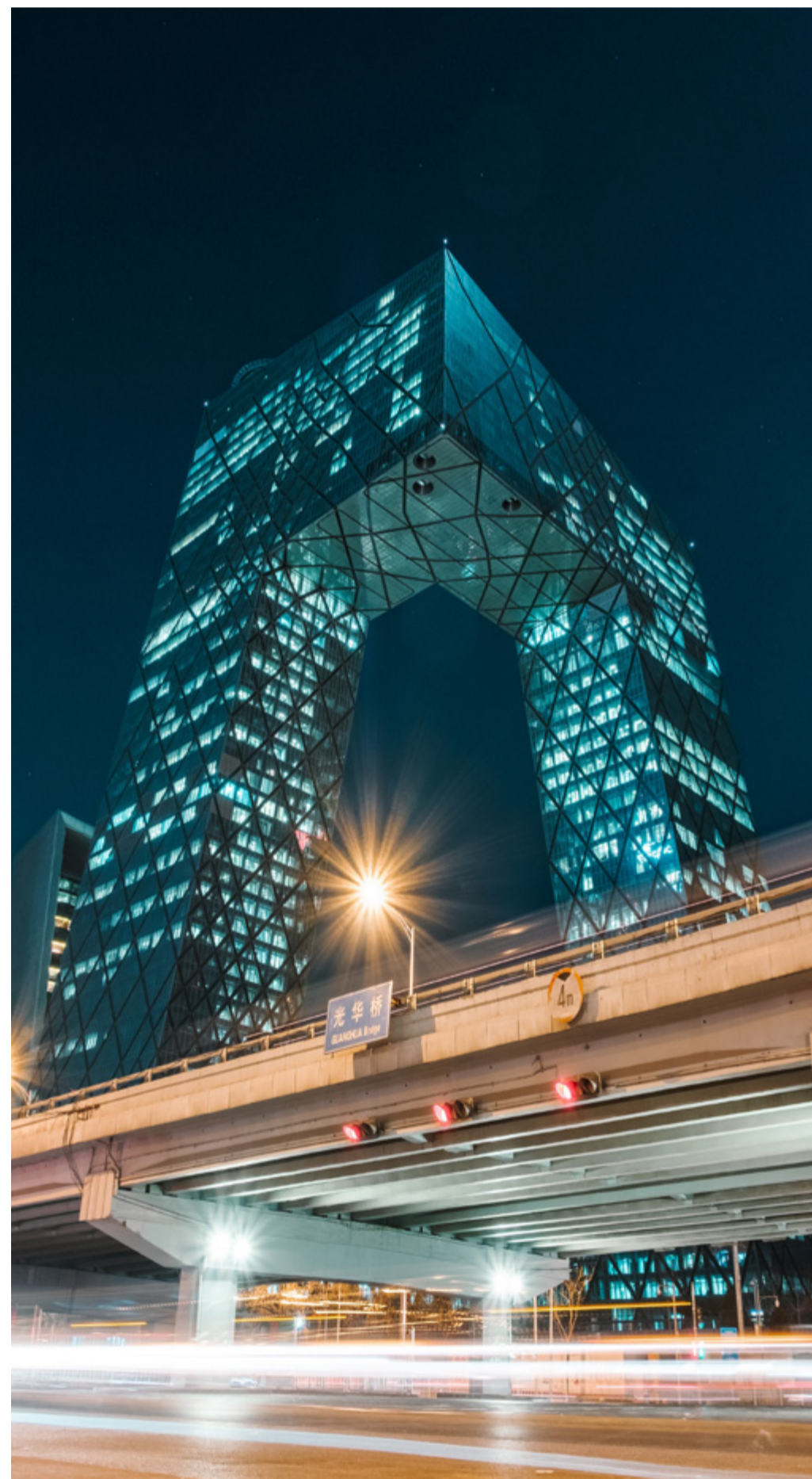
- **Breach of his obligation by the nominee:** if the Chinese owners breach any contracts, it is unclear whether the rights of the foreign investors will be protected by PRC courts or arbitral institutions since the main purpose of the contracts entered under the VIE structure is violating Chinese law

by bypassing governmental review;

- **Change of attitude by the Chinese authorities:** the VIE structure is now only tacitly approved by the authorities but may be legally recognized after promulgation of the new Foreign Investment Law. Regulations in China are requesting that the company holding the licenses shall also be the owner of the main operations assets.

- HOW TO LIMIT THOSE RISKS?

- **Keep control over the activity of the Domestic Company:** a close monitoring over the activity of the Domestic Company is essential;
- **Quality of the control documents:** the VIE contracts shall be carefully drafted.



FRANCHISE

01

The number of foreign brands entering China via franchise has continually increased since the development of commercial franchising in the early 1990s.

The latest regulations were issued in 2007, the **Regulations on Administration of Commercial Franchise** promulgated by the State Council (the “**Franchise Regulations**”), and they equally apply to foreign and domestic franchisors. The MOFCOM amended the **Measures on Record Filing of Commercial Franchises** in 2011 and the **Measures for the Administration of the Disclosure of Information Pertaining to Commercial Franchises** in 2012.

CHARACTERISTICS

Franchise is a **wide concept** in China, and many distribution agreements such as “commission/affiliation,” and agency contracts are facing the risk to fall under the category of franchising agreements.

- WHAT IS A COMMERCIAL FRANCHISE?

According to the Franchise Regulations, “commercial franchise” refers to such **business operations** by which an enterprise owning a registered trademark, corporate logo, patent, know-how or any business resource (the “**Franchisor**”) **licenses such business resources** to other business operators (the “**Franchisee**”) **by way of a contract**. The Franchisee undertakes business operations under the uniform business model as stipulated by the contract and pay franchising fees to the Franchiser.

- WHAT ARE THE REQUIREMENTS TO ENTER INTO FRANCHISE AGREEMENT?

Foreign operators can launch franchising operations in China either through cross-border franchising or by setting up a company in China.

- The Franchise Regulations state the requirement for a **minimum experience**: the foreign Franchisor needs to **own and operate two units** that can be located anywhere in the world, including in its own country, at **least one year before he enters into a franchise agreement**.

The foreign Franchisor needs to own and operate units for at least a year before it can sub-franchise to others.

- Franchising is not classified as a business in which foreign investment is restricted. However, in case of onshore presence with a foreign-invested enterprise, the **business scope** shall allow franchise activity.

- WHAT SHALL BE INCLUDED IN A FRANCHISE AGREEMENT?

Franchise agreements shall contain a cooling-off period in which the Franchisee may unilaterally terminate the agreement. The length of the cooling-off period is not prescribed by the Franchise Regulations and should be negotiated by the parties in good faith.



FRANCHISE

DISCLOSING OBLIGATION

According to the Franchise Regulations and relevant regulations, a Franchisor shall, at least 30 days before concluding a franchising agreement, provide the Franchisee with relevant information, including but not limited to the specific financial information, franchising activities, intellectual property rights, and investment budget for franchise business, financial reports and audit reports for the last 2 years, involvement in litigation for the last 5 years.

Furthermore, the Franchisor shall file the signed franchising agreements and relevant documentations with competent authority within 15 days after execution of the franchising agreement.

HOW TO SET A DEPOSIT/GUARANTEE

If the Franchisor charges a pre-contractual deposit, the purpose of this payment and conditions of refund (if the deposit is refundable) shall be provided in writing.

In practice, a Franchisee is rarely comfortable providing personal guarantee. Instead, a domestic Franchisor charges a security deposit, which may be returned to the Franchisee on the expiration of the franchise agreement if the Franchisee complied with the obligations under the agreement.

SECURING A FRANCHISING AGREEMENT AND PROTECTING YOUR BUSINESS

- WHAT ARE THE RISKS OF NOT FILING YOUR FRANCHISE AGREEMENT WITH THE CHINESE AUTHORITIES?

Any new franchise network set-up in China shall proceed to filing with the competent authority within **15 days** after the first franchise agreement is signed. The major risk is the **contractual instability**. In case of dispute, the Franchisee may report any non-compliance with the Franchise Regulations to the authority.

In several cases, Chinese courts requalified distribution agreements as franchising agreements, and rendered judgments to terminate the “distribution agreements” and require refunding of deposit/license fee to

distributors.

In addition, the franchisor may have to pay fine for the breach of the Chinese regulations.

- WHY MAY YOUR CONTRACT BE POSTPONED FOR TRADEMARK REGISTRATION ISSUES?

Trademarks of the Franchisor shall be registered in China, and the trademark certificates shall be at the franchisor's disposal. A copy of the trademark certificate is required for the filing of the trademark license contract with Chinese authorities.

The registration certificate of the trademark license contract is one required document for the filing of the franchise agreement.

- HOW CAN THE FRANCHISOR PROTECT ITS BUSINESS?

Before establishing a franchise network, the Franchisor shall insure with PRC counsel that its interests are properly protected:

- Making sure that the **business scope** complies with the Chinese regulations and includes the retail operations by means of franchising; least one year before he enters into a franchise agreement.
- Making sure that the **proper information** is provided to franchisees;
- Execute a detailed franchising agreement in accordance with **market practice**; and make sure that the contractual documentation contains the stipulations requested in accordance with **local regulations**;
- Provide standard documentation requested by malls and landlords allowing the Franchisee to open shops which do not conflict with the main contractual information.

COMPETITION ISSUES

Price fixing and **minimum resale prices** are prohibited in vertical agreements or horizontal monopoly agreements between competitors; however, the Anti-monopoly Law provides some exceptions for horizontal agreements. The practice of setting ‘recommended prices’ may attract scrutiny from the anti-monopoly authorities if the Franchisor enforces the recommendation.

Franchisors should observe the price fixing restrictions under the Anti-monopoly Law. The authorities actively enforce the law, including against certain industries such as car dealerships.

This publication is provided for your convenience and does not constitute legal advice. Please talk to your Leaf contact before acting upon the information provided. Leaf paralegals and attorneys are available to advise you on specific queries.

If you have any questions, please contact us via email: contact@leaf-legal.com or phone: (+86) 21 6233 7226. You can also find information on our website: www.leaf-legal.com.