



Legal Handbook 3.

Contractual Options

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CONTRACTUAL OPTIONS

01

DISTRIBUTION ARRANGEMENTS

Foreign investors can enter into distribution arrangements with Chinese distributors who already have distribution networks in China. Careful drafting of your distribution agreement with your Chinese distributor is essential as there are considerable and various legal restrictions on distribution agreements in China compared to other countries.

EXCLUSIVE DISTRIBUTION

- WHAT IS AN EXCLUSIVE DISTRIBUTION AGREEMENT?

Exclusive distribution involves an agreement stipulating that the supplier will distribute only through one distributor. 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 non-exclusive, the supplier can appoint other distributors 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 dominating the market, it cannot refuse to trade with a distributor without justification or to conclude agreement fixing the price of goods; therefore, specific attention shall be paid the drafting the exclusive agreement.

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 resell supplier's products only in a specific geographic area;
- **Customer restrictions:** instead of designating distributors to an exclusive territory, a supplier may request a distributor to resell its products only to a particular group of customers. For example, the suppliers of high-technology products may decide to supply their goods only to one distributor for sales to corporate customers, and to sell to small businesses or individuals on their own;
- **Confidentiality:** when drafting a distribution contract which includes granting an exclusive right to trade secrets, special attention shall be paid as to whether the distributor should be able to act unilaterally when enforcing infringement of trade secrets before Chinese courts;
- **Taxes:** withholding taxes apply when payments are carried out from an onshore payer to an offshore recipient. The withholding taxes shall be

In contracts, Chinese partners may be defined as distributors, trading agents, or sourcing agents. It is a viable 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 need to be approved/licensed, except when otherwise required by competent authorities.



paid by the onshore payer before the remittance. It is important to highlight that the amount remitted to the offshore recipient 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 after the termination or expiration of the distribution agreement.
- **Reserve of ownership:** A sales contract in China should include the provisions for the reserve of ownership. 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 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:** suppliers may require that the distributor or e-commerce intermediaries do not sell products outside of the assigned territory. With the major evolution of online sales in China, specific requirements may be stated to request the distributor to provide more reports as to sales by area, applying a special fee or so-called 'invasion fee' for sales outside 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. As a 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 application 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 this license, 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. At the same time, the trademark owner will be prohibited from using that registered trademark under the agreement;
- **A sole license:** under this license, 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. Under this license, the trademark owner is prohibited from licensing the use of that registered trademark to others.
- **Non-exclusive license:** under a non-exclusive license, 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.

When the trademark license agreement includes the right to sub-license, careful attention shall be paid to the scope of use. Consideration must be paid as to whether the trademark license agreement also covers the use of the trademark under 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 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, who is making products to be distributed under that company's name and branding. Such a relationship needs to be carefully managed with special consideration given to intellectual property issues.

INTELLECTUAL PROPERTY

- WHY DO INTELLECTUAL PROPERTY ISSUES CALL FOR SPECIAL ATTENTION 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. You will want to make sure that the manufacturers neither sell your products behind your back under your trademarks nor copy or steal your tooling.

- SHOULD BE PROTECTED UNDER INTELLECTUAL PROPERTY CLAUSES?

Molds and tooling are essential because you cannot make the products immediately with another manufacturer without them, 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 agreement in order to assert your ownership. A list of liquidated damages shall also be included in the OEM agreement in case the molds and tooling are not returned by the manufacturer.

Registrations of trademarks, patents, or copyrights can prevent the export of counterfeited goods and can preclude a competitor from registering your intellectual property. It is common for a **trademark license agreement** to be 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 an **injunction** shall be obtained only from a Chinese court. If your OEM contract refers to an arbitration commission, you may apply to the arbitration commission for injunction, after which the arbitration shall; according to relevant provisions, submit such application to the competent court.

PRODUCT QUALITY CONTROL

- WHY SHOULD THE OEM AGREEMENT PROVIDE FOR AN INSPECTION CLAUSE, AND WHAT SHALL THIS CLAUSE INCLUDE?

Close 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 the **list of components** used in manufacturing the product. It helps to prevent the manufacturer from using cheaper materials. With a detailed BOM, risks of product defects and recalls are effectively mitigated.

OTHER ISSUES

- WHAT IS THE STANDARD PERIOD OF A WARRANTY CLAUSE?

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

- WHY SHOULD THE OEM CONTRACT STIPULATE FOR LIQUIDATED DAMAGES?

Liquidated damages are damages whose amount is negotiated between the parties during the formation of the contract. Such liquidated damages encourage the parties to comply with terms and conditions in the contract, especially in relation to shipments, deadlines, and quality requirements.



VARIABLE INTEREST ENTITIES (VIE)

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

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

The VIE structure was adopted specifically in the sectors of e-commerce, direct sales, and telecommunication that require certain approvals from authorities. Well-known listed companies 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 are all using a VIE structure.

According to the New Foreign Investment Law, promulgated on March 15, 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, with adequate business scope and licenses, operating in the PRC in the sector subject to foreign-investment restrictions or prohibitions.

- HOW IS THE VIE STRUCTURE ORGANIZED?

The VIE structure includes three main elements:

- The **domestic company** with necessary licenses and adequate business scope to operate in China in the sectors in which foreign investments are 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 existing VIE structures may have to register with the MOFCOM to receive its approval.

As such, the VIE structure was designed with the primary intent to circumvent the Chinese government restrictions on foreign investment in certain industries. The PRC Contract Law does not address the VIE structure directly. At the same time, 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 WAYS TO MANAGE THEM

- WHAT ARE THE MAIN RISKS OF A VIE STRUCTURE?

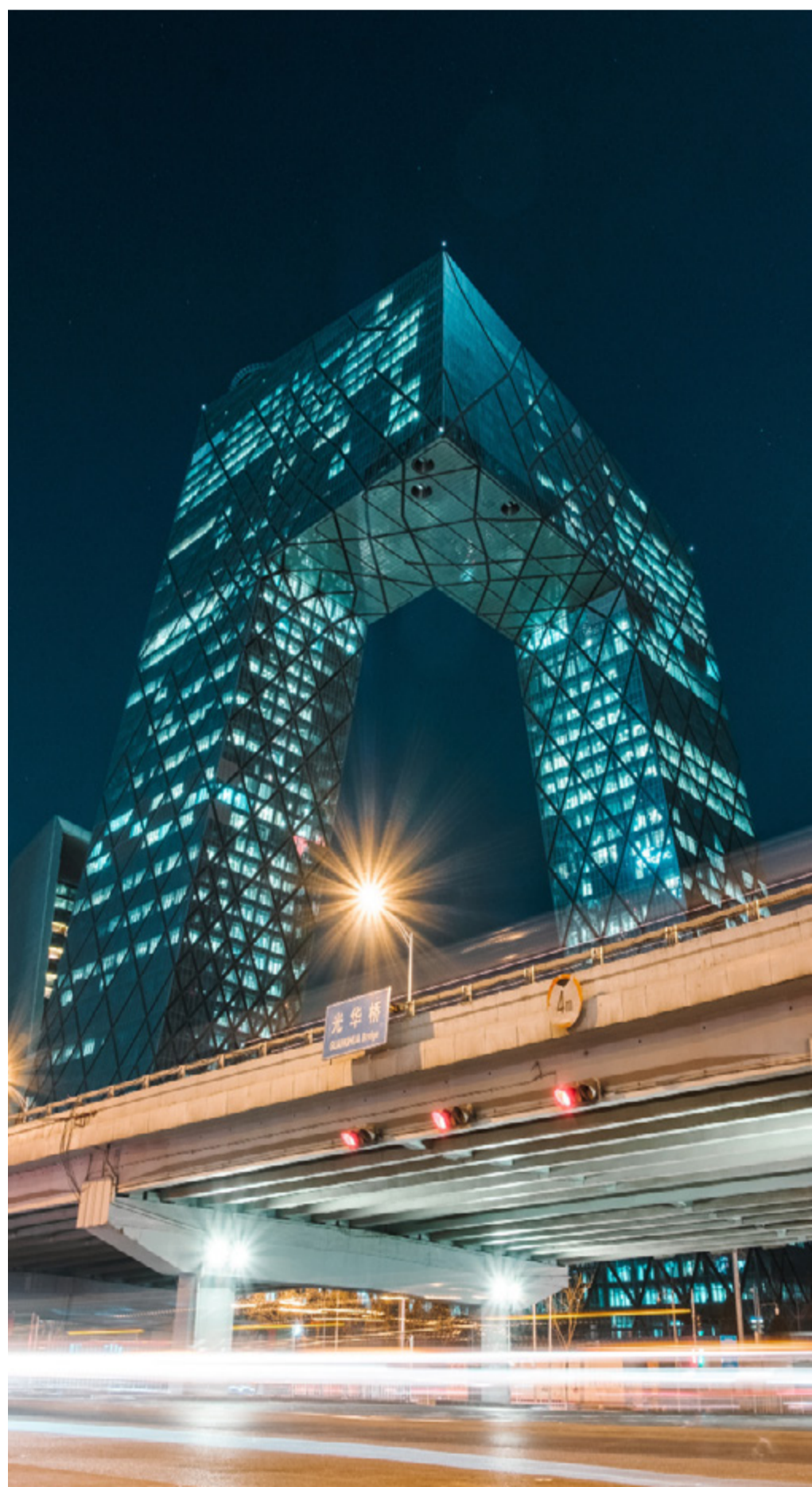
- **Breach of his obligation by the nominee:** if Chinese owners breach any contracts, it is unclear whether the rights of the foreign investors will be protected by PRC courts or arbitral institutions since the primary purpose

of the contracts entered under the VIE structure is violating Chinese law by bypassing governmental control;

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

- HOW TO LIMIT THOSE RISKS?

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



FRANCHISE

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 on Administration of Commercial Franchise**, promulgated by the State Council (the “**Franchise Regulations**”), were issued in 2007. These regulations apply to foreign and domestic franchisors alike. 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 **broad concept** in China, and there are risks that many distribution agreements such as “commission/affiliation” and agency contracts may 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 pays franchising fees to the Franchisor.

- WHAT ARE THE REQUIREMENTS TO ENTER INTO A 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 include 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 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 during which the Franchisee may unilaterally terminate the agreement. The length of the cooling-off period is not predetermined by the Franchise Regulations and should be negotiated by the parties in good faith.

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DISCLOSING OBLIGATION

According to the Franchise Regulations and other relevant laws and 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, as well as information on any litigations to which it was a party during the last 5 years.

Furthermore, the Franchisor shall submit signed franchising agreements and relevant documentation to a 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 willing to provide a 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 with filing to the competent authority within **15 days** after the first franchise agreement is signed.

The major risk is the **contractual instability**. In case of a dispute, the Franchisee may report any incompliance with the Franchise Regulations to the authority.

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

In addition, the Franchisor may have to pay fines 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 of the required documents for the filing of the franchise agreement.

- HOW CAN THE FRANCHISOR PROTECT ITS BUSINESS?

Before establishing a franchise network, the Franchisor shall confirm with its Chinese legal advisor that its interests are adequately protected:

- Making sure that the **business scope** complies with the Chinese regulations and includes the retail operations by means of franchising;
- Checking if all **relevant information** is provided to franchisees;
- Drafting a detailed franchising agreement in line with **market practices** and making sure that the contractual documentation contains the terms requested by **local regulations**;
- Providing standard documentation requested by malls and landlords which allow the Franchisee to open shops and 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 for certain types of businesses, such as car dealerships and others.