IN FACT AND IN LAW

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Doing Business in China: Know the Rules

By Diane Bellavance

China is full of business opportunities due to, among other things, its phenomenal economic and demographic growth as well as its admission into the World Trade Organization. Despite it being easier to do business in China, it would be imprudent to jump on this new bandwagon without a working knowledge of the current legal rules.

Several legal vehicles are available when choosing to do business in China: You may import or export products from or to China, contract out part of your production, grant intellectual property and technology licences, enter into distribution agreements, negotiate development agreements for projects in China, set up joint ventures, open branch offices, etc. Among the numerous means available, which is the most likely to bring you success?

It is important to note that, in order to be admitted into the World Trade Organization, China had to modify its laws and implement new legislation to protect foreigners conducting business therein. Despite great progress in this regard, much remains to be done. Good planning requires consideration of several issues and particularly the following:

Available Legal Vehicles

The choice of a suitable legal vehicle will, among other things, depend upon your decision with respect to the following key elements:

- profit sharing;
- risk sharing;
- return on investment;
- government incentives;
- operational and organizational benefits.

The following are the most popular legal vehicles for conducting business in China:

Joint Venture

A joint venture involves a Chinese legal entity where profit and risk sharing is in proportion to the investment contribution of each partner. Financial contribution of the foreign corporation must be at least 25% and may take the form of money, goods or services. The evaluation of a contribution of goods or services may be challenged by Chinese authorities. Certain issues must be managed and resolved in advance, particularly repatriation of profits by the foreign company. Some contracts need to be approved by Chinese authorities.

Cooperative Joint Venture

This vehicle is a legal structure existing in China and is used mainly where rights in real estate are involved for instance, in matters pertaining to oil and gas exploration, agriculture and the hotel industry.

Foreign Subsidiary

A foreign subsidiary is a Chinese legal entity subject to Chinese laws, which may be 100% held by a foreign corporation. This type of vehicle is safer where the foreign corporation holds intellectual property rights, such as patents, trademarks, copyrights, etc. Although becoming increasingly common, this vehicle may result in a number of problems in respect of on-site management of operations in the absence of a Chinese partner.

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Branch

A branch is not a separate legal entity and its structure does not benefit from any legal recognition in China. This vehicle is not frequently used.

Limited Liability Company With Foreign Investment

Such a company involves a Chinese legal entity, the capital of which is divided into shares. The liability of the parties is proportional to their respective investments. Foreign investment must be at least 25%.

Buying a Business Concern… Quicker But Sometimes Risky

Buying an established state-owned or private company in China may be quicker and bring with it the added benefit of established distribution networks and market shares. The Chinese government has put in place incentives and actively encourages foreigners to buy existing state-owned businesses. However, you must be very prudent as the buyer may sometimes inherit unwelcome responsibilities such as the obligation to keep the employees, as well as provide for such employees and their families.

Hong Kong and Its Known Legislation

Some foreign companies favour a legal structure created under Hong Kong legislation, since business has long been conducted in this jurisdiction according to the English and North American model and its laws are similar to our own. Certain companies will create a corporation under Hong Kong laws and conduct business in China using such legal vehicle. Hong Kong's bank and tax systems are viewed by many entrepreneurs as constituting major advantages for doing business in China.

Due Diligence: An Essential Part of Any Agreement

You believe that you have found a good partner in China, due diligence is the most important step you must take from a legal standpoint before doing business in China. Never forget that Chinese laws, business practices and culture are very different from those of western countries.

Contracts: the Arbitration Clause Is a Must-Have

The first contractual relationship will generally begin with a letter of intent, which is nearly always non-binding. The negotiation process may also be fairly long and complex. Next follow negotiation and drafting of the main contract, where the parties determine in detail the object of the contract, their respective obligations, the capital investment and disbursement conditions, bank accounts and exchange rates, management of operations and various other clauses specific to their legal relationship.

In China, an arbitration clause is an essential part of a contract, since proceedings before the Chinese courts are rarely successful, except in matters pertaining to intellectual property. Indeed, judges are appointed by the Communist Party and sometimes lack even basic legal training. Their rulings are mainly governed by the primacy of the interests of the people's Republic of China. The legal system does not rest on the Rule of Law as in North America – where legal rules will determine the outcome of litigation. In China, political considerations dictate the outcome. This is why an arbitration clause is so vital.

Termination clauses are also very important and must stipulate that the contract may be terminated upon certain events. Fortunately, laws are evolving quickly in China and China is demonstrating its willingness to adhere to international treaties. One must remain prudent.

Intellectual Property: Be Diligent!

We have all heard horror stories about infringement in China. This problem is gradually improving but you need to remain prudent. Upon its admission to the World Trade Organization, China implemented new laws and harmonized its existing legislation. It now recognizes protection of patents, trademarks, copyrights, domain names and trade secrets.

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Intellectual Property Rights

An ever-increasing number of Canadian businesses register their intellectual property rights in China. However, the Chinese system is not similar in all respects to its Canadian or American counterparts.

Trademarks

For instance, Chinese law grants priority to the “first to file” a trademark application. This may result in competitors racing to file a trademark application on a trademark belonging to you before you do.

As soon as you decide to enter the Chinese market, it is advisable to diligently file a trademark application to avoid a situation where someone else files before you – thus compelling you to prove your rights to the trademark. As China is a party to the Paris Convention, it is possible to claim the same filing date for China as that of a new application filed in Canada, within a period of six (6) months from the date of such filing in Canada.

Any transfer of a trademark or an agreement respecting a licence for the use of a trademark must be duly registered with Chinese authorities. China now recognizes “well-known marks”, which allows for filing a trademark application without having to worry about the problems brought about by the “first come, first served” rule.

Patents

China is now a party to the Patent Cooperation Treaty, which means that an application made under that treaty will also be recognized in China. It is important to know that China requires that the invention be filed within six (6) months from the date of first disclosure, failing which the patent will be held to be invalid. Even though a Canadian or American application may be filed within twelve (12) months from the date of first disclosure, one must not rely on this longer delay and instead make sure to file within six (6) months in China. Moreover, as in the case of trademarks, China adopted a “first to file” rule in respect of the filing of a patent application. You should be diligent when filing a patent application in China.

Copyrights

Chinese copyright law was also amended with a view to harmonizing it with certain international agreements. Thus, software is now protected under this law.

Taxation

The tax implications must be carefully reviewed at the time of choosing the legal vehicle and structure, as well as the location and the type of business to be implemented. It is important to mention that tax incentives are available and that the tax rates applicable to a company will vary according to the region in China where it is based. There is a sales tax, a real estate tax and a tax on the transfer of assets. Furthermore, taxation may not be the same for all types of legal structures.

Conclusion

There are many ways to do business in China. Each method has its advantages and disadvantages. The size of the Chinese market and China’s increasing importance among industrialized countries make it worthwhile to consider business opportunities in that country. Remember, however, that it is best to be prudent, patient, and diligent and to obtain advice from competent advisors as these will go a long way towards increasing your chances of success.

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