



Entering Into Business in China and Terminating a Business Relationship in China

*Presented by the Association of Corporate Counsel and The Hong Kong Trade Development Council and
the Hong Kong Corporate Counsel Association*

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1. *Is it possible to get a credit report (similar to a D&B report) for companies in China, and how beneficial would that be? Are there other reliable sources offering this type of information?*

Yes, there are companies in China that will do this. They will often go to the SAIC, the State Administration for Industry and Commerce and its local counterparts to check on information. There are also foreign companies that will do this. But be careful even with people doing that kind of information, investigation, the information isn't always as reliable as you'd like it to be – especially on a financial side where you do have multiple sets of accounts.

I think it's important to realize that the Administration for Industry and Commerce has a few limitations. In particular, it doesn't provide financial information, generally speaking. So if you talk about a private company then you're really looking at the corporate information only. Shareholders, registered capital, that sort of thing. The other thing is, you actually physically need to go there because there is nothing like web-based access or even another way to remotely access the information but you may take copies of documents for a small fee.

There are companies locally that do that for you. There are the Hong Kong companies that specialize in more in-depth type of due diligence that can get additional information for you. Many of these are staffed by former security officers, high-ranking police, police officers, each with the channels and the connections in China that allows them go get hold of information that may not even be publicly available and therefore is very hard to come by.

Employee due diligence in China, you would do well to make sure you know something about the connections of the people that you're actually hiring or taking over. Not just whether their employment contract is in order, but who they know; why they are in a company, what their track record is, and so on and so forth.

These Hong Kong companies we've worked with can do that for you. In China, there is no one-stop shop such as Dunn & Bradstreet that will do these kinds of things.

2. *What is Ministry of Foreign Trade and Economic Cooperation (MOFTEC) registration and what are the requirements. What documentation is required?*

Let me first take a step back. When we talk about due diligence, it's very important in China to realize that due diligence may be a bit of a moving target. Even the legal due diligence. If you look at the last 18 months, there are no less than 6 or 7 major areas of law that have changed in quite a dramatic way. There's a new employment contract law. There is a very substantial revision to the tax law effective 1st January 2008. Real estate rules have been changed quite considerably. There is a new anti-trust law. There are merger control provisions. There are new environmental laws. Each of these changes is very, very significant. So, it is important to hire the people in law firms that are actually capable of tracking those changes and making sure they go into this due diligence process with the right knowledge and the right baggage.

Coming back to this question, please discuss what is a MOFTEC registration. MOFTEC

actually changed its name about 5 years ago. So, sometimes from the question you can derive that the information available to the person asking the question is well out of date. MOFTEC has become MOFCOM, The Ministry of Commerce. Probably the most useful answer to this question is you should take a look at the MOF, Ministry of Commerce website which is www.mofcom.gov.cn. MOFCOM does publish certain laws and regulations. It does publish its procedures: part of the website is in English. And I would definitely encourage you to have a look at that website if you are interested in MOFCOM registration procedures.

The local bureaus of MOFCOM still carry the old name so they are the Bureaus or the Commissions of Foreign Trade and Economic Cooperation. If you go to the local authorities, they will actually have the old name, whereas the Central Ministry has changed its name. That can be a bit confusing, that's why I mention that.

A MOFTEC registration or a MOFCOM registration is not a concept that you can actually define because the Ministry of Commerce has a number of roles. That's why I mentioned the changes in laws earlier, the new merger control regulations, have assigned specific tasks to the Ministry of Commerce to approve mergers that come within its scope.

One other thing I should probably mention is that the Ministry of Commerce is but one, although arguably one of the more powerful, ministries and ministerial level agencies are sort of vying for prominence in many of these areas. So, the Ministry of Commerce is definitely important. But it's not the only one. Registration procedures really depend on what you need to be done. If it's about merger control or if it's about setting up a new company, the MOFCOM authorities will have to approve that. And there may be other areas that you will need them for.

3. *Are there any other agency requirements we should be aware of for companies such as ours that do not have a representative office in China but provides services for clients in China?*

I think the only thing I would say there is that China is much the same as other countries in that if you don't have any presence then you will need a local distributor. You will need a local agent in order to even get your products into the country. If you operate through an agency as in someone that is authorized to act in your name and on your behalf, beware of commission contracts because its one of the areas in Chinese law where, on termination, you will have mandatory payments to be made. As a result of that, most agency arrangements that I'm aware of are done on a written basis.

4. *Then the fourth question is about rather retention amounts withheld by companies that are selling services or products into China. Would you give a review on that?*

I'm assuming that this is referring to some kind of deposit payment that may be returned at the end or that may be used as part of the final payment. I think that in general, most Chinese companies would resist such kind of payments and I would think that the bank would not like to do that. They basically want to pay on a pay-as-you-go kind of basis. However, I guess, in some cases, if the Chinese really want some kind of product or service and that they cannot obtain it elsewhere, then a retainer would definitely be possible.

5. *Is it true that government does not allow Chinese companies to pay retainers in excess of 20%?*

We're not aware of any such limit. But that doesn't mean to say that there are not some limits somewhere. We just don't know about that. When you have an issue of exchange control, and you need to be able for a Chinese company to pay something in foreign exchange, it needs to get approval in most cases from SAFE, the State Administration of Foreign Exchange. That might be a problem if you're paying for services that have not yet been received.

I think it's safe to say that most PRC companies will essentially start off with a requirement to be paid 100% upfront, so don't be scared to do the same thing. Sometimes it works. If they want the product bad enough, then you can do that. Of course, there are all kinds of laws and regulations and in my 15 years experience in China; I've actually not come across any Chinese companies that are not willing to basically invent a new law or regulation on the spot if it serves their purpose.

Many people know, it's perhaps cynical, but, the point is, of course, that for a long time Chinese laws and regulations were either not published at all or they were published only in Chinese and no reliable translations were available. The Chinese had a concept for a long time which is called Nai poo [phonetic], internal regulations, which were specifically prohibited to be revealed to foreign parties. All these concepts have led to an environment where it is fairly easy for a Chinese party to do this. And I'm not saying that it doesn't happen in other countries, mind you. It does happen all over the world. If the other party has the feeling that you are not properly advised, and if there's nobody in the room that could actually catch him with a lie, or he can phrase it in a way that it is actually not a hard statement, but you get the uncomfortable feeling that if you don't agree, you might put the Chinese party in a position of not being able to move left or right. That sort of situation can be used to their advantage. It is very important, therefore, to make sure you are properly advised, and have someone in the room that can say this is nonsense.

I think to try and put this in the perspective: one of the things that I learned when I was at the bank was that people are very concerned about not doing anything that is going to come back and make them look bad later. This is much, much more so than in an American company. For instance, one of the things that were very important when we retained law firms by the bank was;

if possible, get a quote for a particular job. That quote was then put into a budget that was approved. What that meant was that if the law firm later on said that they had done more work and had run over the budget, that they had run over the quote that they had provided, even though we had obviously put some fat into the budget that was approved, this was a very difficult situation.

One would think perhaps in an American company they would understand that if the work had increased from the original scope of work that was contemplated, that it would make sense that more money was required. Anyway, you don't have this, I didn't find working in an American company that there were project-by-project budgets. Whatever the cost was, so long as the people in charge said this was reasonable, that was what was paid.

In a Chinese company it was different. Each project's budget had to be approved and going back at a later time and saying sorry, we didn't ask for enough, we need more money, this was a terrible thing to have to do and was strongly resisted. I think that this attitude extends beyond that particular example. So that, if there are retainers that the foreign company is asking for, and later on there's some dispute and the company, the Chinese company feels that it wants the retainer back, and the American or the foreign company is holding this retainer as a weapon almost, that person in the Chinese company is going to feel a lot of shame. For that reason, I think, retainers would be very, very strongly resisted.

So, anywhere the Chinese company is putting itself in a vulnerable position, the Chinese company is going to be very active in trying to resist any kind of demands. So, this whole idea of the Chinese company, making up regulations on the spot, or there are Nai Poo regulations that nobody told you about, I think it's part of the same attitude that once somebody inside the Chinese company is put in a difficult position, they will have great incentive to try and come up

with any method of resisting whatever it is that is being demanded from the other side. And I think that it's important to understand the way that people operate in Chinese companies. It really is quite different.

6. *Clients in the PRC typically want to have ownership of the IP rights in our designs. Do you have suggestions regarding how to limit this or structure it so that we retain rights in our designs?*

I don't think that China is very different from the rest of the world in this, although there is the technology transfer legislation that in certain instances requires the foreign party to make available intellectual property rights and indeed ownership of intellectual property rights. In fact, the word technology transfer already sort of indicates that is the intent, although most parties that contribute technology do so on a licensing basis and do not have any intension of transferring that in the legal sense of the term. Be careful with written agreements. I think that instances have been known where these agreements are used for purposes they were not intended for, but there's also a very important practical consideration: in the days when joint ventures were still the vehicle of choice, the 50/50 setup was for one reason or another very popular. I've even seen this in other parts of the world. From the perspective of protecting your intellectual property rights that you're licensing to the joint venture, to your subsidiary company, it is very dangerous to have a 50/50 structure.

Why? Because even if you have a formal licensing agreement that requires cancellation of the usage rights on trademarks and designs and patents, if the shareholding of your client drops to less than 50%, you cannot enforce it. For that reason, I believe that foreign parties will do well, and many foreign parties have policies like that, that in case they have to license intellectual property rights to their joint ventures, in a country like China, or in other countries of

the world, they need to have at least 51% of the majority. And need to make sure, be vigilant, that there's no blocking votes for the local party in anything to do with those intellectual property agreements.

I have a case to mention. I was talking to the General Counsel of E-bay and he said there was an issue about tennis rackets. Some Americans were manufacturing tennis rackets in China. In the daytime they were actually manufacturing the product for the American client. The American products have this logo stuck on it and a security tag. But in the nighttime, what they're doing was they're using the same materials, and mass producing the same product but they don't have the logo or security tag. The lesson that he learned is basically companies have to be careful to address not just a day time operations and all that, but what they're Chinese manufacturers are doing in terms of the other customers. Make sure the other lines of business are covered in terms of IP part.

7. *The next question was on payment terms, which seem to be difficult to negotiate with the Chinese. They all indicate that it takes several weeks to process payments, including government approvals to send funds out of the country. Do you have any pointers or strategies?*

I think that relates mostly to currency controls. I think the question is absolutely correct. At the same time, I think that the Chinese are not just trying to delay payment in most cases. Or maybe in some cases they are, but it's true that it does take several weeks to process payments. This is not only a question of currency controls but it's also the way that accounting and approvals work within the bank. Here in Hong Kong, it took months to pay law firms. And that was in Hong Kong not even in China. But I think that it's going to be even worse in China because of internal approvals you need especially, if there are payments in foreign currency. You need approvals from the government and its going to take a long time. So the question of do you

have any pointers or strategies, I think the only thing I can say is begin to work on payment procedures as early as possible. It's always going to take a long time.

I would also add that an underground banking system, that was uncovered recently, exists; even some of the subsidiaries of the largest Chinese companies seemed to have participated in the scheme. This underground banking system is one of the ways that local parties and foreign parties agree to circumvent the rules. What tends to happen very frequently at a working level is that the Chinese client cannot pay; he's not allowed to pay Renminbi (Chinese currency). He either doesn't have the US dollars or the foreign currency to pay directly or he doesn't have an import and export license and therefore is unlikely to get approval, even if he has the foreign currency.

So what happens is that a third party is involved, a befriended company or maybe an affiliate that has the right to send payments abroad but otherwise doesn't have anything to do with the commercial transaction in question. Usually the third party gets a small percentage of the amount is sent out. Obviously this time consuming and not very satisfactory if your local party subsequently says well, yes, we can pay you but we can only pay you a little less because we have to do it through this third party. These systems are known to exist and you would need to take those into account.

Let me make one more point. If possible, try and avoid payment from China. Many Chinese companies have subsidiaries or associates outside of China. In addition, Chinese companies can open bank accounts in China – especially the large ones. You should try and arrange for payment from one of those accounts that of course will avoid the need for government approval and speed up payment.

8 & 9. (Questions 8 and 9 together in the same flow). *Several clients have asked their companies to sign Confirmation Letters that indicate they will pay us from a bank account in Hong Kong, but that we repay the funds back to their bank account when the client makes a duplicate payment from a new bank account from within the PRC. Thus far we have not received one duplicate payment.*

That last addition doesn't really surprise me. Often the solution is found in making payment from a foreign bank account. Of course, the second part, we will make a duplicate payment from our Chinese bank account sounds like a decoy to me. In fact, this case position could be a means to evade local taxes. Many Chinese companies will make sure that by using an off-shore bank account, they're actually artificially keeping their local turn over levels low. The reported income in China, they will keep that low. And therefore, essentially, avoid or evade taxes.

It can be very tricky if your company is being found to be complicit in that. Although to my mind, it's a perfectly legitimate position to formally take, to say, well, look, if you can pay us from a foreign bank account, please do so. You deal with the currency controls and other problems of payment out of China yourself.

10. *Do you have suggestions for ADR? Alternative Dispute Resolution language in the PRC? Are there arbitration bodies that are more fair than others? And how difficult is it to get a fair alternative dispute resolution in the PRC?*

I think in terms of dispute resolution, you have to be careful about the language what you put in. In terms of, for example, what happens if the parties cannot agree to appoint the Chairman of the Tribunal? Another thing, for example, is the court. Now, at the end of the day, if the other

side is not willing to play ball, then what will happen is, you have to go to the Court. Just be careful. The Courts in some of the provinces like Shanghai and Beijing tend to be very good. They have specialists, IP judges, who know about IP laws because some of them are trained in the US or Europe but in other areas of China you might not know what you'll get in terms of a court.

The language of the arbitration clause is very important. I think you have to be careful if you do not mention, the arbitration commission, then you could be in trouble. That could be considered an invalid arbitration agreement. So you end up going back to the courts. You have to be careful which organization you select.

Another thing is that you have to be aware of is that you cannot put down other organizations that are basically foreign to the Chinese party, simply because they're not recognized. You have to be careful what type of language you put in there. And, talking about local versus the one about CIETAC and all of that. It really depends on the type of contract you're entering into. If it's to do with a local distribution, has nothing to do with foreign related matters then I would suggest that you go to some of the local commissions. Some of them are pretty good. But some of them you have to be a bit careful. You have to look at their record. Talk to their executives and so forth.

One other language is when you actually do an arbitration, and if it's done in the English language and the wording is in English, just be careful when you go to the courts for enforcement, it has to be translated into Chinese. So the first thing you have to do is you have to find out who is the judge that is going to enforce this arbitration. Find out from his clerk which interpreter he uses because it helps to speed up the process. If you use an interpreter the judge doesn't know he'll likely be very slow in his adjudication.

Another thing, if you don't hear anything back from the courts, call them up. Find out from the clerk what has happened to this arbitration award. How come it's not being enforced? Because in China, there's no law that says for example, they have to enforce an arbitration within a certain time period, like a limitation period. So they can sit and wait for many years. You have to start pushing them, but do it in a nice way. Always push the clerk and the clerk will give you some advice back in terms of what the judge is looking at. Try to be as helpful as possible. And if you get word back from the court within a week, the chances are your arbitration award will be enforced.

11. *Should the contract be in English and whether that would actually be enforced before the courts.*

Before the courts, no, because everything will be translated into Chinese anyway. Arbitration, you stand a good chance to have this be honored, in particular, of course, if the arbitration is outside of China. But even in CIETAC arbitration it may well be honored. It will depend on, of course, who the arbitrators are. CIETAC has started out as a body where only Chinese arbitrators were on the panel. And, that was also closed. So there was no possibility to have someone else be appointed as an arbitrator unless you were on the panel.

CIETAC has fairly recently opened up its regulations but there is still a chance that your contract, even though it is in English, will first, for all practical purposes, be translated to a Chinese version. The discussions will be conducted in Chinese simply because the arbitrators in question are not able to communicate in English.

One other point is, you do not have to follow the CIETAC rules because the CIETAC rules do have a provision that if the parties agree to other arbitration rules, then the CIETAC secretarial board adopt that. Remember to choose the arbitrator carefully. You don't have to

choose within the panel. CIETAC has foreign related arbitrators on the panel, domestic commissions tend to be very closed. They tend to have mostly domestic arbitrators on their panel. So, you have to be very careful and all. When drafting the provisions relating to how you go about appointing arbitrators you need to set time limits for selection. The Chinese party will always, for example, delay, they will take their time, they will take forever, if you don't have time limits. If they don't agree within a set period state what will happen. Basically, you're forcing the Chinese parties to come to some kind of agreement.

12. The scope of services. We find it difficult to really define the scope because Chinese clients tend to resist. And they seem to change their minds frequently about what they want, yet they seem to think that the changes they request should not result in additional fees.

I think China is not really different from the rest of the world. Obviously, the client will try to keep the scope as open-ended as possible because that's to his advantage if he doesn't want to pay more. And he will also try, at the same time, to get as much of a fixed fee commitment as possible. One story from the past, I used to work for Phillips Electronics, and in the days that they tried to enter the Chinese market, it was still commonplace for a Chinese customer to own a television set, and if it would break down 12 years later, the customer would go back to the shop and they would expect the television set to be repaired at no charge. That was just the culture at the time.

I think, in the same way, if you are talking about IP projects or other projects where scope definition is very important, it's a sign of market development. It's up to the suppliers, in essence, to make sure that that market development takes place. People will accept a defined

scope of work if it is defined in very tight language. And any add-on pieces of work are actually for a charge. And in the same way, because in the electronics industry has had to go through a fairly painful process of trying to make sure the people in the market understand that you have a warranty period and after that, all bets are off. Another tactic may be to make your products guaranteed for a specific period then after that you pay a lot for initial repairs after the warranty period. Such amount in fact, that it becomes more attractive to buy a new model. I know certain companies are working along those lines. But this is where China, I think, is really no different from the rest of the world except perhaps that the market development has been a bit slower.

I think this question goes back to what I was saying before and part of the problem is the budget process. That projects are approved on project-by-project basis at a particular budget. Now, I'm assuming that the practice at the Bank of China reflects the practice of other PRC firms. We did sign contracts with law firms. Almost always the scope of the project would change and the fees would increase. The people that I worked with would go back and say, sorry, you know, this is what you told us. And it's very difficult to change. And to a certain extent, I had to intermediate between the law firms and the other people in the bank.

This was exactly the way things worked. If you need strategy to address this, you need to either try and agree to have a very high initial fee as a maximum amount. You can say this is the amount that we expect but it could run up to a certain amount. Alternatively, it may be easier for the Chinese to deal with is if there are additional things to be dealt with, that are going to incur more fees, if you try and persuade them to sign a separate contract, then that contract can then go back and have a separate budget process. Of course it will be time-consuming but it might make it easier for them to absorb internally.

13. *My company has been inundated in the last couple of months with what we think is a scam.*

Just got another one today where the method is that someone from China will email to us saying we have your company name or a variation of your company name, your company name followed by a product line dot com, dot cn, dot hk. About 6 or 7 variations. Someone is trying to register this. We wanted to notify you and you'd better act quickly. Well, we bid on one of these out of about 25 emails we've received at different points around the company. And, we found that they were charging effectively several times more than it would cost to do it ourselves. So we think that's the scam. Kind of a low level scam, really. Has anyone else heard of this scam or this practice? And how do you recommend how we should respond to it?

There is a new development in Asia that you need to be conscientious about. Recently at ICANN in California, they have approved a top-level domain name called Dot Asia. And through the grapevines in China, many Chinese are aware of this development and are going to register companies, for example, Phillips.asia. So if you're advising a client, just be careful when the sunrise period is, that you register them, if you want to protect your brand. If not, then once it's open, it's first come, first serve. And basically, you're stuck with the dispute resolution process and you have to pay more money again.

Currently there's no directions from the organization. They call them CINC, the China Information Network Center. It has authority to actually issue these domain names, but it has given authority to register them in terms of two companies. One of the companies is using unethical ways of actually getting business. I would suggest what you do is actually register with the other company. Tell them, for example, if I want to register, I will register with the other company. The company who's actually doing these kinds of scams and all that, they're trying to generate income for themselves. We have them all the time in Hong Kong and everyone comes

to us and asks us what can we do about it. It's not really a criminal offense because you really can't say for example that they've done anything. It's just that they're trying to entice business. There's no regulations to govern it in China relating to this. So, my only word of advice is register with the other company rather than the company that's actually trying to entice you to register with them.

14. *What is the downside or the concern for a Sino-foreign venture company going public in China?*

Well, I guess I'm not really up to date on the latest regulations. It used to be that in order to go public you needed provincial level approval at least. Now, I think it's much more liberal in terms of actually taking the company public. I'm not sure anybody on the panel really has enough ability to answer that question in great detail. The question is where do you want to send this company public? Do you want to do it inside China or do you want to do it in Hong Kong? Nowadays, there are much stricter regulations on how a domestic company in a joint venture, would be considered a domestic company.

Of course, once you are listed in Hong Kong, then you have to abide by the listing rules that are quite extensive, though not particularly unfair. For a company listed within China, I'm not sure that I really have enough information on how restrictive or how difficult the regulations applying to a listed company in China are.

I think that perhaps I can say the following. I'm actually looking into a project whereby this exact thing is happening. A joint venture between a European company and a local company that contemplates going public. In very recent times, and I'm talking about the last 4 or 5 months, the Chinese government has sort of curbed the ease with which Chinese companies traditionally would list in Hong Kong. PRC being one of the approved jurisdictions for foreign

jurisdictions for, by the Hong Kong Stock Exchange for companies to go public. And there is only three. Apart from the PRC it's Bermuda and it's the Cayman Islands.

The thing though is I think that's the most prevalent issue for any Chinese company going public is not those regulations. It's become much more much stricter in the sense that unless you're very big, the Chinese government is not encouraging you to list in Hong Kong or anywhere else unless at the same time you're listing in either the Shanghai or Shenzhen stock exchange. And this is obviously done to make sure that not all Chinese companies are going to list overseas and thereby depriving the domestic forces of listed companies.

The main problem I think is in the gap in areas of corporate governance. I think that's one reason that the US, NASDAQ and NYSE tend not to be very popular because many Chinese companies go to take a long hard look at themselves, they will realize that they will fall far short of the requirements that are currently made by NASDAQ and the NYSE. Whether that's right or wrong, because the requirements, I can tell you are fairly stringent here in Hong Kong as well, traditionally Hong Kong has been a popular destination and the London gem markets, so the secondary market has been very popular as well. And in my view that is because of the gem market in particular in London, basically competed on making it very easy, creating a very low threshold for companies to go public there.

I think the Chinese government is recognizing that before Chinese companies can go public, they will need to work on corporate governance in the area that relates to that. Interestingly, the Chinese government has seen as one of the ways to do that, to beef up the in-house counsel function in the Chinese state owned corporations. It has therefore put one of the high-ranking government bodies, the State Administration or the State Asset Supervision Administration Committee, which reports directly to the State Counsel, in charge of basically

beefing up the INS [phonetic] Counsel presence in major Chinese corporations. Currently, the first phase of that has been completed and we're now looking at the mid-size Chinese corporations that are increasingly getting in-house counsel where traditionally they had none.

But the practical difficulties, I think for listing overseas are by far the most prominent difficulties are in just getting the processes into place that in the West you would like to see in a listed company. Having an audit committee, having a remuneration committee, having internal auditors that can perform a serious roadblock to getting the financial statements approved. All of that, I think, was traditionally seen in China as just an impediment for the Chairman who is this all-powerful head of the company, to have his way. Now that is gradually changing and actually quite rapidly changing. You also see that reflected in changes in, for instance, the company law where now the Chairman is no longer the only legal representative of the company, it can also be another board director.

Those are fairly drastic changes that are gradually sort of guiding these companies onto a path of more transparency and better corporate governance. And I think that's, in my view, the most prominent area of challenge.