



803 Product Sourcing & Distribution in China

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Faculty Biographies

Michael H. Chang

Michael H. Chang is a part of the management team at the Vivendi Universal Office of Matsushita Electric Industrial Co. Ltd, based in Hollywood, California. In that capacity, Mr. Chang advises Matsushita's investments in, and business and legal alliance with, motion pictures studios and the media, entertainment, and technology industries.

Prior to joining Matsushita, Mr. Chang was regional counsel at Federal Express Asia Pacific, where he received the 2003 Bravo Zulu Award for excellence in management. Mr. Chang also spent a number of years in Japan as the Asia Pacific regional counsel of PSINet Inc., a pioneering commercial internet service provider, instrumental in selling various subsidiaries of the company to China's CITIC Pacific, and as corporate counsel to Seiko Epson Corporation, a TSE-listed multinational Japanese consumer electronics company with manufacturing facilities in China. Before his Asian assignments, Mr. Chang practiced law with New York-based Stroock & Stroock & Lavan LLP and served a judicial clerkship with U.S. District Judge Linda H. McLaughlin.

Concurrently, Mr. Chang is part of the interdisciplinary management team at the Blu-ray Disc Association, based in Universal City, California, working with a global board of director membership consisting of name-brand companies in the entertainment, information technology, and consumer electronics industries.

Mr. Chang attended the University of California, Davis, graduating Phi Beta Kappa, and UCLA Law School, where he was an articles editor of the Law Review.

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China – new scope for foreign investment in retail, wholesale and franchising in the PRC

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Pre-WTO accession

- Foreign investment has been welcome in China for 25 years, first as JVs and later as WFOEs
- Yet, PRC long maintained severe restrictions on FDI in retail and wholesale, by:
 - **sector**
 - **scope of business**
 - **high registered capital thresholds**
 - **equity proportion limits and geographical limits**
 - **burdensome central governmental approvals process**

The door opens...

- WTO accession on 11 December 2001
- Over following three years, PRC allowed minority stakes, then majority stakes.
- 2004 regulations (*Administration of Foreign Investment in the Commercial Sector Procedures* ("**FICE Procedures**")) were meant to bring PRC into compliance with its WTO accession commitments

FICE Procedures: major changes

- WFOEs allowed from 11 Dec 2004 (w/certain restrictions)
- High capitalisation requirements and geographical restrictions eliminated
- Wider scope of business, now including franchising and commissioned sales for wholesalers
- Simplification of approval processes: power devolved to provinces and municipalities

Relaxation of Investor Qualifications

- Prior to FICE Procedures:
 - for **retail JVs**, foreign parties had to have:
 - annual sales of US\$2 billion
 - net assets of US\$200 million
 - for **wholesale JVs**, foreign investors needed:
 - annual sales of US\$2.5 billion
 - US\$300 million in net assets
- There were correspondingly high requirements for Chinese parties

Capital Requirements have been lowered

- Previously, **retail JVs** needed RMB 50 million (RMB30 million in West and Central regions)
- **Wholesale JVs** needed RMB 80 million (RMB 60 million in West and Central)
- Now, PRC Company Law requirements are imposed (RMB 300, 000 for retail, RMB 500,000 for wholesale)

Further liberalisation

- Previously, for **wholesale JVs** and **retail JVs with 3 or more stores**, Chinese party had to hold at least 51% (with limited exceptions)
- Generally no longer a requirement for minority stake, but
 - **foreign investors still limited to 49% in some sectors** (publications, cars, pesticides, pharmaceuticals, fertilizers, etc. **or** where they sell products from multiple suppliers or with different brand names)
- **"Scope of business"** liberalised: on approval, retail and wholesale can be combined

Franchising

- 1 Feb 2005 *Measures for Administration of Commercial Franchising* (**Franchise Measures**)
- JVs or WFOEs
- **“two outlets, one year”** rule
- Who qualifies? Inconsistency between FICE Procedures and Franchising Measures
- Beijing versus provinces & municipalities

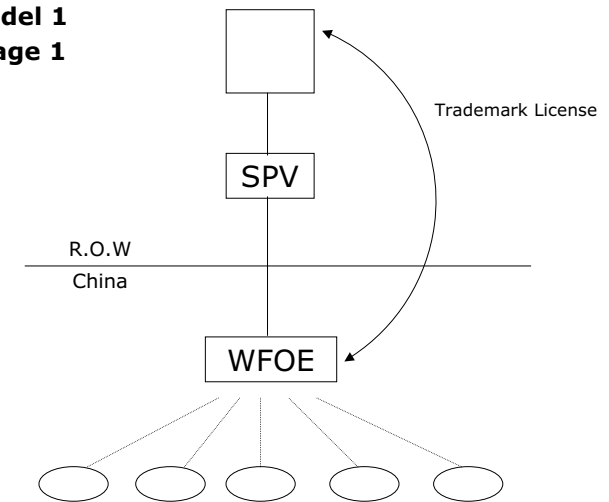
Getting your money out

- Trademark license: royalties not convertible without proof of PRC TM registration
- Service agreements: no registration requirement
- “filing for recordation”: but with which agency?
- Need for sound tax structuring

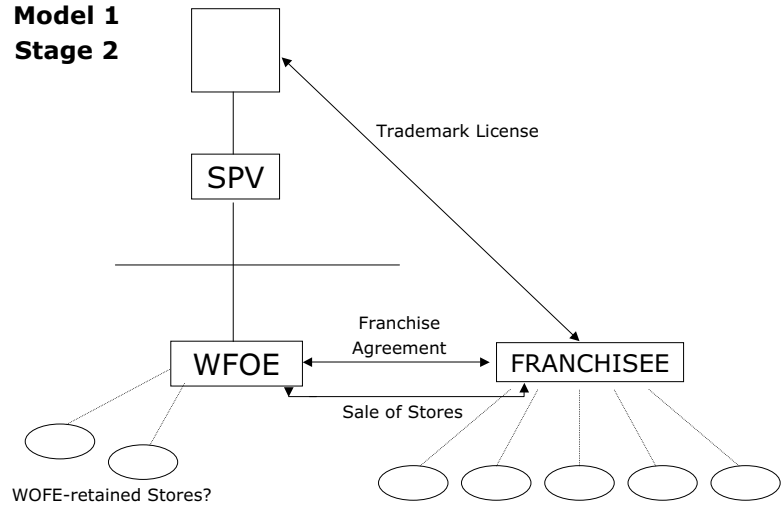
First year models

- Model 1: Pure WFOE
- Model 2: WFOE-managed stores + "franchisee"-managed stores
- Model 3: WFOE + "franchisee"-managed stores
- Model 4: Pure JV with call option

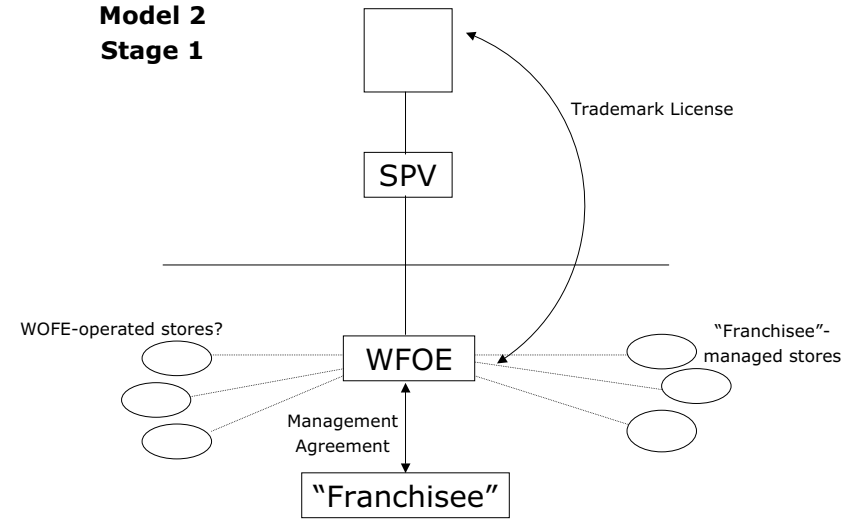
**Model 1
Stage 1**



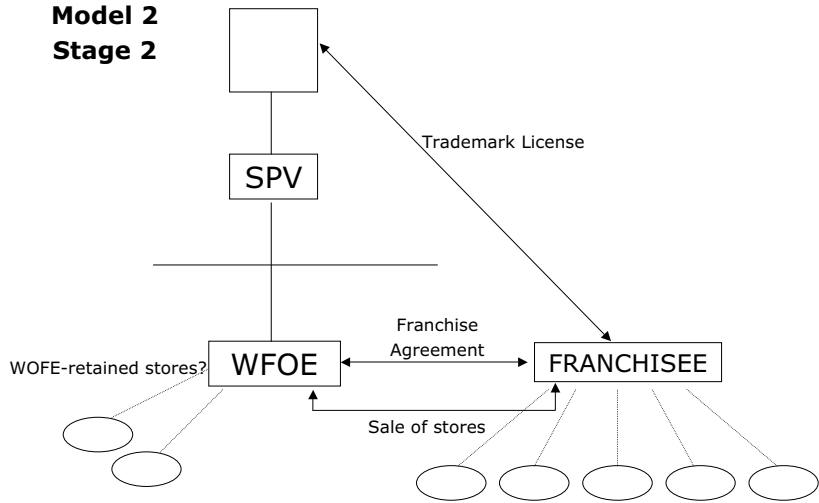
**Model 1
Stage 2**



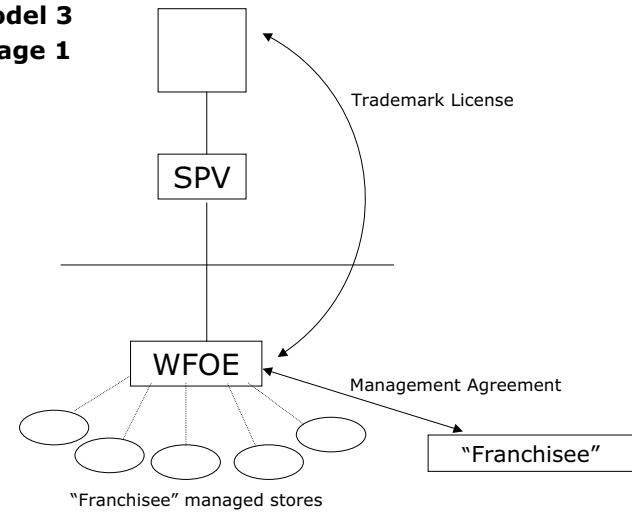
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Stage 1**



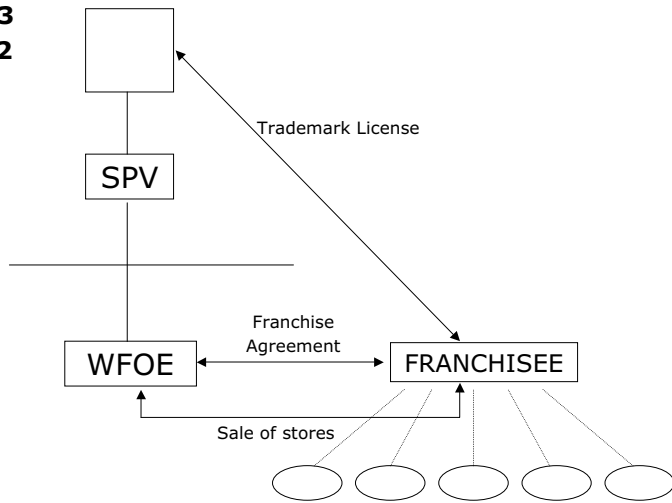
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Stage 2**



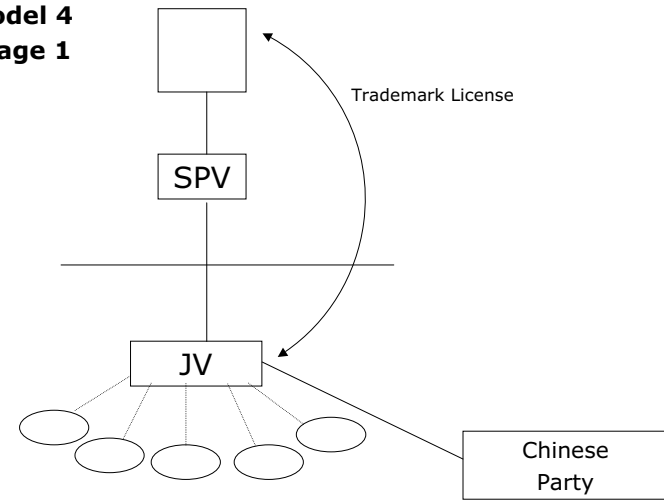
**Model 3
Stage 1**



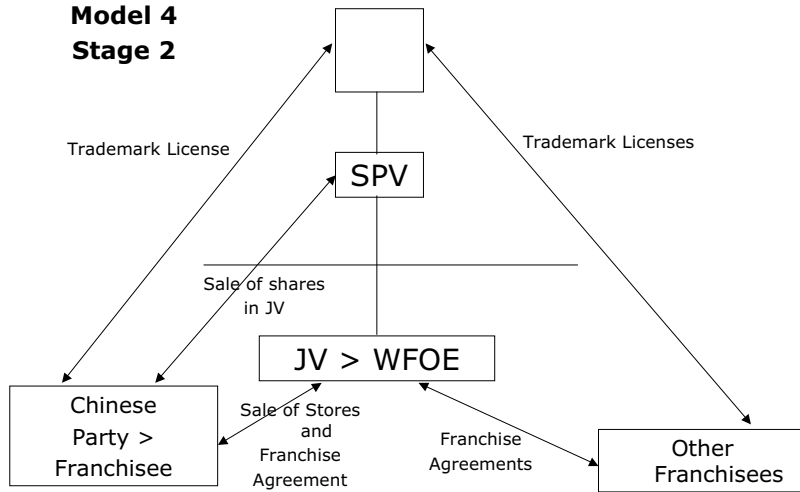
**Model 3
Stage 2**



**Model 4
Stage 1**



**Model 4
Stage 2**



Conclusion

- PRC promised sweeping reform in this sector, and has largely delivered, *but*:
 - legislation is incomplete, and application of law is inconsistent. Regulatory framework is evolving.
 - FDI still subject to restrictions , e.g. scope of business, capitalisation, 2+1 rule
- Careful structuring can overcome most of these difficulties

And on the commercial front....

- Don't put all your eggs in one basket: rarely will a single country-wide franchisee be the answer
- Triangulate and verify: check, counter-check and cross-check everything the Chinese party tells us. Be rigorous in carrying out due diligence.
- Government relations: don't rely on your Chinese partner's *guanxi*. Build your own.
- Franchisor must control the documentation: don't let the Chinese party tell you otherwise...
- Be patient: everything takes longer. Worry if it doesn't!