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China Joint Venture: Context, Contacts and Contracts - September 23, 2009

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GENERAL SURVEY

1. What is your current position?

GC, AGC, Divisional or Senior Counsel (China-specific), Divisional or Senior Counsel (non-China-specific), Attorney/Staff

2. How long has your current company done business in China?

(years) 0; 1 -5; 6-10; 10-

3. How long have you, on a professional basis, worked on Chinese matters?

(years) 0; 1-5; 6-10; 10-

4. What type of disputes have you been involved in and/or successfully resolved in China?

JV; Contract Manufacturing; Distributorship/Supply Chain; Real Property
Employment IP Others

Establishing a presence in China (or not)

1. Representative Office
2. Joint Venture
3. Wholly Foreign Owned Enterprise
4. Foreign Invested Commercial Enterprise
5. Alternatives to a physical presence: contract manufacturing, processing trade arrangements

Representative Office

- Relatively inexpensive and quick to establish
- Limited scope of operations—may not engage in profit making activities except in limited circumstances
- Not a separate legal entity—liabilities of the representative office are liabilities of the entity that established it
- Employees may not be hired directly—must be hired through an approved agency
- Subject to enterprise income tax
- Before a representative office can be established a lease for office space must be entered into (in some jurisdictions negotiating and registering a lease can be more cumbersome than actually establishing the representative office)

Joint Venture v. Wholly Foreign Owned Enterprise

- Before moving forward with the establishment of any form of entity it is necessary to consult the Industrial Catalogue for Foreign Investment
- Foreign investors are not permitted to invest in industries that fall into the prohibited category, either by way of a joint venture or a wholly foreign owned enterprise
- Foreign investors may invest in industries that are categorized as restricted, but there may be limitations, such as a requirement that any investment be by way of a joint venture and that the Chinese party must hold a majority interest
- If one is not required, determine whether it will be truly beneficial to have a local partner (partners should be chosen for their capabilities, knowledge of the local market, useful assets and synergies, not simply for their connections)
- When choosing a partner consider whether interests are aligned—is the local partner interested in building your business or is it more interested in attracting foreign investment and jobs to the region in order to develop good relations with local government officials

Joint Ventures

- Established as a company with limited liability
- Contributions to registered capital may be by way of cash, land use rights, intellectual property and equipment
- Size of joint venture and nature of industry will determine which level of government approval is required
- Foreign investors must remember that a 51% equity stake in a joint venture does not equal control of the joint venture
- On the other hand, allowing the Chinese partner to appoint the Chairman of the joint venture could effectively vest control with the Chinese partner
- Joint venture contracts should contain clear exit strategies
- Capitalization is key—under-capitalization will lead to cash flow problems since increasing registered capital or making a shareholder loan to the joint venture can take a significant amount of time to effect

Wholly Foreign Owned Enterprises

- Allows the foreign investor to have control of the enterprise
- Simpler in some ways to establish because there is no need to negotiate a joint venture contract with a local partner
- Allows the foreign investor to develop the business without the requirement of seeking consent of a local partner with respect to key decisions
- More control over protection of intellectual property
- Profits do not need to be shared with a partner
- Corporate culture of parent company can be more easily established in a WFOE than in a joint venture

Foreign Invested Commercial Enterprises

- Suitable for investors who are interested in developing wholesale, retail and trading presence in China

Practical Tips for Improving Contracts

- Avoid using un-modified standard form government contracts
- Do not engage in business with a Chinese party that refuses to enter into a contract
- Ensure the enforceability of your contracts—do not simply import a form of contract from your home jurisdiction into China without ensuring that it is compliant with Chinese law
- Focus on clear and unambiguous drafting recognizing that the contract will be operational in at least two languages
- Address specific issues that are likely to be of potential concern or importance, even if that means extending the negotiation period—for example, in the joint venture context make sure to include clear exit strategies; in the manufacturing context try to include clear provisions relating to price adjustments in the event of fluctuating commodity prices
- Remember that certain contracts (such as joint venture contracts) must be subject to Chinese law

Practical Tips for Improving Contracts

(Continued)

- Even where it is not necessary to make a contract subject to Chinese law, consider using Chinese law unless there are valid reasons for using the law of another jurisdiction (for example, if the Chinese party has significant assets in another jurisdiction that could make suing in that jurisdiction worthwhile)
- If arbitration is the preferred dispute mechanism process bear in mind that an arbitral award will need to be enforced through Chinese courts—enforcement will be easier to obtain if the contract is governed by Chinese law
- If it is likely that disputes will have a nexus to one of the larger cities in China, consider referring disputes to the Chinese courts
- Enforceability of contractual rights is an issue in every jurisdiction—this is not a problem that is unique to China—a party with a clearly drafted contract will be in a better position to protect its legal rights than a party without a contract
- When there is a dispute that cannot be negotiated, use the available enforcement mechanisms that should be built into your contract

Road Map to Set up a Joint Venture

Letter of intent ⇒ Name pre-registration
JVC/AOA preparation ⇒ Project application
approval from NDRC ⇒ JV establishment
approval from MOC ⇒ Related permits before-set up ⇒
Business license issued by SAIC ⇒ Various post-set up
formalities ⇒ Related permits and approvals

Joint Ventures-Key Issues for Establishment and Operation

- How to Structure Joint Ventures
 - Newly Established Joint Ventures
 - Joint Ventures set up through Acquisition
 - ❖ Equity Transfer
 - ❖ Capital Increase (Tax Consideration for Local Partners)
- How to Fund Joint Ventures
 - Registered Capital —Total Investment (Contribution Evaluation)
 - Overseas/Domestic Financing
- How to Operate Joint Ventures-Board/Management
 - Authority
 - Liabilities
- Capital Repatriation

Updated Legislations for Setting up Joint Ventures through Newly Establishment and Acquisition

- Commercial Bank M&A Loans
- Foreign Investment in Central-Western China
- Decentralization of the Approval Authorities
- Favorable Policies in Certain Industries

Strategies of International Investors of Joint Ventures

- Fully understand the background, reasoning and expectations of the legislation changes
- Possible investment structure changes/alternatives
- Conduct feasibility study and understand associated legal risks
- Pay close attention to the rapidly changing regulatory regime
- Work out feasible strategies with the advisors in compliance with the legal regime

PRC – Real Property Issues

- If the J/V is leasing property, be certain to:
 - Check title registration documents to confirm that your lease is made with the registered owner of certificated land title
 - Register your own lease
- If buying real property, be certain to:
 - Understand the difference between granted and certificated land use rights
 - Understand whether the Seller is a government entity or ‘state-owned enterprise’ (SOE). In either case, PRC anti-fraud regulations may require that the Seller pass land title in an auction process
- If real property will be an in-kind contribution toward J/V equity:
 - Take care in ascertaining accurate fair market value
 - Especially with SOE partners, government approval of the valuation may be required

PRC Supply Chain Issues: Vendor Management

- The PRC market is dynamic, and government policies and programs can have an immediate and dramatic effect on pricing and availability
 - Structure your key contracts as long-term relationships – with high perceived value – but with short-term metrics, to remain flexible
- Avoid sole-source and other unbalanced supply sourcing
- Identify SOE suppliers, especially for FCPA/anti-bribery reasons
- Payment strategies: cash flow management and the use of bank drafts
- Quality Agreements with key vendors
 - Agreed specifications
 - Limits on change of raw materials or manufacturing processes
- Purchase Orders vs. Supply Agreements
- Mind your intellectual property! ‘Black-box’ strategies

PRC Distributors, Sales Representatives and Customers

- Distributors and Sales Reps: high risk relationships, from an FCPA/ Anti-bribery perspective
 - What may not be done directly may also not be done indirectly
 - Carefully drafted agreements, plus (i) annual certification, (ii) frequent audits, (iii) active distributor training
- End-user (final customer) information
 - Stay aware of and connected to end users of your products
 - ❖ Warranty and technical service issues; recalls
 - ❖ Active marketing to all your customer channels
 - Monthly reports from distributors

PRC Distributors, Sales Representatives and Customers (cont.)

- Exclusive vs. Non-exclusive distributors
 - “Territory” definition
 - Exemption for global accounts
 - Distributor poaching (sales to customers outside their territory)
 - Dual role (Distributor and Sales Rep) relationships
- Distributor pricing
 - Defined rebate, discount and similar programs
 - Resale pricing issues
- Sales Rep Compensation
 - Commissions on sale [or payment?]
 - Agents and other third parties

Intellectual Property Enforcement

1. Are trademark rights and copyrights well-enforced in China?
2. Do the trademark laws afford a reliable way to enforce trademark rights in China?
3. Are famous foreign brands or marks recognized in China?
4. What is the concept of trademark recordal? Is it still required under Chinese law?

QUESTIONS AND ANSWER

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