

China legal update

The answer to all your legal questions about China



DANISH-CHINESE BUSINESS FORUM

丹麦中国商业协会

UNDER THE PATRONAGE OF HIS ROYAL HIGHNESS THE PRINCE CONSORT OF DENMARK

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CHINA LEGAL UPDATE

Editor's note

Welcome to the first edition of the "China Legal Update" newsletter produced by the international law firm Eversheds in cooperation with Danish Chinese Business Forum for the benefit of its members.

The newsletter will be issued quarterly and aims to put focus on some of the legal developments that are most relevant to foreign investors in China.

About the launch of the newsletter the secretary general for Danish Chinese Business Forum Tom Jensen comments:

"News about legal developments in China is something that is requested by our members, and by joining forces with Eversheds we can now provide a peak into what is going on one legal side in China".

Partner in Eversheds' China Business Group and editor of "China Legal Update" Nikolaj Juhl Hansen adds:

"We hope that our fellow members will benefit from this newsletter The Chinese legal system changes ever so rapidly and important new legislation is passed and enacted every week. It often proves difficult for foreign investors in China to keep track of all the changes relevant to their Chinese operations. We look forward to participating in this knowledge sharing exercise that will further strengthen the services that Danish Chinese Business Forum already provides to its members".

On the current market conditions in China, the managing director of Eversheds' Shanghai office Peter Corne says:

"Despite the current difficult times, the Chinese economy may be starting to pick up. New economic data show that China may have seen the worst and that China may be the first major economy to recover from the financial crisis. There are many signs that the giant fiscal stimulus is starting to work, and it is not at all impossible that the government may achieve its growth target of 8% in 2009. However, we will still see many foreign investors forced into a restructuring of their Chinese operations; an exercise that should be carefully monitored in order to stay compliant with PRC legal regulations."

Eversheds is the world's 5th largest law firm with more than 45 offices in over 30 countries, including Shanghai, Hong Kong, Singapore, London and Copenhagen. Eversheds' China Business Group is co-located in China and Europe, and in the Copenhagen office partner Nikolaj Juhl Hansen and mandarin-speaking paralegal Sally Liu are part of the team.

Please note that the format of the newsletter only leaves space for a brief description of the legal news we have chosen to include - there may be other developments (more) relevant to your particular business and in this light the newsletter should never be seen to replace focused legal advice.

Theme 1: Employee-related issues

1. China's new Labour Law... now the worker has been spotted!

The enactment of the Labour Contract Law has caused foreign companies operating in China continuing concerns. It came into effect on 1 January 2008 and clearly shows the Chinese government's eager to change its reputation of not caring for the workers' rights and presents a decisive signal for the further development of employee rights in China.

Among the major changes are:

- Lack of written contract within 1 month to cause employer obligation to pay double salary
- Fixed-term contracts to automatically convert into open-ended term contracts and a maximum of 2 fixed term contracts (contrary to the fixed-term schemes applied by many foreign investors)
- More difficult redundancy process
- More consulting obligations - both facing unions and employee representatives
- Restrictions on the use of contract workers
- Limits on the length of probationary periods
- Increased protection: illness, pregnancy, old-age, migrant workers and sole bread-winners
- Employee redundancies in relation to M&A and new mass redundancy requirements
- Restrictions on non-compete restrictions - periodic limit and payment of compensation

Nikolaj Juhl Hansen comments: *Now is the time to check that your contracts and other employment related documents, including your international employment guidelines and hand books, as well as your procedures for hiring staff in China comply with the new set of rules. It may well be the foreign businesses in China that are targeted first, and the consequences of non-compliance could very well prove severe and adverse to your business operations in China.*

With more than 60,000 cases already filed this piece of legislation is characterized by making a strong enforcement mechanism available to the workers.

In one of the first cases decided under the new regime, a PRC court rejected an FDI pharmaceutical company's claim for RMB 300,000 due to an employee's breach of a restrictive covenant - The court started that on compensation was payable since the contract did not specify the rights enjoyed by the employee in consideration for being required to comply with the restrictions.

2. New Provisions in The Labour Dispute Mediation & Arbitration Law.

With effect as of 1 May 2008, new provisions in the Labour Dispute Mediation and Arbitration Law, focuses on disputes between employees and employers. The new provisions expand the scope of labour dispute cases, impose a heavier burden of proof on employers in legal proceedings and extend the statutory limitations of filing arbitration applications. The law has significantly streamlined China's labour dispute mediation and arbitration regime.

The first many cases state a clear tendency: Employers are almost certain to lose at the labour tribunals. There may be political considerations in play, but one thing is certain: Companies must get their documentation in line.

3. New legislation on requirements to report work accidents

The State Administration of Work Safety recently released the Measures for the Reporting and Settlement of Production Safety Accidents (the "Measures"), which is scheduled to take effect on 1 July 2009.

Manufacturers are obliged to report work accidents to the local authorities within 1 hour after they occur. In the event of deliberate concealment businesses may face fines up to RMB 30,000.

The Measures stipulates that the person-in-charge must report all production safety accidents in a manufacturing or operating entity to the relevant local authorities at the county level within 1 hour after the occurrence of the accident.

Manufacturing and operating entities may receive a warning or face a maximum fine of RMB 30,000 for delayed, omitted or false reports, or deliberate concealment of major accidents.

Theme 2: New anti-trust regime

1. China's first antitrust law - a new face of protectionism?

China has introduced a new set of anti-trust rules with teeth. The rules govern merger clearances as well as abuse of a dominant market position and agreements restricting competition.

Local or overseas companies with more than 50 percent of China's market share for any product can be investigated to see if they are "abusing" their "dominant" positions. Even though the law is modelled on the US and European Union antitrust legislation, the Chinese version has a different method to determine "market dominance".

Foreign investors that make an acquisition resulting in a company that exceeds 50 percent market share will have to receive approval from the Anti-Monopoly Enforcement Authority. The law also requires foreign companies to pass a national security test when they acquire a company that may affect China's "national security" - a term that remains undefined.

The new law, as well as many other Chinese laws, has many uncertainties when one has to determine the actual implications. For instance it defines abuse to be when products are sold at "unfairly high" prices or bought at "unfairly low" prices, without specifying what constitutes unfair.

This means that foreign investors will have to be very careful when entering into new agreements and also do a review of whether existing agreements and trade relations violate the new set of rules.

Also mergers have become more difficult since China's Ministry of Commerce on 18 March 2009 rejected Coca-Cola's proposed USD 2.4 billion takeover of the country's leading juice maker, Huiyuan, saying that the deal would have an adverse impact on competition. The decision shows that companies pursuing mergers and acquisitions involving companies operating in China will face tough scrutiny by Chinese competition authorities.

2. New implementation rules set guideline for anti-monopoly investigations

Recently the State Administration for Industry and Commerce of the People's Republic of China (SAIC) issued the Regulations on Procedures of Administrative Authorities for Industry and Commerce for Investigating Cases Involving Monopoly Agreements and Abuses of Dominant Market Positions. The regulations are intended to implement the Anti-Monopoly Law and shall become effective as of July 1, 2009.

Some of the measures for investigation of suspected monopolistic behaviour made possible with this regulation are:

- Entering into the business premises or other related sites of the business operator under investigation to conduct inspections
- Inquiring of the business operator, interested parties, or other related units or individuals under investigation, and requiring them to explain related situations
- Reviewing and copying documents and materials such as certificates, agreements, accounting books, business communications, electronic data, etc., of the business operator, interested parties, or other related units or individuals under investigation
- Seizing and sequestering relevant evidence
- Reviewing the business operator's bank accounts

The new rules leave some concern. For instance there are not enough rules protecting confidentiality and no rules protecting legally privileged documents that should not be reviewed by the authority. And some of the methods cited appear to be quite intrusive, perhaps indicating that AML investigations in China will have powers as extensive as those found in the US, Europe and elsewhere. For instance Article 12b states that where the target under investigation is a business operator, it will be required to provide information on, among other things, overseas investment for the previous three years.

Theme 3: PRC patent legislation and other IPR-related issues

1. New PRC patent law. Now more aligned with international rules.

The PRC National People's Congress passed the third amendment to the PRC Patent Law on 27 December 2008. The new Patent Law will come into effect on 1 October 2009 and brings significant changes to the patent system in China. By many the new law is viewed as an overall improvement of the judicial and administrative protections, but it still leaves some uncertainties.

Some of the major changes to PRC patent law are removal of the "China first filing rule". To replace that a new requirement is introduced so that all applicants seeking first foreign patent filing must apply to the State Intellectual Property Office (SIPO) to undergo a "secrecy examination". Violation of this rule will jeopardize any subsequent patent application in China.

Beside changes regarding foreign patent applications, statutory damages, prior art defences and source disclosure requirement for genetic resources, some of the other changes are briefly introduced below:

Higher standard of novelty: The revised Patent Law removes this territorial restriction and raises the standard of novelty by requiring that the applied-for patent must not belong to the state of the art known to the public in or outside the PRC.

Joint ownership: Under the new regime joint-owners' respective rights shall follow any agreement between the parties. In the absence of an agreement, each co-owner may unilaterally utilise or license the patent, provided that any license fees shall be shared among the joint-owners; other ways of exploiting the patent (presumably including enforcement) shall require all owners' consent.

Compulsory licensing of pharmaceutical products: The new Patent Law introduces a new compulsory licensing regime in relation to the pharmaceutical industry. The PRC authorities may now grant a compulsory license to manufacture and/or export patented pharmaceutical products to designated countries or regions if necessary for public health reasons.

Parallel import and the Bolar Exemption: The new Law clarifies that the parallel import of a patented product does not constitute infringement.

Employee inventor reward and remuneration: A scheme for rewarding employees' participation in the invention process has also been introduced, which seem to cover all "Chinese entities" - and thus also foreign-invested entities. To minimize the risk of uncertainty, employers are strongly recommended to make specific provision in employment contracts for a scheme of reward and remuneration and to set out procedures for resolving any disputes.

2. China's "no. 1" patent dispute now settled.

French electronics company Schneider has agreed to pay RMB 157.5 million (USD 23 million) to Chinese rival Chint Group to end a controversial patent fight concerning a utility model registration. This record settlement is about half the RMB 330 million that the Wenzhou Intermediate People's Court awarded to Chint in September 2007, in what is still the largest award for IP infringement ever made by a Chinese court.

The problem of the case are the so-called junk patents, which are patents based on products already being used outside of China. Chint Group was the first to register in China with this specific patent and therefore protected by law, even though Schneider has been producing the model in Europe for many years.

3. China's Supreme court issues opinion on IP trials in economic crisis

On 21 April The Supreme People's court issued its Opinion on Certain Issues with respect to Intellectual Property Judicial Adjudication Under the Current Economic Situation. The opinion comes as some local officials are encouraging enforcement authorities to take a more lenient approach to IP infringers in the economic crisis.

The opinion encourages courts to be cautious in issuing preliminary injunctions and sets out when they should consider not granting injunctive relief even after finding evidence of infringement. One of the new paragraphs states, that if a rights owner has tolerated infringement for a long period of time or been negligent in the protection of its rights, the court should consider not granting an injunction if it would cause a relatively large imbalance in the interest of the parties. Also pre-trial injunctions are being moderated and only given where public health, environmental protection or other major social interest is involved.

This is a clear indication of the shift in policy to balanced IP protection, and can be of great impact to all foreign companies.

Legal snapshots - Regulatory issues

1. New website launched to improve enforcement of rulings.

The failure of the courts to enforce verdicts on civil cases has been a significant challenge for China's judicial system, with many litigants possessing limited awareness of legal proceedings and refusing to fulfil their legal obligations. Therefore a new website will allow the public to find out who has failed to pay up after losing civil cases in court. The new service lists more than 5.24 million verdicts handed down by 3,484 courts. In 1.44 million of those cases the verdicts have yet to be carried out. The hope is to establish a more effective credibility system. Contact Sally Liu at Eversheds Copenhagen for a link to website.

2. RMB settlement for international trade on trial basis.

The Chinese State Council has decided to start trial of RMB settlements for international trade to improve the conditions of trade. Shanghai City and four cities in Guangdong Province (Guangzhou, Shenzhen, Zhuhai and Dongguan city) were permitted as trial cities. Interrelated departments were requested to promulgate certain regulations to standardize and boost the trial progress in steady.

Using RMB as settlement currency for international trade will play a very important role in pushing forward the development of economic and trade relations between China and its neighbouring countries and areas, avoiding the risks of exchange rate, decrease exchange transfer costs, accelerate settlements, also, it will help making the management anticipation clearer, and ensure the profit.

3. New food safety law - a response to the food safety incidents.

In response to a number of national and international food and other product quality safety incidents the new PRC Food Safety Law was passed on 28 February 2009 and has recently taken effect on 1 June 2009. The objective for the law is to strengthen food safety control "from the production line to the dining table." Not only does the law consolidate hundreds of regulations and standards for food-processing companies, but it also introduces tougher penalties for producers of tainted products.

The new law further establishes an enhanced monitoring and supervision system, a product-recall system and a set of national safety standards. For the food manufacturers, abiding by the law may mean stricter tests on raw materials and tighter control of the manufacturing process. Compliance will most likely increase the cost of production.

4. The new Recycling Economy Promotion Law. New protective rules.

The Recycling Economy Promotion Law, which came into force on 1 January 2009, is intended to control extravagant packaging, high energy consumption, low resources utilization rates and other environmental problems. In addition to these rules and mechanisms, the government will issue a further catalogue of restricted one-off consumables and impose unfavourable tariffs and policies on exporting them.

Affected sectors include steel, non-ferrous metal production, coal, power generation, oil refining, chemicals, construction material production, construction, paper, printing and dyeing.

The detailed monitoring and management rules will be issued jointly by the Recycling Economy Development General Management Office and relevant departments of the State Council. It is yet to be seen when and how detailed rules will be put in place, but companies may have to keep a close eye on the latest developments to allow timely responses.

5. Foreign companies may list on the Shanghai stock exchange this year.

It seems that the plans of listing foreign companies on the Shanghai stock exchange through issuance of shares or depository receipts in accordance with relevant prudential regulations are moving quickly ahead. Preliminary arrangements may be worked out as soon as this year. The move to open China's capital market could lead to relaxation of foreign exchange controls.

The plan for foreign listing is a part of the government's support to the officially announced plan of turning Shanghai into a global financial and shipping centre by 2020.

Legal snapshots: News in the tax/VAT area

1. New VAT Reform - comprehensive changes have occurred.

A new VAT reform became effective from 1 January 2009.

Prior to the VAT reform, enterprises were not allowed to claim the creditable input VAT for purchasing machinery and equipments. FIEs which fall within the 'Encouraged Category' can import machinery and equipments free of custom duty and import VAT whilst processors under contract processing arrangement can import machinery and equipments free of custom duty and import VAT.

However, under the new VAT regulations enterprises are allowed to claim the creditable input VAT for purchasing machinery and equipments. Enterprises cannot however enjoy the VAT exemption for the importation of machinery and equipments and cannot enjoy the VAT refund for the purchase of domestically manufactured machinery and equipments from 1 January 2009 (or from 1 July 2009 if certain conditions can be fulfilled).

Processors under contract processing arrangement are also required to pay import duties for the importation of equipment.

VAT reforms will have an impact on most processing trade operators. Enterprises should therefore evaluate the potential impacts on their business model, tax burden and cash flow.

2. Save 28% tax on Hong Kong to Denmark investments.

It is possible to save 28% Danish source tax just by setting the right tax structure options for Hong Kong investments into Denmark. This theme has become of special interest due to the recently ratified double taxation treaty between Hong Kong and Luxembourg that (when coupled with the Denmark - Luxembourg tax scheme) now allows taxation benefits on expatriation of profits from Danish investments held by Hong Kong parents in a Luxembourg holding structure.

When structuring your Danish investments through Luxembourg you will earn the possibility of saving 28 per cent in Danish source taxation when expatriating profits.

Even if a Danish investment has originally been set up through a direct Hong Kong to Denmark ownership structure, the Danish investment may relatively easy be brought into a Luxembourg holding structure so that tax benefits may be enjoyed.

3. New tax implementation rules for corporate restructuring.

The long-anticipated tax implementation rules for corporate restructuring (officially titled the Circular on Several Issues Concerning the Enterprise Income Tax Treatment of Enterprise Re-organisations) were recently issued by China's finance and tax authorities. The rules were promulgated on 30 April 2009, but it is important to notice that it applies retroactively to restructurings that occurred on or after 1 January 2008.

The new rules not only clarify which forms of transactions that qualify for restructuring, but also clarify the conditions for special tax treatments. The various forms of restructuring are among others merger, changes in legal form, debt restructuring, asset acquisition and spin-off.

4. New transfer pricing rules. Look out for the retroactive effect!

A new set of transfer pricing regulations were approved by the Chinese tax authorities on 8 January 2009. The regulations have retroactive effect from 1 January 2008 and represent a substantial additional compliance burden for Chinese corporations as there are detailed requirements for both annual filing and contemporaneous documentation. The deadline for these requirements is five months after the end of the year, although there is a period of grace for the 2008 tax year (for contemporaneous documentation only),

which needs to be prepared by 31 December 2009. Even with this period of grace, compliance with these regulations will prove challenging for multinational enterprises with complex cross-border transactions.

Legal snapshots - M&A and investments

1. SAFE relaxes FOREX controls for outbound investment - here the Chinese come!

After having also relaxed the approval scheme for Chinese off-shore investments, on 18 May 2009 the State Administration of Foreign Exchange (SAFE) issued new draft provisions on foreign exchange control for outbound investment which should make it easier for Chinese companies to make investments overseas.

Domestic companies will be able to buy foreign currencies or use foreign currency holdings to invest overseas. According to a report in the China Daily, pre-approval of funding sources will no longer be required, and companies can wait until after making an investment before they register with Safe.

Although the draft provisions cover only outbound investment, they may be a sign of more relaxation to come in future for the inbound market. Relaxation of foreign exchange controls is regarded as an essential step towards making the markets in cities such as Shanghai more international.

2. New circulars from MOFCOM speeds up approval process on FDI.

Alarmed by the foreign direct investment (FDI) decline, MOFCOM has issued another series of circulars in additions to those issued on 11 August 2008, to further streamline the process for approval of foreign investments. Besides giving its local branches more power to approve foreign-funded projects, other measures including tax rebates to address falling exports and a stimulus package to enhance domestic demand, are also a part of the new strategy.

One of the key developments came from Circular 8, which expanded the previously set project caps to include holding companies. Now, unless investments in holding companies exceed US\$100 million for encouraged projects, or US\$50 million for restricted projects, foreign investors need not apply to MOFCOM for approval but can go directly to local authorities. The circulars took effect 1 May 2009 and could lead to approval of roundtrip-investments as well.

3. New rules on Private Equity Investment in Shanghai.

The Shanghai government issued the Notice on Business Registration and Other Issues of Equity Investment Enterprise in August 2008 to facilitate the establishment and development of private equity funds in Shanghai so that both qualified domestic and foreign investors (individuals, legal persons or other organizations) may engage in equity investment. According to government officials, investors can set up so-called equity investment enterprises ("EIEs" or the fund) to carry out equity investment activities. Equity investment management enterprises ("EIMEs" or the management company) can also be established to manage equity investments, as appointed by EIEs.

4. Beijing issues new rules to attract foreign companies.

Not only Shanghai is making an effort to attract foreign companies. The government of Beijing has published updated rules covering the establishment of regional headquarters in the city by multinational corporations. The rules will provide tax and foreign exchange incentives and significantly lower the total accumulative paid registered capital in China for the overseas parent company.

The new rules clearly define a regional headquarters as the sole, main institution which manages branches and offers services in different administrative regions. Qualifying multinational corporations which establish or move their headquarters to Beijing after January 1 2009 will get access to favourable policies, such as allowances for renting, building or purchasing real estate as offices. Only certain FIEs are eligible for the preferential treatment.

Besides the tax incentives the provisions also give senior foreign members of a management team a longer residence permit. They can also apply for a Chinese visa when they arrive in Beijing, rather than before they travel.

5. Quick exit from investment for private equity. A route for foreigners?

The Growth Enterprise Market (Gem) will soon open in Shenzhen and this new junior board will make it possible for foreign private equity houses to exit from their investment in China in a reasonably short time. But if the exit is not well-structured, the investors may find themselves caught in a legal trap which could lead to delays of many years.

6. CDM and CER in China... still a very happening market!

Since its creation, the market for Clean Development Mechanism (CDM) projects in China has been very profitable. Recently, foreign investment in China in this area has suffered as a consequence of the global drop in prices in the secondary market for Certified Emissions Reductions (CERs). Secondary CERs prices have reached the floor price set by the Chinese government for primary CERs generated from Chinese CDM projects. Nonetheless, China still remains the main CDM host country, with 440 registered projects and accounting for nearly 70% of the global generation of CERs.

When approaching a CDM project, CERs buyers face a number of issues. They can be essentially grouped under three main categories: project hazards, seller hazards and Emission Reduction Purchase Agreement (ERPA) hazards - which should all be observed when doing a CDM deal in China.

Facts : Eversheds and the China Business Group

- One of the world's largest law firms with more than 45 offices, including in Shanghai, Hong Kong, London and Copenhagen
- +40 legal practitioners who only or regularly work with PRC and Hong Kong regulations or other legal matters relating to China, including off-shore investments
- China Business Group clients include: Coca Cola, Costa Coffee, Tata, MeadWestvaco, Bakkavor, MacAfee, Akzo Nobel, Singapore Airlines, Russell Group of Universities, Next, BASF, Novartis and a major Danish pharma company
- Ability to serve clients round-the-clock on-shore in Hong Kong and China as well as in Europe (London and Copenhagen)
- Copenhagen office with +40 legal staff and Mandarin speaking capability
- Memberships: Danish Chinese Business Forum, Danish Chamber of Commerce in Shanghai, Netværk Danmark - Kina-Gruppe Øst

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