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CHINA Legal Bulletin

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Executive Summary

The Legal Concerns of Foreign Enterprises in China

In the first part of this article, published in issue 2007-3 of the China Legal Bulletin, Maarten Roos discussed the lack of due diligence in commercial transactions as the main cause for commercial disputes. In this second part, he focuses on common difficulties relating to corporate activities and intellectual property protection.

By Maarten Roos

Articles 48 and 85 of the Labor Contract Law and How They Will Effect Foreign Investment

The recently promulgated Labor Contract Law sets out specific provisions to amend various shortcomings of the existing labor laws and makes significant adjustments to the existing legal regime (see the last issue of the China Legal Bulletin for a general introduction). Particularly interesting are the changes to the rules determining compensation in case of illegal termination of the labor contract, i.e. termination without a sufficiently valid reason.

By Lawson Lu

NEW DEVELOPMENTS

At Wang Jing & Co. we are constantly updating our website www.wjnco.com with articles and material concerning legal issues and China. Our lawyers take the time to address their favorite topics and then submit their work always keeping in mind what will be most useful to our clients. An example of this is a recent article by Mr. Sun Honggang on Dormant investments and how to best protect your interests in China. We have included the abstract below, for more information please feel free to contact us.

Analysis of the Juridical Practices and Countermeasures to Dormant Investment in China
by Sun Honggang
http://www.wjnco.com/eng/articles_show.asp?Articles_id=63

Dormant investment of a company involves complicated legal relations as well as many legal issues. This article analyzes the juridical interpretation and juridical practice of dormant investment in China by way of introducing a recent, typical court decision. In addition, as tax preferences for foreign investment are being cancelled, it is reasonable to foresee that dormant investments in the foreign investment field will increase. As a result of the increase disputes over dormant investments will certainly increase as well. This article focuses on the present situation and problems of dormant investment in regards to foreign investment, and then offers some suggestions on how to solve these problems.

EXECUTIVE EDITOR:
WANG JING

SENIOR EDITOR:
MAARTEN ROOS

EDITOR AND DESIGN:
ZACHARY WORTHAM

Legal Concerns of Foreign Enterprises in China



Corporate Structures Realistic Expectations *Joint Ventures*

In recent years more and more companies, including many that are small and medium sized, are establishing offices or subsidiaries in China to take full advantage of lower manufacturing costs, to avoid unnecessary taxes or agent fees, or to provide products and services to China's large and growing markets. Especially for smaller companies, to invest in China represents a pivotal decision, one that may be crucial to their future.

Undoubtedly, the success of such a venture depends to a great extent on commercial factors, at home and in China. However, the legal perspective can add considerable leverage. The basis of any investment should be an understanding of China's controlled regime for foreign investments, so that potential delays or bottlenecks can be identified and tackled early on. Another major problem relates to the concept of the Joint Venture.

China has promulgated numerous laws to guide foreign investment into China, whether in the form of a representative (liaison) office, a wholly owned subsidiary or a joint venture with a domestic enterprise. Up to fifteen administrative departments can be involved in the approval and registrations needed for establishment, with their requirements varying with each separate locale. In the face of so much bureaucracy, too many companies go it alone, or rely heavily on inexperienced consultants, scrupulous or well-intended individuals, or government investment promotion departments. Indeed, sometimes things are done more quickly with the right connections. But a company should always remain cautious. Promises that sound too good to be true are often just that; short cuts in China rarely lead to long-term gain.

Problems that often occur, and will then be time-consuming and costly to resolve include:

- o the signing of a lease agreement and payment of deposit before confirming whether and under what conditions the property in question can be registered as the residence of the office or company
- o the failure to define properly the business scope in the Chinese subsidiaries
- Articles of Association
- o financing problems due to inadequate provisions of investment and registered capital

More generally the failure to understand or take advantage of the Chinese legal framework for investments at an early stage of investment often lead to complications in the establishment process or in the future.

A particular problem that some investors face is the choice between joining forces with a domestic partner, or establishing a business on their own. In the past, investment in many industries was only permitted through so-called Sino-foreign joint ventures, whereby a new company is established through investments from at least one Chinese company and at least one foreign company or individual. Statistics show that the popularity of joint ventures has decreased considerably in recent years; on the other hand, there are good reasons to consider such a partnership. Chinese companies for instance often have a better understanding of the local market, can bring capital in the form of factories or land, and can contribute management, local connections and general support.

The main misconception of the Joint Venture, however, is that it is like a traditional marriage, whereby two (or more) companies join together to grow old and rich. In fact, the Chinese Joint Venture is much more like a temporary union between parties who retain their own identity, ideas and long-term goals. The joining of forces can be beneficial, but the venture is in most cases temporary in nature. At one point or another, the parties will grow apart, ideas will diverge, a battle for control over the operation and future of the Joint Venture will follow, and the parties will break up.

There can also be good reasons to start a Joint Venture; for parties with little experience in China, or those operating in industries in which connections are vitally important, a Chinese partner can provide valuable support. However, expectations should be adjusted to meet reality. If you start a Joint Venture, know that at some point, you will have disagreements on its direction, the investments needed, or the management practices it is governed by. Chinese partners are often very adept at using the Joint Venture to their own advantage mainly to gain a better understanding of the foreign party's business practices. When they feel they have learned enough, they will put all their energy into developing their own, fully-owned companies. The foreign party is entitled to take a similar approach.

IP Protection Preparing Well

A third area of law that provides foreign companies doing business in China with major challenges is that of intellectual property rights protection. China is well-known as the country where everything and anything can and will

WANG JING & Co. **UPDATE** **New Shenzhen Branch** **& Article on the** **Preservation of** **Maritime Assets**

In order to meet our competition and further our goal to remain the leader in providing legal services in South China, this firm has established a branch office in Shenzhen, Guangdong. The Shenzhen Branch is located in the International Commerce Center Tower in the city's commercial center at the corner of Yitian Road and Fuhua Road adjacent to the Shenzhen Convention & Exhibition Center and near the Shopping Center subway station. The Shenzhen Branch will be staffed by a number of our most experienced lawyers and will provide legal services in the fields of admiralty, maritime, insurance, corporate, commerce and intellectual property rights for clients in or around the Shenzhen area.

Shenzhen Branch Address:
*Suite 2708, International Chamber of Commerce Tower,
Fuhua Road 3, Central Business District,
Futian District,
Shenzhen 518048, P. R. China*

One of the key problems for dispute resolution in China is that a favorable judgment is often difficult to enforce, when the opposing can easily hide its assets. To avoid such a situation, the claimant can ask for a preservation of assets. In maritime disputes, the arrest of a ship serves exactly this purpose, as is described in much detail in an article on Arrest of Ship in China.

http://www.wjnc.com/eng/articles_show.asp?Articles_id=65

The author, Mr. Xu Jianfeng, is a senior associate at the Wang Jing & Co. Shanghai Office, and mainly represents foreign clients in maritime and insurance disputes. Last year Mr. Xu trained for 5 months at Holland and Knight LLP, one of the leading law firms in the United States.

Legal Concerns of Foreign Enterprises in China



be copied, and unfortunately China's system of legal enforcement of intellectual property rights is still young and lacks sufficient resources to significantly attack the current prevalence of infringement. Nonetheless, foreign companies can take measures to be better prepared.

Above all, trademarks and patents should be registered in China to be protected under Chinese law. Since China maintains a first-to-file system, basically meaning that the first party to successfully register a trademark or patent will own such rights irrespective of prior uses by third parties, the early filing of applications for registration of such intellectual property rights is crucial to combat infringements later on.

Many foreign IP owners delay too long in applying for registration. For trademarks in particular, companies often wait till they are actually selling or investing in China. By this time, Chinese competitors, business partners, or independent third parties may have already acquired the rights to the trademark in China. Getting back the trademark is difficult and costly, and will take many years during which time there is no protection from third parties already using your brand. While the holding of IP rights such as trademarks, patents or copyrights is not a guarantee that third parties will not infringe on such rights, it does form the basis for any action against infringers.

Contrary to popular belief, China's legal regime for enforcement of IP rights is actually quite comprehensive. The bad news is that enforcement is often expensive, with a high burden of proof, and the number of infringers is ever growing. The good news is that the available measures against infringements are becoming increasingly effective. Many foreign companies make the mistake of giving up on the outset. But for all those IP owners that cannot constantly stay ahead of infringers, it is important to acquire full awareness of the various actions that may or may not be effective in specific situations, and to have protection mechanisms in place so that they can be implemented when they do become cost-effective. Protection mechanisms include:

- ✓ registering IP rights;
- ✓ keeping your IP portfolio ready to use;
- ✓ recording certain IP rights with customs authorities;
- ✓ including proper clauses in commercial and labor contracts;
- ✓ teaching employees about the value of IP rights and the penalty for infringing them;
- ✓ collecting evidence of infringement in the market using employees and partners.

To take action against every infringer is not practical for most companies operating in China, however to do nothing is tantamount to formal acceptance. Taking preliminary steps, understanding the options, conditions and benefits of the various

remedies under Chinese law, and a careful balancing of expenses, risks, and results on a case by case basis will allow a company to maximize a limited IP enforcement budget.

Conclusions

Every foreign company in China faces challenges, and must find a way to deal with those challenges effectively. How to manage these daily obstacles depends on the company culture and the specific challenges it is facing. Nonetheless, the general issues discussed above can serve as a guideline for approaching some of the most common problems that foreign companies face when they enter and operate in China.

Foreign companies should take the time to fully determine what their goals are and understand how they can be achieved. China is not an easy place to do business, and companies face hurdles that may not be as distinct or familiar as in other countries. But these hurdles can be overcome.

By Maarten Roos

Articles 48 and 85 of the Labor Contract Law and How They Will Affect Foreign Investment

I. How to compensate the employee if the employer illegally terminates the labor contract?

The Measures on Economic Compensation for Violation and Termination of Labor Contracts, promulgated by the Ministry of Labor in 1994, set out the circumstances under which an employer shall pay economic compensation if it can reach an agreement on the termination with the employee, and such an agreement is valid under the labor law. The Labor Law of the Peoples Republic of China (1994) and the Measures on Compensation for Violating Provisions of

Labor Law Concerning Labor Contracts (1995) both confirm that employers should pay compensation to employees if the parties cannot reach an agreement on termination, and the contract is terminated illegally. However neither of the above provide any guidance on how much compensation should be paid by the employer if the termination of the contract is held to be illegal, and the contract can no longer be performed. In the past, this uncertainty on the rights and obligations of employer and employee has resulted in many labor disputes. Without clear guidelines, it is often difficult for the employer and employee to come to an agreement, with judgments rendered by courts failing to provide stability.

Article 48 of the Labor Contract Law provides that where an employer terminates a labor contract in violation of the Labor Contract Law provisions, and the employee demands the continuance of contract performance, the employer may not refuse such demand. If the employee waves his right to demand continual performance of the contract or the labor contract can no longer be performed, the employer shall pay compensation. The standard of compensation shall be calculated on the basis of the years the employee worked for the employer, and be equal to two

Articles 48 and 85 of the Labor Contract Law and How They Will Effect Foreign Investment



months salary for each year of service. Any period of more than six months shall count as one full year, while any period of less than six months shall be compensated with only one month salary.

Most disputes involving possible illegal termination (i.e. termination of the labor contract without valid reason for termination) result from the unilateral intentions of the employer, and following a claim in labor arbitration, a workable rehire of the employee is rarely an option. The case then becomes about the amount of compensation; the above guidelines provide legal basis for resolving 80% of the present labor dispute cases.

II. Whether the employer should pay extra compensation for non-compliance if the arbitral commission or court holds that the employers contract termination was illegal?

Article 10 of the Measures on Economic Compensation for Violation and Termination of Employment Contract prescribes that upon termination of the labor contract, if the employer fails to pay economic compensation as prescribed in law, the employer can be held liable for an additional late payment penalty equal to 50% of the economic compensation originally due. Thus courts will often add such a penalty to any judgment of compensation in the employees favor. The Labor Contract Law however seems to limit the late payment penalty concept.

Article 85 provides that under any of the following circumstances, the competent labor department shall order the employer to pay wages, overtime pay or economic compensation (upon termination of the contract) within a stipulated period (remedy payment order); if the wages are lower than the minimum local standard, the employer shall compensate for the balance; and if the employer delays the payment of wages,

overtime pay or compensation, the employer shall be liable for a late payment penalty of between 50% and 100% of the amount payable to the employee.

According to the aforesaid provision, the precondition for the employer to be liable for the late payment penalty is that it fails to abide by the remedy payment order from the labor department. Thus in the writers opinion, according to Article 48 of the Labor Contract Law, if an employee in a labor dispute applies directly to the labor arbitral commission for resolving a dispute without first getting the labor department to issue a remedy payment order then that labor arbitral commission or a first or second instance court (in case the arbitral decision is appealed) may not order the employer to pay the employee any extra compensation for late payment.

Other interesting issues

Article 14.2 of Labor Contract Law provides that after two fixed-term contracts have been signed and expired, if the employee either demands or agrees to renew his or her labor contract, then the employer must offer him an open-term contract (the only exception being that the employee himself prefers a fixed-term contract). If the employer fails on this obligation, it will be liable to pay the employee double salary every month starting from the date the open-term contract should have been provided.

Article 46 of the Labor Contract Law prescribes that the employer shall pay compensation upon expiration of a fixed-term contract, except if the employer maintains or raises its offer on terms and conditions in a new labor contract but the employee rejects this offer

By Lawson Lu

TAX REGULATIONS UPDATE Foreign Investment

A recent development in the PRC Tax environment is the issuance of Guoshuihan [2007] No.236 (Circular 236), which calls for tax officials to investigate loss-making FIEs and FEs with single manufacturing functions and is a clear indication of the SATs decreasing tolerance towards contract manufacturers and toll processors in China, which may be making losses. Many FIEs / FEs have losses or make marginal profit though performing pure manufacturing activities according to their foreign parents overall operational plan. Many of these losses arise because the companies are in start-up positions and may have initial one-off costs or low capacity utilization. Tax audits on these FIEs / FEs are carried out by the respective local tax bureaus on a case-by-case basis. Circular 236 demonstrates that the SAT is organizing a nationwide tax investigation campaign into the transfer pricing arrangements within these single manufacturing-function FIEs / FEs.

Based on this new circular, loss making FIEs / FEs with single manufacturing functions will become a major target of future transfer pricing investigations, and the immediate consequences could be tax adjustment or expedited triggering of tax holiday. It is recommended that FIEs / FEs in China conduct self transfer pricing assessments based on this new circular and seek advice when continuing losses or marginal profits are identified.

GUANGZHOU

Tel. (+8620) 8760 0082
Fax (+8620) 8778 4482
info@wjnc.com

SHANGHAI

Tel. (+8621) 5887 8000
Fax (+8621) 5882 2460
shanghai@wjnc.com

TIANJIN

Tel. (+86 22) 2532 3818
Fax (+86 22) 2532 3820
tianjin@wjnc.com

QINGDAO

Tel. (+86 532) 8666 5858
Fax (+86 532) 8666 5868
qingdao@wjnc.com

XIAMEN

Tel. (+86 592) 268 1376
Fax (+86 592) 268 1380
xiamen@wjnc.com

FUZHOU

Tel. (+86 591) 8781 2260
Fax (+86 591) 8781 2210
fuzhou@wjnc.com

HAIKOU

Tel. (+86 898) 6672 2583
Fax (+86 898) 6672 0770
hainan@wjnc.com