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Luxury goods - Legal guide to China

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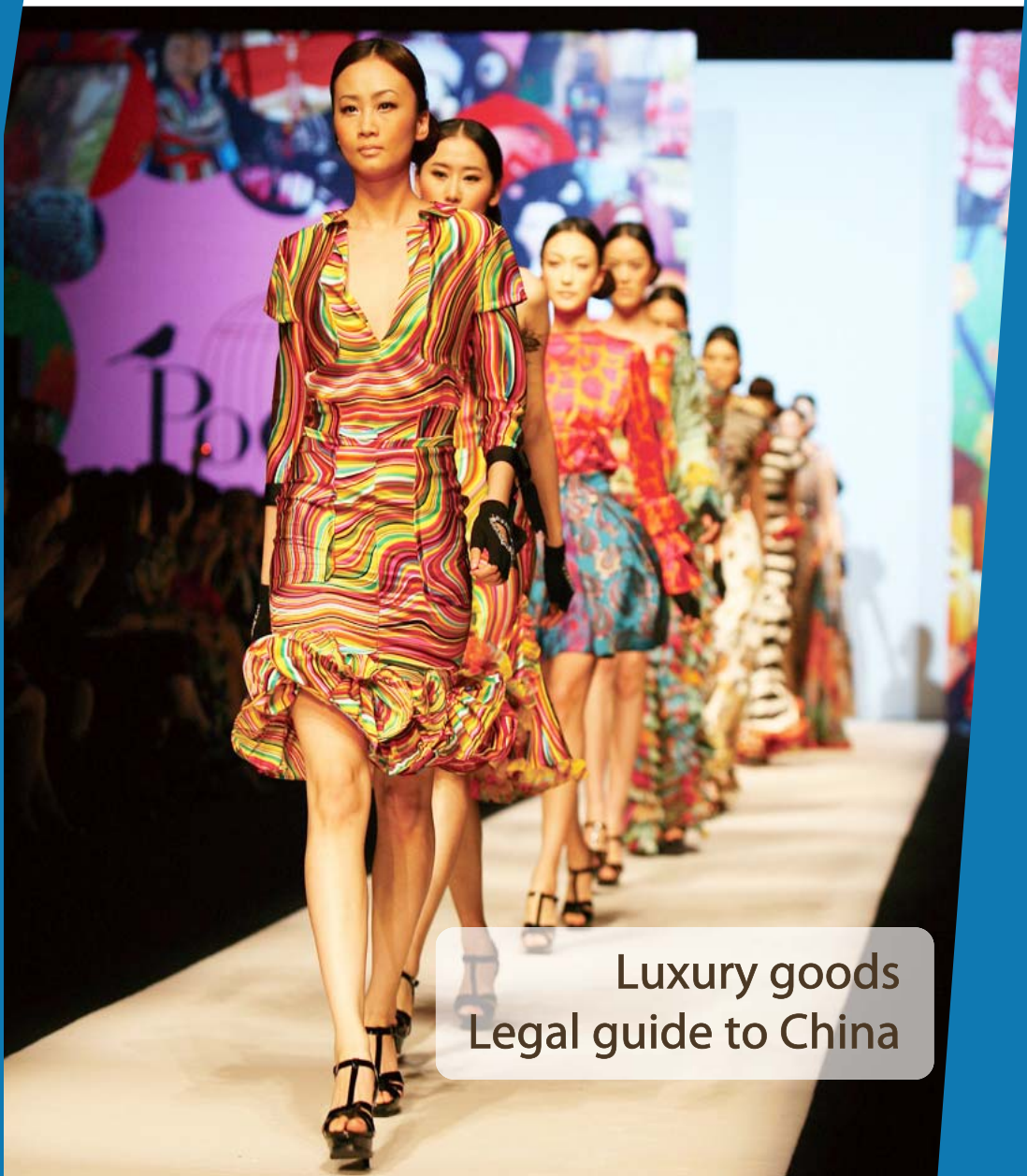

Luxury goods
Legal guide to China

Introduction

This legal guide to the luxury goods industry in China provides an overview of the rules and regulations applicable to companies in the luxury goods sector, which are looking to establish a presence or expand in China.

Our CMS Luxury Goods Sector Group explains in this guide the legal framework surrounding establishment of a business, distribution of products, intellectual property protection, taxation and pricing in China. You will find answers to issues that directly impact your business' legal compliance, expenses and profitability of your business.

CMS Shanghai Office
October 2009

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About CMS China and CMS

CMS is an organisation of 9 major European law firms that provides clients in Europe, China and emerging markets with a full range of legal and tax services based on a thorough understanding of their business.

CMS was established in 1999 and integrates over 2,400 legal and tax advisors in 53 offices across 27 countries. CMS has been advising clients conducting business in China for more than 30 years. From our Shanghai and Beijing offices, we maintain a close eye on the rapid legal and commercial developments occurring in China. The Shanghai office is staffed with over 30 lawyers, mostly Chinese, working alongside lawyers from France, Germany, the Netherlands, Switzerland and the UK, enabling us to provide an extensive range of legal expertise and services to clients doing business in China. We work hard to be a truly client-focused law firm. This means understanding the unique needs and challenges of the luxury goods sector.

Abbreviations and definitions

AIC	Administration for industry and commerce
APA	Advance pricing agreement
AQSIQ	Administration of quality supervision, inspection and quarantine of China
Catalogue	Catalogue of industries for foreign investment industries issued and updated from time to time by the State development and reform commission and MOFCOM
China	Mainland China (Hong Kong SAR, Macau SAR and Taiwan excluded)
CIETAC	China international economic and trade arbitration commission
CIF	Cost, insurance and freight
CIT	Corporate income tax
CJV	Cooperative joint venture
COD	Collect on delivery
COFCOM	Commission of commerce
DNDRC	Domain name dispute resolution centre
EJV	Equity joint venture
FICE	Foreign invested commercial enterprise
FIE	Foreign invested enterprise (including WFOE)
HKIAC	Hong Kong international arbitration centre
International Bureau	International bureau of WIPO

IP	Intellectual property
Madrid System	The Madrid system for the international registration of marks
MOFCOM	Ministry of commerce
OECD	Organisation for economic co-operation and development
NDRC	National development and reform committee
OEM	Original equipment manufacturer
Patent Bureau	Patent bureau under SIPO at local level
Patent Cooperation Treaty	Patent cooperation treaty concluded in 1970 and administered by WIPO
Paris Convention	Paris Convention for the protection of IP (20 March 1883)
RMB	Renminbi (the official currency of China)
SAFE	State administration for foreign exchange
SAIC	State administration for industry and commerce
SFDA	State food and drug administration
SIPO	State intellectual property office
Trademark Office	Trademark office under SAIC
TRIPs	Agreement on trade-related aspects of IP rights
T/T	Telegraphic transfer
VAT	Value added tax
WFOE	Wholly foreign owned enterprise
WTO	World trade organisation
WIPO	World intellectual property organization

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Chapter 1 Investment structure – establishing a business

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The first step to setting up a business in China is to decide which form of investment vehicle to use.

A foreign investor may choose to invest directly in a greenfield project, through an existing Chinese company, or by establishing a representative office.

1. Legal vehicles

1.1 Wholly owned or joint venture

Luxury goods companies wishing to establish a business in China can choose between the following forms of business entities: WFOE, EJV or CJV.

1.1.1 WFOE

A WFOE is a company that is wholly owned by one or more foreign investors. If there is more than one foreign investor, the parties share profits and bear losses in proportion to their respective equity interest ratio.

1.1.2 EJV

An EJV is a Sino-foreign company, which is invested in by both Chinese and foreign investors. The parties share profits and bear losses in proportion to their respective equity interest ratio.

1.1.3 CJV

A CJV is a cooperative arrangement between Chinese and foreign investors. This arrangement may be reflected in the form of a contract only, or a company may be established for these purposes. The parties are permitted to determine the allocation of profits between them, therefore allowing more flexibility. Parties usually choose to establish a CJV when it is agreed that one party shall recover its investment through an accelerated refund scheme.

In practice, the Chinese authorities are sometimes reluctant to approve the establishment of CVJs.

Determining which of these three legal entities is the most suitable for a particular business will be influenced by whether the investor wishes to have a partner and, if so, whether the partner will be a Chinese or foreign investor. The desired profit allocation will also be a deciding factor.

1.2 Representative office

A representative office of a foreign enterprise in China is not a legal entity in itself, but rather an extension of its overseas parent company. Representative offices of foreign enterprises are not allowed to carry out any profit-making business activities or to issue invoices. They may only engage in non-profit activities such as business liaison, marketing or market research.

1.3 Establishing branch offices

A branch is a subdivision of a company which does not have legal person status. A company must fully bear all liabilities of its branch office. Branch offices prepare their own accounts, which are consolidated with those of the company.

When a luxury goods company has established an FIE in China and wishes to expand its business into other cities across the country, it can choose to establish branches of the FIE. This model is especially useful where an FIE wishes to open retail stores across China.

2. Greenfield or merger & acquisition

2.1 Greenfield investment

Establishing a legal entity in China requires approval and registration with the competent local authorities. Generally, these are COFCOM and AIC. However, under certain circumstances (for instance if the total investment exceeds USD 100 million), MOFCOM also needs to give its approval. In addition, the new entity must be registered with the local tax, customs and financial authorities, amongst others, before commencing operations in China.

2.2 Acquisition of existing Chinese companies

Due to the fact that a large number of the most well known luxury goods companies came into the Chinese market in the 1990s through distribution agents appointed by the overseas luxury goods companies, such distribution agents naturally became the targets of acquisition. A number of luxury goods companies have acquired a majority or entire equity interest in their distribution agents with the aim of directly controlling and operating retail outlets within a region of or across China.

The acquisition strategy in the Chinese market helps foreign investors to enjoy many benefits, including immediate access to the rapidly expanding Chinese domestic market. An investor may choose to acquire equity or assets of an FIE or a domestic company.

Every merger or acquisition deal involving a foreign party is subject to the approval of MOFCOM or its COFCOMs, upon review of the related executed contract. The transaction must also be registered with AIC and the tax authorities to enable registration details to be updated and to ensure that, in the case of an equity transfer, all tax matters are settled. If the target company is a state owned company, additional approval from the State Owned Assets Administration Commission is required.

3. Business scope

Luxury goods companies wishing to establish a business in China must strictly define the scope of business activities to be carried out by the FIE.

Generally, luxury goods companies establish an FIE to distribute their goods in China. Most of the time, the FIE will take the form of a WFOE rather than an EJV or CJV. The scope of business may include wholesale, retail, franchising and/or commission agency. This type of FIE is a trading company normally defined as an FICE.

In certain very specific circumstances, luxury goods companies may also decide to establish manufacturing operations in China and establish a manufacturing subsidiary. For the purpose of this guide, we only refer hereafter to FICE which is the most commonly used legal entity in the luxury goods industry.

3.1 The Catalogue

The Catalogue classifies different sectors of foreign investments into three categories: encouraged, restricted and prohibited. Foreign investment projects which are classified as (i) encouraged, are subject to a preferential policy, (ii) restricted, are subject to restrictions on foreign investment and (iii) prohibited, may in no circumstances be invested in. Investments in sectors that are not expressly listed in the Catalogue are automatically deemed to be permitted.

Luxury goods companies, like any foreign investors, are encouraged to invest in the wholesale and retail sector for distribution of goods but are restricted from investing in certain areas such as direct sales, online sales and commodity auctions. To invest in such restricted business areas, foreign investors must obtain prior approval from MOFCOM in Beijing, which will lengthen the time required for the approval process.

3.2 Carrying out business activities within the authorised business scope

In China, every company must carry out its business in accordance with the business scope appearing on its business licence and may incur penalties (such as fines, profit confiscation and/or business licence revocation) for any business activity falling outside the approved business scope.

As such, the business scope to be examined and approved by the authorities should be defined as broadly as possible to cover any current and envisaged future business activity that the proposed company might undertake. Nevertheless, the approval authorities will still scrutinise and sometimes narrow the proposed business scope to ensure it complies with the Catalogue and the other provisions of Chinese law and may request the proposed business scope be adjusted and amended if necessary.

AIC supervises the business activities of all companies during their business term. All companies must undergo an annual examination by AIC.

3.3 Typical business scope of an FICE

The typical and basic business scope for an FICE in the luxury goods sector is: "Wholesale and retail of *[list type of goods]*, commission agency (auction excluded), import and export of the aforementioned commodities, after-sales services and related ancillary services, repair and maintenance services related to the aforementioned commodities".
（从事/具体商品/的批发和零售、佣金代理（拍卖除外），上述商品的进出口，售后服务及相关配套业务、上述商品的相关维修服务）。

The terms used within this business scope may be explained as follows:

3.3.1 **"commission agency (auction excluded)"**: an FICE engaged in auction activities is subject to special approval and licensing from MOFCOM in Beijing;

3.3.2 **"import and export"**: an FICE may entrust agents to import and export luxury products on its behalf, therefore will not need the business scope of "import and export". However, an FICE may still apply for such business scope to be able to import the goods directly in future; and

3.3.3 **"related ancillary services"**: such service scope is broad and general and covers matters such as the provision of consulting and training services related to the luxury goods. However, note that revenue arising from the provision of consulting and training services must not exceed a company's principal operating revenue, otherwise it may be challenged by the competent tax authorities. Where a trading company provides "related ancillary services" together with performing its main business activity (such as distribution, or import and export of luxury goods), such ancillary services shall be subject to VAT; if the related ancillary services provided are separated from the main services, such ancillary services shall be subject to a 5% business tax.

4. Funding the business

4.1 Equity

The registered capital of a limited liability company is the total amount of capital contributions made by all registered equity holders.

Chinese law provides a minimum registered capital requirement. However, companies engaging in certain restricted activities must be established with a higher level of registered capital. Local approval and registration authorities may sometimes fix their own minimum threshold.

Capital contributions may be made in one lump sum or in several instalments. At least 15% (20% in some municipalities) of the registered capital needs to be paid within three months of the date of issue of the business licence and the remainder of the capital must be fully contributed within two years.

In China, a company may use its entire registered capital for commercial use without being required to maintain minimum funds.

4.2 Debt

Chinese law distinguishes a company's registered capital from its total investment. The latter is calculated according to fixed ratios. The difference between the total investment and the registered capital is known as the "foreign debt quota" of the company. The foreign debt quota is the maximum amount of debt which may be owed by a company in the form of foreign currency, or as guaranteed by overseas collateral. Any loan granted to an FIE in a foreign currency must be registered with SAFE to become valid and enforceable.

5. Foreign exchange

5.1 General information

China implements a strict foreign exchange control system and restricts the full convertibility of RMB. The RMB official exchange rates against major foreign currencies are issued daily by the People's Bank of China. The RMB is only allowed to float within a narrow band pegged to a fixed basket of foreign currencies mainly composed of the US dollar, the Euro and the Japanese Yen.

SAFE is the principal competent authority responsible for controlling, regulating and supervising the regime of foreign exchange control.

The conversion of registered capital from foreign currency into RMB should be based on the entity's actual needs under current rules. If the cumulative annual amount of the converted amount exceeds USD 50,000, a detailed description of the proposed usage of the converted RMB is required. A request to convert RMB into foreign currency for trade and daily settlements must be submitted to the bank with relevant supporting documents, including any related tax payment certificates.

Foreign exchange transactions categorised as current account items generally no longer require prior approval from SAFE. Instead, designated banks are responsible, under a delegation of power from SAFE, to verify and review evidence / documentation which provide justification for the transactions and to handle the foreign exchange payment out of China.

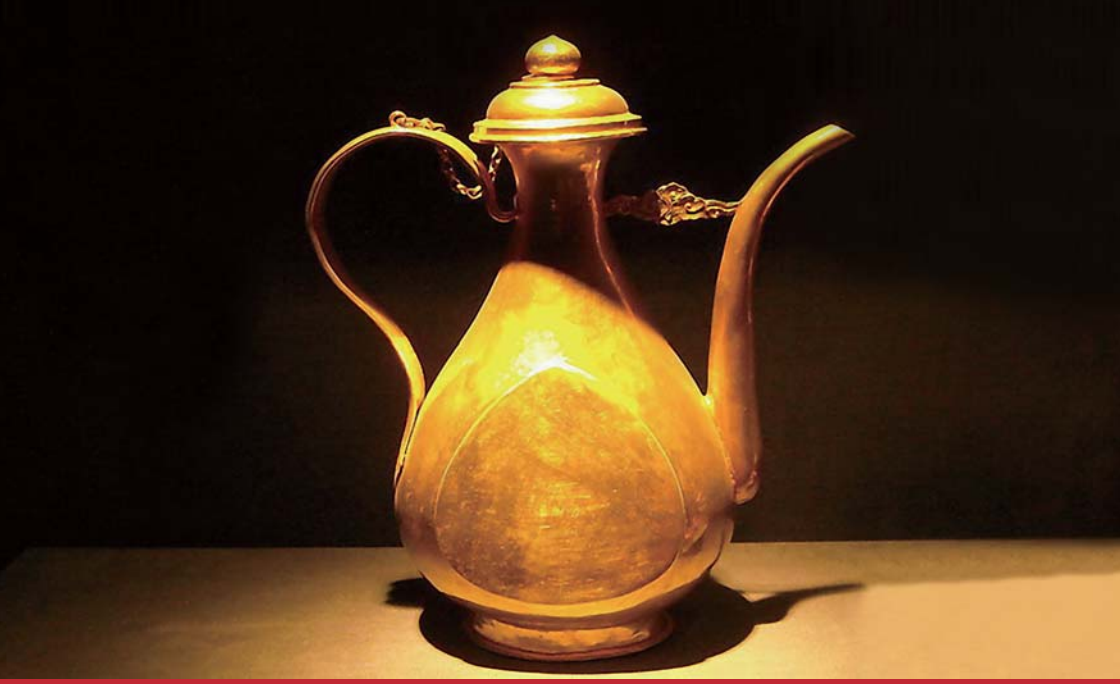
5.2 Overseas advertising fees

Chinese regulations on foreign exchange only permit a qualified local Chinese advertising agent (and not the Chinese subsidiary of a luxury goods company) to pay fees overseas for advertising services conducted overseas. Such services may include creation, design and production of an advertising campaign.

To illustrate, if the Chinese subsidiary of a luxury goods company wishes to hire an overseas advertising agency or shares the cost of an international advertising campaign, the Chinese subsidiary will have to first instruct a local qualified advertising agent to contract with the overseas advertising agency. The payment to the overseas advertising agency must then be made through the local qualified advertising agent and will most likely incur payment of an agency commission.

6. Accounting and reporting

All FIEs in China are required to prepare annual financial statements, including balance sheets, profit and loss statements and cash flow statements. These accounts must be maintained in accordance with the relevant Chinese accounting standards, which differ from international accounting standards. A mandatory annual audit by a Chinese certified public accountant is required for all FIEs.



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1. Taxation of business income

1.1 Corporate income tax

1.1.1 Tax rate and taxable income

The CIT rate is 25%. This standardised rate applies to Chinese domestic enterprises and FIEs.

Certain favourable tax regimes and incentives continue to apply and be granted in certain zones. However, they will mostly be cancelled after 2012.

Taxable income includes income derived from sale of goods, provision of services, transfer of assets and receipt of interest, dividends, rental payments, royalties and donations. Tax losses can be carried forward for five consecutive years.

It should be noted that if expenses are incurred for advertisements and business publicity these expenses are CIT deductible up to a maximum of 15% of total sales turnover in a tax year. Any amount exceeding this ceiling can possibly be deductible in the subsequent tax years.

1.1.2 Tax filing

CIT is usually prepaid on a quarterly basis.

Within fifteen days of the end of each quarter, a company must submit to the tax authorities a CIT return for prepayment and then, within five months of the end of each year, submit an annual CIT return to settle the payable or refundable amount of CIT.

For a company with one or more branches, the entire CIT of the company shall be re-allocated to the branches according to certain ratios and the CIT shall be prepaid locally with each competent tax authority on a quarterly basis. An annual consolidated CIT filing shall then be conducted by the company by the end of May of the subsequent tax year. The same allocation method is used to calculate the entire CIT for the whole tax year. Any surplus or shortage of CIT payments shall then be refunded to or made up by the company.

1.2 Repatriation of dividends, interest, royalties and know-how

1.2.1 Dividends

Chinese subsidiaries and joint ventures may repatriate their post-tax profits to overseas parent companies.

Dividends are generally declared and paid after the end of a tax year. It is possible, albeit uncommon, to declare and pay interim dividends, which are subject to special approval from SAFE.

The total amount that can be paid out as dividends is limited to the accumulated after-tax earnings. Furthermore, at least 10% of the net profits achieved in a tax year must be paid into a company reserve before dividends can be paid. This reserve must accrue until the balance of the reserve reaches 50% of the company's registered capital.

Dividends paid abroad are subject to a 10% withholding tax, subject to more preferential provisions of any applicable double tax treaty. As an example, the Mainland China and Hong Kong Tax Arrangement ("Tax Arrangement") and the double taxation treaty between Singapore and China offer a reduced withholding tax rate of 5% in China on dividends.

1.2.2 Interest, royalties and know-how

Interest on loans, royalties and other related fees paid by Chinese companies in China to foreign entities are generally subject to a 5% business tax on the gross income and a 10% withholding tax on the gross income, subject to the more preferential provisions of any applicable double taxation treaty.

2. Indirect taxation

2.1 VAT

2.1.1 General regime

VAT is a turnover tax levied on the import of goods, the sale of goods and the provision of processing, repair or replacement services in China.

VAT payers are classified either as general taxpayers or small taxpayers. The appropriate category is determined predominantly by business scale or annual sales volume.

As a general VAT taxpayer, VAT taxpayer can credit its input VAT against its output VAT. The standard rate for most luxury goods is 17% for general taxpayers. As a small scale VAT taxpayer, VAT taxpayer shall pay VAT calculated on the basis of a fixed percentage (3%) of the total net sales revenues. The actual VAT paid by a small taxpayer is output VAT at 3% without any deduction of input VAT.

2.1.2 Requirements for obtaining VAT general taxpayer status

After being granted a certificate of approval by MOFCOM and a business licence by AIC, the FICE must also complete other registration procedures (such as organisation code, tax, foreign exchange, finance and customs registration). After obtaining a tax registration certificate, the FICE may consider applying at the same time for the general VAT taxpayer status if the expected annual sales volume exceeds the threshold of RMB 0.8 million.

2.2 Business tax

Business tax is another turnover tax imposed in China on the transfer of intangible goods, the provision of services which are not subject to VAT, the provision of taxable labour services and on the sale of immovable property in China. VAT and business tax are mutually exclusive. Business tax is levied on gross turnover of the service provider. No crediting of input tax against output tax is available. Generally, the provision of consulting, training service or other services which are not subject to VAT, the assignment of intangible assets or the sale of immovable property in China are all activities which are subject to business tax.

2.3 Consumption tax

Consumption tax is another turnover tax imposed on manufacturing, commissioned processing, importation and distribution of some specific consumption goods mostly in the luxury sector. This tax is levied in addition to VAT. The tax rates range from 3% to 45% depending on the nature of the goods.

Exports are exempt from consumption tax.

Taxable luxury goods include:

(a) cigars, which are subject to consumption tax at a rate of 25%, 30% or 45%;

(b) alcohol, which is subject to consumption tax at a rate of 5%, 10% or 20%;

(c) cosmetics, which are subject to consumption tax at a rate of 30%;

(d) valuable jewellery and ornaments, which are subject to consumption tax at a rate of 5% or 10%;

(e) golf and golfing equipment, which are subject to consumption tax at a rate of 10%;

(f) yachts, which are subject to consumption tax at a rate of 10%; and

(g) high-end watches, which are subject to consumption tax at a rate of 20%.

2.4 Stamp duty

Stamp duty is a tax that is levied on certain types of legal documents concluded or received by companies (including Chinese companies, FIEs and foreign companies) or individuals with Chinese or foreign nationalities in China.

Legal documents generally include:

(a) contracts such as those for sales, processing, construction, property lease, logistics services (including transportation, warehousing and storage), loans, property insurance, technology related contracts or other specified contractual documents;

(b) documents relating to the transfer of property ownership;

(c) financial accounting books which illustrate the business activities of companies or individuals; and

(d) titles, licences or certificates.

At present, the rate of stamp duty for titles, licences, certificates or accounting books for the recording of funds is RMB 5 per document/book. The stamp duty tax rate levied on other legal documents ranges from 0.005% to 0.1% of the value of the contract. Generally, all the parties to the legal document are liable to pay the stamp duty.

Chapter 3 Trading with overseas affiliates: imports and transfer pricing

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In this chapter, reference is made to a common business model used by a luxury goods company when establishing an FICE. The goods are manufactured overseas by another subsidiary or by the parent company, imported into China and distributed and sold by the FICE. This business model triggers issues such as import procedures, involving the import certificate, logistics and compliance with foreign exchange regulations. The luxury goods company also needs to pay attention to transfer pricing regulations when selling goods to its FICE.

1. Import of goods: formalities, customs and logistics

1.1 Import procedure

1.1.1 Pre-import product certificate

The import of certain goods is subject to an import product certificate that must be obtained prior to any import of the goods in China. This will most likely occur when the goods may have an impact on human health and safety and therefore need to have received prior approval from the relevant authorities.

For instance, overseas manufacturers of cosmetics goods must obtain a hygiene certificate for imported cosmetics issued by SFDA before they are authorised to import their goods into China.

1.1.2 Customs clearance procedures and import agent

When imported goods enter Chinese territory, the designated importer – including Chinese subsidiaries of the luxury goods company – must go through customs clearance procedures before the goods can be distributed throughout China.

The main customs clearance procedures that must be satisfied include clearance of the goods for distribution in China and payment of all import customs duty, import VAT and/or consumption tax levied on the imported goods. Depending on the nature

of the goods, additional formalities may need to be handled, such as applying to the Entry-Exit Inspection and Quarantine Bureau when importing cosmetics.

Even if the FICE holds an import/export licence, the FICE may prefer to engage a specialised import/export agent to handle the cumbersome customs clearance procedures in its name and on its behalf in exchange for the payment of a marginal service fee calculated on the basis of the sales value of the imported goods.

1.1.3 Import customs duty

Goods imported in China are subject to import customs duties. For some goods, export duties may also apply when they are exported.

Each year, the Chinese government produces a customs declaration handbook which indicates the tariff that will apply to goods to be imported and exported, as well as the conditions for customs clearance.

Import tariff rates mostly consist of:

(a) the most favoured nation rate, which is applicable to goods imported from a WTO member based on the principle of reciprocity or from a country which has concluded a bilateral trade agreement with China which contains a mutual most favoured nation treatment clause;

(b) the conventional tariff rate, that is applicable to goods imported from a country or region which has concluded a regional trade agreement with China containing a preferential duty clause;

(c) the special preferential tariff rate, which is applicable to a country or region which has concluded a trade agreement with China which contains a special preferential tariff clause;

(d) the standard rate, which is applicable to imported goods other than those contained in (a), (b) and (c) above and those whose place of origin cannot be identified; or

(e) the tariff rate, which is applicable to certain goods in relation to antidumping, countervailing, counter-subsidy and safeguard measures.

In addition, the Chinese government also usually annually announces the temporary more favoured tariff rates applicable to certain imported and exported goods (exclusive of the imported goods to which the standard rate applies) during a specific period.

Currently, the normal applicable customs duty rate for luxury goods varies from 10% to 35% for the most favoured nation rate and 100% to 180% for the standard rate. The following table gives examples of applicable customs duties for ease of reference ("MFN Rate" in this table meaning the most favoured nation rate).

Type of luxury goods	Customs Duty	
	MFN Rate (%)	Standard Rate (%)
Perfume	10	150
Cosmetics for lips (such as lipstick, lip gloss, lip balm and lip liner)	10	150
Cosmetics for eyes (such as mascara, eye liner and eye shadow)	10	150
Cosmetics for nails (such as nail polish and nail oil)	10	150
Facial powder (such as powder foundation, loose powder and blush)	18	130
Jewellery made from silver or gold, with or without a diamond setting	20	130
Articles of Jewellery and parts thereof, goldsmiths' and silversmith's wares and other articles	20 to 35	130
Handbags, briefcases, purses, wallets, etc.	10 to 20	100
Watches	11 to 23	80 to 100
Whisky, tequila, vodka, liqueur, rum, etc.	10	180

The basis for the calculation of customs duty is usually the CIF price, including the purchase price of the imported luxury goods, the freight cost to China and related transportation and insurance fees. Customs can adjust this basis if they consider that the transaction price has not been set on an arm's length basis or cannot be verified.

1.1.4 Classification of imported goods

China is a contracting party to the International Convention on the harmonized commodity description and coding system ("HS Code").

The importer may apply for a preliminary ruling on the customs tariff on the goods to be imported when the importer is not sure about the HS Code. This application shall be submitted to the local customs authority where the goods are to be imported, forty-five days prior to the physical import of the goods. Customs shall make a ruling on the application within fifteen working days. The preliminary ruling is only applicable to the importer who applies for such ruling.

The importer may also apply for an administrative decision on the classification of the goods when no existing HS Code is applicable to the goods to be imported. The application shall be submitted three months prior to the physical import of goods. The administrative decision is applicable to any importer and shall be implemented by all local customs.

Customs may also issue administrative circulars from time to time to clarify or determine the classification of those goods whose HS Code classification is difficult to determine.

1.2 Logistics

1.2.1 Outsourced logistics

A luxury goods company may choose to outsource the logistics, warehousing and transportation activities involved in the distribution of its goods to a local qualified logistic agent by entering into a logistics agency agreement.

The logistics agent shall be responsible for the transportation of luxury goods from the entry port in China to a warehouse provided by the logistics agent, which is fit for the storage of luxury goods.

The logistics agent shall bear all operating expenses incurred in connection with the operation of such warehouses, such as rent and utility charges, and shall make available sufficient staff in order to process all luxury goods orders.

The logistics agent shall also be responsible for managing stock, processing orders and arranging safe delivery of luxury goods to the designated place in compliance with the FICE's instructions.

In addition, the logistics agent shall procure and maintain, at its own expense and cost, the relevant insurance policy to cover for damages caused to goods as a result of fire, flood, theft and other incidents during the transport, storage and delivery of such goods.

1.2.2 Self-provided logistics

An FICE can provide integrated logistics itself, ranging from storage and transportation services, stock inventory and distribution centre, to sophisticated forecasting for the distribution of its imported luxury goods.

An FICE may choose to store imported luxury goods in bonded warehouses or in a bonded zone (such as the Waigaoqiao free trade zone or Ningbo free trade zone). In such cases, no customs duty or import VAT will be levied at the time when luxury goods are imported into bonded zones. However, when such luxury goods are to be sold outside the bonded zone in China, the FICE will have to handle customs clearance procedures and settle all the customs duty and import VAT in advance.

2. Foreign exchange and payment terms

When importing goods into China, the luxury goods commercial company will need to conclude an import sales contract with overseas affiliated suppliers. The provisions of this contract must comply with the Chinese foreign exchange regulations. If such regulations are not adhered to, the luxury goods commercial company will not be able to remit payments to purchase the imported goods. In particular, when an import sales contract provides advance and/or deferred payment terms, the commercial FIE must register such terms with the relevant authority in advance.

2.1 Advance payment

Advance payment in foreign exchange refers to payment in foreign exchange that shall be made on a date prior to the import date of the goods as stipulated in the import sales contract.

Where an import sales contract provides advance payment terms, the Chinese party (including any FIE) to this contract is required to register with SAFE:

(a) the import sales contract through an online registration system within fifteen working days of the execution of the contract; and

(b) each advance payment in foreign exchange within fifteen working days prior to the actual payment date as provided in the import sales contract.

When approving the registration of each advance payment, SAFE will check whether or not the amount of the advance payment exceeds the fixed quota for the company, according to the following formula:

Quota = total amount paid in foreign currency for imported products during the preceding 12 months x basic ratio – (total registered amount of the advance payment – de-registered amount of the advance payment)

In principle, the basic ratio in the above formula does not exceed 10%. For newly established companies, SAFE will verify the quota on a case-by-case basis.

Within fifteen working days of the issue of the customs declaration or of the date on which the foreign currency is remitted back via the original inward remittance route due to a failure to import the goods, the enterprise shall apply for de-registering the advance payment.

2.2 Deferred payment

Deferred payment in foreign exchange refers to payment in foreign exchange under an import sales contract with COD that shall be made on a date later than the date of import of the goods as stipulated in the import sales contract.

Where an import sales contract provides deferred payment terms of over ninety days (but less than one hundred twenty days), the Chinese party (including any FIE) to this contract is required to register with SAFE:

(a) the import sales contract through an online registration system within fifteen working days of the execution of the contract; and

(b) each deferred payment over ninety days through the same online registration system within fifteen working days of the lapse of ninety days following the issue date of the customs declaration.

Where the import sales contract does not provide the deferred payment terms over ninety days but the Chinese party does not make the payment after the lapse of ninety days from the issue date of the customs declaration, the Chinese party shall handle the above two registrations simultaneously within fifteen working days after the lapse of ninety days from the issue date of the customs declaration.

Note that the above registrations only apply to payments by T/T or by collection and exclude payment by letter of credit and payment made by overseas agencies.

SAFE shall first confirm the registered deferred payment within the total allowed company's annual cumulative amount of deferred payments in foreign currency. Otherwise, such deferred payment cannot be remitted out of China. In principle, the total allowed annual cumulative amount of deferred payments in foreign currency of a company shall not exceed 10% of the total amount paid for imported goods in the previous year. When the bank makes the deferred payment, it should write it off in the system.

Note that if the importer defers the payment over one hundred twenty days, it shall apply to SAFE for further approval in addition to handling the above-mentioned two registrations.

3. Transfer pricing policy

The Chinese transfer pricing rules mainly reflect OECD standards but currently lack detailed implementation regulations. Existing transfer pricing regulations require annual declarations of transactions between associated and affiliated companies (being "related parties") to be made, along with the establishment of control mechanisms.

3.1 Related party filing

Chinese companies or foreign companies having subsidiaries in China should file nine different annual reporting forms disclosing the transactions with a related party along with their annual tax returns.

The definition of "related party" contains eight types of affiliated relations, such as direct or indirect control, or holding of more than 25% of the shares of one party in another.

3.2 Transfer pricing methods

Based on the arm's length principle, the transfer price should normally be decided according to the market. A price below the market price would be considered "abnormal" and could lead to a re-evaluation of taxable income and tax adjustment by the Chinese tax authorities.

3.2.1 Target companies

When conducting transfer pricing inspection, the tax authorities focus on certain companies, notably on:

(a) companies which have suffered long-term consecutive losses, low profitability, or fluctuate between profit-and-loss;

(b) companies whose profit levels are lower than those in the same industry;

(c) companies showing an obvious mismatch between their profit levels and their functional and risk profiles; and

(d) companies obviously violating the arm's length principle.

3.2.2 Transfer pricing inspection by the tax authorities

The tax authorities may at any time decide to carry out a transfer pricing inspection.

The investigating tax authorities will impose a deadline for the companies to provide the requested detailed documentation. Moreover, tax authorities may require not only the target companies and related parties, but also comparable third parties to submit related information.

3.2.3 Adjustment methods to price

As a result of the transfer pricing inspection, the tax authorities may adjust the price of the transaction in question and any relationship or similar activity with such related party within the preceding ten years.

The tax authorities may resort to the following methods to determine the actual market price:

(a) comparable uncontrolled price method;

(b) resale minus method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method; or

(f) profit evaluation method.

3.3 APA

To avoid later price adjustments by the tax authorities, companies can reach an APA with the tax authorities on pricing principles and calculation methods to be applied to related party transactions,. The APA should determine the level of taxation and thus avoid uncertainties arising over transfer pricing.

The APA only applies to companies meeting all of the following criteria:

(a) companies with an annual of related party transactions exceeding RMB 40 million;

(b) companies that comply with the related party disclosure requirements; and

(c) companies that duly prepare, maintain and provide contemporaneous pricing documentation.

An APA covers related party transactions during three to five consecutive years starting from the year following the year in which the formal written application was submitted.

3.4 Cost sharing agreements

In China, costs for the promotion of luxury goods borne by the parent company (outside China) may trigger cost sharing issues in China.

A company and its related parties which jointly develop and assign intangible assets or jointly provide or receive services may enter into a cost sharing agreements. The costs expected to arise under a cost sharing agreement may be deductible from CIT.

Other than the standard contractual elements, a cost sharing agreement should include calculation methods and assumptions relating to the anticipated benefits to the participants, explanation of its arm's length nature and description of accounting methods.

The costs anticipated in a cost sharing agreement should be reasonable, measurable and conceivable and should be based on reasonable commercial assumptions and normal business practices.

The cost sharing agreement shall be submitted to the local tax authorities for filing with the State Taxation Bureau within thirty days of its execution.

The costs allocated by the company cannot be deductible from CIT in any of the following circumstances:

(a) lack of reasonable commercial purpose and economic substance;

(b) failure to comply with the arm's length principle;

(c) failure to comply with the cost-revenue matching principle;

(d) failure to file or prepare contemporaneous documentation; or

(e) the operating period of the company being less than twenty years from the execution of the cost sharing agreement.

3.5 Thin capitalization

The CIT law contains a ratio for non-deductible interest expenses from taxable income. The regulations provide detail for the calculation method of this ratio.

This requirement of thin capitalization is to prevent shareholders from reducing the amount of registered capital to be injected into their subsidiary (known as thin capitalization) by using a shareholder loan as a mean of financing instead. Such a solution enables the subsidiary to pay less income tax by fully deducting the interest accruing on the loan from its taxable income. To prevent this practice, the regulations provide in detail for the scope of ratio under which the interest can be deducted.

A company may deduct interest paid to the related parties only in accordance with the debt-to-equity ratios:

(a) 5:1 for financial institutions; and

(b) 2:1 for other enterprises.

Here, the term "equity" generally equals to the paid-in capital of the company and the capital surplus. "Debt" includes not only the debts or guarantees granted by shareholders or any other creditors but also those granted by Chinese or foreign financial institutions.

However, if the debt-to-equity ratio exceeds the above statutory ratio and the company would still like to apply for the deduction of the interest in excess of the said ratio, the company must provide necessary documents to the tax authorities to prove that this special transaction complies with the arm's length principle.

3.6 Anti-tax avoidance

The following behaviour constitutes tax avoidance: abuse of preferential tax treatment, abuse of tax treaties, abuse of organisational structures, use of tax havens for tax avoidance purpose and use of other arrangements without reasonable commercial purpose.

If the tax authorities find out that any of the behaviours listed above has occurred, they may initiate a general anti-avoidance investigation of the target enterprise and the enterprise shall, within sixty days of receiving the investigation notice, present evidence to justify how the occurrence of such behaviour has a reasonable commercial purpose.

3.7 Contemporaneous documentation

Chinese law specifies in detail the content specifically related to a transfer pricing transaction which must be included in the contemporaneous documentation. For example, a description of transactions with related parties, organisational structure of such related parties and a selection of transfer pricing methods must be included in the contemporaneous documentation.

Companies should prepare contemporaneous documentation before the end of May of the year following the related-party transaction. As from that date, companies must submit the necessary documentation to the tax authorities within twenty days of a request to do so.

The documentation should either be in Chinese or in bilingual with Chinese and another language.

Companies that fall into one of the following categories are exempted from preparing contemporaneous documentation:

(a) a company with annual related-party purchases and sales totalling less than RMB 200 million and related-party transactions of other kinds totalling less than RMB 40 million, excluding amounts arising under cost sharing arrangements or APA within the year;

(b) related-party transactions occurring under APA; or

(c) a company with less than 50% of equity held by foreign shareholders and when related-party transactions are conducted with Chinese parties only.

An exception to the above rules is provided in the case of a company which has limited functions and risks in production, distribution or research, does not bear any risk of financial crisis and market decision and is profitable. If such company has losses in a given year, the company is required to prepare the contemporaneous documentation and related documents for the year of loss and shall submit the documents to the tax authorities prior to 20 June of the subsequent year.

3.8 Penalties

3.8.1 Criminal penalty

The abnormal transfer of profit is not considered to be criminal tax evasion under Chinese law.

3.8.2 Administrative penalty

Manipulation of transfer pricing or tax avoidance is not considered to amount to tax fraud. Therefore, no administrative fine shall be imposed except for tax adjustments from the tax authorities.

However, if the tax authorities make a tax adjustment for a company involved in the manipulation of transfer pricing, an additional interest payment will be required from the company in respect of any tax levied on transactions occurred after 1 January 2008.

Other administrative fines provided in the regulations are relatively weak. Companies that fail to submit the nine different annual reporting forms for the related-party transactions or to prepare contemporaneous documentation will be subject to a fine of a maximum of RMB 10,000. If the company fails to provide relevant documentation or submits false or incomplete information, the company will be subject to a fine of a maximum of RMB 50,000.

Chapter 4 Distribution models

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A luxury goods company will usually establish an FICE to directly distribute/sell its goods in China. Various distribution models are available for it to choose from, such as wholesale (including counters), retail (including online retail) and the ability to authorise third parties to operate franchises. An FICE can also engage in import and/or export of products connected to its business scope, as well as related ancillary services.

1. Wholesale and commission agent

1.1 Wholesale/retail distributors

1.1.1 Local retail distributor

A business model consists of using one or several wholesale distributors or directly dealing with local retailers. The FICE will either (i) conclude first a distribution agreement with the wholesale distributors which will build a local retail network with retailers under its control and supervision, or (ii) conclude distribution agreements directly with retailers.

1.1.2 Distribution agreement

The content of a distribution agreement is subject to the negotiation of the parties.

With the exception of the anti-monopoly regulations, there are no specific regulations in China on distribution. In particular, there is no regulation, restriction or limitation on selective distribution or distribution networks. There are also no mandatory regulations or practices which require compensation of the distributor when the distribution agreement expires.

1.2 Wholesale/counters

1.2.1 Local practice

The FICE will solicit leased counters located in department stores and will share the profits with the department store.

Under such a model, the FICE and the department store conclude a consignment contract (sometimes referred to as a "joint operation contract"). Pursuant to a consignment contract, the FICE is responsible for deciding the retail price and providing the goods to be sold in the department store. The department store is responsible for providing property management services, collecting proceeds from sale of goods, issuing invoices and resolving customer complaints regarding defective goods. From a legal perspective, the retailer is the department store.

It is industry practice that the department store provides a standard form contract with standardised terms and conditions applicable to all counter lessees in the department store. On very rare occasions the department store may agree to accept certain amendments or supplementary terms to such a contract, subject to the attractiveness and market penetration of the luxury goods company among Chinese customers and whether such company matches the standards of the department store.

1.2.2 Location, area and decoration of counter

The FICE must conduct fitting out activities in compliance with the uniform decoration requirements of the department store. This is applicable to all counter lessees in the department store.

1.2.3 Consignment term

There is no mandatory requirement for the length of the consignment term. It normally varies from half a year to three years, based on the respective business plans and subject to final negotiation between the department store and the FICE.

1.2.4 Commission fee, service charge and miscellaneous fee

The calculation method of the commission to be charged by the department store varies on a case-by-case basis. The following are the most commonly used methods in China.

(a) Fixed commission rate

The department store is entitled to a commission fee of an agreed percentage of the retail price for any retail sales. For branded perfumes and cosmetics for example, this rate tends to range between 20% and 30%.

(b) Guaranteed return

The department store is guaranteed a pre-agreed minimum commission fee.

For any retail sales less than or equivalent to a pre agreed target monthly retail sales amount ("Monthly Base Sales"), the department store will receive the guaranteed commission fee.

For any part of the retail sales over and above the Monthly Base Sales, the department will receive a commission fee of an agreed percentage of the retail price. This commission fee is calculated on a lower percentage than the one which is usually negotiated when no minimum guaranteed commission is agreed.

(c) Base rent or fixed commission rate

The department store is entitled to a commission fee of an agreed percentage of the total monthly retail sales, or to an agreed monthly rent, whichever is higher. This practice applies more frequently to large surfaces (normally over 100 square meters) in department stores.

1.2.5 Service charge and miscellaneous fee

The department store provides a uniform property management service to all counter lessees, such as utility supplies, security guards and patrols and a cleaning service. The FICE pays service charges for the aforesaid services at a fixed rate on a monthly basis or alternatively based on an agreed percentage of the turnovers made on retail sales.

1.2.6 Counter staff

The FICE is responsible for recruiting staff either by itself or through an employment agent. The staff must adhere to the internal rules or regulations imposed by the department store.

1.2.7 Termination of consignment

The department store usually retains the right to re-arrange on a regular basis the location of the counters. In certain department stores, the general practice is that if the monthly retail sales of a branded good rank among the lowest three or five in that store in three consecutive months (or alternatively three times in half a year), the department store shall have the right to unilaterally terminate the consignment contract with the luxury goods company.

2. Retail

2.1 Retail licence application and establishment of branches

To legally operate a retail business activity, an FICE must first make sure that its business scope includes retail activity as defined in its business licence (reference is made to Chapter 1 paragraph 3 above).

The FICE may either apply to include retail in its business scope upon its establishment or later upon extension of its business scope. For such application, the FICE must provide the original of one lease agreement (or one purchase agreement) of the commercial premise that it has entered into.

In general, for any retail stores the FICE intends to open, a branch must be established and registered at the address of the retail store. The principle is “one retail store, one registered branch”. The establishment of such a “retail branch” requires prior approval from the authorities at the location of the FICE.

2.2 Lease of retail premises

The operation of a retail store requires the lease or purchase of commercial premises. The purpose of the commercial premises must specifically be for retail.

The law gives the landlord and tenant plenty of flexibility to arrange their contractual relationship.

It should however be noted that some local authorities, such as Shanghai Municipal ity, impose the use of a standard commercial lease contract template which restricts the parties' chosen contract format. The registration of the lease contract with the real estate bureau is usually a necessary and prior step required by the approval authority to approve the establishment of a company or a branch at that location.

These commercial lease contract templates usually contain a section named "supplementary provisions" where the parties can freely amend the content of the contract and/or add any additional provisions.

Furthermore, for premium buildings, landlords often have agreed and pre-registered their own lease template with the real estate bureau.

All landlords experienced in handling commercial leases usually prefer to use their own commercial lease templates and only certain terms and conditions are negotiable. Needless to say, the final outcome of such negotiations depends on the market position of the given scheme and the attractiveness of the contemplated tenant's brand.

Flagship store

When opening a flagship store, some of the most common lease issues become of even more importance and are worth being highlighted here.

The luxury goods company will also have to ensure that its business licence is sufficiently wide to operate the flagship store for all the intended services and activities.

Negotiation of the lease agreement

The lease agreement for the store premises is a key document. The luxury goods company should pay particular attention to the following terms when negotiating the lease.

(a) Authority to lease: whether the lessor is the actual and legitimate owner or a tenant duly authorised to sub-lease.

(b) Nature of the premises: in particular whether it is located on a historic site which will trigger additional legal requirements and conditions for the fitting-out of the store.

(c) Term of the lease: the maximum lease term is twenty years. During any period exceeding the term, any contractual party may terminate the lease with advance notification.

(d) Conditions of termination: fixed term leases may only be terminated under circumstances stipulated in the lease contract or in accordance with the law. The law provides that the tenant may terminate a fixed term lease if the premises become unfit for the purpose of the lease or if the premises (as delivered by the landlord) poses a danger to the health of its occupiers. On the other hand, the landlord is also authorised by law to terminate a fixed term lease under certain circumstances, such as the tenant sub-leasing the premises without the landlord's approval or delaying payment of the rent for more than six months.

(e) Lease extension: options to extend are legally binding subject to certain conditions, including that the total lease term (initial and extended term) is within the permitted maximum legal term of up to twenty years.

(f) Rent: there are no statutory minimum/maximum rents in China.

(g) Maintenance and renovation: maintenance and renovation of the premises are generally obligations of the tenant, unless otherwise agreed by the parties in a maintenance contract.

(h) Insurance: the landlord shall insure the common areas and the premises. Tenants are required to insure against any possible damage their operations may cause.

Special operating licences

Flagship stores sometimes offer additional services, such as food & beverage. It should be noted that most of these services require special operating licences and prior approvals from the relevant authorities. For example, the provisions of food & beverage services are subject to approval from the environment protection, food hygiene and fire prevention authorities.

3. Online retail

By law, FICEs are permitted to apply to include "online retail" in their business scope and to engage in online retail. However, according to the current practice of MOFCOM and its local branches, FICEs stand little chance of actually obtaining such business scope to conduct online retail.

Nevertheless, in practice, some FICEs with retail rights engage in online retail activities without obtaining a business scope encompassing online retail. It is noted that AIC could legitimately challenge and stop such online commercial activity at any time.

In such cases, the FICE hosts its own website for online retail after applying for a not-for-profit internet content provider ("ICP") certificate. The FICE files records of its activities with the local telecommunications administrative authorities at provincial level, under the direct control of the Ministry of Industry and Information Technology, as a not-for-profit internet content service provider. Note that the local telecommunications administrative authority normally will not check if the business scope of the FICE includes online retail or not when dealing with applications for filing.

4. Franchise

4.1 General regime

According to Chinese law, franchising means conducting business whereby a company, through execution of contracts, allows an operator to use registered trademarks, patents, know-how or any other business resource owned by such company; such operator undertakes business operations under the unified business model in accordance with the provisions of the contract and pays franchising fees to the company.

4.2 Qualification of the franchisor

The franchisor must have at least two directly owned stores which have been in operation for more than one year. Other requirements are possessing a mature business model and being capable of providing continued operational guidance, technical support, business training and other services to the franchisee.

4.3 Overseas franchisor

The reference in the regulations to the franchisor having two directly owned stores does not specify where such stores need to be located. In the preceding, now defunct regulations, the franchisor was specifically required to own and directly operate two stores within China.

As such direct reference to China has now been removed, the foreign franchisor having two directly owned stores overseas is also able to franchise in China without having to first establish a legal entity within China.

4.4 Disclosure of information

Chinese law requires that the franchisor discloses significant information in writing to the franchisee at least thirty days prior to the signing of the franchise contract, including but not limited to (i) basic information about the registered trademark, patent, know-how and business model of the franchisor and (ii) specific contents, methods and implementation plans for continuously providing management guidance, technical support, business training and other services to the franchisee.

4.5 Franchise contract registration

The franchisor must register the franchise contract and other required information with the Chinese authorities within fifteen days of the execution date of the first franchise contract in China. If the franchisor is an overseas entity, the competent authority is MOFCOM. If the franchisor is a Chinese entity (including FICE), the competent authority is COFCOM at provincial level.

The franchisor also needs to report to the registration authorities any information regarding the conclusion, termination, renewal and/or modification of its franchise contracts during the previous year, prior to 31 March of each year.

4.6 Withdrawal of franchise

As the requirements for engagement in franchise activity in China are quite stringent and trade secrets may be disclosed when training the franchisees, foreign investors in the luxury goods industry do not usually favour the establishment of franchises. On the contrary, quite a lot of foreign investors try to withdraw any existing franchise rights, such as by acquiring part or all of the franchisees' equity interest, in order to make more profits, control the quality of services and protect its reputation and IP rights in a more efficient manner.

Chapter 5 Product quality and product liability

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Luxury goods companies must ensure that their products comply with certain essential quality requirements imposed by Chinese law. In particular, they must pay attention to all the legal requirements on product quality, including labelling and packaging requirements. They must also be aware of product liability rules.

These general rules apply to any product distributed in the Chinese market, whether manufactured in or imported into China. It should however be pointed out that food products, including spirits and wines, are subject to more complex and stricter legal rules, which are not detailed in this chapter.

1. Product quality: obligations and requirements

1.1 General quality requirements and product standards

1.1.1 General principle and mandatory requirements

(a) General quality requirements

Any manufacturer or distributor of products must ensure that the products comply with certain legal warranties.

As general principles, the law imposes that products must:

(i) not reach any unreasonable risk level which may lead to personal injury or property loss and comply with the state and trade standards in respect of personal and assets safety;

(ii) comply with their functions; and

(iii) comply with the applicable standards and with the quality level as stipulated in the product specification and shown through samples.

(b) Product standards

➢ Product standards apply to manufacturers, importers and distributors

To ensure a certain level of quality and safety of products, the law has imposed product standards on manufacturers, importers and distributors.

When the product is manufactured overseas and imported in China, the importer must ensure that such product complies with all mandatory product standards. For instance, when the luxury goods company has established an FICE in China, the FICE would have to ensure compliance of the products with mandatory product standards.

A famous Japanese cosmetic products company punished for sub-standard products

The case described below arose in September 2006.

It is reported that AQSIQ announced in September 2006 that upon investigation and inspection, the imported cosmetic products manufactured by a famous Japanese cosmetic products company were found to contain certain forbidden chemical substances and in violation of the State Hygiene Standard for Cosmetics ("GB7916-1987"). It is reported that all AIC ordered suspension of sale of the product and unconditional acceptance of return of all sold products.

It should also be pointed out that in addition to Chinese mandatory product standards, certain products listed in the Catalogue of Imported or Exported Products Subject to Inspection (such as cosmetics, watches and cigar) are subject to inspection by AQSIQ prior to completion of customs procedure.

➢ Categories and nature of product standards

There are three administrative types of product standards in China, which are (i) state standards, (ii) trade standards, (iii) safety and hygiene regional standards (formulated by competent departments at provincial level when neither state nor trade standards are available).

State or trade standards relating to health, safety, hygiene requirements, environmental protection and other fundamental issues and safety and hygiene regional standards are mandatory.

State or trade standards other than the aforesaid or otherwise expressly provided are recommended and companies are encouraged to apply them voluntarily.

It should be noted that the authority may choose to change the nature of standards for certain products. For example, the former state standards for wine were recommended standards, but they were modified and reissued in 2008 and are since mandatory.

Furthermore, when no state or trade standards exist, manufacturers must adopt and specify their own standards or when state or trade standards exist, manufacturers are encouraged to voluntarily adopt stricter standards than existing state or trade standards.

1.1.2 Sanctions for non-compliance

(a) Authorities in charge

SFDA, AQSIQ, AIC and specific authorities responsible for supervising the market of certain luxury goods are in charge of implementing administrative penalties for the production and/or distribution of sub-standard luxury goods which do not meet relevant mandatory product standards and/or infringe consumer rights.

These authorities may decide to carry out random inspections of the products to ensure consistency in product quality requirements and product standards.

In addition, if a consumer files a complaint for suspected sub-standard luxury goods, these authorities are responsible to carry out investigations.

(b) Types of sanctions

If the goods are found to be in breach of mandatory standards, the authorities may:

(i) order cessation of production or sale;

(ii) confiscate products illegally manufactured or sold and any related gains;

(iii) impose to the manufacturers, importers and distributors of such goods a fine of up to three times the value of the products illegally manufactured or sold; or

(iv) revoke the business licence of the manufacturers, importers and distributors of such goods.

The above administrative penalties may be imposed cumulatively.

A famous French luxury goods company punished for sub-standard products

The case described below arose in June 2008.

It is reported that Zhejiang AIC investigated the Hangzhou flagship store of a famous French luxury goods company and announced that the store was selling sub-standard handbags. According to the media, Zhejiang AIC considered that some of the handbags were in violation of the Chinese

product standards QB/T1333-2004 ("QB/T"). According to the media, the alleged violation was due to the absence of "reference material" (a piece of leather sample of the same leather as the bag's one) attached to the handbag. It is reported that Zhejiang AIC confiscated all income "illegally" obtained and imposed a fine of more than RMB 700,000 (approximately EUR 73,000).

Zhejiang AIC considered that although the QB/T were only recommended standards, as long as the French luxury goods company applies them as applicable standards, it should have strictly complied with.

The QB/T does not expressly require each manufacturer to attach a reference material to a bag and in practice, many handbags in the domestic market do not have such reference material attached. The use of reference material attached to a bag is at the manufacturer's discretion.

The case illustrates the inconsistency in implementation practices and, as a result, the regulatory uncertainty in China. It takes a great deal of effort to manage such risks well but the first recommended step is to research the area to identify such uncertainties, including terminology in the product standards which may lead to different interpretations.

1.2 Labelling and packaging

Products distributed in the Chinese market (whether manufactured in or imported in China) must be labelled and packed properly.

1.2.1 General regime

Generally speaking, the following information must be included on the label: product name, specifications (such as type, contents and size), applicable product standards (if manufactured and distributed in China), shelf life (if appropriate), warnings

(including risks that the goods may hold for the consumers' personal or property safety), instructions for use (if appropriate), manufacturer's name and address and manufacturing date and place of origin (if imported in China).

For products (such as wines and cosmetics), that require a regulatory authorisation licence or certification from a government agency, the serial number of such market authorisation, licence or certificate must also be added to the label.

Distributors must provide consumers with accurate information on the goods. In addition, the price, name and brand logo should also be clearly indicated on the packaging.

The labelling requirements of the products (such as cosmetic products) which may directly impact human health are more stringent. In this respect the following three points shall be noted:

(a) it is prohibited to use misleading expressions that may cause misunder standing about the product's function;

(b) a detailed list of ingredients should be included on the label; and

(c) warnings should be provided in adequate detail if proper usage or storage is critical to the quality and safety of the product.

1.2.2 Sanctions

AQSIQ and AIC are responsible for implementing the labelling regulations and can impose the following administrative penalties for the manufacture or distribution of products without proper labelling:

(a) order correction of the improper labelling; or

(b) order cessation of production or sale for serious cases and confiscate the "illegal" income obtained and impose a fine of up to 30% of the value of the products illegally manufactured or sold.

1.3 Guarantee system

In China, a mandatory guarantee system at national level (repair, replacement or return of the products under certain circumstances) is adopted as a statutory supplement to contractual relationship between the consumer and the distributor. Local regulations, mandatory regional standards or guidelines may also be promulgated on this matter and therefore distributors of luxury goods should carefully check both national and local rules to ensure at least minimum guarantee conditions are in place.

So far, the applicable mandatory guarantee system at national level only covers watches and clocks in the luxury goods industry and foresees a minimum guaranty period of one year.

Under the mandatory guarantee system, a distributor of watches and clocks is responsible for:

(a) repair, replacement or acceptance of return of goods within seven days of the sale date if the goods have a defect of non compliance (which means the goods do not comply with safety, hygiene and other applicable product standards, do not have the due functions for such kind of goods or do not meet the specified quality conditions);

(b) repair or replace of goods within fifteen days of the sale date if the goods have performance fault;

(c) repair of goods within the guarantee period, unless the defect of the goods is caused by the consumer's improper use; and

(d) replacement or acceptance of return (if within the guarantee period the goods still cannot be used after two unsuccessful attempts to repair).

After the distributor has fulfilled its obligations of repair, replacement or acceptance of return, it may claim for compensation against the manufacturer or supplier of the related goods, unless otherwise contractually stipulated.

In addition to the aforesaid national level mandatory guarantee system, provincial authorities and industry associations may also, from time to time, issue local rules to expand the list of goods which will be subject to the mandatory guarantee system or extend the guarantee period for particular goods in order to complement the shortfall of the national rules for goods such as shoes, jewellery, clothes or leather products.

Local guarantee systems on watches and clocks/gold and jewellery

Shanghai Watch and Clock Industry Association extended the guarantee period to two years. Shanghai Consumer Association and Shanghai Gold and Jewellery Industry Association jointly issued the mandatory guarantee system for gold and jewellery with a guarantee period of six month of issue of "fapiao" (the official receipt for tax purpose).

2. Defective products: liability

The law provides a very general definition of defective products. Products are considered defective when they unreasonably threaten personal or property safety. If there are applicable mandatory standards relating to personal and property safety, products are considered defective when they are found to not comply with such standards. For instance, product defects may arise due to improper product design, labelling or production, etc.

It should be noted however that a manufacturer may still be liable for a defect even if the product is manufactured in accordance with the relevant product standards.

2.1 Civil liability

2.1.1 Consumer's claim

Consumers may at their discretion choose to initiate a civil action against the manufacturer in tort and/or against the distributor and/or upper distributor for breach of contract or in tort.

(a) Principle of liability and possible exemptions

➢ Liability of manufacturer

Manufacturers shall assume strict liability. Manufacturers shall be liable for any claim for personal injury or property loss arising out of defective products, regardless of whether such claim arises as a result of the fault of the manufacturer.

However, a manufacturer may be exempted from such strict liability if he can prove that the personal injury or property loss occurred under any of the following circumstances:

(i) the product has not been put on the market;

(ii) the defect which led to an injury or property damage did not exist when the product was marketed for the first time; or

(iii) the state of scientific and technical knowledge at the time when the product was marketed for the first time was not such as to enable the defect to be discovered.

➢ Liability of distributor

A distributor is liable for any related consumers' claim as a manufacturer would be, regardless of whether or not such claim arises as a result of his own fault.

(b) Burden of proof

The consumer who initiates a damage claim due to a defective product must prove:

(i) the actual damage (i.e. he has suffered personal injury or property loss);

(ii) the defect in the product; and

(iii) the causal relationship between the damage and defect.

However, regarding the "defect in the product" mentioned in (ii), the judge may at his own discretion shift the burden of proof from the consumer onto the defendant (manufacturer or distributor) if such consumer is unable to produce such proof due to his lack of technical knowledge.

(c) Damage covered

Any direct personal or property damage may be compensated.

(i) Personal injury

Compensation for personal injury arising from defective products covers medical expenses, care expenses and loss of income of the claimant during medical treatment. If the victim suffers a permanent disability, the compensation may also include expenses arising for any related equipment, living allowances, compensation for disability and living expenses for any dependents of the victim. If the victim dies, compensation shall include funeral expenses, compensation for death and the required living expenses for dependents.

(ii) Property loss

If a defective product causes any loss of property, the distributor and/or the manufacturer shall restore the property to its original state or financially compensate for such loss.

(iii) Punitive damages

In addition, if the distributor or manufacturer commits fraud whilst engaging in the sale of the products, he shall be liable towards the consumer for punitive damages of an amount twice the purchase price of the products.

(d) Expiration of liability

The time limit for claiming for compensation for damages arising from defective products is two years from the date when the concerned party became aware or should have become aware of any personal injury or property loss caused by such defective products.

However, this right ceases after ten years from the date of receipt of such defective products by the consumer unless it is still within the products' shelf life period (if applicable).

2.1.2 Claim back by distributor/manufacturer

(a) Claim back by distributor: If a consumer has claimed against the distributor only, such distributor would have to directly compensate the consumer. The distributor may then have a claim against the distributor further up the chain (if any) or the manufacturer, unless such defects are shown to be as a result of its fault.

(b) Claim back by manufacturer: If an action is initiated by a consumer against the manufacturer only, the manufacturer may have to compensate if he fails to prove exemption from liability as mentioned under second paragraph in 2.1.1(a), but he can also claim back against the distributor if such defect arises as a result of the fault of such distributor.

2.2 Criminal liability

The production and/or distribution of defective products may trigger criminal liabilities of the manufacturer and/or distributors.

Any manufacturer or distributor that manufactures or sells defective products generating sale incomes above RMB 50,000 or causing severe injuries or damage may face criminal penalties. The individual representative of the manufacturer or distributor (legal representative or department representative) who knows or should have known that the company was responsible for such substandard products could also face criminal sanctions, such as detention, imprisonment, ranging from a fixed term sentence up to life, or even death penalty. The severity of such sanctions depends on the nature of the criminal act, the nature of the defective products and the severity of the consequences.

Chapter 6 Protecting IP rights and dealing with counterfeits

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1. Preventive measures

1.1 IP registration

1.1.1 Trademark protection

(a) Trademark registration

The name of a company, product or brand may be protected if registered as a trademark.

Note that there is no specific company name protection regime in China. If a company name is identical or similar to a registered trademark and therefore confuses the public, the trademark right holder has the right to claim for the cancellation or modification of the company name.

There are two ways to register trademarks in China:

(i) National registration

Companies can apply directly for trademark registration with the Trademark Office.

The applicants can register words, letters, characters, logos and any combination of these. In addition, it is also possible to register three dimensional trademarks.

Foreign investors should enhance the protection of their trademarks by registering not only in western characters but also in Chinese characters (whether phonetic and/or semantic transliteration).

The period of protection of a trademark is ten years from the date of issue of the certificate of registration. This can be renewed indefinitely.

Since China is a member of the Paris Convention, a foreign citizen or company can benefit from a priority right of six months from the date of application for registration of its trademark in its own country, provided that its nation state or place of incorporation (as applicable) is also a member of the Paris Convention.

In practice, the registration of a trademark in China will take at least two to three years. The Trademark Office is trying to resolve the poor efficiency of the trademark examination process and is making efforts to handle all pending trademarks within the next three years. As from 2010, the application period might be reduced to one year.

(ii) International registration (Madrid System)

Foreign investors can also apply for trademark registration in their home state with an extension of protection to China through the Madrid System with the International Bureau of WIPO. The period of the protection of trademark in this case is ten or twenty years, depending on the type of application and can be renewed.

(b) Well-known trademark

The status of "well-known trademark" is granted to trademarks that are widely known and/or have an established reputation among the relevant public in China.

To determine whether a trademark is "widely known and/or has an established relative reputation among the relevant public", the authorities may (i) define the knowledge of the trademark by the level of public awareness, (ii) review the period of continuous use of the trademark in China, (iii) determine the extent and geographic scope of any publicity for the trademark, (iv) require material showing that the trademark has been protected as well-known and (v) other factors.

Well-known trademarks enjoy a more favourable level of protection. For instance, the holder of a well-known trademark can file a claim, even if the products or business activity of the infringer does not fall within one of the classes, categories or products covered by the registration of the well-known trademark. Well-know trademark status also widely facilitates and simplifies the administrative procedure before AIC for IP infringement.

As at April 2009, 1,624 trademarks were recognized in China as "well-known", among which 98 were foreign trademarks.

Other types of protections also exist for provincial ("famous trademarks") and municipal ("known trademarks") levels.

Well-known trademarks may be protected through administrative recognition or judicial recognition.

(i) Administrative recognition of a well-known trademark

Application for administrative recognition of a well-known trademark must be filed with AIC, which will examine and submit the application to a higher level AIC, until it eventually reaches the Trademark Office.

Administrative recognition may only be filed under one of the following circumstances:

- an infringer has registered a trademark which is identical or similar to the applicant's trademark which can be considered as well-known in China;
- the Trademark Office has published an application for registration by a third party of a trademark which is identical or similar to the applicant's trademark which can be considered as well-known in China; or
- the applicant considers that an infringer has infringed its trademark which can be considered as well-known.

(ii) Judicial recognition of well-known trademarks

Compared to administrative recognition, judicial recognition is very limited. Courts at intermediate level or above have the right to recognize well-known trademarks in China.

First, judicial recognition applies on a case-by-case basis. A court is not bound by any previous judicial or administrative decision on the recognition of a trademark. The plaintiff must request that the court decide on the recognition again, unless the defendant does not challenge that a previous judicial or administrative decision has recognized the trademark as well-known. Such practice inevitably causes divergence of treatments on the recognition of a trademark as well-known.

Second, the well-known trademark holder may not use a judicial recognition decision in any advertisement.

1.1.2 Patent protection

Chinese law provides patent protection for designs, utility models and inventions.

There are two ways to register a patent in China:

(a) National registration

Companies can apply directly for patent registration with SIPO.

The period of protection is twenty years for an invention patent and ten years for a design and a utility model, as from the application date.

Since China is a member of the Paris Convention, a foreign citizen or company can benefit from a priority right of twelve months (for an invention or a utility model) or six months (for a design) as from the date of application for a patent/utility model/design in its own country, provided that the nation state, residence or place of incorporation (as appropriate) is also a member of the Paris Convention.

(b) International registration (Patent Cooperation Treaty)

Patent right holders that are registered in countries that are contracting parties of the Paris Convention can also apply for patent registration (with China being the designated country of protection) under the Patent Cooperation Treaty with the International Bureau of WIPO.

1.2 Contractual protection

1.2.1 Distribution and sales in China

(a) Third party distributors in China

Distribution contracts with third party distributors should contain specific clauses to protect the company's IP rights, for example clauses stating clear ownership of the relevant IP rights and an obligation on the distributor to notify the luxury goods company of the infringement of IP rights by third parties.

Distribution contracts should include liquidated damages clauses in case such IP rights-related obligations are breached.

In practice, it should be noted that the more the luxury goods company is commercially dependent on one distributor, the more sensitive it will be to seek enforcement of liquidated damages.

(b) Separate retail stores

If the sale of goods to end consumers is subcontracted by the distributor to third parties' retail stores, the luxury goods company does not have a direct contractual relationship with the retail stores.

In the wholesale distribution contract concluded with the distributor, the luxury goods company should ensure that the distributor remains responsible for binding each retail store with IP rights protection clauses.

1.2.2 Manufacturing in China

Manufacturing and OEM contracts should contain clauses designed to limit potential infringement of the company's IP rights, such as confidentiality and non-competition clauses as well as liquidated damages clauses.

2. Actions against IP right infringements

2.1 Actions against infringements of registered IP rights

2.1.1 There is no certainty whether parallel imports might constitute an infringement.

Chinese law does not specifically provide whether the holder of a trademark may make a claim against parallel imports. In practice, courts have varying points of view relating to the legitimacy of trademark parallel imports in China.

For patents, the Chinese patent law provides for an international exhaustion system and allows parallel imports.

2.1.2 Civil protection against infringements

(a) Pre-trial actions

In order to avoid rights and interests suffering irremediable harm, a trademark or patent right holder or any interested party is entitled to apply for pre-trial injunctive measures to freeze the potential infringer's assets (such as sealing up valuable goods and freezing assets and bank accounts), against provision to the court of a security bond of no less than the estimated value of the property to be preserved.

Such measures shall be limited to the scope of the claim or to the property relevant to the case.

The court may also, in respect of trademarks or patents of the defendant, freeze their transfer, license, cancellation or pledge with the Trademark Office or SIPO.

However, the alleged infringer may cancel the injunction by providing a counter-security bond.

(b) Interim injunction

The court may, before commencing proceedings, order the cessation of any alleged trademark or patent infringement, the freezing of the production capacities of the alleged infringer and the preservation of evidence of infringement.

The applicant must submit a security bond to the competent court for such an interim injunction, which cannot be cancelled by the provision of a counter-security bond by the alleged infringer.

In order to avoid the abuse of requests for an interim injunction, a claim should be filed with the court within fifteen days of the issue of the interim injunction, after which the court may decide to cancel the injunction.

(c) Procedure on the merit

When a claim is filed for a trademark or patent infringement, the court has a wide array of remedies available to it (including cessation of infringement, compensation for losses, damages for breach of contract and formal expression of an apology).

In addition, the court may also impose a penalty and confiscate the infringing products and infringing trademark labels, as well as any materials, tools and equipment used for the manufacture of goods bearing infringing trademarks.

Furthermore, for patent infringement only, the court may force the infringer to apologize in writing and may confiscate the property used for illegal activities, as well as the related illegal income.

In principle, the compensation payable shall be equal to the illegal gains or losses suffered by the claimant as a result of the infringement activity (reasonable expenses incurred to stop the infringing acts may be claimed for trademark infringement, but not for patent infringement). If such gains or losses are difficult to quantify, compensation may be calculated as a multiple of royalty payments existing under any licence granted by the trademark or patent right holder to third parties or by reference to a standard or reasonable royalty sum widely used in the industry.

The court may also impose, at its discretion, statutory damages up to a maximum of RMB 500,000.

2.1.3 Administrative protection

Administrative protection against the infringement of IP rights is generally preferred to civil protection, especially when the infringement is not ambiguous. In any case, administrative protection is often chosen as a preliminary step to gather sufficient evidence to commence a civil action.

Obtaining results through administrative protection is much faster than civil protection which can involve a long trial period and possible scope for appeal. In addition, administrative protection is cost effective as the administrative authorities do not charge a fee. Furthermore, in terms of the remedies available, administrative protection can provide a quick practical end to a trademark infringement.

(a) Trademark and patent infringement procedures

Besides the civil protection measures, the trademark holder, patent holder or any interested party may directly ask AIC (for trademark counterfeit cases) or the Patent Bureau (for patent counterfeit cases) to take necessary measures to prevent continuation of the infringement.

AIC can impose a fine, order the cessation of infringing acts, confiscate and destroy infringing goods and trademark labels and destroy the materials and tools used for the manufacture of infringing goods and trademark labels.

The Patent Bureau may order the infringer to rectify its act and to publish details of such act and the consequent sanctions, to pay a penalty and to surrender the illegal gains obtained.

However, AIC cannot oblige the infringer to pay damages to the right holder.

(b) Trademark cancellation procedure and patent invalidation procedure

➢ Trademark cancellation procedure

The trademark cancellation procedure must be filed with the trademark re-examination committee, after the trademark has been registered.

If a registered trademark is registered illegally or by deceptive means, any interested party may ask the trademark re-examination committee to cancel such trademark registration.

In addition, if a trademark is registered and (i) infringes other parties' prior rights, or (ii) has already been used by a third party and has had a certain impact before its registration, the trademark re-examination committee may cancel the registration of such trademark within five years of its registration.

If an infringing party has registered a trademark that is identical or similar to a well-known trademark which has not yet been registered in China,

which gives rise to confusion amongst the public, the trademark re-examination committee can cancel the registration of such trademark within five years of its registration. Once the five year period has expired, it must be proved that the trademark was registered in bad faith in order to cancel the registration.

If any party is not satisfied by the decision of the trademark re-examination committee, an appeal action may be filed before the Beijing intermediate civil court within thirty days of the decision.

➢ Patent invalidation procedure

A patent invalidation application should be submitted to the patent re-examination committee in Beijing.

If a party does not agree with the decision of the patent re-examination committee, it can bring an action against the committee's decision within three months before the Beijing intermediate civil court.

(c) Border measures

Border measures were first established in 1995 and offer a key tool in detecting the existence of counterfeit products.

In 2008, the Chinese customs authorities investigated 11,135 batches of infringing goods. In 2008, infringing products found in ten key coastal cities (Shenzhen, Shanghai, Gongbei, Hangzhou, Fuzhou, Guangzhou, Qingdao, Fuzhou, Xiamen and Nanjing) represented 90% of the total infringing products found in all Chinese coastal cities.

A trademark or patent right holder with a registered trademark or patent in China may ask customs authorities to take border measures, including the detention of suspected and actual infringing goods (for a maximum of fifty days, except where as a result of an interim injunction or pre-trial measures), the imposition of penalties on consigners and consignees for infringing goods and the transfer of the matter to the police security bureau for further investigation.

Customs may act upon the applicant's request or on their own initiative. In order for customs to take the initiative, the applicant must first undergo trademark and patent archive filing with the customs authorities in Beijing, which will be valid with all local Chinese custom authorities. The filing is valid for ten years and can be renewed. Until 11 May 2009, 6,629 trademarks and 4,071 patents had been filed with customs.

In order to apply for border measures, the applicant must pay a bond to customs. If the applicant applies for border measures, the bond must be equal to the value of the goods to be detained based on the value of the genuine goods. If, however, customs takes the initiative to detain the goods on the basis of a trademark and patent archive filing, the guarantee shall have a maximum cap of RMB 100,000 per trademark or patent.

Customs may release the detained goods if the party accused of infringing IP rights provides a guarantee equivalent to the value of the detained goods (based on the value of the genuine goods), or if customs consider that no trademark or patent infringement has occurred.

2.1.4 Criminal prosecution for IP rights infringements

AIC may refer to the police any matter which it considers to constitute a crime. In addition, any person may declare infringing activities to the police in order for the police to initiate criminal proceedings if criminal liabilities should be pursued. The police will then decide whether to transfer the case to the public prosecutor, who in turn, shall decide whether to transfer the case to the competent criminal court.

If the police consider that the infringement does not constitute a crime, the initiator of the declaration may report the infringing activities to the public prosecutor. If the latter also refuses to proceed with criminal prosecution, only the alleged victim of the infringing activities may then initiate a case directly with the competent criminal court.

Any trademark infringer which has been found to have committed a crime faces criminal sanctions (fine and imprisonment up to seven years).

Any patent infringer which has been found to have committed a crime faces criminal sanctions (fine and imprisonment up to three years).

If the infringer is a company, the company officer who is responsible for the infringement may face criminal sanctions. The legal representative who should have known that the company is responsible for infringing a third party's rights may face criminal charges.

2.1.5 Preferred actions against counterfeits

Of the above civil, administrative and criminal protection measures available to act against infringements, the initiation of action with AIC (administrative action) is always the fastest and most cost-effective solution.

For example, Shanghai AIC took action to stop the sales of counterfeits of famous foreign-branded products in 2004 and 2007, which involved products bearing the trademarks "Louis Vuitton", "Giorgio Armani", "Versace", "Gucci" and "Rolex". The results of such action have been satisfactory as a large amount of counterfeit goods were confiscated and many sales venues were closed down.

However, AIC does not grant damages, so, if required, the IP rights holder must claim damages before the civil courts.

2.2 Domain name

Legal action against a domain name holder may be initiated before dispute resolution institutions. These are the DNDRC of CIETAC and of the HKIAC for disputes related to ".cn", ".com.cn" and ".net.cn" domain names. If unsuccessful, a claim may be brought before Chinese courts.

Claims before dispute resolution institutions are generally preferred, as they constitute a cost and time-efficient solution. However, dispute resolution institutions only decide on the outcome of the domain name registration. Chinese courts have greater powers, including the ability to order the payment of damages.

An action before Chinese courts may be brought by either party, either in parallel during a procedure or after receipt of a decision by the dispute resolution institution. Claims do not necessarily need to be based on the same requests.

2.2.1 Claims before DNDRC

Within two years of the registration of a domain name, any entity which considers that such registration infringes its legitimate rights or interests may file a complaint with DNDRC.

The claimant shall evidence cumulatively (i) the similarity or identical nature of the disputed domain name with the claimant's name or trademark, (ii) the absence of rights or interests of the disputed domain name holder and (iii) the registration or use in bad faith of the disputed domain name by its holder.

A panel appointed by the claimant and the defendant renders its decision to DNDRC. The domain name agent shall implement DNDRC's decision.

If the decision is in the claimant's favour, the respondent may bring an action with the courts within ten days of publication of the decision.

2.2.2 Claim before Chinese courts

The claimant may bring an action against the disputed domain name holder before the local intermediate court in China at the place of the defendant.

A claimant may only bring an action before the court within two years of it becoming aware of the occurrence of the facts on which the action is based.

The court may order the defendant to cease the infringement, cancel the domain name or grant this domain name to the claimant. It can also order the defendant to pay damages to the claimant for actual losses.

Any party who disagrees with the decision of the court may appeal to a superior court.

2.3 Actions against unfair competition

The anti-unfair competition law provides an additional protection for IP aspects which are otherwise not covered by IP rights related provisions of Chinese law.

2.3.1 Basis for unfair competition action

(a) Trade secret protection

Under the anti-unfair competition law, there are sanctions for the infringement of a trade secret which has been illegally acquired, disclosed or used by a third party. A trade secret is technology and business information which (i) are not known to the public, (ii) have economic value and (iii) are subject to a confidentiality obligation. Examples of trade secrets include, but are not limited to, know-how, processes, customer lists and marketing strategies.

The owner of a trade secret whose rights are infringed can ask the competent AIC to impose administrative sanctions (such as fines) and orders to stop and rectify the illegal actions.

The owner can also bring a separate action for compensation before a civil court. In addition, criminal liabilities may be pursued.

(b) Protection for well-known products' names, packaging and decoration

It is prohibited to use the same or similar names, packaging and decoration as those unique names, packaging and decoration (including the design on packaging, fitting-out of stores or sales counters, sales assistants' clothing and other factors which form a unique business image) of well-known products, which may mislead the customer. Certain products with a certain level of market popularity are recognised by AIC or the courts to be well-known to the public, based on factors such as the duration of their existence, region, volume and target customers of the products' distribution.

AIC may impose administrative sanctions (including fines) and order to confiscate the infringing packaging and decoration or even destroy infringing products.

A separate civil law suit may be initiated to claim for economic compensation. In serious cases, criminal liabilities may also be pursued.

In 2007, a French luxury cosmetic company successfully brought an action before a civil court against a Chinese company that sold cosmetic products under a non-registered brand with a similar name and with similar packaging to that of the French luxury goods company. The Chinese counterfeiter was ordered to cease production and sales of the infringing products, destroy all infringing packaging and pay compensation of RMB 100,000 to the French luxury cosmetic company.

2.3.2 Unfair competition action - advantages

Although certain kinds of activity are not explicitly prohibited by the anti-unfair competition law, the courts adopt a general principal of fairness and business ethics to protect the legitimate rights of IP right holders.

In 2007, a famous French luxury goods company sued two Shanghai real estate companies for using the picture of a model holding a bag showing one of its trademarks in the advertisement for their building under construction, without its prior consent. The court ruled that, while the rights over the trademark had not been infringed by the defendants as they did not intend to use the bag to specifically benefit from the trademark, the defendants did intentionally take advantage of the notoriety of the branded goods of the French luxury goods company to improve the image of their building, which constituted illegal unfair competition. The defendants were ordered to pay compensation of RMB 50,000 to the French luxury goods company.

Chapter 7 Competition concerns

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In China, there were no comprehensive regulations in this respect prior to publication of the Anti-monopoly Law, released on 30 August 2007 (effective on 1 August 2008).

The Anti-monopoly Law is very much influenced by the European system and includes concepts such as concentration, monopoly agreements and abuse of a dominant position. It applies to both domestic and foreign entities whose activities trigger effects in China.

The anti-monopoly enforcement agencies are composed of three distinct state bodies: SAIC, NDRC and MOFCOM.

(a) NDRC has authority to investigate price-related matters with respect to monopolistic agreements and abusive conduct of a dominant business operator.

(b) SAIC has authority on non-price related matters of monopolistic agreements and abusive conduct of a dominant business operator.

(c) MOFCOM is in charge of control of concentrations in China.

Key competition concerns of luxury goods related companies are distribution agreements and price-related practices.

1. Selective distribution, franchising, exclusive distribution, single branding

The Anti-monopoly Law prohibits vertical agreements that interfere with business operators at different levels of the production or supply chain (for example, distribution and retail) which have the effect of eliminating or restricting competition.

However, the Anti-monopoly Law does not clarify what type of anti-competitive behaviour contained in such vertical agreements is prohibited. For the time being, the issue remains ambiguous as it has never been tested before the courts and it is still unclear whether the Chinese competition authorities will adopt an approach similar to Europe in relation to luxury goods companies.

2. Price-related practices

2.1 Price fixing

Resale price maintenance is stringently regulated as it prevents resellers from freely deciding product prices according to their own judgement of the market. Resale price maintenance includes:

(a) resale price fixing;

(b) minimum resale prices;

(c) maximum resale prices; and

(d) recommended resale prices.

The Anti-monopoly Law only expressly prohibits resale price fixing and fixing minimum resale prices. It seems that maximum resale prices and recommended resale prices are permitted but they may be prohibited if they are found to have the effect of restricting or eliminating competition.

2.2 Price-related practices constituting abuse of a dominant position

Several practices, considered to constitute an abuse of a dominant position, are defined by the Anti-monopoly Law as anticompetitive practices. It should however be noted that such practices are only applicable to a dominant company in the relevant market. Although it is still unclear how the authorities will define the market of luxury goods in China, it is unlikely that luxury goods companies will be considered "dominant" in China.

The following price-related practices are prohibited by the Anti-monopoly Law for companies in a dominant position:

(a) refusal of trade: refusing to trade with other business operators without an objective justification (such objective justifications are not defined in the law but an example would be a refusal to supply, thereby excluding a business operator at a lower level of the production chain);

(b) discriminatory policies: adopting discriminatory policies without an objective justification, such as different pricing policies for different counterparties which provide the same trading conditions; and

(c) excessive pricing: taking advantage of its dominant position by setting an unreasonably high sale price or an unreasonably low purchase price for a product.

Notes

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