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Trade successfully with China

Ten important principles

10 principles that can help make your sales to Chinese buyers successful

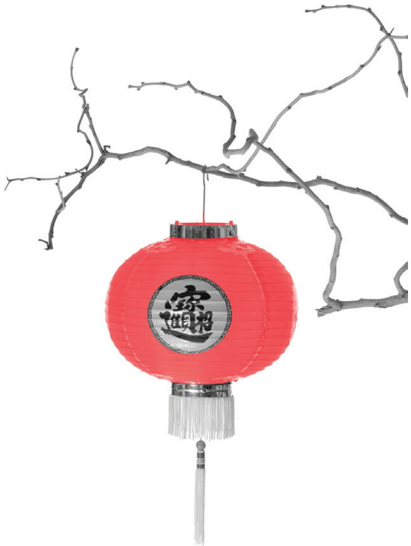
"To open a shop is easy: to keep it open is an art"

Chinese proverb

Since opening up to foreign trade and investment in 1979, China has become one of the world's fastest-growing economies, emerging as a major economic and trading power. As Atradius' recent publication 'Economic Outlook' (April 2012) observed, China has experienced enviable growth rates in recent years: 10.4% in 2010 and 9.2% in 2011. Even though these are set to slow to nearer 8.5% in 2012 and 2013, due in large part to weaker demand from the Eurozone for China's exports, there are many opportunities for foreign companies to export to China, where rising wages and a burgeoning job market continue to stimulate private consumption.

When it rejoined the World Trade Organisation in 2001, after a lengthy absence, China made its domestic rules on trade compliant with those of the WTO, and has made major strides in promoting foreign trade: relaxing tariffs, quotas and other trade barriers.

In general, supplying to China does not require any more preparatory work than supplying to any other country. However, foreign suppliers do need to understand and take account of significant peculiarities of Chinese law – and the practicalities of supplying to customers in China – when planning their sales. In this overview, we set out ten simple-to-follow rules that can help make your trading relationships with China lasting and successful.



1: Beware of import restrictions

Not all goods can be freely imported into China. China classifies goods into three categories: prohibited, restricted and permitted. Some goods, such as waste and toxic material, are not allowed to be imported in the public interest or for environmental protection, and some are strictly restricted: requiring quotas or licenses, e.g. electrical equipment, metal melting machinery. The Ministry of Commerce (MOFCOM), the government department in charge of foreign trade in China, periodically publishes and revises the lists of restricted or banned goods. In practice, it is primarily the second category - restricted goods - that may be of relevance to European suppliers.

It should be stressed that most goods fall into the permitted category, and foreign suppliers and their Chinese customers can at their discretion decide how much and when to supply and buy these goods. For some permitted goods – including those as diverse as cattle and certain electrical products, MOFCOM oversees a licensing system to monitor imports into China. It should also be noted that, although all companies have the right to import most products, a limited number of goods, such as crude oil and fertilizer, can be imported only through state-owned enterprises.

It is therefore advisable for any foreign supplier intending to supply goods to Chinese customers to clarify in which category its goods fall - and whether they are subject to any licensing or quota requirements – and also to verify that the Chinese buyer is authorised to import those goods. Otherwise, the supplier may run the risk that its goods will not be allowed into the country or are challenged by the Chinese customs authorities.

2: Verify your counterparty's authority

As in any supply relationship, it is important to verify the corporate authority of the Chinese party to the transaction. Among other things, the following documentation should normally be requested from a Chinese company to verify that the contract can be executed:

- articles of association
- business license
- certificate of approval and approval letter (applicable if the Chinese party is a foreign-invested enterprise)
- board resolution or shareholder resolution approving the supply agreement and authorising a specified person or persons to execute the supply agreement on its behalf (if required by the articles of association)
- a sample setting out the name and signature of the authorised signatories and the stamp company.

Unless the articles of association of the company provide otherwise, Chinese law stipulates that the legal representative of a company takes actions and signs documents on behalf of the company.

3: It's all about the money

China's currency, the Renminbi (RMB), is not fully convertible. Transactions that create a liability on Chinese companies to make or receive payments in a foreign currency are subject to foreign exchange administration by the Chinese State Administration of Foreign Exchange (SAFE) and its branches.

In 2010, SAFE introduced a new regime requiring all Chinese importers to register with it for the purposes of paying for imports. Since then, all importers are recorded in the so-called Name List of Importing Companies Making Foreign Exchange Payments (Name List) and are classified into three grades (A, B and C) based, among other things, on the results of SAFE's on-site examinations and the importers' compliance with foreign exchange administration regulations.

Importers that have materially breached foreign exchange laws - perhaps incurring fines from SAFE or having been investigated for obtaining foreign currency by false representation - are classified as 'Grade C' importers. Importers that have not always fully complied with foreign exchange laws - for example, by failing to report their payments for imported goods to SAFE - are classified as 'Grade B' importers. Finally, all other importers are automatically classified as 'Grade A' companies.

For foreign suppliers, it is worth noting the administrative requirements that SAFE applies to foreign exchange payments by each of these three categories:

Grade C importers and those that are not registered in the Name List have to register with SAFE before making any payment outside China. Only on sight of the registration form issued by SAFE and various other documents required by law will banks allow the Chinese importers to make payments to foreign suppliers. In addition, there are various restrictions on foreign exchange payments by Grade C importers: for example, they are not entitled to make advance payments or to pay the purchase price by way of letter of credit.

Grade B importers are required to report to SAFE after any outward payment. In addition, they cannot open usance letters of credit (i.e. allowing a stipulated period before payment is due) with a payment period exceeding 90 days. If the amount of a single advance payment exceeds US$ 500,000 (or its equivalent), an advance payment confirmation must be provided by the foreign party's bank.

Grade A importers are regulated in a more relaxed way. They are not subject to any prior registration or subsequent reporting requirements.

There are various requirements in addition to the above basic rules. For example, any importer – including those classified as Grade A - must report payments to SAFE if the value of the goods and the amount paid by the Chinese importer differ by more than US$ 10,000 (or its equivalent) for a single contract.

Although the onus is on the Chinese importer to comply with foreign exchange laws, foreign suppliers should take into account the risks associated with the Chinese foreign exchange control regime, as it can have a major impact on the supplier's ability to collect payment. Whenever possible, suppliers should try to deal only with Grade A importers.

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4: Comply with Chinese competition law

Irrespective of the governing law chosen by the parties to the sales contract, any agreement relating to supplies to China is subject to China's competition laws: mainly covering anti-monopoly, anti-unfair competition, anti-dumping and countervailing (anti-subsidy) regulations. As in most other jurisdictions, competitors are prohibited from entering into agreements to fix prices, restrict production and sales volumes, divide markets, restrict the purchase or development of new technology, or boycott suppliers. In vertical relationships between suppliers and buyers, the parties are prohibited from agreeing on fixed re-sale or minimum re-sale prices.

In foreign trade activities, companies must not engage in unfair competition practices, such as misleading advertising, acting in collusion when bidding, practicing commercial bribery or predatory pricing. Moreover, the governmental authorities may take anti-dumping or countervailing measures to protect domestic industries.

5: Secure your payment

Chinese companies import large volumes of goods from suppliers around the world and there is no reason to worry about the risk of non-payment simply because the goods are supplied to China. Even so, as a general principle in any supply relationship it is advisable to verify the creditworthiness of your Chinese buyer before entering into a supply agreement. If in any doubt, a supplier should seek to obtain some form of security: the most commonly used security instruments in China include the following.

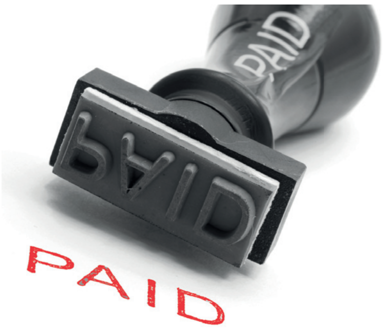
Guarantees are available under Chinese law and are commonly used. The legal characteristics of guarantees are similar to those existing in other jurisdictions. In any event, a guarantee agreement must be concluded in writing.

Mortgages may be appropriate to secure large payment claims by mortgaging immovable property in favour of the supplier. Mortgages to real estate are subject to mandatory registration. Mortgages over certain other types of property, such as manufacturing equipment and vehicles, are effective from signing. However, these mortgages must be registered with the competent registration authority to ensure that the mortgagee's claims take priority over those of any bona fide third parties.

Pledges are typically easier to agree in relation to supply agreements as they require less due diligence and are less regulated than mortgages. Chattel and rights, such as cheques, transferable shares, bonds, and portions of intellectual property rights, can be pledged to a supplier to secure payment claims. Pledges have a disadvantage under Chinese law, in that possession of the pledged movable property must generally be transferred to the pledgee: which is not normally workable in supply relationships.

In respect of enforcement of a mortgage or a pledge, where the Chinese party fails to perform its obligation, the foreign supplier will be entitled to a priority right in receiving payment only by converting the property into value or in receiving proceeds from the auction or sale of the secured property. The law forbids the parties from agreeing to a mortgagee or a pledgee keeping the property.

It should be noted that the granting of a security to a foreign supplier by a domestic partner will constitute a 'foreign security' under the foreign exchange control regime and may be subject to registration with and approval by SAFE on a case by case basis. An exception to the approval requirement may exist where the security is within the pre-approved foreign security quota of the domestic security provider or where a mortgage or pledge is created for the mortgager's or pledger's own debt. If these requirements are not complied with, the security provider may not be permitted to make a foreign exchange payment outside China when the supplier attempts to enforce the security. When creating a security, the supplier should therefore request evidence that the relevant SAFE approval and/or registration procedure has/have been completed.



6: Protect your intellectual property (IP)

Chinese laws provide for a multi-faceted protection of IP, including copyrights, patents and trademarks. Copyrights are protected for fifty years after the author's death (except for the right of an 'author' to affix his/her name to the work, the right to revise a work and protection of integrity of works, which enjoy unlimited protection time). Patents and trademarks are protected on a first-to-file basis. The validity period of a registered trademark is ten years and is available for renewals. The duration of patents depends on the different types of patents regulated by the patent law – twenty years for invention patents and ten years for utility models or designs.

Besides the protection given through the IP registration regimes, various governmental authorities may take administrative actions against IP infringers. For example, a right holder can apply for filing its recordal (the submission for evaluation of documentation relating to the assignment or licences of patent, design and trade mark rights) with the Chinese customs authorities. The import or export of goods suspected of infringing a registered right can then be suspended by the customs authorities at the request of the right holder. As a rule, such a request must be accompanied by a guarantee in an amount of no less than the value of the goods in question, to cover any liability in case the import or export is suspended and it is later established that there was no actual violation of IP rights.

In practice, while China has significantly strengthened its legal framework and enforcement of IP protection, violations of IP rights are not uncommon in China. According to market analysts, approximately 20% of all consumer products available in the Chinese market are counterfeited. Because any supply of goods to China involves the risk of illegal duplication in China, before starting any exports, suppliers should register their IP rights locally. They will then have IP protection under the local regime and significantly improve the chances of any enforcement actions against IP infringers.

7: Choose your law and court

Apart from only very few exceptions, the parties to a cross-border supply agreement may freely choose Chinese or any foreign law to govern their relationships. In practice, it is common for European suppliers to use the laws of their countries of origin for their supplies to any country, including to China. It should, however, be kept in mind that the mandatory provisions of Chinese law, such as the tax, currency regulation and competition regimes, will apply despite the parties' choice of any foreign governing law.

When choosing the right forum to resolve any potential disputes between the parties, there are generally four types of forum available for cross-border supply agreements: Chinese state courts, Chinese arbitration institutions (most notably, the China International Economic and Trade Arbitration Commission - CIETAC), foreign courts, and foreign arbitral tribunals. The choice of the most appropriate forum should be made on a case-by-case basis and should take into account the following factors.

- Foreign litigation and arbitration are available only for agreements with foreign elements, which is however normally the case in relation to sales by foreign suppliers into China.
- Foreign arbitral awards can be - and frequently are - enforced in China under the New York Convention, while foreign court judgments are usually unenforceable in China.
- Local litigation and arbitration may be desirable when interim relief (such as an injunction) in China is the parties' major concern. Asset and evidence preservation orders are available in support of PRC litigation and arbitration, and interim injunction can only be obtained in support of PRC litigation involving copyright, trademark and patent infringements.

In any event, careful drafting of the supply agreement will be required where the parties opt to use a foreign law combined with litigation before the Chinese state courts. Most local courts are inexperienced in applying foreign laws and, if a court finds that the governing foreign law cannot be properly verified, it is entitled to apply Chinese law despite the parties' contractual choice.

8: Tariffs can be a deal-breaker

As in any other jurisdiction, the import of goods into China is subject to the local customs and tax regime. Several factors affect the customs clearance requirements and the time required for clearance, including the value of goods, product code and their description. As a practical matter, it is advisable for both parties to keep all documentation relating to the transaction, as customs authorities may require all relevant import documentation and are often very thorough and formalistic before clearing imports.

Value-added tax (VAT) and tariffs will normally be levied on the imported goods. The standard VAT rate for most goods is 17%, while a concessionary rate of 13% applies to agricultural machinery, books, utilities and certain other types of goods. Consumption tax is applicable to certain goods, including cigarettes, jewellery and motor cars.

Tariff rates vary depending on the goods and country of origin. Tariff rates may range up to 270%, which may make the purchase of goods from a foreign supplier very expensive and can therefore be a deal-breaker for supplies to China.

As a rule, tax and tariff are levied on the importer: typically the Chinese party to the sales contract. Nonetheless, it is highly advisable that supply agreements contain appropriate tax gross-up and indemnity provisions to protect the foreign supplier.

9: A local presence can increase your sales

Instead of selling goods from abroad directly to Chinese customers, foreign suppliers can choose to establish an entity in China to distribute goods and expand the Chinese market. The most common types of investment vehicles are:

- a wholly foreign-owned enterprise (WFOE): a limited liability company with 100% foreign ownership;
- an equity joint venture (EJV): a limited liability company that is established by both the foreign and Chinese parties; and
- a cooperative joint venture (CJV): a joint venture with both foreign and Chinese investors.

Foreign suppliers with significant experience in China are more likely to establish a WFOE without a Chinese partner as this will provide sole control over technology, know-how and commercial secrets. WFOEs are also often used as umbrella companies to hold various investments in China. In some industries, the establishment of WFOEs is not permitted, but these are rarely of relevance when foreign manufacturers set up local investment vehicles to ease the distribution of their goods.

Foreign investors with less experience in doing business in China will often prefer to jointly set up a vehicle with a local partner. For foreign suppliers, this normally means that the local partner has better access to local customers and can help expand sales within China. In this case, the EJV would normally be the more preferable type of investment vehicle. The foreign supplier's shareholding in an EJV must generally be at least 25%. Profits are distributed pro-rata to each party's contribution to the registered capital.

From a legal perspective, the CJV forms a more flexible alternative to the EJV. Most significantly, the parties can agree to a profit sharing arrangement that is not based on the pro-rata principle. This may be an important aspect for a sales vehicle that might have better market access if it is formally controlled by the Chinese partner, while goods and investments are provided mainly by the foreign supplier. The CJV may or may not be incorporated and can therefore enjoy a very flexible management regime. The use of CJVs is, however, only available for investments in certain specialised areas and is, therefore, not in common use.

There are a number of other commercial and legal aspects to be considered by a foreign supplier when setting up an investment vehicle, including the scope of local business, the advantages of establishing a local vehicle beyond a one-off supply, and the complexity of local labour, tax and administrative requirements. However, despite the additional administrative burden, an increasing number of foreign suppliers consider it beneficial to gain more direct access to local customers, better control over the distribution channels and more flexibility to provide maintenance and after-sales service locally instead of having to handle these tasks from abroad or through local agents.

10: Protect your credit sales

As holds true in any sales contract made on credit terms and to any country, even if all the above rules are strictly complied with, there is always a certain level of risk of non-payment and unpredictability, e.g. due to currency inflation or changes in China's foreign trade policy.

It is therefore advisable for the supplier to seek protection in the form of credit insurance to mitigate those potential risks that due diligence alone cannot avoid. Moreover, credit insurance provides not only protection, but also reassurance about the identity and creditworthiness of your potential customers. In a country as vast as China it is only too easy to confuse two similarly sounding company names. With that combination of protection, reassurance and market intelligence, those foreign companies seeking to establish a market for their goods and services in China can afford to offer competitive payment terms.

"Don't assume that the business techniques that prove successful in your home market will work in China."

To summarise, provided that foreign suppliers take sensible measures when planning their sales to Chinese buyers, this is a dynamic market that holds huge potential, especially at a time when many mature and traditional markets are beset with problems of poor business sentiment, consumer confidence and falling demand. Even the Chinese government's recent move to raise import tax does not appear to have had much impact on demand for foreign goods, especially for high-end goods: last year, consumers in mainland China spent 100 billion Renminbi (€12 billion) on luxury products. Tellingly, news channel Chinadaily.com has reported a boom over recent years in foreign companies exhibiting at the prestigious Canton Import and Export Fair: last year 530 companies from 49 countries exhibited there.

Atradius' Senior Manager and Asia expert Malcolm Terry summed up the recipe for successful trade with China in a recent Atradius publication 'Leading Edge – what businesses can learn from emerging market success':
"Don't assume that the business techniques that prove successful in your home market will work in China. You may be used to quick, straight talking – maybe even pushy – informal meetings at which a business proposal is put on the table and a deal forged. But in China it's a very different story. Building a relationship comes first, so don't expect a contract to be agreed at a first, or even a second or third meeting. The Chinese have a word – 'Guanxi' – that describes the personal connection, respect and trust that must be created before a business relationship can go further. The existence – or lack – of Guanxi will influence the ease with which a deal can be struck."

Atradius would like to thank international law firm Clifford Chance for their contribution to this publication. They have asked us to point out that the ten principles in this overview are intended as general guidance on the legal framework applicable to supply relationships with Chinese customers and are not intended as legal advice, nor can they replace a thorough analysis of specific supply arrangements.

Atradius' 'Economic Outlook' and 'Leading Edge – what businesses can learn from emerging market success' can be downloaded from www.atradius.com

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Atradius Credit Insurance N.V
David Ricardostraat 1 · 1066 JS Amsterdam
P.O. Box 8982 · 1006 JD Amsterdam
The Netherlands
Telephone: +31 20 553 9111
Fax: +31 20 553 2811

www.atradius.com