

Retail Update

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Once again, R&P China Lawyers made the rankings of the Chambers Asia-Pacific Guide. Listed in Band 2 under Corporate/Commercial East Coast, Shanghai, this ranking is testimony to R&P's continuing influence in the Chinese legal market especially for general corporate work, focusing on foreign investment, corporate structuring, joint ventures and liquidations. R&P's expertise in the media and retail sectors received special attention.

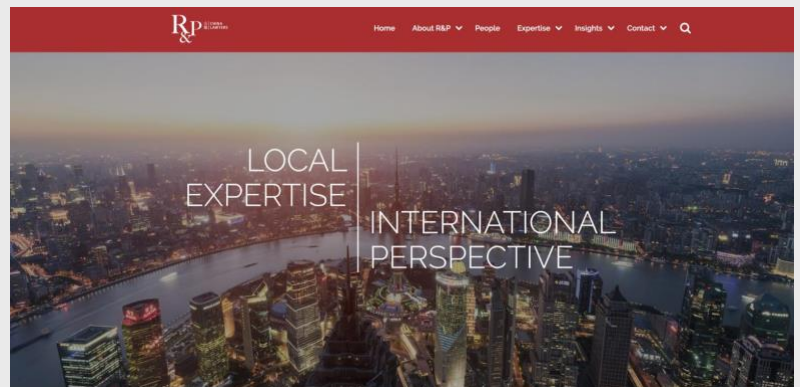
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R&P Beijing team moves into new office in CBD

The Beijing team of R&P have moved into a new office space in the capital's central business district (CBD) located at Wanda Plaza.

From the new premises, R&P will continue to support clients with excellence in legal services and expand its operations, including to cities in the region, such as Tianjin.

R&P opened their office in Beijing in 2014 to provide their clients in North China with legal assistance on investment projects, various legal advice and practical solutions.



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R&P Legal Briefing is written to inform clients and friends of the latest developments in Chinese law and practices.



Legal Aspects and Best Practices for Retailers in China

By Maarten Roos & Robin Tabbers

China has become the world's leading consumer market and is predicted to grow faster than the West – at 6% annually over the next decade (World Economic Forum). International brands are taking advantage of this, despite increased competition from local competitors and from each other.

While e-commerce is now a firm part of the landscape, most international companies remain convinced of the importance of developing a network of brick-and-mortar stores. In this article, we summarize some of the key legal challenges specific to international businesses that plan to open retail stores in China.

Corporate structuring: company set-up

The first step to establishing stores is to incorporate a legal entity. Rules for establishing entities have been liberalized over the years, but it may still take four to six months for a subsidiary to become fully operational. Key

issues to decide upon when establishing a retail business are:

- The **registered address** is the location where the company is legally registered and determines in which district (and under the supervision of which authorities) the company is incorporated. For larger companies, local governments may be able to offer subsidies and tax benefits; smaller retailers may be offered a virtual address. The office lease must be signed before the company can be formally established.

- The **business scope** determines the activities that the company may engage in and must be approved by the competent authorities. Certain types of products (e.g. food, medical products) may be subject to special licensing. Also, some districts will not allow the inclusion of “retail” in the business scope until an office has been leased for the first branch; this requires a two-step process of establishing the company first, and then expanding its business scope to include retail.
- The **company name** will be in Chinese and should consist of a location indicator, an industry indicator, and the trade name. For retailers in particular, a good Chinese trade name (and its registration as a trademark) is crucial. Different levels of location (Shanghai vs. China) and different industry indicators may require different levels of approval.
- The **registered capital** is the amount of capital that the (foreign) investor commits to the company. There is no legal minimum, but companies should consider actual operational needs, since increasing the registered capital later will take three to six weeks. There is no immediate deadline to contribute the registered capital in full, and so some investors prefer to set a higher registered capital. Others prefer to finance partially through foreign debt, which is subject to strict rules.
- The Chinese entity will need to have a board of directors or executive director, a legal representative, one or more supervisors, and rules on the authority of these positions and the shareholder. These issues of **corporate governance** are a major part of the company’s Articles of Association, which is a legal document and should be drafted with care.

Branch establishment

While technically the first branch can be opened at the location of the company, it is much more common to keep the company’s address as an office and establish the first store at a retail location elsewhere. Subsequent stores will normally require the registration of separate branches.

The most common model is to have one company with many branches across the country – there is no limit to the number of branches that a single company can have. An

alternative is to establish separate companies in major cities / regions (e.g. Shanghai, Beijing, Guangzhou / Shenzhen, Chengdu / Chongqing) and structure local branches under each of these companies. In that case, an extra option would be to set up a China Holding Company to consolidate all this business.

When establishing a branch and to ensure that it is ready in time, your legal team must coordinate closely with the builder in charge of construction and decoration of the store on related approvals, including store design and fire protection, as these can take weeks or even months to procure (especially where the location is in a new mall). The store should open for business only when all licenses, permits and approvals are in place.

For stores selling food or other products that are subject to special licensing, additional steps must be completed. Examples are the Food Business License (for catering and non-catering), the Public Sanitations Permit, and the Alcohol Retail Permit. The timing and necessity of these licenses varies by location, so professional expertise is crucial.

Signing lease contracts

A good location is one of the key components for the success of a store, even more so for retailers who are relatively new to China and less well-known to Chinese consumers. As in other competitive markets, the best locations are difficult to secure, which means that the landlord is in a very strong position in negotiations over the lease.

On the other hand, signing a very one-sided lease can bring huge risks. It is never advisable to directly sign the landlord’s version. Where the landlord refuses revisions and a company still wants to sign, an analysis of the legal risks can at least establish the tenant’s legal position, especially when it comes to crucial clauses such as term, termination and renewal, competition and confidentiality.

As the retailer’s reputation in China develops, it will become increasingly easy to negotiate more favorable lease terms. This offers a valuable opportunity, especially if background knowledge can be obtained on what the landlord has offered to others and therefore may be willing to accept.

Ensuring legal compliance

China has communicated a clear focus on consumer health and safety issues. These rules

and standards also differ significantly from other jurisdictions, and so can have a major impact on retail operations. To give an example, a very successful F&B retailer in Shanghai was closed in 2017, and some of its staff imprisoned, because it was using flour that was past its formal expiration date – while in the U.S. and Europe, flour often has only a best-before date.

Product Quality and Local Standards

China has established extensive standards for all kinds of consumer products, not only for food but also for clothing, electronics, etc. This sometimes results in the ironic situation where products made in China cannot be sold in China without adjustments. For food products, these standards may extend to store organization and supplier management systems.

Failure to meet legal standards can be a serious offense and may lead to large financial penalties and even potential criminal liabilities. The authorities dealing with such matters, especially the Administration for Industry and Commerce, will investigate individual complaints. Responding to an investigation correctly and with the right amount of information is a

delicate matter, but it is worth the extra attention, as an unfavorable decision can have huge financial and operational consequences.

Advertising and Pricing

A special compliance risk relates to advertisement and pricing. Areas that are regulated include discounting and minimum pricing. Violations of these rules are often used by professional buyers to extort money from retailers and producers. In the case of complaints, companies must balance between giving in too easily (encouraging more professional buyers to target them), and the cost of defending claims and even lawsuits, whether frivolous or not.

Labeling

Labeling is another sensitive area. Besides expiration dates, the composition and type of ingredients / materials should be accurately listed on the label to adhere to the stringent rules that apply in this field. Labels must be in Chinese, and meet other specific standards. Violations may result in fines, but also potential lawsuits by professional buyers.

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*“A Shanghai boutique, well equipped to advise on a wide range of issues incorporating foreign direct investment, corporate restructuring, joint venture establishment and liquidation. Standout expertise in the media and **retail sector**, assisting international companies with their investments and operations in China.”*

*“R&P China Lawyers is described as ‘**outstanding when compared with more established and branded firms**’; it ‘**always provides a prompt and informed answer on any topic**’ and has ‘**deep insights into the market, and good local knowledge**’.”*

“The lawyers at R&P are very knowledgeable in many different areas of the law in China, they communicate clearly with clients and understand their challenges.”

“Outstanding!”

“Quick replies; efficient; combines in depth local knowledge with a hands on attitude; not afraid to take a position; good understanding of local culture; solid legal quality.”

Data Privacy

Data privacy is a “hot” topic in China. The legal framework for using private data is still being developed and is not yet as sophisticated as in many Western jurisdictions, but the recently-adopted PRC Cyber Security Law (effective 2017) shows purpose. The law puts the burden on “network operators” (i.e. owners and administrators of networks and network service providers) to protect “personal information” on information networks. Moreover, certain kinds of personal information and other important data must only be stored domestically (i.e. in China). Violations of the law can result in high penalties and even detention of those persons responsible.

Employment

When operating stores, employees form an integral part of the company. Chinese labor laws are strict and tend towards protecting the employee. Establishing strong employment contracts and official company rules (in the form of a staff handbook), and adopting these rules in a legal manner, are key steps to lower incompliance risk and create more leeway to manage (and where necessary) terminate employment contracts. A retailer should also consider whether to use standard working hours for employees, or alternative systems (flexible or comprehensive working hours) subject to special approval.

Trademark Protection for Retailers

The protection of intellectual property (IP) such as trademarks is a key concern for foreign businesses in China, because IP helps to determine their identity and distinguish between other brands, in particular domestic ones. For retailers, this is arguably even more important, because retailers are consumer-facing and because reputable landlords, advertisers and especially online platforms will require trademark ownership before beginning cooperation. Reviewing the trademark portfolio and making sure that all relevant brand names are protected in the correct classes and subclasses is not only a prerequisite to the start of China operations, but should be repeated on a regular basis.

For international companies that are new to the country, this can present a huge problem. It is common to find that one’s international trademark has already been registered in China by another party, often a squatter. China’s trademark protection system is first-to-file, and despite exceptions for well-known trademarks and trademarks registered in bad faith, it can be hugely complex and costly to get back a trademark once it has been registered by a third party. Therefore, companies should always register trademarks as quickly and as broadly as possible, preferably directly in China (instead of using the international Madrid system). If too late, then a comprehensive strategy is needed to get back the trademarks.

Another aspect particular to China: not all Chinese consumers speak or read English fluently, so it is important to come up with a good Chinese brand name that can adequately represent the business. This brand name should also be registered in all relevant classes and sub-classes.

Conclusions

China is the land of opportunity for many international retailers. The large, growing and relatively sophisticated market of consumers interested in high-quality international brands, which is increasingly willing to pay for premium products, is a dream for many. Not every retailer that enters the China market is able to take advantage of these factors, but successes are easy to find.

There are plenty of factors that may contribute to success in China, not all of them under the company’s control. When it comes to legal challenges, an international company should be able to avoid big surprises. Company structuring, lease contracts, trademark protection and legal compliance are all subjects that can be managed effectively with timely investment in resources and the right external support.

For more on R&P’s retail practice, and on the challenges that you may face selling retail in China, please email your usual contact at R&P or email to info@rplawyers.com.



China's Strict Rules on Advertisement: Foreign Companies Be Prepared

By Maarten Roos

Foreign companies may be surprised to know that China is extremely protective of its consumers, with laws that set a very high bar and therefore regularly cause problems to even the most compliant retailers selling their consumer goods in China.

One of the areas that many companies, both foreign and Chinese, often fall foul of, is advertisement. In this article, we briefly review:

- The legal framework that is challenging good-faith operators;
- The consequences of non-compliance;
- Steps that operators can take to protect themselves.

Legal Framework

The legal framework that establishes what can(not) be used in advertisement comprises mainly of the *PRC Advertisement Law* and the *PRC Unfair Competition Law*, though it involves a myriad of specific rules and

guidelines as well. For an operator that in good faith tries to sell its products in the Chinese market, the key principles are:

1. An operator must not resort to **any falsehood that results in deception or misleads consumers** (Article 4, *PRC Advertisement Law* [2018]).
2. An operator is prohibited from **commercial publicity** in respect of the **performance, functions, quality, sales, users' comments and honors** received regarding its products, in order to **defraud or mislead consumers** (Article 8, *PRC Unfair Competition Law*).

The above principles are easy to understand, but the challenge is in their implementation, and in particular how strict terms such as “falsehood” and “misleading” are interpreted. In practice, this interpretation by both administrative authorities and China’s courts is often much stricter than what multinationals are used to from their experience in other markets. Some examples of risky practices:

- Use of certain terms are deemed misleading by default, including “world leading” and “first”, but also more general terms such as “top”, “most”, “permanent”, “best” and “effective”.
- Use, even in disguised form, of China’s national flag, emblems, or songs is prohibited, as are terms that suggest recognition by the State or other official organization (e.g. State level).
- Inclusion of politically-sensitive statements can cause problems, especially those that challenge the territorial integrity of China (e.g. the status of Hong Kong, Macau and Taiwan).
- Any encouragement of vices such as the drinking of alcohol is prohibited; this includes anyone actually drinking alcohol, or suggestions that drinking alcohol relieves tension and anxiety, increases physical strength, or has any other positive effects (such as related to success of an individual, her business or sex life).
- Statements on health functions, or expressing effects of some ingredient(s) intended to expressly or implicitly indicate the health functions, are not permitted.
- References to minimum market prices, ex-factory prices, wholesale prices, special prices, or super prices are prohibited when they are baseless or cannot be compared.
- Terms should never suggest that an operator has less liability than is mandated under the law (e.g. statement that the operator has no liability as the price is on sale).

Serious Consequences of Incompliance

A government investigation is usually the result of a third-party complaint, whether made in good faith or by a professional buyer that is looking for mistakes. Either way, the consequences can be very serious.

A consumer who has been disadvantaged by false advertisement can file a civil claim for compensation based on fraud – for three times the price of the goods (minimum CNY 500), or ten times (minimum CNY 1,000) if it relates to food safety standards. However, this is minor compared to the effects of a government investigation. The local Administration for Market Regulation (AMR) that handles complaints on false advertisement, can decide to penalize a violation under either the *PRC Advertisement Law* or under the *PRC Unfair Competition law*. We summarize below:

Penalties under the <i>PRC Advertisement Law</i> , <i>PRC Unfair Competition Law</i>		
Degree	Fine Calculation	Alternative calculation
Regular	3-5 times advertisement fees*	CNY 200k - CNY 1 million
Serious**	5-10 times advertisement fees	CNY 1-2 million
* includes design fees, agency fees, publication fees etc. ** if more than 3 violations in 2 years, or other serious circumstances		

The *PRC Unfair Competition Law* also establishes the tools that the AMR has at its disposal, to investigate an alleged incompliance. This includes interviews, the right to inspect or make copies of agreements, accounting books, invoices and receipts, documents, records, business correspondence and other materials related to the alleged unfair competition; seizure or confiscation of monies and assets related to the alleged unfair competition; and inquiries into the bank account(s) of a business operator allegedly engaging in unfair competition. In other words, the investigation can be extremely invasive.

These risks are not just theoretical. Many companies have already been penalized. Below are some well-known examples; though it must be emphasized that not only large and famous companies get in trouble.

- Crest was fined CNY 6.03 million for advertising a celebrity statement that

“Using Crest Dual Action White toothpaste made my teeth white in only one day”.

- Walmart was fined CNY 90,000 by the Pudong AMR for falsely claiming that its Alligga and HJY oils were low-fat.
- Dali Foods Group was fined CNY 36.7 million for misleading advertisement on the packaging of its Capico potato chips. Almost 92 million cans were sold with misleading packaging; and so the authority calculated CNY 0.10 per can and multiplied this by four.

Best-practices for Consumer Companies Selling in China

The first step to minimize the risk of investigations and penalties, is for employees to be aware of all the restrictions that apply on advertisement in its business. A process should be established to verify compliance. It is not uncommon to use a third party such as a law firm to support this process, but creating internal awareness on the key rules and regulations is just as important. Trainings can be

organized internally (with employees) and externally (e.g. with designers), and regular updates can be provided with examples and case-studies.

A second step that companies can take, is to establish a protocol in case the AMR or another authority approaches the company for an investigation. Usually an investigation starts with a notice, and so businesses should make sure that processes are in place so that the notice comes to the attention of the right people. In more serious circumstances, the authority could also show up at the company with a whole team, demanding immediate access to computers, files and people. Dawn raid protocols are a way to make sure that employees know how to respond.

If a company is investigated, then the key issue becomes how to respond to such an investigation. Authorities continue to have a lot of discretion when it comes to determining a violation and administering a fine, and it is worth spending time and effort to maintain a good relationship with the investigating officers. Most important, a careful balance must be maintained between full cooperation with the investigation, and protecting the interests of the company.

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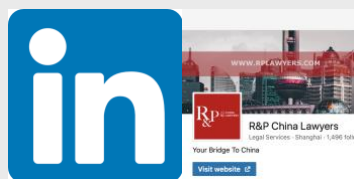
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Conclusion

Sales to Chinese consumers has become the main objective of many international companies operating in China, in food but also in a broad range of non-food categories. China's standards for products is often more rigorous than in Western countries, and penalties for non-compliance more severe. In advertisement for example, huge penalties have already been levied on companies that have made mistakes. The best way to avoid future issues is to be proactive on internal trainings and processes, to ensure maximum compliance as well as minimizing the consequences in case an incompliance is investigated.

R&P China Lawyers is a full-service law firm with a strong compliance practice. The firm assists clients to screen advertisements and advise on compliance risks; and it supports companies that are the target of a complaint or government investigation. For more about our practice, please email Maarten Roos at roos@rplawyers.com), or your usual contact at R&P China Lawyers. The firm can also assist with general compliance matters.