



China-Britain
Business Council
英中贸易协会

PROTECTING YOUR BUSINESS INTERESTS

CBBC CHINA BUSINESS GUIDE

Advice 建议 Analysis 解析 Access 渠道

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COMMON BUSINESS RISKS IN CHINA

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China remains a key investment destination and driver of global economic growth. And given its more recent focus on upgrading to a consumption economy, the potential business rewards remain high - but so too do the risks. To capitalise on the opportunities and mitigate such risks, British investors need to scrutinise not just the potential investment target or sector, but also have a solid understanding in terms of financials, strategy, regulatory compliance, sustainability/contingency planning, market differentiation, and general location- or sector-specific business practice. Outlined below is a summary of some of the priority risk areas investors must be cognisant of.

KEY RISK AREAS

- » Cybersecurity and personal data handling (legal requirements and data/intellectual property (IP) protection);
- » Strategic risk (market knowledge and staying agile to counter new business models and nimble competitors);
- » Management and staff integrity (conduct, historical track record, governance, etc. in respect of a joint venture (JV), supplier, or general partnership, in addition to general staff);
- » Regulatory compliance (ever-changing and complex regulations);
- » Negative lists;
- » IP protection;
- » Importing/exporting.

Each of these key risks should be assessed separately after an initial market assessment and feasibility analysis as to your various market entry options. The specifics of each may vary depending on your investment approach. For example, the risk matrix may differ if you opt for a JV or partnership as opposed to a greenfield approach, and would differ further still depending on whether you opt for an asset or equity deal (if going a JV or general M&A route). Ultimately, a high-level analysis as to your optimal approach would be needed before delving deeper into the associated respective risks.

However, the above-listed key risk areas represent the minimum that should be covered before you engage in business, extrapolated briefly as follows.

CYBERSECURITY AND PERSONAL DATA HANDLING

China introduced its China Cybersecurity Law of the People's Republic of China in 2017, which has repercussions in terms of general cybersecurity management/MLPS, digital cyber compliance, personal data protection, and personal data/important data cross-border transfer management, amongst others – which combined give rise to various regulatory and IT/Cloud issues. Several other cyber-related laws, regulations and supporting national standards are currently in draft or under discussion. It is anticipated that these will possibly be finalised in the near future, and are expected to be more restrictive. Consequently, security and compliance pose key emerging risks given digital-based interaction (with customers, suppliers, and payments, amongst others) and remote working is becoming commonplace. Further, owing to high demand for related talent to handle such aspects, investors must gauge the most suited approach in terms of outsourcing or onboarding of talent. In essence, investors must ensure a thorough localised cybersecurity/IT framework, infrastructure and policy is formulated before doing business in China, particularly as most businesses and government services are now digitalising.

STRATEGIC RISK

The sheer size and potential rewards of the China market means competition can be fierce. The diverse geographic regions and markets may also require diverse and location-specific approaches, as the country should not be considered as one uniform market in most cases. Nor should it be assumed that your current business model will necessarily transplant successfully into the China market – adjustments, sometimes extensive, may be needed. Couple this with the rapid ability by some local players to ramp up or change course quickly should your business, service line, or product start gaining rapid market share, it then becomes imperative to pre-empt and have mitigating or counter-strategies in place to maintain a competitive edge. A deep understanding of the various markets, trends and conditions – and an effective plan to deal with new business models or market entrants – is a must.

MANAGEMENT AND STAFF INTEGRITY

Screening talent is crucial everywhere, and China is no exception. What is sometimes overlooked though is effective governance and management controls to mitigate improper dealings between associated parties and potential cash leakage, avoid breach of international bribery and corruption laws (e.g. the UK Bribery Act), and secure proprietary information, business strategy, and reputational standing. Also, nurturing of *guanxi* – essentially far-reaching relationship networks to advance business and opportunities – is common practice in China. While such a notion is not endemic to China, it is not uncommon in the country for some to favour transactions, tender bids, or purchases in favour of those they know, as opposed to what might be in the company's best interests.

REGULATORY COMPLIANCE

China's regulatory landscape is constantly evolving, with a tendency towards more complex regulations. While the country is increasingly opening up in terms of previously restricted sectors or industries, tighter regulations as to tax and transfer pricing, environmental protection, IT and data handling, and labour and associated social benefit contributions, amongst others, are clearly apparent. Ensuring compliance from the get-go is far less costly than addressing non-compliance post-investment given the potential for penalties, business disruption, and other added costs inherent to a rectification process.

NEGATIVE LISTS

The new Foreign Investment Law, effective from 1st January 2020, is intended to grant national treatment to foreign investors and foreign-invested companies in China with one exception: the negative lists. These lists refer to certain specific fields (printing and publications, tobacco products, telecommunications, and auction businesses, amongst others.) where foreign investment is still subject to certain restrictions (e.g. no controlling interest) or prohibitions. The lists also vary depending on the location of the entity: namely whether they are within or outside of the trade free zones, in which where there are less restrictions for foreign investment.

IP PROTECTION

IP is a longstanding and substantial concern for companies when they enter the Chinese market. China has been constantly revising its IP laws and regulations to align with international standards – most recently with the newly revised Regulations on the Administration of the Import and Export of Technology (Revised in 2019), which rescinded less favourable terms towards foreign entities. The key concept is that IP is local, and companies need to register their trade names, trademarks, and patents in China for better protection in China.

IMPORTING AND EXPORTING

INITIATING BUSINESS

Traders in China often prefer to initiate business face-to-face or via introduction from someone they know, so if starting up it is worth leveraging any China-based contacts you have if possible. For British importers, engaging a reputable China-based trading agent should be considered, as this trading agent can handle samples, ensure the requisite licensing in place, quality check production, liaise on communications and problems, handle customs, and help facilitate equitable payment. For exporters, checking the veracity/history of the buyer or distributor is equally as key as ensuring robust and clear contracts and payment guarantee mechanisms are in place. Payment guarantees should be sorted via a professionally-checked contract and mutual use of a reputable bank, restricted accounts for any pre-production deposits, and sound letters of credit. Insurance from a reputable broker to counter any potential non-payment is also recommended. And as lead times between contract signing and end delivery may be long – and that trading may often be on a US dollar basis – thought should be given to exchange-rate mechanisms or options to counter potential forex losses.

VETTING AND COMPLIANCE

Regulatory compliance and avoiding customs-related violations is always a priority when importing or exporting; pressures around quick customs clearance and mitigation of financial losses may also be exacerbated if markets are volatile or business uncertainties prevail (e.g. the COVID-19 pandemic). Thorough risk-based vetting of new suppliers/clients and/or import-export agents should be undertaken. It is also important to include audit rights and acknowledgement of compliance with local laws and regulations in your related contracts to protect your interests in the event of any defective product or customs clearance issues.

DISPUTE RESOLUTION

If you plan on entering into a supply agreement to either import or export goods with a Chinese counterparty, the applicable law and the place of dispute resolution would be among the key terms that you should consider. For example, unlike in many common law countries, the contract law in China stipulates one party may rescind the contract or at least be excused of certain obligations if it was affected by a force majeure event (such as the COVID-19 pandemic) to a certain degree, even if the contract does not have a force majeure clause. For the location of dispute resolution (either of courts or arbitration tribunals), you need to consider the extra and considerable costs (travel and local attorneys, amongst others) associated with appearing in a foreign court or tribunal.

IMPORTING FACE MASKS AND PROTECTIVE CLOTHING (ADDENDUM, 1ST MAY 2020)

As the Chinese economy and manufacturing are slowly recovering from the COVID-19 pandemic while many other countries suffer from a shortage of medical supplies – including face masks and protective clothing – there is a strong demand for importing medical masks and protective clothes from China. As of the date of this document, the Chinese government does not prohibit exporting medical face masks and even encourages export of protective clothes. For importing such products, the local manufacturer should have its business licence (with a business scope incorporating manufacturing medical equipment), medical equipment manufacturing certificate, medical equipment registration certificate (class II), and product quality report in place. If the manufacturer does not have an export licence, an export agent should provide the services related to the export. For a preliminary check, you may visit www.nmpa.gov.cn and search the medical device registration number or the name of the manufacturer.

FINANCIAL AND TAX DUE DILIGENCE

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Financial due diligence assesses the key issues facing a business and the drivers behind maintainable earnings and cash flows, in addition to identifying major financial risks and potential deal breakers.

Tax due diligence focuses on a target's potential historical tax underpayments, which may affect the investment going forward. If the potential liability risk is high, this could also be a potential deal breaker.

Such due diligence can help facilitate M&A undertakings, especially cross-border deals targeting Chinese businesses where the following common issues can be gauged.

QUALITY OF FINANCIALS AND INTERNAL CONTROL

Poor quality financials (multiple sets of books, off-book transactions, cut-off errors, cash-based accounting, and purchased tax invoices, amongst others) and insufficient internal control are common issues for Chinese companies, and may also lead to potential tax underpayments.

Substantive testing is often needed (e.g. for off-book sales) during due diligence. Sometimes fully adjusted financials are needed to understand the true financial position and performance of the business.

Additional post-transaction standalone costs may be needed to reinforce the management team, finance team capability, internal controls, and reporting requirements.

EXAMPLE

Company A had two sets of accounts – tax accounts and internal (management) accounts. The tax accounts, used for tax filing purposes, recognised sales upon invoice issuance (rather than goods delivery) and costs were overstated (by purchasing false invoices). Non-invoiced sales were settled off-book by cash and off-book cash was used for bonus payment, sales commission, and customer rebates. Management also prepared internal accounts (P&L only) to reflect actual performance. The internal accounts recognised sales upon goods delivery and did not record false costs. However, no balance sheet was prepared, accounting errors were identified, and there was no reconciliation between the two sets of accounts.

QUALITY OF AUDIT AND BASE INFORMATION

A statutory audit is mandatory for most companies in China, however, many are audited by local accounting firms and the quality may typically be less reliable compared with Big Four firms.

Consequently, the management accounts are normally more representative of the business and are used as a starting point for due diligence in China (unlike targets in Western countries where audited accounts are used).

EXAMPLE

Company B recognised sales upon invoice issuance and recorded expenses on a cash basis. It was audited by a small local accounting firm. The only audit adjustment proposed by the auditor was reclassification between current accounts.

FULL ACCESS TO THE TARGET

Due diligence is normally conducted via virtual data room and Q&A sessions in Western countries, while fieldwork and full access would be more efficient and preferable in China.

SOCIAL WELFARE EXPOSURE AND INDIVIDUAL INCOME TAX

Employers in China are required to make statutory social welfare contributions at rates determined by each jurisdiction's local authority. Employees are technically required to contribute a portion as well; it is the employer's obligation to withhold the employee's portion of social benefits.

Non-compliance with social welfare regulations is not uncommon in China. But the Chinese government has been tightening policy and supervision over social welfare contribution (e.g. since 1st January 2019, responsibility for social welfare is gradually being transferred from the Social Security Bureau to the Tax Bureau).

Similarly, as with social welfare, companies in China have individual income tax (IIT) withholding obligations for their employees. Where salaries are paid via cash or reimbursements, potential under-withholding risks can arise for the target entity.

REASONABLE BENCHMARKING

When assessing a target company in China it is important to consider a reasonable benchmark against a similar company via sector, size and location within the country (rather than against international standards) in an appropriate context:

EXAMPLE

Company C used several personal bank accounts to settle cash receipts and payments for non-invoiced sales, purchases and expenses, as well as to pay off-book salaries, which would likely also occur in other similar companies in China.

TAX INCENTIVES AND LOSSES

China offers a number of different subsidies by way of either tax rate deduction, incentives, or rebates; these may be either formal or informal. It is important to understand whether the target satisfies the requirements to enjoy such incentives and to determine their sustainability.

EXAMPLE

Company D claims it can enjoy a reduced corporate income tax rate of 15% given a claimed eligibility of 'high and new technology enterprise' status (instead of the standard 25%). Upon tax audit it was discovered that the company did not qualify for such benefit, giving rise to possible clawing-back of the tax benefit enjoyed.

RELATED-PARTY TRANSACTIONS AND CROSS-BORDER PAYMENTS

China has stringent transfer pricing rules and restrictions on cross-border payments. The withholding tax on such payments could vary depending on nature of payment – during due diligence it is imperative to ensure such payments have been cleared from a tax bureau perspective.

ASSET DEAL VERSUS EQUITY DEAL CONSIDERATIONS

The decision to structure an acquisition as either an asset deal or an equity deal should be determined on a case-by-case basis considering the advantages and disadvantages of each deal

structure. If the historical risks of the target are deemed excessive, investors may consider an asset deal as opposed to share deal, to shelter from potential liabilities.

EXAMPLE

Company E had significant VAT exposure as non-invoiced income represented 50% of total income, in which case an asset deal might be recommended, subject to any potential legal restrictions.

DIRECT VS INDIRECT SHARE DEALS

China is one of the few jurisdictions globally with indirect transfer rules. When structuring the deal, care should be taken to ensure both buyer and seller comply with the relevant tax reporting and payment requirements to avoid potential withholding tax underpayments.

POST-DEAL ROLES OF OWNERS

Chinese entrepreneurs tend to have strong control of their businesses, leading to poor controls, a vacuum in middle management, and a lack of leadership and expertise to run the business in the absence of the founders.

Retaining the sellers as minority shareholders would have the advantages of maintaining their commitment to the success of the business (rather than starting a competing business) and ensuring the smooth transitions of customer and supplier relationships and transfer of technical know-how. Their equity could also be used as a guarantee against indemnities or to help manage relationships with the local tax bureau where potential contingent liabilities may arise in the future:

EXAMPLE

The commercial relationships with the top 10 customers and suppliers of Company F were all established and managed by the owner, who had also developed technical know-how crucial to the production process. As the owner appeared to be a key manager, the buyer should consider whether to retain the seller in the shareholding structure and/or in a management capacity.

ANTI-BRIBERY AND CORRUPTION DUE DILIGENCE IN M&A ACTIVITIES

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In tandem with the maturing M&A market, the Chinese government has recently strengthened its regulatory requirements regarding commercial compliance. Key regulatory developments include the establishment of the Social Credit System, update of the Law Against Unfair Competition, and other local regulations.

Similarly, the UK's Serious Fraud Office has also strengthened enforcement and global reach of the UK Bribery Act (UKBA). Many notable enforcement actions have been linked to various bribery-related activities at multinational companies' China businesses.

As the regulatory focus on anti-bribery and corruption (ABC) enforcement increases, management of bribery and corruption risk related to M&A is becoming increasingly important regardless of industry. Failure to adequately assess bribery and corruption risk and conduct robust anti-bribery and corruption due diligence (ABC DD) for M&A-related activity could lead to the purchase of a toxic business, as well as other collateral consequences including:

- » Reputational damage.
- » Declining business performance.
- » Costly post-M&A investigations.
- » Inheriting successor liability for improper conduct incurred prior to the acquisition (improper engagement and compensation of third-party intermediaries and inappropriate gift/entertainment/hospitality/payment to government officials, amongst others).

Also, the acquirer's senior management would be vulnerable to potential criminal and civil liability under the UKBA and Chinese anti-corruption laws and regulations.

ANTI-BRIBERY AND CORRUPTION DUE DILIGENCE

A robust ABC DD programme can help companies navigate bribery and corruption risks related to M&A, and can demonstrate that adequate procedures are in place to mitigate such risks. This is particularly important for UK companies as the only defence available to commercial organisations under the UKBA is to demonstrate “adequate procedures” are in place to prevent bribery. Once potential compliance risks are identified via ABC DD, the buyer can not only make a more accurate assessment of the equity or asset value of the target company, but can also build a targeted risk firewall based on the levels and attributes of the risks identified. The ABC DD is critical to helping enterprises establish a long-term mechanism to manage risks and ensure maximum return on investment from M&A activities.

M&A typically involves a time-sensitive process focused on assessing the target’s key risks. Nevertheless, certain flexibility exists in that ABC due diligence can occur pre- or post-acquisition. Regardless of the timing of when ABC due diligence occurs, it is critical to consider the following key issues, in conjunction with local cultures and business practices, when conducting ABC due diligence in China:

- » The ABC compliance programme:
 - » Existing ABC-related compliance policies and procedures including ABC risk assessment, due diligence on business counterparties, and internal audits;
 - » Senior management’s commitment to establishing an ABC environment;
 - » Resources, training, ethics hotline, and gift management;
- » Understanding of the business model:
 - » Sales and purchases;
 - » Government-controlled points (e.g. agents designated by government agencies);
 - » Overseas business nexus;
- » Interactions with government entities and officials
 - » Licences, regulatory approval, inspections, and donations;
 - » Government incentives, subsidies, and/or special treaties;
 - » Hiring of government official’s relatives;
 - » Facilitation payments;
 - » Customs, tax, immigration, and other government supervision;
- » Use of third-party intermediaries (TPIs) (e.g. agents, distributors, vendors, consultants, brokers, joint venture partners, and contractors):
 - » TPI selection;
 - » Government touch points;
 - » The TPI’s business model;
 - » Inappropriate service fees (e.g. listing, entrance, advertising, and promotion fees);
 - » Rebates and discounts;
- » Books and records controls:
 - » Travel and entertainment expenses;

- > Petty cash;
- > Off-book transactions.

In our experience of delivering ABC DD services to clients, the importance of the key ABC compliance issues is clear as it relates to managing M&A risks. The following case studies demonstrate the key challenges clients face regarding ABC DD in an M&A context.

CASE STUDY 1

A global med-tech company sought to establish a joint venture (JV) with a Chinese distributor. The deal was threatened by several bribery and corruption issues identified from the pre-deal ABC DD on the Chinese distributor. Key challenges included:

- » A lack of understanding of the distributor's business model, which indicated a historical record of bribery and corruption involving its subsidiary and certain employees;
- » A lack of books and records control(s), exemplified by gift and entertainment expenses;
- » Dubious use of TPIs as evidenced by inappropriate service, promotional, and sponsorship fees.

Key takeaways include the following:

- » Be proactive – gain a solid understanding of the historical bribery and corruption practices of potential M&A partners and assess the business impact in terms of discontinuance of such practices post deal.
- » Do not overlook books and records – these should not only be of high quality, but should be accurately recorded and easily accessible. This is especially pertinent for UK organisations, as accurate books and records are a key requirement under the UKBA's "adequate procedures requirement".
- » Always be aware of TPI risks – when the target's business involves heavy use of TPIs, organisations should ensure a clear rationale is in place, with adequate systems and controls involved.

CASE STUDY 2

A multinational appliance manufacturing company was unable to conduct adequate pre-deal ABC DD owing to a tight time schedule. As an alternative risk mitigation effort, KPMG was engaged by the client to conduct a post-acquisition review and assess the ABC risks of the acquired company. Our ABC DD identified a number of serious ABC risks regarding gift-giving practices, cash payments to government officials, and ABC control gaps around TPI management.

We helped the client obtain in-depth knowledge over the business processes and industry practices at the acquired business. Further, we helped the client with post-deal remediations via targeted training, internal control enhancement, and quarterly compliance audits.

Key takeaways in this case include the following:

- » Do not overlook the need to follow up – there is often either insufficient time to execute ABC DD or inadequate access to the target entity’s books and records pre-acquisition. Consequently, timely post-deal ABC DD would be crucial.
- » Always seek to mitigate successor liability – when ABC risks are identified, the buyer is advised to seek special terms with the seller to avoid unnecessarily inheriting the successor liability for the previous actions of the acquired entity.

ABC risks can vary by industry in China, and are typically difficult to detect without a deep understanding of local customs, regulations, and business practices.

LEGAL DUE DILIGENCE

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LEGAL DUE DILIGENCE (LDD)

Legal due diligence (LDD) can help companies evaluate their prospective and existing business partners and merger/acquisition targets in China from a legal perspective. Companies may consider preliminary LDD before investing more time and resources on a prospective opportunity. It was historically the notion that preliminary LDD, however important, was fairly limited in scope given the lack of accessible public information regarding Chinese companies. However, recent advancements via third-party business data and search companies (e.g. Qichacha and Tianyacha) have substantially broadened such scope and lowered the costs incurred by attorneys or other qualified professionals to conduct preliminary LDD. Now the following information regarding a Chinese company is instantly available online and can be directly obtained from such third-party business data providers:

- » General corporate information

An initial check can be done on whether the prospective partner/target is an entity duly organised and in good standing, the year of its establishment, and its business scope. Such information should be consistent with the company's business licence if you already have a copy provided by the prospective partner/target. All for-profit enterprises in China should carry out activities strictly within their business scope, accompanied by the relevant licences and permits from competent authorities. For example, if an enterprise in China claims it operates an import and export business, its business scope should explicitly incorporate "import and export business" or similar wording, together with permits issued by and registrations with competent authorities.

» Shareholders and subsidiaries

The information with respect to a company's shareholder(s) and subsidiaries is available in the database because in China, shareholders, their respective ownership interest percentages in a company, and the changes thereof are registered with the local Administration for Market Regulation. Many business data providers can help analyse shareholder structures and determine the control person who indirectly owns equity interest of a company.

» Board members and legal representative

This information can help you verify the name of a company's board members, but not the names of management members. Some Chinese partners work closely with their relatives for business, and it is likely the prospective partner/target is a family business if many members of the board share the same last name, especially when the last name is uncommon. Generally speaking, the legal representative of a company is the control person or decision-maker of the company. However, in many cases, control persons or decision-makers may designate a nominal legal representative to reduce their own exposure to legal risks associated with the management and operation of the company.

» Registered capital

The amount of a company's registered capital generally correlates with the size and scale of the company. Under the current corporate law, the registered capital of a company refers to the funds that all shareholders contribute or promise to contribute to the company. Thus, it does not necessarily represent the funds already invested in the company.

» Intellectual property (IP) rights

If dealing with the wrong partner, foreign companies face a high risk of losing their IP rights to the local partner in China. If looking for a joint venture (JV) partner, you should formulate a sound IP protection strategy beforehand. You may also see if any trademark and/or patent applications have been filed by your local partners from the online database.

» Litigation, administrative violations, and fines

You may, to a certain degree, deduce a company's scale and approach to business operations from its litigation and administrative records. However, the information online is by no means conclusive as the database may be outdated and incomplete. You should also check whether the prospective partner/target is in the red-flag entity list available at the National Enterprise Credit Information Publicity System website.

SELF-DISCLOSURE

Moreover, public information is only a small part of a comprehensive LDD. Self-disclosure made by the prospective partner/target is another crucial aspect of LDD because it provides more in-depth information that helps you understand the business and details that you can cross-check with public information. More importantly, attorneys can incorporate the self-disclosure in representations and warranties of future transaction documents, by which the partner/target represents and warrants there are no risks or potential issues, other than what is disclosed, associated with certain key aspects of the company or its business. Thus, in the event of fraud or

misrepresentation, the transaction documents, if well prepared by the attorney, would help you recover your losses.

CONFIDENTIALITY AGREEMENTS, COMMERCIAL CONTRACTS, AND SUPPLIER CONTRACTS

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Linklaters

The negotiation, interpretation, and terms of a contract in mainland China can be very different from experiencing the same in a common law or more developed jurisdiction (such as the UK).

In this short document we present several key points to consider when negotiating commercial contracts with Chinese counterparties, with a focus on confidentiality agreements and supply contracts. When in doubt, consult your advisors or local business council.

CONFIDENTIALITY AGREEMENTS

Confidentiality agreements (also known as non-disclosure agreements or NDAs) require the party that receives particular information during negotiations, or performance of business arrangements, to keep that information confidential in order to protect the business interests of the information provider. For example, if you are sub-contracting the manufacture of a product to a counterparty, you might ask them to sign a confidentiality agreement to define what they can and cannot do with the engineering drawings you share with them.

INCREASING AWARENESS

To facilitate your Chinese counterparty's awareness of the information which is protected under the measures set out in your NDA, the scope of confidential information, especially including your IP rights, should be described and identified as comprehensively as possible. To the extent that it is practical, you should also mark important documents and emails as "confidential".

PROTECTING AGAINST MISUSE

You will want to stop any information which is provided to your counterparty being used contrary to your business interests. For example, where lists of key contacts are exchanged, include an express prohibition in the NDA that your counterparty cannot communicate with these contacts without your written permission.

CONTROLLING DISCLOSURE

Extra caution may be needed to protect your information where there may be a higher risk of information leaking into the public domain due to the nature of the counterparty. Such protection may include specific restrictions against the transfer of information among a group of their entities or among officials (which is a common practice among large corporate groups or state-controlled bodies).

ENFORCING OBLIGATIONS

As additional protection to a right to claim contractual damages, you should seek agreement from your Chinese counterparty of inclusion in your NDA of a so-called “specific performance” clause. These provisions clarify that a party can compel a party in breach of their contract to comply with its non-monetary obligations (such as refraining from disclosing or otherwise misusing confidential information in breach of the NDA).

PRESERVING VALUE AFTER TERMINATION

You will want to protect your confidential information at the end of your business arrangements, or if negotiations break down early. Confidentiality obligations imposed on the recipient of information should therefore expressly extend beyond termination of your contractual dealings. Consider also seeking a right in your NDA to require your counterparty to return or destroy any confidential information (or analysis derived from it) in order to maintain your control over the information.

SUPPLY CONTRACTS

A supply contract aims to set out the terms on which a supplier sells its goods or services to the buyer and will apply to the various stages of such a business relationship.

USING “MASTER AGREEMENTS”

It is common for Chinese parties on either side of supply arrangements to use what would be considered in markets outside China as extremely short and simple forms of contract.

Whereas there may be good reason to respect convention when engaging with a Chinese counterparty, in a long-term, high-value supply arrangement there is benefit in convincing your counterparty to conclude a comprehensive master agreement as a basis for short-form purchase orders. In other words, this would be a longer document of common terms that will apply to each purchase of goods or services made by the buyer. It is entered into so as to commence the supply relationship (the master agreement), with the specific terms applicable to each individual order being detailed in a shorter document agreed and signed at the time of each order (the purchase order).

TREAT PRE-CONTRACTUAL DEALINGS WITH CARE

Parties to a Chinese contractual negotiation are required to conduct themselves with “good faith”. This means that they shall not:

- » Provide false information or intentionally conceal essential information that is relevant to the contractual relationship; or
- » During negotiations enter into or continue with negotiations without any intention of reaching agreement with the counterparty.

A party may be liable to compensate its counterparty for any losses suffered due to bad faith. However, in practice, bad faith is not easy to prove. Closely linked to this concept is the principle that a business can be considered to have accepted its obligations before signing up to the written agreement in which those obligations will be set out. If a contracting party performs its main obligations under a Chinese law contract, and such performance is deemed accepted by the other party, the contract may be enforceable against the first party – even if it has not yet been signed.

IMPORTANCE OF CLEARLY DEFINED TERMS

Establishing agreement between you and your counterparty on the parties’ names, subject-matter, and quantity of supply are all that Chinese law requires to affirm the existence of a valid supply contract. Important terms in supply contracts on which the parties may not have expressly agreed – such as price, payment currency, quality, or place and timing of performance – may be implied in the contract as a matter of Chinese law. Clearly defining all key terms at the outset will help to avoid terms that the parties did not intend being read into the contract.

DISSUADING MATERIAL BREACHES OF CONTRACT

It is a common practice in China to stipulate a pre-agreed sum to be payable by your counterparty if a contract is breached or prematurely terminated – so-called “liquidated damages”.

As a general principle under Chinese law, damages are recoverable by reference to the actual loss that a party suffers. If this loss exceeds the amount of liquidated damages contractually agreed with your counterparty, the aggrieved party can request a court to increase the amount payable to it. However, the party that has breached the contract is also entitled to seek a reduction of the amount of liquidated damages contractually agreed if it is “excessively” higher than the actual damage suffered.

USING INDEMNITIES AS CONTRACTUAL PROTECTION

In common law jurisdictions such as the UK, an indemnity refers to a promise to compensate in full the party that is granted the benefit of the promise if a defined event or loss occurs, irrespective of who caused the loss. However, Chinese law does not define indemnities as clearly. Contractual protection from known risks must therefore be carefully negotiated and drafted. You should be specific as to:

- » What event or other grounds are intended to trigger a claim;
- » What losses are intended to be compensated and how they are to be quantified;
- » What form of evidence of the losses should be put forward to substantiate a claim.

OTHER ISSUES IN COMMERCIAL CONTRACTS

CHOICE OF GOVERNING LAW

Parties to a commercial or supply contract with foreign elements are generally free to choose a foreign law as the governing law. Sometimes, it is mandatory to apply Chinese law. This may be the case in joint ventures, or other situations when the application of foreign law would constitute a violation of public policy or interest.

Factors relevant for determining whether there are foreign elements include:

- » Whether any party to the contract is a foreign party, or habitually resides outside China;
- » Whether the object of the contract is located in a foreign country;
- » Whether the contract is signed, modified, performed, or terminated in a foreign country;
- » Other factors which could be recognised as foreign elements by the court.

A foreign-invested enterprise (FIE), such as a wholly foreign-owned enterprise (WFOE), Sino-foreign joint venture, or Sino-foreign cooperative enterprise, and any other entity established under the PRC Company Law, is considered a domestic entity and may be unable to choose a foreign law to govern its commercial contracts with Chinese counterparties, unless the relevant contract contains other foreign elements.

Despite being permitted under the law to choose foreign law, enforcing foreign law clauses in Chinese courts can be arduous. The parties must identify and present issues of foreign law to the courts, which will review opinions provided by the parties on foreign legal matters and proceed to render judgements on the basis of their understanding of such foreign law. Also relevant, as detailed below, is the fact that foreign court judgements are rarely recognised and enforced in China. The alternative approach would be to seek enforcement by a Chinese court of a foreign arbitral award rendered under a foreign law.

IMPORTANCE OF DISPUTE RESOLUTION SELECTION

While you should be optimistic for your business transactions in China, as elsewhere, you should also prepare for the worst. Therefore, when writing contracts, think about the possibility that disputes with your counterpart may need to be resolved. Common options for this are court litigation and non-court arbitration.

Compared with litigation, arbitration in China tends to be a more effective dispute resolution mechanism for foreign commercial disputes. Parties to an arbitration may appoint arbitrators from the panel list of the arbitration centre, giving flexibility in the composition of an arbitral tribunal more experienced with foreign disputes than a court. Arbitral awards are final except in certain special circumstances, but the decision of a Chinese court is open to appeal.

If you opt to resolve a dispute overseas, an award of (i) a Hong Kong/Macao court with exclusive jurisdiction to hear the dispute or (ii) a foreign court in a country which has approved a bilateral treaty with China on judicial assistance in civil and commercial matters would be enforceable in China. Awards of other foreign courts are generally not enforceable in China. Foreign arbitral awards, on the other hand, can generally be enforced in China pursuant to international conventions.

Chinese counterparties are quite often reluctant to accept an unfamiliar dispute resolution venue, so Hong Kong arbitration can often be a compromise on the basis of close proximity and cultural similarities.

LANGUAGE AND DRAFTING

Unless your agreement is to be submitted to a government authority for approval, registration or other procedures in China, there is no general requirement under Chinese law for agreements in English to have a Chinese version, and contractual stipulations that a non-Chinese language prevails are generally given effect in China. That said, if you wish to introduce an English language agreement as evidence in proceedings before a Chinese court or present the agreement to a Chinese bank to facilitate a cross-border payment, translation fees need to be factored in as an additional cost.

What is more important than the language itself is that both parties have the same understanding of the contractual terms. The Chinese legal system has developed less specific rules to ascertain the effect of ambiguously drafted terms in contracts. Therefore, concise, plain language provisions are preferred over confusingly long clauses and legal jargon, and you should use examples to illustrate general principles where appropriate.

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REGISTERING TRADE MARKS AND INTELLECTUAL PROPERTY PROTECTION

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Intellectual property (IP) rights are a common concern for companies doing business in China. If you are doing business in China or plan to do so, it is important that you know how to use, register and enforce the IP rights that are relevant to your business activities in China.

This document provides an introduction to obtaining IP protection in China. However, we strongly recommend that you seek advice from your IP advisor.

China has modern, comprehensive IP laws that generally match international standards and is party to important international agreements relating to IP, such as the Patent Cooperation Treaty, the Paris Convention, the Madrid Protocol, and TRIPS.

This document will focus on obtaining registered rights, including the recordal of copyright.

The factors to consider when deciding to obtain registered IP rights in China are no different from those that you would consider in any other country. IP rights are an important business tool in the 21st century and it is vital that your IP filing strategy supports your business objectives, both in the short term and the medium to long term.

It is extremely important to appreciate that registered IP rights are territorial. Thus, for example, a patent granted in the UK has no effect in China (however it could be used to prevent importation of a product made in China into the UK). Additionally, a Chinese patent, or other registered intellectual property right, provides protection in mainland China only. Separate registration is required in Hong Kong and in Macao.

TRADE MARKS AND REGISTRATION

A trade mark is a sign that allows consumers to distinguish the goods or services of one undertaking from those of another. A wide range of signs can be registered as a trade mark provided that they are capable of graphic representation, such as words, stylised words, letters,

numerals, shapes, colours, and combinations of these things. It is generally advisable to register word marks in both English and in Chinese characters.

The term of trade mark protection is 10 years but can be renewed indefinitely.

TRADE MARK REGISTRATION

Unlike in the UK, China has a first-to-file trade mark system. Consequently, your use of your trade mark in China will not give rise to unregistered trade mark rights. It is entirely possible that someone could register the same or similar trade mark, despite the fact that you have been using it first in China. Furthermore, once their mark is registered, they could prevent you from using or registering your trade mark in China. Steps have been taken by the Chinese authorities to clamp down on trade mark hijacking (bad faith registrations), but it remains the case that removing such registrations from the register can be very difficult.

In light of the above, you should (1) consider whether you need a Chinese equivalent trade mark, (2) carry out trade mark clearance searches, and (3) register your trade mark(s) as soon as possible.

1. If your trade mark contains words in Roman characters (e.g. English) then you should also consider registering a Chinese equivalent as well. It is very common for names in Roman characters to be given or become known by an “equivalent” name in China. The risk is that your mark becomes known by another name, not of your choosing, with possible negative connotations and/or a third party might seek to register that name before you. Ideally you should seek to adopt/register a Chinese equivalent that sounds the same/similar to your Roman character mark, and also has a positive meaning.
2. A trade mark clearance search will identify whether there are any confusingly similar trade marks already registered (or applied for) in China. Without conducting a search, you will not know whether you are at risk of infringing someone else’s registration. Please note that even manufacture for export (i.e. goods are manufactured in but not sold in China) can constitute a trade mark infringement. Furthermore, the Chinese Trade Mark Office will refuse your application, if it identifies a similar earlier registration.
3. Once you have identified your marks and confirmed that they are available, you should seek to register them. Trade marks can be registered through the national system or through the International (Madrid Protocol) Registration system. Using the Madrid Protocol system, the application in China is based either on a trade mark application or registration in your home country. The best route for you will depend on many factors. However, by way of example, if you also need protection in other countries, then the Madrid Protocol route might be more cost effective.

We recommend consulting your IP advisor before using and registering your trade mark in China. They will have the expertise and have access to reliable local advice, which should help you to avoid running into trouble. They will also be able to assist in other aspects such as drafting a suitable specification for your application, and for preparing the necessary documentation.

PATENTS

In China, there are three types of patent: invention patents, utility models, and design patents.

China, like most other countries, has a first-to-file system for patents, utility models, and designs. This means that it is usually necessary to consider your filing strategy for China at an early stage in the development of a product, perhaps many years before you are ready to take the product to China (whether to manufacture or market it there).

INVENTION PATENTS

Invention patents provide protection for a product or process which has a practical application.

To be patentable an invention must be novel. This means that it must not have been made public anywhere in the world, in any language and in any form (such as in a printed document, an electronic disclosure, or an oral disclosure, or by use) before the patent application is filed.

The invention must also be inventive. This means that the invention must not have been obvious in view of information that was publicly available before the patent application was filed.

Chinese invention patents provide protection for a maximum period of 20 years from the date on which the patent application was filed, subject to the payment of annual fees. Before a Chinese patent can be granted the application is subject to an examination by the China National Intellectual Property Administration (CNIPA) to ensure that the invention satisfies the requirements for patentability. Thus, it can take several years to obtain a granted patent.

UTILITY MODEL PATENTS

Utility model protection is an extremely useful form of protection in China and remains underused by companies based outside China. We would strongly recommend that companies based outside China make more use of utility model protection in China.

Utility model protection is available for products that have practical application, but not for processes, chemicals, or biotechnology.

The requirement for novelty for a utility model is the same as for an invention patent. However, although there is a requirement for the product to be inventive, this is a significantly lower hurdle than for an invention patent. As a result, utility models are particularly useful if you wish to obtain protection for an incremental improvement to an existing product.

Utility models provide protection for a maximum of 10 years, subject to the payment of the necessary fees.

The validity of a utility model application is not examined in detail before the utility model is granted. This means that a utility model can be granted in a matter of months after filing. Thus, utility models offer a quick, simple, and cheap means of protecting a technical product in China, which can be useful for the budget-conscious or for when quick action against infringers is required.

DESIGN PATENTS

Chinese design patents are very much like registered designs in Europe and protect the visual appearance of a product, such as the shape, pattern, or colour of a product or any combination of these. Design patents provide protection for a maximum of 10 years and are usually granted in less than a year.

FILING FOR PATENTS AND DESIGN RIGHTS

Timing is extremely important when filing an application for registered IP.

INVENTION PATENTS AND UTILITY MODELS

We will now briefly discuss a possible patent filing strategy for a UK company assuming that the invention is made in the UK. Typically, a UK company will file a UK patent application first. As discussed above, this needs to be done before there has been any public disclosure of the invention. This inevitably means that the patent application is filed at an early stage of the development of a product. After filing the UK application, the applicant has 12 months in which to file applications in other countries. At this point, he/she has the option to file national applications in each country of interest or to file what is known as an International or Patent Cooperation Treaty (PCT) patent application. Filing a PCT application at this stage is the most popular route.

Please note that there is no such thing as an International patent. Therefore, a PCT application provides the option of obtaining patent protection in the vast majority of economically significant countries and more time to decide which countries are important for the business. Within 30 months of the filing of the patent application in the UK it is necessary to convert the International application into national patent applications in the countries of interest; it is at this point that a patent application is filed in China. The 20-year patent term runs from the date on which the International patent application was filed, although it is not possible to enforce the patent until after it has granted.

Alternatively, a Chinese patent application can be filed within 12 months of the filing of the initial UK application. This can be advantageous if the applicant wishes to obtain more rapid granting of the Chinese patent application, but it does bring forward significant costs.

It is also possible to file the utility model application based on a UK patent application or to convert a PCT application into a Chinese utility model application. It is not possible to convert a PCT application into both a Chinese invention patent application and a Chinese utility model application. However, the option to convert a PCT application into a utility model could be advantageous if, from the information received during the International phase, it looks as though it will be difficult to obtain a granted patent. It is also not possible to have both a granted Chinese patent and a granted Chinese utility model for the same invention. However, there can also be advantages in filing both an invention patent application and a utility model application in China; particularly if there is a serious risk of infringement before the patent application is likely to be granted. If you wish to adopt this strategy, it is recommended that you file both a Chinese utility

model application and a Chinese invention patent application on the same day within 12 months of the date on which the UK patent application was filed. The utility model patent should be granted within a few months of filing, and it will then be possible to enforce the utility model to prevent infringement. Once the patent application has been granted, the utility model can be allowed to lapse. By this strategy, you achieve the right to enforce your IP rights quickly by virtue of the utility model and to also obtain protection for the longer period of time provided by a patent.

Your patent filing strategy will need to be slightly different if you employ staff in China or are in collaboration with a Chinese company and the invention you wish to protect was made in China. In this situation, it is necessary to file the first patent application in China or to obtain clearance from the CNIPA office to file abroad.

DESIGN PATENTS

An application for a design patent can be filed directly at the CNIPA office or may be based on a design registration filed in another country, provided that the application in China is filed within six months of the filing in another country.

An important difference between the UK and China is the absence of a grace period in China for designer-originating public disclosures of the design anywhere in the world. In the UK (and many other jurisdictions), the grace period provides a safeguard for applicants who have disclosed their design before filing an application. Since Chinese design law does not provide for such a grace period, it is essential for the Chinese design patent application to be filed before, or be based on another design registration that was filed before, the design was first publicly disclosed.

COPYRIGHT RECORDAL

Copyright arises automatically and protects written or published works such as books, computer software, songs, films, artistic content, and web content. It is not essential to record copyright in China, but it can be advantageous to do so, particularly if a dispute over ownership arises, because the copyright recordal is taken as prima facie evidence of ownership.

Copyright is recorded at the National Copyright Administration of China. To record copyright, it is necessary to provide evidence of ownership and the date of creation of the copyright work.

ASSISTANCE WITH OBTAINING REGISTERED IP IN CHINA

A foreign company with a legal presence in China can apply directly to the CNIPA or China Trade Mark Office (CTMO) office to obtain patent, utility model, design or trade mark registration. Foreign companies without a legal address in China need to file via a Chinese patent or trade mark attorney. You may, of course, instruct a Chinese patent or trade mark attorney directly. We would, however, recommend that you use your European patent or trade mark attorney to manage your patent and trade mark filing strategies in China and elsewhere around the world. Most European patent and trade mark attorney firms can recommend Chinese patent and trade

mark attorneys that they trust and have an established business relationship with. Additionally, not only can they help you ensure that you satisfy all of the requirements of the patent or trade mark office, they can also provide invaluable assistance to help you achieve a consistent intellectual property strategy around the world.

INTELLECTUAL PROPERTY ENFORCEMENT CHANNELS

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There are four main routes for intellectual property (IP) enforcement in China, as follows:

1. Administrative (including customs)
2. Civil
3. Criminal
4. Online

This section provides a brief overview of how IP rights are enforced in China, but does not replace the need to seek qualified (in some cases legal) advice in relation to any specific IP matters.

It goes without saying that enforcement is only available where you own applicable IP rights in China (most forms of IP require registration), and you are not able to directly enforce UK (EU or so-called “international” – unless they have specifically been extended to China) IP rights in China. A separate document in this ‘China Business Advice’ series provides information on securing IP rights, which in China, unlike the UK, generally involves taking the formal steps of applying for and securing registration of these. This is an important step, especially since China operates on a first-to-file basis for trade marks. Patents also must be extended from overseas applications within six months or should be filed specifically in China before being made public.

While administrative enforcement of IP is often the first avenue explored and pursued by UK IP owners, China is moving in the direction of developed jurisdictions like the UK, by which enforcement of IP is becoming increasingly a matter of private dispute. In other words, the levels of IP litigation have been growing over the last 3-5 years at an unprecedented rate, and this is reflected in all IP fields, but especially the field of design rights, utility models (like patents but with lower permitted thresholds for inventiveness), and patents (called “design patents”, “utility model patents” and “invention patents”, respectively, in China). Damages and compensation awarded by Chinese courts have been growing, which now makes China a very attractive venue for claiming damages for IP infringements through private settlement or civil courts.

ADMINISTRATIVE ENFORCEMENT

Administrative enforcement is one of the most common forms of IP enforcement in China, as it can often provide a quick, low-cost remedy that does not require representation by a law firm or any court action.

THE STATE ADMINISTRATION FOR MARKET REGULATION

China's IP laws empower various government agencies with the jurisdiction to enforce IP rights. During a reorganisation in 2018, IP enforcement power was consolidated with the State Administration for Market Regulation (SAMR). This body replaced and merged several previous agencies such as the State Intellectual Property Office (SIPO) and State Administration of Industry and Commerce (SAIC).

In relation to trade marks, false advertising, and trade dress infringement, authority is given under the trade mark relevant laws to the SAMR and its local branches, which can be referred to as the Market Supervision Administrations (MSAs). The MSAs are organised hierarchically at state, provincial, city, and district levels.

If an IP owner discovers an infringing act, such as infringing products being sold at a retail outlet, stored in a warehouse, or produced at a factory, they file a case before the nearest MSA branch. Note that an investigation to establish the location of infringement must be done by the IP owner – the MSA will not investigate general information of infringing goods in the market; they will only respond to a specific complaint against a specific legal entity or entities. This is a trend found throughout China's IP enforcement system – there is a lot of “do-it-yourself” demanded of IP owners. This is showing signs of change with some administrative and criminal authorities now proactively finding sightings and leads. However, they will often request rightsholder support at an early stage.

Whereas MSAs would previously only take on straightforward matters of counterfeiting, it is now possible to convince authorities to act in more complicated cases, such as those relating to lookalikes, copyright infringement, and design patent infringement.

The MSAs generally do not require complex formalities or evidence in order to act, and often ask only for:

- » Copies of the IP rights concerned (such as trade mark certificates);
- » A power of attorney (scanned copy is often sufficient);
- » A brief written submission with the case facts.

Note that documents issued by overseas entities should be notarised and legalised to guarantee that the MSA will accept the case.

Samples of the items suspected of infringement are usually not required for a case of identical counterfeiting, but will generally be requested if the MSA are not familiar with products (in other words, the matter does not concern products that are well-known), or if brands and/or the trademarks or packaging are not identical and require comparison. The MSA officers will often act

promptly, sometimes within the same day, if the case is urgent (for example, if there are goods which may be shipped imminently). The MSA officials will conduct an on-site inspection of the target premises and have powers to seize all suspected items suspected of infringement, including finished and semi-finished goods, packaging, and tools such as moulds.

Unlike police, the MSA do not have powers of search or arrest, but the suspected infringer is required by law to cooperate with their investigation. The MSA officials may seize sales records and other electronic or physical records. However, generally their enforcement is based on physical articles at the scene – so the best results are obtained if infringement is in progress and there are sufficient stocks of infringing items found.

There is much benefit to having a representative agent attend a raid. This ensures that as much evidence as possible is gathered during the process and reduces the risk of compliance breaches such as bribery or local protectionism. The MSA officials may allow the IP owner's representative to attend the raid, although this is not stipulated in law and the MSA in certain locations have sometimes refused to allow this. The MSA will normally provide a record of the seized goods to the IP owner's representative. This can form the formal proof of the nature of infringement and quantity of products.

If the scale of infringement discovered is noticeably large, the MSA may transfer the case to the Public Security Bureau (PSB, or the police) for criminal prosecution (see information about criminal enforcement below).

The MSA will later interrogate the responsible person, determine infringement and, after around two to three months, will issue a Punishment Decision that typically includes:

- » An order to cease infringement;
- » Forfeiture and destruction of the seized items;
- » A fine based on the turnover of the infringing goods – generally fines are low, just a few hundred or thousand pounds.

On the IP owner's request, the MSA will usually provide a copy of the Punishment Decision.

As their workload has increased dramatically, MSAs are sometimes not forthcoming about the Punishment Decisions. However again IP owners should insist on them as this is the only formal proof that a finding has been made against the infringer (and if the criminal enforcement threshold is met, criminal penalties pursued).

The IP owner is sometimes allowed to witness destruction of the goods, but this is not a right specified by law. IP owners should ask their representatives to maintain contact with the MSA to ensure that they are notified well in advance, should the MSA decide to destroy infringing products as part of a "batch destruction", which is often the case.

The fines issued by the administrative authorities such as the MSA are retained by the national treasury, and if the IP owner is seeking compensation for the infringement, they will have to use the administrative punishment decision as the evidentiary-basis for filing a fast-track civil suit.

The Punishment Decision can be very useful for proving infringement on online platforms, especially in non-straightforward cases. They can also be used to claim damages through follow up private settlement or civil litigation.

While the above describes the enforcement process of the MSA for infringement of trade marks and trade dress, amongst others, similar principles broadly apply to actions brought regarding copyright, patents, quality, and labelling standards – especially since these functions have been merged under the SAMR's remit.

CUSTOMS ROUTE

Chinese Customs are another source of administrative enforcement, albeit with a special jurisdiction over goods both entering and (most importantly for those familiar with border-measures in other countries) also those exiting China. Like other administrative enforcement bodies, Chinese Customs have independent powers to handle cases without recourse to the judicial system, although in certain situations a case must be brought before the courts (see below). As already mentioned, Chinese Customs enforcement has an important differentiating feature compared to other border measures, namely that Chinese Customs actively monitor exports – this is especially helpful to IP rights holders who have relevant rights in China as it allows them to impede the distribution of infringing products originating in China right at their source rather than in several destination markets.

To prepare for customs enforcement, an IP owner must first record their IP rights with Chinese Customs on a national database, which must also include a contact person in China – either an agent or the IP owner's own local representative. The IP owner may also choose to file an up to date "white-list" of any companies authorised to export their products so as to avoid unintended customs detentions, which they manage on Chinese Customs' database via a password-protected portal.

For customs enforcement to be effective, it is essential for IP rights holders to provide training for Chinese Customs officers at key ports. Training should avoid detailed technical information and instead provide officers with very simple indicators as to how to recognise suspicious shipments and products (for example "our products are never shipped mixed with competitors' products"). Experienced IP agents can organise training sessions.

Over 95% of Chinese Customs cases are discovered by random inspections, and involve goods exiting, not entering China (again, a unique feature to China's customs enforcement system).

When Chinese Customs find goods suspected of infringement, they will notify the IP owner who then has only three working days to request its detention or release. Chinese Customs will not send samples or spend time on detailed photographs, so it is essential to have a local contact person authorised to conduct verification.

If the IP owner wishes to detain the goods, they are required to place a cash bond, up to a maximum of RMB 100,000 (£11,500) with Chinese Customs for the duration of the case, but bank guarantees can often be arranged for IP owners who have a large volume of cases. Since turnaround times are tight, it is best to have a payment method organised in advance of receiving

a seizure notice. Where the value of a case meets the threshold for criminal prosecution, a Chinese Customs case can be transferred to the PSB for prosecution.

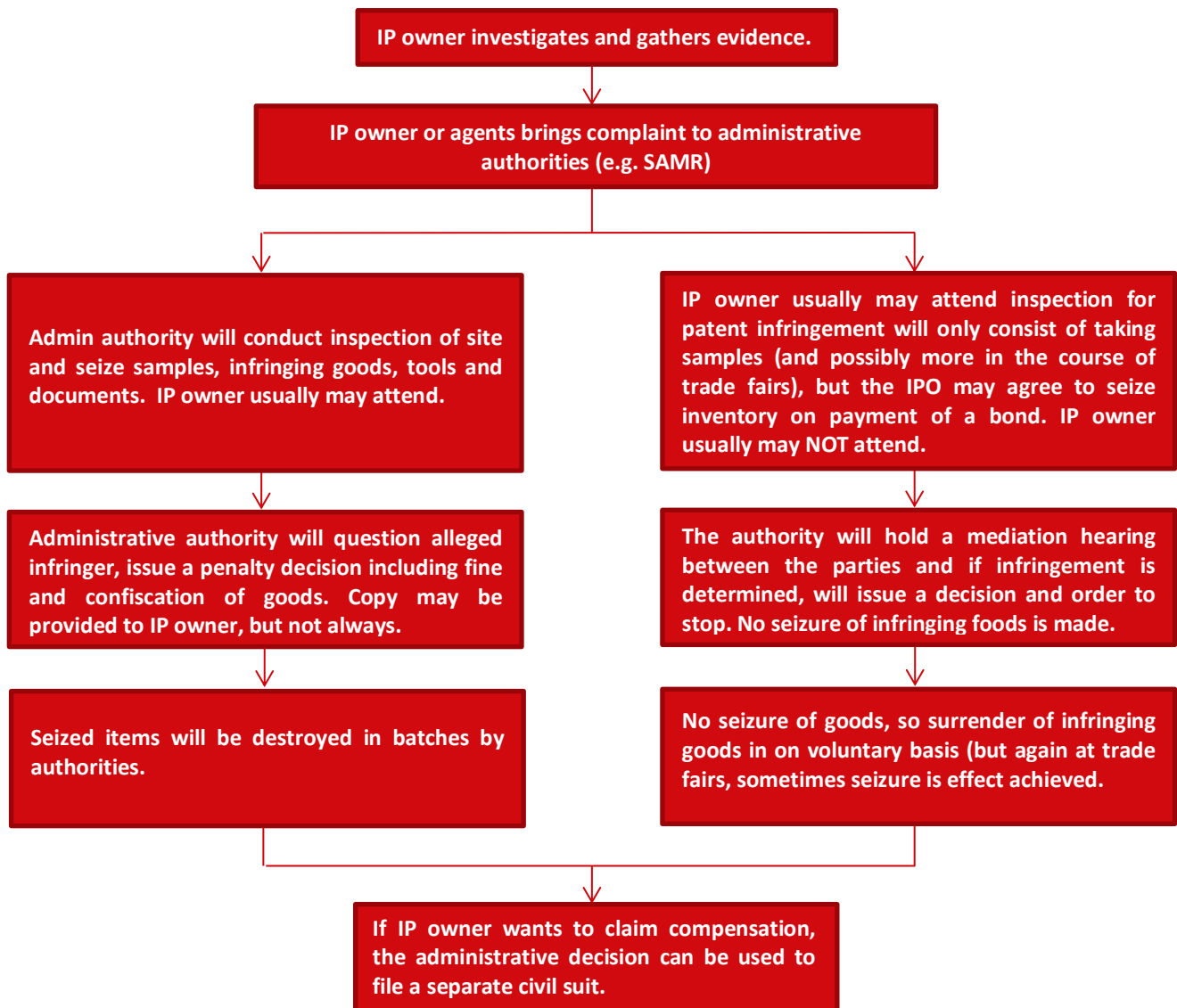
After detention, Chinese Customs will conduct an investigation against the shipper, order the goods to be seized, and issue a modest fine, which may be no more than a few hundred pounds. This fine is submitted to the national treasury and there is no provision for compensation to the IP owner. With the conclusion of a case, the IP owner must pay storage costs which are deducted from the bond. The confiscated goods will either be destroyed or, if they have resale value, by law can be re-sold provided that the infringing features are removed (via removal of logos, designs, and other relevant features).

The Chinese Customs seizure decision can also increasingly be used to claim significant damages from the exporter or importer, either through private settlement or litigation.

Chinese Customs will not share shipping documents with IP owners as this is deemed confidential. However, information contained therein may on occasion be obtained orally when visiting the port to take sample photos of the infringing products. The IP owner may consider threatening civil proceedings against the shipper to demand disclosure of the other parties in the supply-chain, and may also demand that the shipper pay storage and disposal costs.

Chinese Customs officials only have powers to handle relatively straightforward cases of counterfeiting and piracy. For cases involving patents or non-identical infringement, Customs will act to detain goods on the IP owner's instructions, however it will also require the IP owner to file a civil litigation within 50 days. Therefore, Chinese Customs border protection measures for IP rights are most simple and effective for dealing with counterfeit goods rather than more complex types of IP infringement. Having said that, where it is difficult to gain access to the infringement premises or to catch the infringement in transit, Chinese Customs enforcement can be a useful tool in design, copyright, and even patent cases.

ADMINISTRATIVE ENFORCEMENT (E.G. TRADE MARKS AND PATENTS)



CIVIL LITIGATION

Civil litigation of IP infringement through China's courts is becoming increasingly common. In 2018, Chinese courts received 301,278 new IP cases in the first instance, of which 287,795 were concluded. These figures represent an increase of 41% and 42% respectively compared to those for 2017. In fact, 2017 was the first year where civil cases for IP infringement surpassed administrative cases.

China is increasingly becoming a "preferred venue" for settling international IP disputes, with judgments now being widely recognised by international counterparts as being leading.

The Chinese court system can be characterised as procedurally simple and fast. Without such tools as discovery, interrogations, and juries, IP civil litigation cases generally involve only 2-4 days in court, one of which is usually spent in the evidence exchange procedure and the others on the hearing of the merits of each side of the case.

Since there is no evidence discovery process imposed by the court, the plaintiff must gather as much relevant evidence as they can themselves and have it notarised by a domestic public notary – this is not least because there are also no sanctions against perjury or for contempt of court. An experienced corporate investigator should be engaged for this, through a law firm or qualified agency.

Judges in China prefer to deal with cases in a quick and practical manner and actively encourage parties to settle, which may result in an enforceable mediation decision issued by the court. They are often more involved in the meditation of the case and it is not uncommon for the judge to have discussions with counsel from both sides to find a resolution to the dispute. This can be useful if the IP owner wants to conclude the case and obtain monetary compensation using as little time and cost as possible. Alternatively, if the parties cannot reach a mediated decision, the judge will issue a court decision in the usual manner.

The law provides preliminary measures such as interim injunctions, evidence preservation orders (i.e. a court search orders executed by procedural judges) and asset preservation orders (an asset freeze/sequestration). After an initial trend when injunctions were readily granted, courts have become increasingly reluctant to grant them. Beginning with the inception of the specialist IP courts which were formed in the second half of 2014 and the beginning of 2015 in Beijing, Shanghai, and Guangzhou, this changed. Previously, Chinese courts would rarely grant preliminary injunctions because the practice is to strictly apply the “irreparable harm” test. However, due to procedural changes allowing for a preliminary injunction request to be filed after the main case is filed (an injunction granted at the proceedings), as opposed to the traditional pre-filing injunction, the courts are generally more willing to grant a preliminary injunction at the proceedings because they have more time to fully review and respond to the request. Conversely, a court must issue its ruling on a pre-filing injunction request within 48 hours.

Evidence and asset preservation orders can be more easily secured but require the deposit of a bond, set by the court. Asset preservation orders, which freeze the defendant’s bank account, Alipay, WeChat Pay, or other online wallet accounts can be a useful tactic to force negotiations, stop the defendant from wasting time and delaying or evading the litigation, and ensure that the plaintiff can secure some of the defendant’s assets for recovery.

In 2016 the Shanghai IP Court granted preliminary injunctions (along with evidence/asset preservation orders) in 216 cases, among which only 30 were pre-filing injunctions (along with evidence/asset preservation orders), while the remaining 186 were injunctions (along with evidence/asset preservation orders) granted at the proceedings. In one high-profile litigation case handled by the Suzhou Intermediate People’s Court, plaintiff New Balance successfully obtained an injunction at the proceedings and the court imposed a significant fine of RMB 1.7 million (£195,000) against the infringer, which had copied the “N” device mark on its sports shoes.

Courts generally do not engage in a detailed analysis of compensation to the plaintiff. Most commonly, judges will rely on statutory damages, which means a discretionary range of damages that the judge can award in the absence of a clear evidentiary basis. For an overview of what damages to expect, you may consult the CIELA database (www.ciela.cn) which compiles information on all published IP cases.

Damages granted by the courts in IP civil cases have been increasing gradually since May 2014, when the Trade Mark Law – which increased the statutory damages from RMB 500,000 (£57,000) to RMB 3 million (£345,000) – was amended and implemented. In some cases, a court may even grant damages that are higher than the statutory damages if it is convinced by supporting evidence. For example, in a 2016 trade mark infringement and unfair competition action filed by Hugo Boss, the Shanghai IP Court granted damages of RMB 4.92 million (£566,000).

The amendments to the Trade Mark Law have also enabled some courts to grant punitive damages in trademark infringement actions, although in practice such awards are rare.

Overall, the magnitude of damages remains relatively low in most cases, partly due to the difficulties in proving the illegal profits of infringers. Courts in developed cities generally grant higher damages than those in less developed cities, particularly if the case involves a well-known mark. In 2016 the Beijing IP Court granted average damages of RMB 2.2 million (£253,000) in cases of well-known trademark infringement.

Enforcement of court decisions in China needs to be well thought out, and plaintiffs may find that they have to spend further costs on following up procedures to try to compel the defendant to comply with the court orders. In practice plaintiffs often agree to accept a lower percentage of the amount of court ordered compensation (say 90% of the award) in exchange for avoiding the cost of enforcement. With the new restrictions on foreign currency transactions making it difficult for winning plaintiffs to repatriate awards/compensation outside China, with defendants being able to do this more easily, more pressure to settle for less than the award may be expected.

Innovative new measures under China's social credit system, such as blacklisting individuals that owe damages from taking aeroplanes and high speed trains, and also from staying in certain hotels, are making enforcement of judgments easier.

Due to the relative speed and low cost of civil litigation for straightforward cases, many IP owners use the courts as an add-on to an administrative action (see above) where the facts of infringement have already been established and the only issue the compensation amount to be paid. Such cases may conclude within four to six months or more quickly if the parties settle.

However, some types of case may involve the trial of one or more substantive and complex issues, for example, passing off a product's trade dress, or patent, utility model, and design infringements. Such cases can be time consuming, but are a comparative bargain if one looks at the cost of litigation in the UK. Such cases generally do not take longer than one year from filing until judgement is received at first instance, making them useful for cases where a more in-depth consideration of the issues is required – something that some administrative authorities are often unwilling, unqualified, or unable to do.

While warning letters threatening action and requesting undertakings can be effective in stopping smaller or less determined infringers, IP owners should be aware that the recipients of such warning letters can file a potential claim for “non-infringement declaration”, effectively dragging the IP owner into the infringer’s jurisdiction. As would be the case in the UK, IP owners should ensure that their warning letters are reasonable and do not constitute groundless threats – if not sure, it is better to put the infringer “on notice” than threaten actions.

CRIMINAL PROSECUTION

China’s Criminal Code provides offences for various types of IP infringement, including the sale of counterfeit or shoddy goods, certain types of copyright piracy, and theft of trade secrets. Criminal sanctions are not available for patent infringement (except for the slightly obscure action against “patent passing off”, which effectively imposes criminal sanctions for wrongfully claiming someone else’s patent and similar offences), passing off or non-identical trade mark infringement. China’s PSB have the jurisdiction to investigate suspected IP crimes.

A criminal offence can be established where a case has exceeded a minimum threshold of economic value – for trade mark counterfeiting this is:

- » For a manufacturer: The amount from illegal business turnover is no less than RMB 50,000 (£5,700) (i.e. the total value of goods sold and unsold) or the amount of illegal earnings (i.e. goods sold) is no less than RMB 30,000 (£3,400).
- » For a seller: The thresholds are RMB 150,000 (£17,200) illegal turnover (goods sold or unsold) or RMB 50,000 (£5,700) illegal earnings (for goods sold).

The value of the sold infringing products shall be calculated at the actual sales price as shown in the evidence obtained from the criminal investigation. The value of unsold goods is calculated by marked or average price, or if this cannot be determined, the average market price of the genuine goods. In general, it is easier to request the PSB to bring a criminal prosecution where the valuation of the case is clearly over the threshold, especially in parts of China outside of major cities where the PSB may be less experienced with IP cases.

Many IP-related criminal cases are not launched by the PSB initially, but through seizures made by administrative authorities such as the MSA (note sections above). This is because the PSB do not prioritise IP crimes and they can be slow to investigate. By contrast, an IP owner can arrange a raid with the MSA very quickly and if the case is clearly above the threshold for a criminal offence, the MSA can be requested to transfer the case to the PSB immediately.

Criminal enforcement is the most powerful of the enforcement routes as the PSB have powers to detain suspects, interrogate, and search for physical and electronic evidence. Successful criminal convictions can lead to some of the harshest penalties for IP infringement and therefore send a strong deterrent to the counterfeit market.

Following a PSB investigation, a case is brought to the public prosecutor who will review the case, issue arrest warrants, and indict the suspects for trial. The IP owner will be required to provide a statement verifying that the suspect goods are counterfeit.

While the IP owner is not required to engage a lawyer to represent them as the victim, it is generally advisable for the IP owner to do so to see that the case proceeds smoothly. A good criminal raid does not always result in a good criminal conviction. Lawyers attending the criminal trial can also settle the civil claim with the defendants for significant amounts, in exchange for a letter to the judge which will result in a more lenient sentence being imposed. The amount recovered can often cover the costs associated with bringing the enforcement action.

Sentences for IP crimes are typically a monetary fine of a few thousand pounds and often a suspended sentence. For large scale and serious crimes, there may be a custodial sentence imposed of up to seven years, although such a high sentence is rare.

A criminal case will generally take six to 12 months from the start of a PSB investigation to the issuing of a sentence, while it can take 12 to 24 months in some protective jurisdictions.

IP RIGHTS INVESTIGATIONS

It should be noted that for all the above enforcement routes (except for ex-officio actions by Chinese Customs), the IP owner is expected to conduct most of the investigation work to identify the infringing activity and the involved parties. The enforcement authorities rarely conduct lengthy investigations on their own initiative. Therefore, much of the success of the above enforcement relies on IP owners investigating and preparing cases themselves before bringing them to law enforcement authorities or the courts.

As the investigation industry is not regulated in China, it is advisable for IP owners to arrange investigations through their lawyer.

ONLINE ENFORCEMENT

China has become the world's largest e-commerce market. In 2019, e-commerce spending in China was estimated to amount to US\$1.9 trillion (£1.5 trillion), around three times greater than the US market.

As a major driver of the country's retail economy, e-commerce sales share experienced a considerable rise from 12.4% of the total retail sales in 2014, to an estimated 36.6% in 2019.

Tech giants such as Alibaba, Tencent, and JD.com are the key players, with flash sale platforms like Pinduoduo and short-form video apps with e-commerce functions like TikTok growing rapidly. The online entertainment industry is also developing very rapidly, presenting both opportunities and challenges for copyright holders.

Online monitoring is an important source of data on infringement trends and key infringers. Many platforms now have their own fully developed ecosystems allowing the brand owner and their IP agent to enforce IP rights through notice and take-down procedures.

In order to file takedowns, rightsholders or their agents can submit by email, or for the more developed ecosystems, register for an account on the relevant IP protection platform.

Using Alibaba's popular IPP platform, registering an account takes three to seven working days. The next stage of the process is registering the IP rights that you wish to use, including providing proof of identity and ownership. Local rights must be used on domestic consumer facing platforms, whereas international rights can be used on some international export-orientated websites.

Next, a complaint can be submitted to the platform against the sellers or listings, based on the platform's rules. The rules are typically based on but not identical to the corresponding legal IP regulations. For Alibaba, the following reasons can be used:

1. Trademark infringement such as misuse of identical or confusingly similar marks, and use of counterfeit marks;
2. Copyright infringement such as unauthorised use of third party's copyrighted photography as well as offer of unauthorised copies, including copies of books, music, videos, software, video games, television programmes, paintings, and photos;
3. Patent infringement such as infringement on invention and design patents;
4. Deceptive practices such as intentional covering or blurring of infringing marks on products offered for sale.

It usually takes three to five working days for the platform to action the complaint. The seller has a chance to file a counterclaim against the complaint. Unfortunately, false authorisation documents and purchase receipts are common, which can also be a good source of intelligence on key infringers. If the platform accepts such false documents in counterclaim, complaints can be escalated. For the Alibaba platform, the Brand Co-operation Team is well placed to handle such escalations.

FACTORS YOU SHOULD CONSIDER

To determine which manner of IP enforcement is most appropriate in a given situation, IP owners will need to consider a number of factors including:

- » Nature of the rights infringed: Trademarks and look-alikes may be best combated via administrative enforcements including through Chinese Customs, while in the case of patents, unless the action is to take place during trade fairs, civil litigation may be the only tenable option.
- » Complexity of the evidence and legal circumstances: If the IP infringement is less straightforward – for example the look-a-like is not all that similar – then even trade mark infringement cases may require deeper consideration for which courts and civil litigation is often more suitable.
- » Jurisdiction concerned and remedies sought: Administrative authorities in non-first-tier cities can sometimes be prone to local protectionism. Administrative enforcement has to be sought at the authorities in the jurisdiction of the infringement or infringer. Where experience shows that such authorities may be reluctant to take enforcement action against local companies, or the intended target, then civil litigation provides a way out by offering some flexibility to find a jurisdiction that may be more neutral.

- » Costs: Administrative enforcement is generally cheaper than civil litigation. Where costs are a major factor, and/or the volumes of infringement do not justify such costs, administrative enforcement may be the more suitable option.

ONLINE INTELLECTUAL PROPERTY ENFORCEMENT

This section was written by CBBC

China is the largest e-commerce market worldwide. According to a McKinsey Global Institute report, more than a decade ago, China accounted for only 1% of e-commerce transactions globally. Today, it accounts for 42% of the total and processes 11 times more mobile payments compared to the US. In fact, China's annual volume of mobile payments is larger than that of France, Germany, Japan, the UK, and the US combined.

There are three main factors for this leap in development:

- » A large and young Chinese market enabling rapid commercialisation of digital business models;
- » A rich digital ecosystem expanding beyond large companies;
- » A government that allows space for digital companies to experiment, and also acts as an investor in and consumer of digital technologies.

As well as facilitating legitimate commercial opportunities; it also allows criminals a degree of security, by disaggregating the manufacture, advertisement, sale, and delivery of illicit goods. This also includes intellectual property (IP) – the Chinese internet has been a popular channel for those selling counterfeit and pirated products – adversely affecting producers and exporters of legitimate product.

It is possible to protect your IP online in China and we outline some of the ways to do so below. However, it is of critical importance that IP rights are registered in China in order to be able to enforce them.

REMOVING INFRINGING PRODUCTS

In recent years, a principle has developed from Chinese Tort Law that an e-commerce platform (or other website) can be deemed jointly liable for an IP infringement, if it “knowingly” allowed the sale to take place. In response to this, platforms have developed various communication channels to facilitate the reporting of product listings that infringe IP. These can range from a simple complaints email address to a sophisticated management portal, which can accept and process hundreds of notifications or complaints simultaneously.

The Chinese E-commerce Law, effective since January 2019, establishes the rules by which e-commerce platforms deal with IP infringement complaints. Platforms are now required to take action against listings when notified by rights owners. If e-commerce platforms transferred the non-infringement declaration from the infringing sellers, rights owners shall file administrative complaints to competent authorities or file law suits within 15 days upon receiving that declaration. E-commerce platforms will remove the actions it has taken against the infringing sellers if rights owners fail to do so.

Below we outline the notification systems of a number of leading e-commerce and social media companies in China. Generally, the operating language is Chinese only and they vary in their degree of user-friendliness. However, there are many law firms and other service providers who can help companies navigate the systems and file complaints. Whereas some platforms internally police their listings to a degree, it is recommended that rights holders proactively monitor for counterfeits. Again, service providers can also provide these services.

ALIBABA PLATFORMS

Established in 1999, the Alibaba Group has grown to become a global leader in the online and mobile commerce industries. The group consists of several E-commerce platforms including:

- » Taobao.com: China's largest mobile commerce destination.
- » Tmall.com: the largest third-party online and mobile commerce platform for brands and retailers in the world in terms of GMV in the 12 months to 31st March 2019.
- » Alibaba.com: China's largest integrated international online wholesale marketplace in 2018 by revenue.
- » AliExpress.com: a global marketplace targeting consumers worldwide and enabling them to buy directly from manufacturers and distributors in China and around the world.
- » 1688.com: China's leading integrated domestic wholesale marketplace in 2018 by revenue.
- » Lazada: the leading online shopping site in South East Asia.

Alibaba has a relatively sophisticated [IP Protection Platform](#) (IPP), which accepts complaints and notifications for all its platforms. However, this does not mean that the company's policy vis-à-vis IP protection is the same for all sites; rather the company's general practice is to accept take-down requests subject to the territorial protection of IP rights. For example, on its China domestic operating platforms (Taobao.com, Tmall.com and 1688.com), Alibaba accepts take-down requests based on registered IP rights in China; on its international platforms (Alibaba.com and AliExpress.com), take-down requests are processed based on international IP right registrations.

IP rights can be protected on IPP as follows:

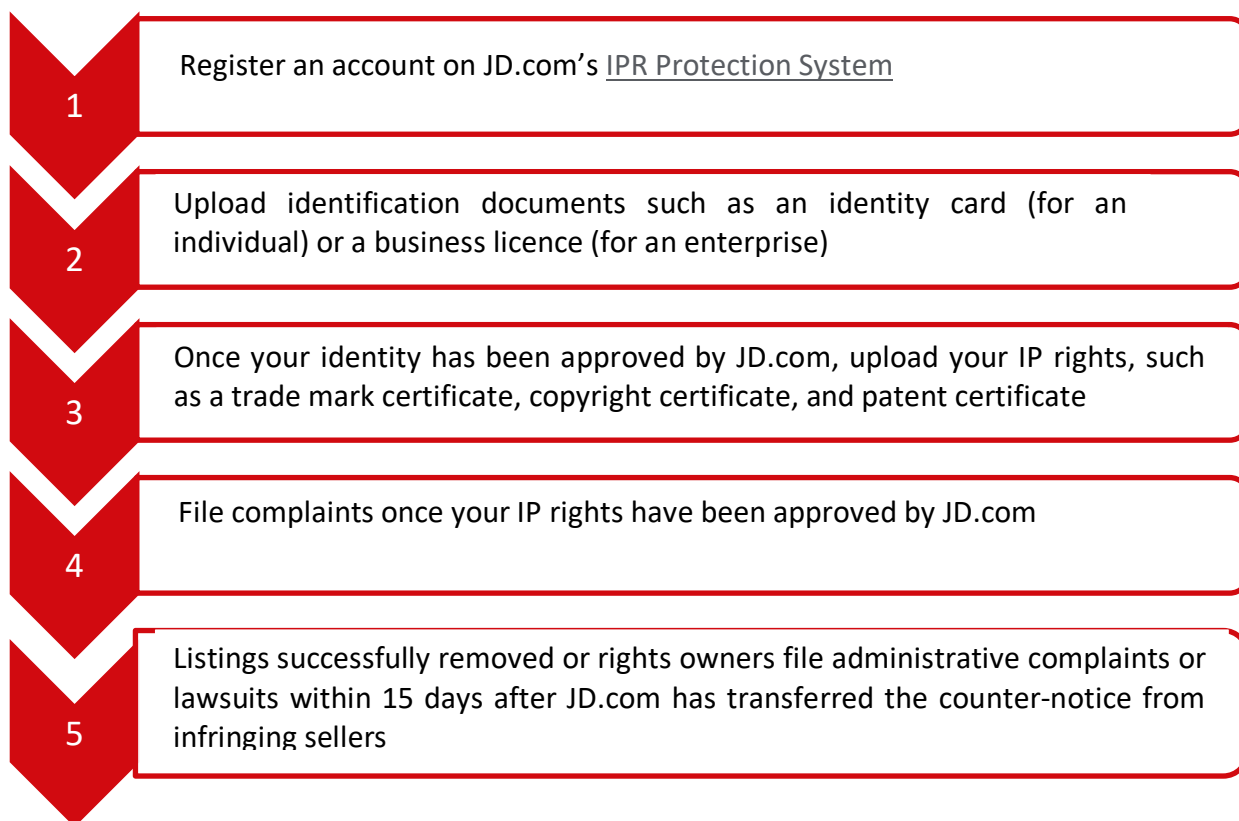
- 1 Register an account on [IPP](#) with your email address
- 2 Provide your identity (an ID card or passport for an individual, a business licence for an enterprise) and IP rights (trade mark, copyright, and/or patent)
- 3 File complaints on IPP once these IP rights have been approved by Alibaba
- 4 Check the status of your complaints on IPP and reject appeals from infringing sellers
- 5 Infringing listings rejected or removed by Alibaba

For more detailed information, please refer to the [FAQs](#) provided by Alibaba.

JD.COM

JD.com is among the top three Chinese e-commerce platforms, offering a set of online retail services to its 300 million users. It also has a sophisticated system for receiving notifications of IP infringement, and is currently available in Chinese and English.

To lodge a complaint via JD.com's [IPR Protection System](#), rights owners should follow these steps:



For more information, please refer to JD.com's [IP Protection Guide](#).

TENCENT WEIXIN (WECHAT)

Established in 2011, Weixin (or “WeChat” as it is known in English) has grown to become the most widely used social media app in China. An increasing number of operators are using Weixin as a distribution channel for counterfeits and other IP infringing goods. In response, Weixin has developed a mechanism to protect rights owners’ IP on the platform. Weixin users have an interface through which complaints about personal accounts within the app can be submitted. Complaints are sent to relevant brand owners registered with Weixin for verification.

WEIXIN BRAND PROTECTION PLATFORM

Rights owners can receive complaints from Weixin users against personal accounts selling counterfeits after joined Weixin's Brand Protection Platform (BPP). Rights owners can verify the evidence submitted by Weixin users and upload the verification result to Weixin's legal team, who will take actions against the infringing personal accounts according to the severity of infringements.

Rights owners that would like to join the BPP should submit the application and required materials via <https://www.wechatlegal.net/>. The rights owner needs to use a Weixin account to scan the QR code on the website in order to fill in the application documents. Weixin will review the submitted documents within seven working days upon receipt of them, and will inform the rights owner of the result by email.

If a rights owner has any questions during the application process, they can contact Weixin's legal team via notice_wxpbr@tencent.com.

INFRINGEMENT COMPLAINTS AGAINST PERSONAL ACCOUNTS

Rights owners can also file a complaint using the Weixin app if they find that their right of name, business name, reputation, portrait, privacy, copyright, trademark, or patent have been infringed by Weixin personal accounts. Rights owners should choose the reason code "infringement" ("侵权") to file complaints accordingly. For more information, please refer to the complaint guide below:

https://weixin110.qq.com/security/readtemplate?t=person_report/guide

INFRINGEMENT COMPLAINTS AGAINST OFFICIAL ACCOUNTS

Rights owners can file complaints against infringements found on WeChat's official platforms (including official accounts and mini programs) via the channel below:

https://mp.weixin.qq.com/acct/infringementlogin?action=getkey_brand&lang=zh_EN

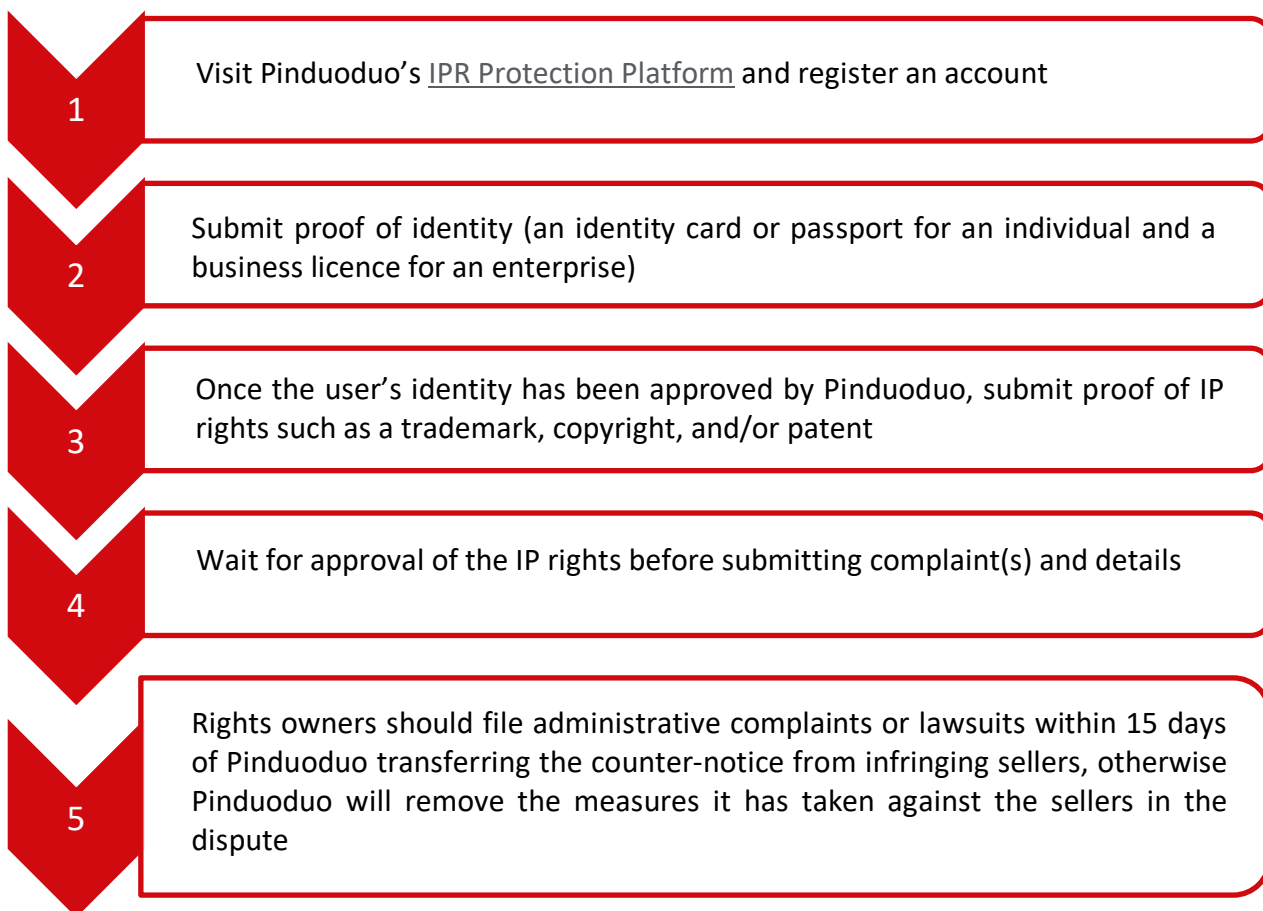
Weixin will deal with the complaints within seven working days, and rights owners can check the status of the complaint after logging into the platform.

For more information, please refer to Weixin's [guidelines for its IP protection system](#).

PINDUODUO

Pinduoduo is an emerging mobile e-commerce platform in China. It enables users to discover interesting and value-for-money products through an interactive and personalised recommendation model.

Pinduoduo launched its online IPR Protection Platform in 2018 and rights owners should follow the steps below to file IP complaints.



For more detailed information, please refer to Pinduoduo's [IP Guide](#).

CBBC plays an active and collaborative role in the on-going IP dialogue between the UK and China. We regularly engage with the above companies and other key stakeholders to communicate UK rights-holders' issues, concerns and experiences of using the above procedures. CBBC has also launched various successful IP initiatives with Alibaba, Weixin, JD.com, Pinduoduo, and UK rights owners to further the fight against counterfeits.

BUSINESS DISPUTE RESOLUTION

This section was written for CBBC by Bird & Bird. For more information, please contact Michael.Chik@twobirds.com

Bird & Bird

Despite careful planning and thorough due diligence, one cannot rule out the possibility of becoming embroiled in commercial disputes with Chinese business partners. However, advance preparation can assist in resolving disputes in the unfortunate event they do arise.

OPTIONS FOR RESOLVING COMMERCIAL DISPUTES

Commercial disputes in China can be resolved in a number of ways:

ADMINISTRATIVE ACTION

Depending on the type of dispute in question, several government departments and agencies in China can assist parties to resolve commercial disputes. A common example is action taken against intellectual property infringement by the State Administration for Market Regulation (SAMR) and its local offices. The SAMR is empowered to conduct investigations and raids, and to impose penalties and sanctions.

This route can provide a low-cost and effective means of resolving intellectual property (IP) disputes, in particular when the complainant has a strong and clear case. The SAMR also has the authority to handle consumer complaints against suppliers of goods or services.

CONSULTATION AND MEDIATION CONSULTATION

Consultation is an informal means of dispute resolution in China. It is common for contracting parties to meet to discuss their respective positions prior to escalating their disputes to formal litigation or arbitration. This is often seen as a cooling-off period for the parties to communicate and to attempt to preserve an otherwise mutually beneficial relationship. Subject to the parties' agreement, a neutral third party can be appointed to act as a facilitator for the discussions. Even though the consultation is intended to be casual and informal in nature, its results can be made to be legally binding if this is expressly stipulated in the parties' agreement.

MEDIATION

The idea of mediation is that the contracting parties in dispute voluntarily present their respective cases to a trained and impartial third party (mediator), who assists in making suggestions to resolve the issues in dispute. It is non-binding and confidential in nature, which promotes communication between the parties and may also help to preserve their business relationship. Mediation can also result in pragmatic settlement terms beyond the legal remedies which a court is entitled to grant. Mediation is commonly conducted in China as part of arbitration and litigation (see below), where parties are encouraged to participate in mediation by judges or an arbitration tribunal. However, it is a voluntary process and the court and/or the tribunal cannot compel the parties to participate in it.

JUDICIAL MEDIATION

Pursuant to China's Civil Procedure Law, a Chinese court shall consider whether the case is suitable for judicial mediation. If so, the court should encourage the parties to resolve the conflict in this way. Judicial mediation is conducted by a judge (as both mediator and adjudicator) during the early stage of the litigation proceedings. If a party refuses mediation or the mediation fails, the parties will need to argue their respective case with the same judge. However, if it is anticipated that a settlement may be reached after a trial but before the judge hands down a judgment, judicial mediation is still possible. In the event that a settlement agreement can be reached at the conclusion of the mediation, it becomes legally binding and can be enforced by the court.

ARBITRATION

Arbitration of China-related disputes can be divided into domestic arbitration and international arbitration. The respective rules and procedures can be very different, and once again, care must be taken in selecting the most appropriate forum.

DOMESTIC ARBITRATION

Onshore arbitration is conducted by Chinese arbitration commissions established under China's Arbitration Law. There are over 200 arbitral commissions in the country. The China International Economic and Trade Arbitration Commission (CIETAC) and the Beijing Arbitration Commission (BAC) are well-known and established commissions that can handle both domestic and international commercial disputes. One of the shortcomings of China-seated arbitrations is that the Chinese courts have supervisory jurisdiction over any disputes relating to an arbitral award issued within the jurisdiction. Furthermore, the choice of arbitrators is usually restricted to a relatively local tribunal which often constitutes a significant concern for foreign parties. The position has improved recently in that CIETAC have allowed parties to appoint arbitrators who are not on their official panel, subject to their final approval. This change has been followed by several different arbitration commissions over the past few years, including by the Shanghai International Economy and Trade Arbitration Commission (SHIAC) and the Shenzhen Court of International

Arbitration (SCIA), although they are only available in specified circumstances and some may impose certain restrictions to qualify for the freedom of choice outside the panel.

Another issue is that, in general, Chinese arbitration commissions have limited powers to make orders in respect of interim measures. Although the latest CIETAC arbitration rules now allow its tribunals to grant interim remedies prior to commencement of arbitral proceedings (for example an injunction), the availability of certain types of interim measures hinges very much on the applicable national law. The current Chinese law expressly provides that any application for an order of preservation of property and evidence must be made to the People's Court and not to the arbitration commission. Where a Chinese arbitration commission has received an application for preservation of property or evidence, the arbitration commission shall submit such an application to the People's Court.

INTERNATIONAL ARBITRATION

Foreign investors naturally prefer to turn to foreign-seated or Hong Kong arbitrations when resolving their commercial disputes with their mainland Chinese business partners, as some of the disadvantages associated with mainland Chinese arbitration can then be avoided. The Hong Kong International Arbitration Centre (HKIAC), the Singapore International Arbitration Centre (SIAC) and the International Chamber of Commerce (ICC) are all well-established and experienced in handling disputes involving mainland Chinese parties.

One practical issue is that, as stated above, only “foreign-related” disputes maybe legitimately arbitrated outside China pursuant to Chinese law. It is also common during contract negotiations for mainland Chinese parties to be unwilling to arbitrate overseas. Hong Kong often serves as a compromise, given that it is a common law system commensurate with international standards but based in China.

Another advantage of Hong Kong-seated arbitration is that parties can now also seek interim measures from the courts in China. Whilst the courts in China generally do not have the power to order interim relief in respect of foreign-seated arbitrations an exception has been made for Hong Kong-seated arbitration by an arrangement on mutual assistance in court-ordered interim measures between the Hong Kong Government and the Supreme People's Court of China signed in April 2019. Under the arrangement, parties to a Hong Kong-seated arbitration can now also apply for the usual interim reliefs from the courts in China in accordance with the law, including property and evidence preservation.

LITIGATION

There are four levels of courts in China and each has its specified jurisdiction: the Basic-level People's Courts, the Intermediate People's Courts, the Higher People's Courts, and the Supreme People's Court, which now includes six circuit courts located outside of Beijing, each acting as the agent of and possessing the same level of jurisdiction as the Supreme People's Court, which is the highest judicial body in China and has appellate powers over all the lower courts. Contractual disputes which involve foreign elements (for example, the contracting party or subject matter of the commercial contract is foreign) are usually heard by the Intermediate People's Courts.

Mandarin Chinese is the official language in litigation proceedings and foreign litigants are required to use interpreters at their own cost. Any party which is dissatisfied with the decision of the court of first instance may appeal once to the court immediately above.

ARBITRATION VS LITIGATION IN CHINA

For most foreign parties, arbitration (whether domestic or international) is a better option than litigation for resolving disputes in China. The advantages include the finality of an arbitral award and arbitral rules and processes which are usually more transparent than litigation. Although China continues to reform its civil litigation system, significant concerns remain over substandard adjudication, bias, and local protectionism.

DISPUTE RESOLUTION AND GOVERNING LAW CLAUSES

ONSHORE VS OFFSHORE

Litigation in China can be a frustrating experience for foreign parties because of the language barrier, bureaucracy, and unfamiliar legal procedures involved. It also limits a foreign party's choice of legal representative as only PRC-qualified lawyers can appear in local courts.

It is important to bear in mind that mainland China generally does not enforce foreign judgements, except in the few instances where there is a treaty of mutual recognition and enforcement, or where there is reciprocity with that foreign jurisdiction. Enforcement of an arbitration award in China will face fewer obstacles given China is a party to the New York Convention, of which most countries are member states. In general, arbitration in China tends to be the preferred option for resolving China-related disputes.

Whichever option is preferred, it is always of crucial importance to seek legal advice and communicate clearly with counterparties during contract negotiations.

Governing law clauses may appear to be routine provisions. However, they play a critical role when disputes arise. A good governing law clause promotes certainty in deciding the enforceability and validity of a contract, which may become invalid if the contract is illegal under Chinese law.

In China, commercial contracts which are not "foreign-related" must be governed by Chinese law, and disputes resolved (whether by litigation or arbitration) within China. A contract may be considered as "foreign-related" if any of the following apply:

- » One of the contracting parties is incorporated offshore or is a non-PRC citizen;
- » Habitual residence of one of the contracting parties is outside the jurisdiction;
- » The subject matter is or will be at least partly outside the jurisdiction;
- » There are other legal features concerning "the occurrence, modification or termination of civil rights and obligations" outside the jurisdiction;

- » There are other circumstances indicating that the business relationship between the contracting parties is foreign-related.

Chinese law will still apply to certain “foreign-related” contracts, including where the subject matter involves foreign exchange control, employment issues, and food or public health safety. Also, a contract between a wholly foreign-owned enterprise (WFOE) and a Chinese party will not be “foreign-related”.

DRAFTING TIPS

For the sake of certainty and clarity, the dispute resolution and governing law clauses should be drafted in simple wording. Prior to drafting or agreeing to such a clause, always refer to the latest version of the relevant legislation or rules to confirm their validity and application.

In summary, there is no hard and fast rule in respect of dispute resolution and governing law clauses in relation to Chinese contracts. Each case should be reviewed in accordance with its specific circumstances, taking into consideration factors such as the location of the parties’ assets and the types of remedy to be sought.

OFFSHORE SECURITY AND CROSS-BORDER ENFORCEMENT

ASSET TRACING AND RECOVERY

China has signed mutual legal assistance treaties with over 70 countries, including the UK, which can assist in asset tracing and recovery in China. Upon receipt of an official request from a requesting country, the relevant Chinese court will examine the supporting documents to ensure that the request does not violate the legal principles of China. If the request is considered to be detrimental to the sovereignty, security, or public interest of the country, the Chinese court is entitled to refuse the request.

Recovery procedures can include investigations by the relevant government authorities to identify, restrain, and seize assets within the jurisdiction. Since time is of the essence, it is common that parties also engage private local investigators to speed up the process. In the event that assets can be identified, Chinese courts will arrange for the return of assets in accordance with the procedures stipulated under the relevant bilateral treaties or international conventions.

ENFORCEMENT OF FOREIGN JUDGMENTS/ARBITRAL AWARDS IN LOCAL COURTS

Enforcement of foreign judgments is mainly accomplished in accordance with international agreements signed by China or the principle of reciprocity, provided that the foreign judgment does not violate state sovereignty, security, or public interest. Examples of enforcement of foreign judgments in China include a case in December 2016 where the Jiangsu Nanjing Intermediate

People's Court recognised and enforced a judgment from a Singapore court. More recently, in September 2018, the No. 1 Intermediate People's Court of Shanghai Municipality recognised and enforced a judgment from a court in Illinois in the US. While these are significant milestones, they are relatively rare cases and it remains unclear whether other Chinese courts may start to follow suit.

As there is presently no agreement on mutual recognition and enforcement of judgment between China and the UK, a UK court judgment cannot be enforced in China. The only option in these circumstances is for either party to submit the case to a Chinese court to be re-litigated, which means the foreign judgment will then be of limited significance or influence.

In light of the above, arbitration has become a preferred option for foreign investors as China and most other countries in the world are party to the New York Convention, so foreign arbitral awards should not be rejected by a Chinese court for enforcement. In practice, the geographical location and status of the Chinese party and its assets can still have a significant role to play. Enforcement is usually easier in major cities such as Beijing and Shanghai.

ARRANGEMENT ON RECIPROCAL RECOGNITION AND ENFORCEMENT OF JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS BETWEEN HONG KONG AND MAINLAND CHINA

In July 2006, Hong Kong and mainland China entered into a special arrangement for mutual recognition and enforcement of monetary judgments. This applies to commercial contracts which contain an exclusive choice of jurisdiction in either Hong Kong or mainland China and which are entered into after 1st August 2008.

This arrangement has significant implications for foreign investors as it further expands the choice of jurisdiction for contracting parties, taking into account the geographical proximity between Hong Kong and the mainland. It also saves the time and expense which would be required to bring parallel enforcement proceedings in mainland China. More importantly, a Chinese court is required to give effect to the relevant Hong Kong judgment and cannot simply ignore it.

In January 2019, Hong Kong and mainland China signed a new arrangement on reciprocal recognition and enforcement of judgments in civil and commercial matters. The new arrangement is said to be "with the broadest coverage and of great significance". Under the latest arrangement, effective judgments in civil and commercial matters in one jurisdiction, which even includes civil compensation for criminal offences, can be recognised and enforced in another jurisdiction. The scope of the new arrangement also extends to cover non-monetary reliefs. This new arrangement is not in force yet.

PROTECTIVE/INJUNCTIVE MEASURES

TRAVEL BANS

In the event that foreign nationals in China become involved in a commercial and/or civil dispute and the case is submitted to a Chinese court, the Chinese court has the power to prohibit the foreign party from leaving the country until the resolution of the dispute, and his/her travel documents may be confiscated.

If a foreign national is found at the crime scene and suspected of having engaged in any serious criminal acts, the police can exercise their power of detention for 24 hours for interrogation. If a travel ban is imposed by the Chinese government, the relevant embassy or consulate will be notified. Any detainee has the right to appoint a legal representative, who must be a qualified PRC lawyer. Any person who is subject to a travel ban in China is advised to request assistance from the relevant embassy or consulate for assistance without delay.

PROHIBITION ORDERS TO PRESERVE PROPERTY AND EVIDENCE

If there is a likelihood that a losing party will not comply with an execution order granted by a Chinese court at the conclusion of civil proceedings, the winning party can apply to the court for a preservation order to freeze that party's assets. Such an order may be granted by the court prior to the commencement of court proceedings or arbitration if it can be shown that irreparable damages to the subject's property may occur without immediate preservation.

The applicant is generally required to provide a security upon the application for a preservation order, failing which the application will be dismissed. Prior to commencement of a civil action or arbitration in China, the potential plaintiff can also apply to the Chinese court to preserve evidence on the basis that such information or materials may be destroyed or altered.

REVIEW OF GOVERNMENT AUTHORITIES' SANCTIONS OR DECISIONS

In general, there are two ways to challenge a sanction or decision made by PRC authorities: an administrative review and administrative proceedings.

An administrative review is an internal check conducted by the legal offices of the administrative body which carried out the relevant act. This covers a range of issues including physical detention, freezing and seizure of assets, and suspension of a business licence. The review will usually be conducted in the form of a paper trial and be processed within 30 days upon request. A complainant should usually first apply for an administrative review before resorting to administrative proceedings.

Although this option saves time and cost, in practice it has proved ineffective in reversing government decisions.

An alternative is to submit a complaint to a Chinese court for determination. The procedures involved are similar to those for a normal civil matter. One point to note is that the court will not

accept cases involving national defence and foreign affairs, or an administrative regulation or order that has a binding effect on the general public.

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