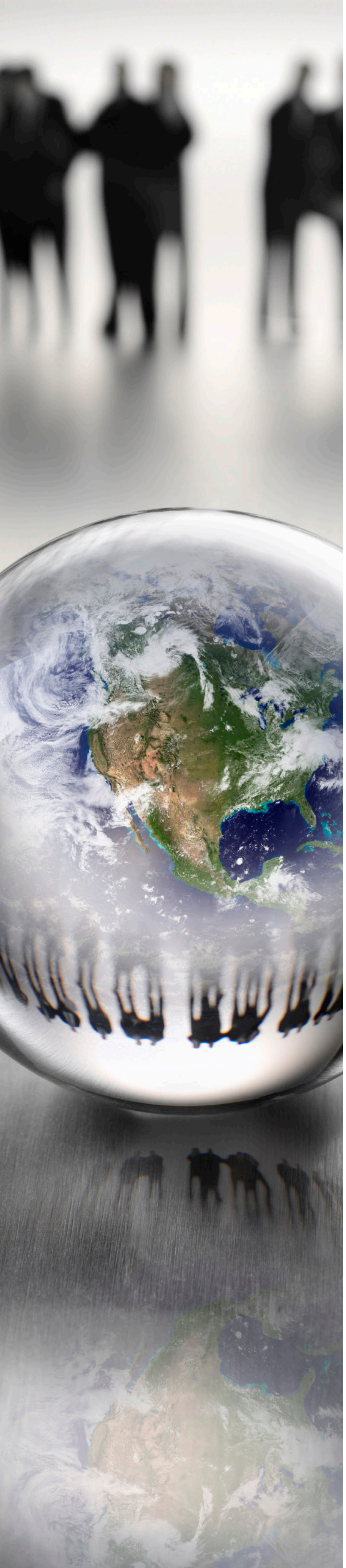

Effectively Accessing Chinese Consumers Through Distribution Relationships

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A new generation of U.S. companies has recently begun to take advantage of the Chinese consumers' growing spending power by selling products directly into China. Despite the risks and challenges that foreign companies face in China, growth projections are too enticing to ignore. The Chinese retail market has grown more than 14% over the last two years, and Chinese consumers increasingly desire to buy goods and services offered by foreign companies.

While direct investments by U.S. companies into China were often the preferred vehicle for U.S. manufacturers seeking to establish production operations or partnerships in China in the 1990s and 2000s, U.S. companies are considering alternative contractual relationships.

One structure that often makes sense for U.S. companies, from both a business and legal perspective, is a distributor relationship. This typically involves a local distributor that purchases goods and then resells them in its local market (the risk of loss is transferred upon the sale of the goods to the local distributor). While some Chinese companies are reluctant to take on this reselling risk, many are willing to enter into distributor relationships when there is a strong demand for the foreign product.

Following are some of the basic principles to keep in mind.

Select the Right Distributor

This is the most important step. A local distributor will represent the U.S. company in China and as such will leave a lasting impact on the company's reputation and brand image in China.

Accordingly, conducting the proper due diligence is a crucial component in the process of selecting a local distributor. A U.S. company should investigate the potential local distributor's ability to perform as a distributor within China by researching its experience, references, past performance, qualifications, and investigating its facilities in China in person. In addition to this business due diligence, legal due diligence and related protective actions should include the following:

1. Conduct a company and credit search on the potential local distributor. A company and credit search helps to verify the shareholders, the board of directors and the legal representative of the distributor. It also provides a legal and financial picture and helps to avoid conducting business with a non-compliant Chinese company. Additionally, U.S. companies should review the distributor's corporate documents and any applicable licenses or permits required relating to the types of goods it distributes. Through this due diligence process, U.S. companies may identify any direct or indirect relationships between the distributor and Chinese government officials. Such relationships can have significant implications relating to the U.S. company's ability to comply with the Foreign Corrupt Practices Act.

2. Require the potential local distributor to sign a non-disclosure agreement. This should be done before disclosing any important information including (a) trade secrets; (b) information relating to any intellectual property rights; and (c) other business information such as engineering drawings, products specification, models, prototypes, tools, tooling technology, etc.

3. Register the U.S. company's trademarks in China. Trademarks should be registered in both English and Chinese characters. This should be done prior to engaging in negotiations with potential local distributors.

Address Distribution Agreement Requirements

While a company's existing cross-border distributor agreements can serve as a useful starting point, distribution agreements in China require special considerations, including the following:

1. Exclusivity. Distribution agreements often provide the local distributor with the combination of certain exclusivity rights such as the right to exclusively sell (a) certain product lines; (b) in a certain territory; or (c) to certain customers. If any form of exclusivity is granted to a local distributor in China, the U.S. company should maintain the ability to terminate the relationship in the event of underperformance. Alternatively, if the local distributor commits little to no capital at the beginning of the relationship, a shorter term for the agreement is often easier and more palatable.

2. Termination. Statutory restrictions and penalties are imposed by many U.S. states and European countries upon a company's termination of its local distributor. Favorably for U.S. companies, China does not maintain such restrictions or penalties upon the termination of a local distributor. As a result, it is even more important for a distribution agreement with a local Chinese distributor to clearly specify the actions and obligations of each party upon the termination of the relationship.

3. Governing law and dispute resolution. It is legally possible for a distribution agreement to be governed by a law other than Chinese law if the law can provide better protection or is more suitable than Chinese law. However, it is not always easy to convince a Chinese partner to sign such an agreement.

Similarly, most U.S. companies prefer to resolve disputes either in the United States or in a third country with a well-established judicial system. However, most foreign judgments are not automatically enforceable in China. Although a U.S. company may be better able to secure a judgment in a foreign jurisdiction, it may be unable to enforce that judgment in China without significantly engaging the Chinese court system. The advantage of a Chinese court issuing judgment is that it can be directly enforced by the Chinese court.

Alternatively, the parties to a distribution agreement may choose an international arbitration commission in China. Arbitration awards are enforceable by Chinese courts without the recognition and enforcement process described above. Also, documents and evidence submitted at the arbitration hearing can be in English. Arbitrators may be selected from a pool of lawyers approved by the China International Economy and Trade Arbitration Commission and include both Chinese and foreign arbitrators.

In summary, the distributorship arrangement can be an effective tool for U.S. companies looking to do business in China. As with all ventures in foreign countries, U.S. companies need to exercise proper care in structuring their arrangements.

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