



MMLC Group  *China Update*

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China Head Office
Level 7, Tower W3, The Towers, Oriental Plaza
No.1 East Chang Avenue, Dongcheng 100738, Beijing, China
p: +86 10 8515 1091
f: +86 10 8515 1089
w: www.mmlcgroup.com

Business

Economy and Finance

We are regularly asked to give our views on the economic health of China. Many commentators regularly advise of a great slowdown being imminent, social unrest problems causing instability, and bubbles forming in the property sector. We are confidently optimistic about China's ability to handle these issues – during 2009 and 2010, the government announced a series of measures aimed at stabilizing the economy and slowing growth in certain areas – we have started to see these measures bear fruit over the last few months, with inflation dropping to 6.1% in September (down from 6.8%), property sales dropping substantially in the hot spots such as Beijing and Shanghai, and domestic consumption rising very quickly soaking up excess capacity of the factories. The Chinese

have recognized that China's rate of growth from 2000 to 2010 was probably too fast and led to major environmental problems and large gaps between the rich and common workers. They have welcomed slower rates of growth, greater environmental protection and plans for increased investment in the rural and Western areas of China, where average wages are still very low by world standards. Confidence is high. A sobering fact: China's next group of millionaires currently possess nothing, yet China was reported to have more than 535,000 millionaires in 2010 (4th highest in the world).

IT and Telecommunications

China's Vice-Premier, Zhang Dejiang, has confirmed that the IT and communications industries are to remain two of China's strategic emerging industries. His comments came during a visit to China Ministry of Industry and Information Technology's PT/Expo Comm China 2011 event in Beijing in late September. Mr. Zhang reiterated that the government would increase its support for local IT and communications companies and start-ups, with the view to enhancing their creative abilities and securing new technologies. Areas of particular interest, appear to be the development of the TD-SCDMA and TD-LTE technologies and cloud computing, as well as convergence of television, telecommunications and the Internet.

Retail

Nike's CEO, Charlie Denson, has stated in interviews with the Chinese media, that they intend to invest more heavily in China over the next 3 to 5 years, with the objective being to double sales by the year 2015. Nike has been in China for 30 years, however it did not achieve the magic sales revenue amount of US\$1B until 2007 – earlier this year, Nike announced sales revenue for China of US\$2B. Nike currently claims over 7,000 retail stores across China.

Wenzhou SMEs in Trouble – Bailout Planned

China's liquidity crunch has caught out a number of Chinese SMEs in Wenzhou (Zhejiang Province), leading to many to seek financing from entities other than banks – this has led to high interest loans being on offer, and a rapid rise in insolvency and bankruptcy claims in Wenzhou (widely thought of as the heart of entrepreneurial activity for China). The Wenzhou SME Development Association has prepared an emergency fund of US\$141M to assist

private SMEs in urgent need of cash to sustain operations. Clearly social unrest from large scale redundancies is a major concern in Wenzhou at present, so it is anticipated that the proposed bailouts will end up coming to fruition in the near future.

Legal

Competition/Anti-Trust

Essential Facilities/Administrative Monopolies Lawsuit

Chapter V of the PRC Anti-Monopoly Law deals with the regulation of anti-competitive behavior by administrative authorities in China. It deals with certain negative behavior, such as an administrative authority unduly compelling another party to agree to certain terms in a transaction, the imposition of regional economic barriers and general anti-competitive conduct. Last month, Shanxi Transport Group Co Ltd filed a lawsuit against Taiyuan Railway Bureau claiming that it had contravened Chapter V – Shanxi Transport has alleged that Taiyuan Railway had failed to respond to applications filed over a four year period, for permission to open additional railway ticket outlets. Interestingly, over the same four year period, Taiyuan Railway had permitted 74 new ticket outlets to be opened by entities that were owned by Taiyuan Railway. Given that litigation against large state owned administrative authorities is relatively rare in China, this case has raised

eyebrows amongst the legal sector in China. The outcome of the case is awaited with great interest.

MOFCOM Confirms Examination of Nestlé's bid for Hsu Fu Chi

On September 20, Shen Dan Yang, a spokesman for China's Ministry of Commerce ("MOFCOM"), disclosed that the ministry had officially accepted Nestlé's acquisition of Hsu Fu Chi for assessment according to the PRC Anti-Monopoly Law. In effect this means that the initial Phase I review period will expire on October 20 (lasting 30 days), with Phase II expiring on February 20, 2012 – most cases of this nature receive a decision from MOFCOM in Phase II. Nestlé has agreed to acquire 60% of Hsu Fu Chi, for around US\$1.7 billion. It is one of the largest foreign takeovers of a Chinese food player to date. Other recent similar transactions that received Chinese government approval were: (i) Nestlé's acquisition of a 70% interest of Yunnan Spring, (ii) Nestlé's acquisition of a 60% stake in Silver Heron Group, (iii) Diageo acquiring 16.87% of Swellfun and (iv) Yum acquiring 93% interest in Little Sheep. Some analysts are comparing this transaction to Coca-Cola's bid to acquire Huiyuan Juice, which was eventually rejected by MOFCOM on competition law grounds, however unlike that case, so far, little negative publicity has developed surrounding this transaction thus public sentiment appears to be relatively neutral.

Corporate

M&A Security Review Legislation

As noted in an earlier update, China's Ministry of Commerce ("MOFCOM") has enacted a new security review system outlining the documents to be submitted when foreign investors are looking for approval to acquire local Chinese entities, or interests in such entities. It is important for

foreign investors to understand that the legislation contains strong anti-avoidance provisions, including the prohibition of the use of nominal holdings, trusts, leases, loans, franchises and variable interest enterprises (see our September update), to try to avoid complying with the legislation – see MOFCOM Announcement [2011] No. 53. The legislation contains provisions promoting early consultation with MOFCOM, prior to filing a formal application for approval – indeed, it is thought that in many international M&A matters, the initial informal consultation will lead to MOFCOM advising that the transaction is not caught by the legislation and no formal filing would be required. Further, it should be noted, that provisions exist allowing third parties, such as industry associations, government departments and "upstream and downstream" enterprises, to apply to MOFCOM to have a security review of a transaction, carried out before the transaction can be approved or completed. Finally, being consistent with the processes followed by MOFCOM in most cases, Article 11 of Announcement 53 has confirmed that all security review cases are to be conducted in strict confidence, and the results and processes to be treated as state and trade secrets.

Employment

Unions Require Notification of Termination

Article 43 of the Employment Contract Law requires an employer to provide notice to a union before any unilateral termination of an employment relationship occurs. It is often overlooked in the heat of the moment, but a recent court case in Jiangsu province (Eastern China) has confirmed that the failure to comply with Article 43 will render a termination invalid. In August 2011, a court in Yancheng, Jiangsu was asked to look at a case where a company bus driver was terminated on the basis that he had sold two forged bus tickets to

employees (pocketing the proceeds for himself) – the court admitted that the company’s employment guide and business conduct rules allowed immediate termination in such a case, but that the company should have also notified the relevant union under Article 43 before proceeding with the termination.

Environment

The Shanghai Environmental Protection Bureau (“SEPB”) has commenced ordering temporary and permanent plant closures in Pudong in Shanghai, after unhealthy levels of lead were detected in the bloodstream of children living in the area. Johnson Controls has received a temporary closure order and has reportedly agreed to keep its Pudong plant closed until the end of this year at least – the SEPB has confirmed that Johnson Controls has largely complied with emission standards, but that its plant had already exceeded annual production limits for the year. Earlier this year, a court in Hangzhou (Zhejiang province) imposed a 15 month prison sentence on the CEO of battery maker, Suqi Battery Co., Ltd. for the lead poisoning of over 100 villagers in a small town near Hangzhou. China has come under increased social pressure to enforce its environmental protection laws more aggressively and consistently across the country, with many lawyers now refusing to label China’s environmental laws as toothless tigers – further, the National People’s Congress is also currently revising China’s main environmental protection laws so as to strengthen investigatory powers, allow for private consumer actions to be filed against polluters for the first time, and to allow greater criminal penalties to be imposed on persons that contravene the laws.

Tax

New Resources Tax Commences in November

China’s State Council has confirmed that the country’s new resources tax regime will come into operation on 1 November 2011. The new tax applies to crude oil, natural gas, salt and rare earth metals. For oil and gas, a tax of between 5 and 10% of sales will be levied on local entities and foreign invested enterprises. The government has said that the revenue raised from the new tax, will be invested back into the local areas from where the resources has been extracted. A trial of a resource tax was introduced in Xinjiang province (North Western China) in 2010, and was warmly received by residents and the local government given it lead to a significant increase in revenue for the region. Various resource production taxes have been in place since 1993.

Transfer Pricing

The Beijing Tax Bureau recently held training sessions on transfer pricing for its officials that specialize in this controversial area – it was made clear that the Tax Bureau officials would be paying even more attention to transfer pricing issues, and would keep the following issues in mind when dealing with transfer pricing cases (it should be noted that these principles are largely consistent with the approaches adopted by the Tianjin, Shanghai and Shanxi Tax Bureaus as well) – if an entity’s transfer pricing documentation does not comply with SAT Guoshuifa [2009] No. 2 “Implementation Measures of Special Tax Adjustments”, then a more detailed review is mandatory; tax payers should not only evaluate the operational results of the related party transactions, but also document how the global transfer pricing policies are determined by the group in their documentations; different types of related party transactions should be described and tested

separately and evaluated individually as to whether these transactions comply with the arm's length principles laid out in the tax legislation; tax payers should use an appropriate method to allocate revenue, costs and expenses between related party transactions and third-party transactions; information should be disclosed regarding the tax payer's position with respect to the entire group's supply chain, as well as company's main competitors; and tax payers should also disclose in their documentations any information regarding either direct or indirect equity transfers with related parties during the review period.

In addition, China's State Administration of Taxation has continued to promote pre-transaction consultation with its Tax Bureaus regarding a proposed transfer pricing arrangement, in order for parties to avoid expensive audits and penalties after a transaction has been concluded. Many old China hands will be surprised to hear that early and frank discussions with local Tax Bureaus often lead to extremely satisfactory results in many cases, although the locality is often an issue for such a strategy.

Shanghai VAT and Business Tax Reforms Tipped for 2013

As reported in earlier updates, China is planning on rolling out revisions to its indirect taxation system involving its Value-Added Tax and Business Tax regimes. The SAT has stated that it intends trialing a new system in Shanghai from 2013. Further details are available from our office.

This update is aimed at keeping our clients informed of developments in Greater China. Whilst every care has been taken to ensure the accuracy of this update, it should not be relied upon before individual advice is obtained. The MMLC Group is an international legal and corporate advisory group.
