# THE ISOLATIONIST POLICY IN CHINA AND ITS CONSEQUENCES: HOW DO I AVOID THE CREEPING LOSS OF CONTROL OVER MY CHINESE SUBSIDIARY?

The current isolationist policy, as well as the associated extremely strict entry restrictions and other coronavirus measures in the People's Republic of China, has for a long time presented a significant problem for European companies with Chinese subsidiaries: There is a creeping loss of control over the subsidiaries, since adequate control of the company by the European shareholder is no longer guaranteed on-location.

During our day-to-day operations with our clients in China, we have for some time now observed the occurrence of a variety of abuses at the subsidiaries related to the lack of local control in China. On the one hand, established European corporate standards are no longer adequately implemented. On the other hand, there is a significant increase in liability cases and compliance violations all the way to cases of intentional harm to the company.

In the following, we would like to provide an overview of the regularly occurring abuses, as well as best practice solutions for preventing these abuses and harm to company.

## I. WHAT ARE THE REASONS FOR THE RESULTING LOSS OF CONTROL OVER SUBSIDIARY COMPANIES IN CHINA?

European subsidiaries in China were previously regularly structured in such a way that the relevant management positions were assumed by European managers (so-called "expatriates"), and simultaneously, the representatives of the shareholder visited the subsidiaries several times a year in order to gain an overview of the current status on-location.

This structure has undergone drastic changes due to the pandemic and the isolationist policy of the People's Republic of China. The European managers who worked on-site with appropriate work and residence permits have left the country in flocks due to the strict coronavirus measures, and at the same time, there is little willingness to return there due to the restrictions upon entry in China (including several weeks of quarantine at state-specified hotels). In addition, it has become virtually impossible for shareholder representatives to enter China with a business visa. Due to the applicable coronavirus measures, such a business visa is only issued in very limited cases and only after receipt of a formal invitation letter from the local government. However, the prerequisites for receiving this invitation letter are so high that the vast majority of European shareholders cannot meet these prerequisites.

Thus, both the direct management of the subsidiary and the direct control on-site currently fall into the hands of the local employees together with the negative consequences described above.

In this respect, for some clients Schindhelm Allianz, with its locations in Shanghai and Taicang, has for some time now taken on the regular “internal auditing” of the subsidiaries on-location in China in order to identify and effectively remedy such abuses.

## II. WHICH LIABILITY CASES IN THE SUPPLIER/CUSTOMER RELATIONSHIPS REGULARLY OCCUR AT CHINESE SUBSIDIARIES?

At both the sales and purchasing level, we observe in China that side agreements to existing purchase contracts and order confirmations are concluded verbally or via WeChat (Chinese equivalent to WhatsApp). This is indeed an industry standard in some areas. In these side agreements, supplementary performance promises for the products or changes to the warranty rights are usually effectively agreed. Irrespective of the question of the right to conclude such agreements internally (more in this regard later), there is regularly no written documentation of this procedure after the conclusion of this side agreement. This results in companies not being able to accurately estimate the exact scope of their performance obligations and warranty rights and not being able to prove them in a manner that stands up in court in the event of a dispute. If the responsible employee, then leaves the company, such side agreements are ultimately no longer traceable.

*Our recommendation: Implement for these areas an obligation to prepare a protocol of negotiations suitable for proof (according to a sample template), in which the persons acting document all aspects of the agreement accordingly and then send this documentation to the respective customer/supplier for acknowledgement and confirmation. In addition, a clear company policy should be established to identify those areas where side letters by verbal exchanges or WeChat correspondence are permitted or prohibited.*

Another "classic" problem at the sales and purchasing level is the incorrect inclusion of the company's General Terms and Conditions in offers or order confirmations. This is mainly due to the fact that the persons acting do not have sufficient knowledge of the legal framework conditions of a correct inclusion of the General Terms and Conditions.

*Our recommendation: Train the acting persons with regard to the legally effective inclusion of T&Cs, give the persons a corresponding information sheet, and have its receipt confirmed in writing.*

In addition, we always find contractual arrangements in which jurisdiction clauses that are not suitable for the company have been agreed. There are essentially two classic configurations here:

One configuration involves contracts with state-owned/state-invested companies in China that provide for jurisdiction clauses in favour of state courts in China.

*Our recommendation: Always include an arbitration clause (e.g. CIETAC clause) in such contracts and have the effectiveness of the clause legally verified. In this respect, it is still observed that “surprise judgements” are made in proceedings involving state-owned/state-invested companies before state courts in China.*

The second configuration is shown in international legal transactions. In this case, the subsidiary usually includes a choice of law in favour of Chinese law, as well as a jurisdiction clause in favour of the Chinese courts. This can be a serious mistake in international legal transactions. Due to the lack of bilateral enforcement agreements, judgements of a Chinese court are regularly not enforceable in the business partner’s state of registration. Even worse: In this configuration, only [sic] the business partner could thus obtain judgements in China and enforce them against the subsidiary.

*Our recommendation: For international contracts, always select an internationally recognised arbitration institution (and, if applicable, the substantive law of a third country) so that any arbitration awards can later be enforced internationally.*

Finally, at the sales level, it often appears that an intermediary is engaged between the end customer and the subsidiary. This has the pleasant side effect for sales that they do not have to clarify the detailed questions directly with the end customer and thus save themselves work. However, there is a significant liability trap here: Within the framework of the contracts of the subsidiary with its intermediaries, there is regularly a clause according to which the intermediary may agree on the joint liability of the subsidiary in his contractual relationship with the end customer. Thus, the subsidiary is liable for all obligations arising from the intermediary's business with the end customer without knowing the specific content.

*Our recommendation: Contracts with intermediaries should be subject to legal review if the involvement of the intermediaries cannot be avoided.*

## III. WHICH COMPLIANCE CASES REGULARLY OCCUR AT CHINESE SUBSIDIARIES?

The issue of granting benefits is still a regular problem in China today. At the purchasing level, the question always arises as to whether the suppliers are actually selected here on the principle of the best price-performance ratio or whether private affiliation with the respective suppliers or even (legally relevant) kick-back agreements play a role here.

*Our recommendation: Regularly check the price-performance ratio of your suppliers and have the conditions of other suppliers checked at frequent intervals.*

A similar problem can be found on the sales side. Particularly in cases with the involvement of intermediaries, we repeatedly observe that senior staff of the subsidiary participates at such intermediaries (co-shareholders / executive bodies). Such an action not only constitutes a violation of the secondary employment ban from the employment contract of the respective employee, but also leads to the fact that the company must share the actual profit margins with the (possibly unnecessary) intermediaries engaged.

*Our recommendation: Regularly check the need for engaged intermediaries. In addition, our local lawyers in China can determine whether the local executives are participating in the intermediaries by reviewing the relevant registries.*

Finally, we repeatedly find that there is no sufficient corporate policy in place in the subsidiaries to regulate authorisation to represent and to use the company stamp for the effective conclusion of legal transactions. In particular, the ability of a larger group of persons to access the company stamp is suffused with liability risk, since effective declarations of intent of the company can be made externally with the use of the company stamp.

*Our recommendation: Implement internal policies that, first, define the group of authorised representatives and the scope of their authority (use of the company stamp) and, second, that place liability-bearing transactions, as well as other significant business decisions under the mandatory proviso of consent of the shareholder.*

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