



CHINA LAW INSIGHT

How Luxury Brands Can Cooperate with Agents to Protect Their Rights

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The Hemline Index, presented by American economist George Taylor in 1926, suggests that the hemlines on women's skirts and dresses rise and fall with the rise and fall of the economy. Under this theory, the popularity of short hemlines coincides with a booming economy, but in bad times, long skirts and dresses show the modesty that bad economic times seem to require. However, assorted 2009 fashion weeks did not really reflect staying power of this economic theory. Only a few top luxury brands had ankle-length skirts in their fashion lines. This lack of modesty in the face of the recent recession probably has more to do with the fact that the clothes were designed one season before the weight of the recession had come to bear. Yet, even with fashion not reflecting the angst of the economy, people are seriously concerned about how the world will face this economic downturn.[1]

The Wall Street Journal is predicting that the global sales of luxury goods will plunge 10% in 2009.[2] However, many top brands will be able to offset some of this loss by an increase in sales revenue from emerging luxury brands markets like China. During the first 11 months of 2008, revenue from luxury goods sales fell 35% in Japan and North America, but Chinese

sales increased 22%. Thus, the world is looking to see if the Chinese markets can stand up with continued economic growth while the rest of the world takes an economic step back.

[1]“The Four Major Fashion Weeks Under the Economic Crisis,” *Sina eLadies*, posted 23 March 2009, available at <http://eladies.sina.com.cn/fa/p/2009/0323/1212843496.shtml> (last visited on April 14, 2009).

[2]*The Wall Street Journal Digital Network*, “Sales of Luxury Goods Seen Falling by 10%”, posted 11 April 2009, available at <http://online.wsj.com/article/SB123939180511509151.html> (last visited on 14 April 2009).

Many luxury brands have been testing the Chinese market by teaming with local agents to help limit brand risk because wide availability of luxury goods is a new concept to the Chinese market that is subject to entry restrictions. Moreover, many brands felt like they needed the support of an agent because they did not have confidence that their brand would be able to find a foothold in the Chinese market. Now that China has fulfilled its WTO commitments, and opened its retail industry to foreign investors, brand owners, and agents competition for market share is beginning to grow, and the current economic situation will only intensify this competition.[1]

However, many luxury brands that entered the Chinese market with an agent are abandoning them. The most common reason for a brand and its agent to break up is one of the inherent defects in the brand owner-agent cooperative model. Often, brand owners will completely cede a market to an agent, but when a brand owner feels a market is not being well managed by an agent they attempt to rework their brand agency agreement. Yet, brand owners have a hard time using the terms of the agency contract to discipline an agent because the owner has a limited amount of manpower in the market, and the owner does not want to dampen the agents’ enthusiasm for promoting its brand, which could cause the brand to lose what market share it has.

In general, the brand owner-agent cooperative model gives agents a dominant position, especially, when a luxury brand is completely novel in a market. For example, some agents may completely disregard the agency agreement and open stores outside of its stipulated territory when they are the sole agent in a market, or agents may develop a set of sub-

agents to market the product without the brand owner's permission. Brand owners are sometimes forced to accept these kinds of breaches or amend an agency agreement to allow these kinds of activities because they want to enter a given market. However, as a country's luxury goods market matures a brand owner will usually try to retrieve some of the control that it ceded to its agent to enter the market, and these attempts to regain control inevitably intensify conflict between brand owners and their agents.

Often, brand owners have found the best way to protect their long term interests is to have an overall understanding of the potential market for their product in a given country, and insure, that they use this knowledge to create a agency contract that will fulfill that potential, and as part of that contract there is a dispute resolution procedure that will make sure the terms of the contract are adhered to.

A. Brand owners should refine an agency agreement by taking as many dispute scenarios as possible into account when creating the agreement.

1. Granting Agency Rights

Brand owners should clarify the scope of the agency agreement as much as possible, specifically, the agent's territorial rights and the owner's requirements for the agent. For example:

- (i) If the agent is located in a shopping mall, where exactly is the booth located in that mall, and what is that booth's number?
- (ii) Who will be responsible for the inner decorations of an agent's store?
- (iii) Who will be responsible for recruiting the staff in an agent's store?
- (iv) Can the agent redistribute products?

2. Breach Clause

Brand owners should detail what conditions constitute a breach. For example:

- (i) What circumstances constitute compensatory breaches?

- (ii) When can a brand owner immediately terminate an agency agreement?
- (iii) How much and what kind of damages will be owed in case of a breach?

Sometimes it can be difficult for a heavily damaged brand owner to show its exact losses from an agent's breach. Thus, establishing how much damages will be owed in the agency agreement will prevent the brand owner from needing to show how damages should be calculated when an agent breaches.

3. Dispute Resolution Clause

Brand owners should need to create a procedure that will address all disputes that could rise between it and the agent. It must try to uniformly address issues, including, trademark licensing and other relevant contracts. If the owner allows for more than one procedure to resolve disputes then the inconvenience and intensity of the brand owner-agent dispute will probably increase as the party's relationship grows.

Furthermore, if a brand owner decides that it would like to use an agency agreement template provided by non-PRC based lawyers. The brand owner must be sure to have Chinese lawyers examine the agreement because PRC law will govern the agreement even if the agreement attempts to allow non-PRC law to govern it.

B. Brand owners need to properly supervise their agents' and they need to preserve any evidence of breach they observe an agent committing during the agency agreement.

1. Brand owners need to properly supervise their agent's performance, no matter how detailed the agency agreement is. For example:

- (i) They should frequently inspect an agent's store.
- (ii) They should maintain a good relationship with the shopping malls where their agents' are located to insure that the shopping mall will assist the brand owner in making sure the agency agreement is adhered to.
- (iii) They should save all purchase orders, invoices, and communications with their agents to help provide evidence in case the agent breaches the agency agreement.

(iv) When brand owners do find that an agent is in breach of its agency agreement, they should collect and preserve additional documentation, including, photos and certifications from their shopping mall location notifying the agent that it is in breach and must rectify its acts.

C. Brand owners need to take the proper steps to protect their rights and resolve disputes with agents.

If a dispute appears likely or inevitable, a brand owner may protect its rights by applying one or a combination of the following strategies:

1. Review the agency agreement and look for behavior that constitutes breach.

Generally, an agent's obligations are specified in the agency agreement, which is equivalent to breaching a contract. The most common agency breaches in the Chinese luxury goods market include:

- Opening stores outside the agent's territory;
- Developing sub-agents that directly sell the brand's products;
- Using distribution channels outside of the agreement to sell branded products;
- Breaching retail price clause requirements;
- Distributing a competing brand of luxury goods in breach of the agency agreement;
- Mixing counterfeit goods into the branded products.

2. Collect and Preserve Evidence

As soon as the brand owner has discovered a breach, it should immediately collect and preserve evidence of the breach. For instance the owners should investigate if the agent has established any sub-agent relationships, seek the cooperation of the shopping mall where the breaching agent is located, check correspondence with that agent for evidence of additional breaches. Finally, the brand owner should consider notarizing any evidence it collects to authenticate the information.

3. The brand owner should inform the agent it knows about the breach, and immediately request that the breach be remedied or the owner must take legal action.

Initiating a lawsuit or an arbitration may not be the best way for the brand owner to resolve an agent's breach. The main reason it may not be the best decision is because a litigation or arbitration will probably have a negative impact on the brand's sales and goodwill in the Chinese market. Therefore, the brand owner's best course of action is usually to work with the agent to resolve the breach and maintain as much brand goodwill as possible. If the brand owner can quantify how much damage the agent's actions did to it may want to try to collect the damages by working out a way to allow the agent to pay them while still allowing the agent to market the branded product. However, if the agent's breach is a fundamental breach of contract and the loss or the working relationship is irreparable, the brand owner may terminate the agreement. Yet, the brand owner may still need to negotiate with the agent about issues like store handovers and product buy-back. In circumstances where negotiation is not realistic, a brand owner must initiate a lawsuit or arbitration to protect the brand's best interest.

Overall, brand owners need to be smart about who they choose as their agents in China, using a PRC lawyer to will insure that any potential agents are properly vetted and brand agency agreements are established in a way that gives the brand owner advantageous position in disputes with an agent and completely protect the brand's interests in the Chinese market.

(The article was originally written in Chinese, the English version is a translation.)

[1]*Economic Information Daily*, "How Can Luxury Brand Agents in China Bear 'the Pain of Growth'", Liu, Dan, posted 2 March 2009, available at http://bt.xinhuanet.com/2009-03/02/content_15830601.htm (last visited on April 14, 2009).

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