

**Practice
Guides**

CHINA M&A

Fourth Edition

Contributing Editor
Richard Pu

 LEXOLOGY
Getting the Deal Through

CHINA M&A

Practice Guide

Fourth edition

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Introduction

Richard Pu¹

The M&A market in China has continued to be profoundly influenced by ongoing legal reforms in the country. An amendment to the Anti-Monopoly Law was adopted in August 2022, which serves to affirm certain regulatory developments and enhance antitrust enforcement in China. It has been proposed that thresholds for merger control filings be raised to reflect China's economic development, while the penalties imposed for failure to notify concentrations of undertakings, long viewed as insufficient, have been significantly increased to enhance their deterrent effect. The national security review mechanism has also been developing and may pose additional uncertainties to M&As involving foreign investors. In addition, major amendments have been proposed to the Company Law for the first time since 2005. If adopted, these proposed amendments could bring significant changes to the structure, design and negotiation of M&A transactions in China. Furthermore, the landscape of PRC data privacy laws and regulations also continues to develop rapidly. The long-awaited Measures for the Security Assessment of Outbound Data Transfer were finally issued in July 2022 and, together with various other forthcoming rules and regulations, will provide companies with a greater degree of certainty as to the extent of their compliance obligations.

While the private investment market has slowed recently due to covid-19, geopolitics and other factors, 'hard tech' investment deals have seen unprecedented growth and competition compared to investments in internet-related fields. The market slowdown and the rise of hard tech investments have increased the involvement of dispute resolution counsels and IP counsels in M&A transaction legal practice. The economic slowdown has resulted in more disputes between investors/purchasers and portfolio companies/sellers, which has resulted in more frequent appointments of dispute resolution counsels in M&A transactions, while the increase in hard tech investments has necessitated more in-depth IP and technology due diligence to be conducted by IP counsels.

Another reason for the slowdown of the private investment market is the delisting risk of Chinese companies listed in the United States, caused by disputes between China and the United

¹ Richard Pu is the joint general counsel at Tencent.

States on audit oversight cooperation. The recent execution of the agreement on audit oversight cooperation between the regulators of the two countries is a positive signal, but it is yet to be seen whether the implementation of the agreement will be satisfactory to both countries.

Amendments to the Anti-Monopoly Law and potential impacts on M&A transactions in China

On 24 June 2022, the Standing Committee of the National People's Congress of the People's Republic of China adopted an amendment to the Anti-Monopoly Law (the amended AML), which became effective on 1 August 2022. This is the first time that China's Anti-Monopoly Law has been amended since its introduction in 2008, marking a significant milestone in the development of China's antitrust law. Following the adoption of the amended AML, the State Administration for Market Regulation (SAMR, the Chinese antitrust authority) issued exposure drafts that propose to amend six of the AML implementing rules (the 'draft amendments'), which are designed to align with the amended AML.²

The changes to China's antitrust legal framework continue the trend of progressive enhancement of antitrust enforcement that began at the end of 2020. Alongside the global trend of increasing calls to rein in monopolistic practices, China's top policymakers vowed to 'strengthen anti-monopoly efforts and prevent disorderly expansion of capital'. Nevertheless, positive rhetoric has emerged recently, especially considering China's announcement to set up 'traffic lights' to give full play to the positive role of capital while effectively curbing its negative effects. This tone has also been reflected in the recent legislative developments. It is expected that the amended AML and the draft amendments will have a considerable impact on M&A transactions in China.

The first key takeaway is the regulator's determination to increase the review efficiency of merger control filings. For this purpose, the draft amendments propose to increase the current turnover thresholds for merger filings, which is expected to exempt certain transactions from filing obligations in China. The draft amendments also introduce a new provision on filing thresholds, proposing to capture 'transactions' initiated by large-scale enterprises.

Apart from the transactions of many leading Chinese companies, these new filing thresholds would also likely affect a number of transactions by large-scale international enterprises, such as leading private equity firms, investment companies associated with an established group, or leading industrial players with a significant presence in China, particularly their investments into or transactions involving China.

The changes to the filing thresholds are in line with the 'classified and graded' merger review mechanism introduced in the amended AML, which proposes to prioritise the review

2 These draft amendments include (1) the Rules of the State Council on the Notification Thresholds for Concentrations of Undertakings; (2) the Rules on the Review of Concentrations of Undertakings; (3) the Rules on Prohibition of Monopoly Agreements; (4) the Rules on Prohibition of Abuse of Dominance Conducts; (5) the Rules on Prohibition of the Conduct of Abusing Intellectual Property Rights to Eliminate or Restrict Competition; and (6) the Rules on Prohibition of the Conduct of Abusing Administrative Power to Eliminate or Restrict Competition.

of transactions in critical sectors concerning the national economy and people's livelihoods. Companies are advised to use extra caution to ensure compliance for transactions in these sectors.

Another aspect of the 'classified and graded' review mechanism is the delegation of merger review responsibilities to local antitrust regulators, namely the provincial counterparts of SAMR. This delegation seeks to alleviate SAMR's heavy workload due to the soaring number of filings and limited staff resources, which may lead to faster reviews in general. That said, efficiency and consistency of the local review remain to be monitored.

The second key takeaway is the increased scrutiny against gun-jumping (ie, failure to file before the closing of a notifiable transaction or closing before clearance is received). The amended AML raises the maximum fine applicable to gun-jumping significantly, thereby addressing the long-discussed concern, and is intended to deter gun-jumping. As a result, many companies have stepped up their compliance efforts in their transactions with respect to merger filing obligations.

Recent developments in national security review

Article 38 of the amended AML refers to the foreign investment national security review system for M&As initiated by foreign investors, which was streamlined by the Measures for the Security Review of Foreign Investments (the Security Review Measures) released by the National Development and Reform Commission (NDRC) and Ministry of Commerce on 19 December 2020. According to the Security Review Measures, the national security review mechanism may apply to a broad range of M&As in the form of foreign investments under the Foreign Investment Law of China. The scope of review is broad, including not only military and military related sectors, but also other sectors that are important to national security, such as 'important cultural products and services, important information technology and internet products and services and important financial services'. Currently, the authority responsible for national security review is a joint work mechanism with NDRC being the interfacing authority. National security reviews can be initiated both by filings submitted by the parties and by proactive investigations launched by NDRC. The national security review regime poses additional uncertainties to M&As in the form of foreign investments, as it theoretically could also capture M&As of Chinese companies or individuals made through their offshore entities.

Proposed amendments to the Company Law

A draft amendment to the Company Law (the Draft Amendment) was issued for public comments on 24 December 2021, which proposed to significantly amend a few key provisions of the current Company Law, such as provisions relating to a shareholder's right to information, corporate governance, process of equity transfer, etc. These proposed amendments, if adopted, would likely have a significant impact on the negotiation of M&A transactions in China.

The Draft Amendment extends the scope of information that a shareholder of a limited liability company is entitled to have access to, to now include, among others, accounting vouchers. It has long been unclear under the previous Company Law whether a shareholder is entitled to have access to the company's accounting vouchers in addition to the account reports and books of accounts. This proposed amendment in the Draft Amendment represents the balancing of a

minority shareholder's right to information while not overly burdening the company with disclosure requirements and protecting its interests.

The Draft Amendment also proposes to give companies more discretion when determining their corporate governance, which includes, among other things: (1) setting up an audit committee under its board of directors instead of appointing one or more supervisors or a board of supervisors; and (2) the scope of duties of the board of directors will be removed and the board of directors will be entitled to resolve any matters that are not reserved for the shareholders' meetings under the Company Law and the articles of association. On the other hand, the Draft Amendment would also require companies with more than 300 employees to have employee representatives elected by employees on the companies' boards. If the Draft Amendment is adopted, investors are advised to pay special attention to the corporate governance of invested companies when negotiating shareholders' agreements and articles of association.

The Draft Amendment further proposes to streamline the process of transferring equity to new shareholders. The Draft Amendment would remove the non-selling shareholders' consent right and further require non-selling shareholders to exercise their right of first refusal within 30 days after receipt of a written notice from the selling shareholder. As such, the Draft Amendment provides clearer guidance as to the exercise of the right of first refusal by other shareholders if the articles of association do not otherwise provide.

Other notable proposed amendments in the Draft Amendment include provisions concerning the legal duties of directors and joint liability for certain acquiring shareholders. The Draft Amendment would impose additional legal duties on directors. Directors may bear joint liability with the company if they cause damage to others intentionally or due to gross negligence while performing their duties. Directors may also be liable to the company if the directors fail to perform their duties in respect of the company's capital sufficiency. In addition, acquiring shareholders may bear joint liability with the selling shareholder if the selling shareholder fails to make its capital contribution in full as required, or if the actual value of any non-monetary property used for the capital contribution is lower than the amount of the capital contribution to which the shareholder is required to make and the acquiring shareholders knows or should have known of such circumstances.

The Ashe Draft Amendment is still in draft form; further changes are likely before it is formally adopted. Following its expected adoption, some M&A terms or common M&A practices in China may need to be adjusted accordingly.

Recent developments in data protection

The Cyberspace Administration of China (the CAC) issued the Measures for the Security Assessment of Outbound Data Transfer (the 'Assessment Measures') on 7 July 2022, which took effect on 1 September 2022. The Assessment Measures implement provisions on cross-border data transfers found in the Cybersecurity Law, the Data Security Law and the Personal Information Protection Law. The final version of the Assessment Measures generally conforms to an exposure draft previously released in October 2021, which proposed to stringently regulate cross-border data transfers. On 31 August 2022, the CAC further issued guidance relating to applications for security assessment, specifying the relevant application procedures and application materials.

According to the Assessment Measures, a CAC security assessment is required for outbound data transfers under certain circumstances, including (1) where a data handler exports 'important data'; (2) where a critical information infrastructure operator exports personal information; (3) where a data handler who has processed the personal information of at least 1 million individuals exports personal information; and (4) where a data handler exports personal information, and, since 1 January of the preceding year, this data handler has exported the personal information of at least 100,000 individuals, or sensitive personal information of at least 10,000 individuals.

The Assessment Measures have retroactive effect for cross-border data transfers conducted prior to 1 September 2022. Data handlers are entitled to a cure period of six months to rectify any non-compliance pertaining to China outbound data transfers.

Given this development, investors planning to invest in PRC companies with overseas businesses, such as companies in the fields of e-commerce, gaming and social media, are advised to carefully review the impact of the Assessment Measures on target companies when conducting due diligence.

In addition to the promulgation of the Assessment Measures, numerous new regulations and national standards have been released recently in relation to outbound transfer of data, including the Standard Contract Provisions on the Export of Personal Information (Draft for Comment), issued by the CAC on 30 June 2022, and the Technical Specifications for Certification of Personal Information Cross-Border Processing Activities, issued by the National Information Security Standardization Technical Committee on 24 June 2022. These regulations and standards are intended to implement key provisions of the Cybersecurity Law, the Data Security Law, and the Personal Information Protection Law related to cross-border data transfers and lay a foundation for future data protection enforcement.

Trends in legal due diligence in 'hard tech' field investments

The Chinese government has recently increased its support of 'hard tech' development, which has created unprecedentedly intense competition among investors in 'hard tech' fields such as semiconductors, artificial intelligence, life sciences, etc. Specifically, in this context, teachers in universities and researchers in research institutions (teachers and researchers) have been encouraged to commercialise their research findings. As a result, it has become increasingly common for teachers and researchers to launch start-ups that present attractive investment opportunities for investors. Teachers and researchers who hold equity in these start-ups and their holding of part-time or full-time positions in the start-ups are normally subject to various legal and regulatory restrictions as well as the internal rules of the universities and research institutions, most of which are state-owned. Therefore, during the legal due diligence investigation, investors should pay close attention to the legal compliance of the teachers' and researchers' shareholdings in and employment with the start-ups.

In China, teachers and researchers are obligated to comply with both national laws and regulations as well as internal rules of the universities or research institutions where the teachers and researchers are employed in relation to their shareholdings and the holding of part-time or full-time positions in a company. Critical aspects of these arrangements to review during legal due diligence include: (1) whether teachers or researchers are required to terminate their employment with their university or research institution in order to hold equity interests or part-time or full-time positions in a start-up (ie, those teachers and researchers taking

certain senior administrative positions in the universities or research institutions or those who are among the leadership of the Communist Party), or, if not required to do so, whether teachers' and researchers' holding of equity interests and part-time or full-time positions have been approved by the universities and research institutions in accordance with their internal rules; (2) whether any intellectual property owned by the universities and research institutions will be used in the business of the start-up and, if so, whether this intellectual property is contributed as paid-in capital, transferred or licensed (exclusive or non-exclusive) to the start-up and whether approval and other procedures for this contribution, transfer or licensing have been duly completed; (3) whether the start-up is dependent on the universities and research institutions in terms of business, assets, personnel and finance, and if the universities and research institutions hold equity interests in the start-up, what rights they have and whether these rights may affect the financing and operation of the start-up; (4) whether the teachers and researchers could breach non-compete obligations, non-disclosure obligations or rules regarding service invention of the universities and research institutions; (5) whether the technology of the start-up could infringe on the intellectual property of the universities and research institutions; and (6) whether there is any actual or threatened dispute with the universities and research institutions.

In addition, investors should also pay close attention to in-depth intellectual property due diligence (IP DD) in M&A transactions. Normally, a basic IP DD will focus on documentation and may review: (1) whether material intellectual properties used by the company have been properly registered or licensed and whether there are encumbrances or other third-party rights on the company's intellectual properties; (2) whether the founders and R&D personnel would breach any non-compete or non-disclosure obligations of their prior employers; and (3) whether there are pending or threatened claims for infringement. Recently, in investments in 'hard tech' fields, greater attention has been paid to real risks of key technologies, and thus in-depth IP DDs conducted by IP lawyers with relevant technology backgrounds have become more common. Sometimes, investors will also require a freedom to operate analysis for certain key technologies, which would normally cover an assessment of (1) the likelihood that an intellectual property will be successfully registered and the likelihood that a granted intellectual property would be invalidated; (2) whether the patents correspond to the company's own products and the products of its competitors and analysis on the overall situation of its patents and its position in the industry; and (3) whether a technology will infringe upon others' patent rights if the technology or product already exists on the market.

Dispute resolution

The number and complexity of dispute resolution issues related to M&A activities in China have gradually trended upwards with the further development of M&A activities in China in recent years, especially with the continued impact of the covid-19 pandemic and the increase in investors' withdrawal needs. As a result, the dispute resolution services of law firms and other intermediary service providers have gained more and more attention, and even some large group enterprises, investment banks, and private equity institutions have begun to set up or expand their own dispute resolution and compliance teams to respond to these changes.

The most typical and contentious disputes relating to M&A activities arise during the investment withdrawal stage, such as redemption disputes or compensation disputes that are triggered by a failure to realise promised company profits or qualified initial public offerings (IPOs),

as well as disputes among investors arising out of a failure to realise expected returns on investment (eg, limited partners filing a lawsuit against the general partner due to the general partner's failure to be diligent and responsible). In addition, dispute resolution matters related to M&A also cover common disputes such as disputes arising from breaches of investment agreements, investors' right to know, and company dissolution, etc.

Drafting dispute resolution clauses is often the first issue to consider for M&A-related dispute resolution, and foremost is the choice of forum, whether it be for arbitration or litigation. It is important to note that, in addition to the inherent differences between arbitration and litigation regarding confidentiality, efficiency and decision-making mechanisms, there are also some key differences between the two approaches in terms of ruling on substantive issues, particularly as the law in mainland China continues to develop and the dispute issues related to M&A become more and more nuanced and complex. For example, an arbitral tribunal is more likely to respect original contractual agreements, while a court may try to strike a balance between the legal and societal consequences of their judgments and thus may give greater weight to principles of equity rather than be constrained by contractual agreements. In addition, on some especially controversial issues, a judge will typically follow the internal guidelines and precedents issued by a higher court, while an arbitral tribunal is not legally bound by these court guidelines and precedents, thus may follow different criteria and reach a different conclusion on the same issue in different cases. Therefore, it is necessary for relevant parties in M&A transactions to pay attention to such procedural and substantive differences between litigation and arbitration.

Revisions of laws and judicial interpretations is also a key legal concern in M&A activities. In recent years, Chinese laws and judicial interpretations have been revised more frequently in response to difficult issues arising from commercial dispute cases. Revision of the corresponding laws and judicial interpretations often has a direct and significant impact on dispute cases related to M&A. For example, the Law on Civil Enforcement (Draft), which was first submitted to the meeting of the Standing Committee of the National People's Congress for deliberation on 21 June 2022, is worth monitoring as it involves comprehensive rules regarding enforcement procedures, which is an important stage of dispute resolution.

Recent developments in Chinese companies' overseas listings

IPOs in the United States have been an important exit strategy for investors in Chinese companies. However, due to delisting risks caused by disputes between China and the United States on audit oversight cooperation, many Chinese companies listed in the United States have, or are in the process of, conducting secondary or dual primary listings in Hong Kong, and some are also considering listings in Singapore. An increasing number of private companies are considering Singapore as a potential listing venue in their transaction documents with investors, in addition to the United States, mainland China and Hong Kong.

On 26 August 2022, the China Securities Regulatory Commission (CSRC) announced the signing of an agreement between the CSRC, the Ministry of Finance of the PRC and the Public Company Accounting Oversight Board of the United States (PCAOB) regarding the audit oversight cooperation. This agreement is a breakthrough in resolving the audit oversight issue, which have caused concerns for more than a decade. However, the signing of this agreement is merely one step in resolving the issue. It is yet to be seen whether the implementation of the agreement will be satisfactory to both countries.

1

Introduction to dispute resolution in equity financing transactions

Yiqing Zhuang and Jie Shen¹

Summary

Equity financing transactions and post-deal management usually involve multiple parties, including founders, the target company, several rounds of investors, and the management team. Disputes may arise due to factors such as misaligned interests and conflicting interpretations of clauses in financing documents. This article aims to introduce typical scenarios where disputes may arise and related dispute resolution methods, including litigation and arbitration.

Common types of disputes in equity financing transactions

Disputes arising from breach of representations and warranties, post-closing covenants

In the course of an equity investment, the target company and its founders are usually required to make representations and warranties on certain matters of the target company, such as ownership of the target company's assets, the target company's financial performance, and the target company's compliant operations. Post-closing covenants will include matters that cannot be completed before closing or ongoing matters that should continue after closing.

If the target company or founder makes a misrepresentation or fails to honor a post-closing covenant, liquidated damages or other liabilities may result. Parties may agree in the financing documents on liquidated damages or on an indemnification clause that provides for the causes and scope of any potential indemnity. Under PRC law, absent such agreed terms, the non-breaching party will need to provide proof of its losses and establish causation when seeking damages against the breaching party. In addition, if the target company fulfils the monetary compensation liability to the investor under such scenario, there is a potential self-compensation issue for the investor as it is also an existing shareholder of the target company, which means

¹ Yiqing Zhuang and Jie Shen are senior legal counsel at Tencent.

there might be some potential risks for the investor's recovery from the target company as it might conflict with the interests of the target company's creditors (especially when the target company becomes insolvent).

Redemption disputes

A redemption clause protects an investor's investment principal and its bottom-line desired investment return. Investors require these clauses mainly out of their concern that the target company's shares could be relatively illiquid due to its failure to complete an initial public offering in a certain time frame or the target company or founder have made some material misstatements regarding the company's prospects. After an investor exercises its redemption right, the target company or the founder are usually required to pay an amount that equals investment principal plus a certain premium. Redemption may be one of the most common scenarios where a dispute will arise due to its wide usage in the venture capital investment in China and low success rate of a portfolio company's IPO. Parties may argue whether a redemption right is triggered, how much the target company is required to pay under the redemption clause, or how to allocate among exercising investors in case of insufficient funds.

Information rights disputes

Information rights are generally provided under PRC company law and information rights clauses in financing documents. Statutory information rights enable investors to access the target company's resolutions, board meeting minutes, articles, and financial reports, etc, while contractual information rights enable investors to obtain financial or operation information from the target company on a periodic basis and the right to arrange to inspect the site of the target company. The target company, out of various concerns, may refuse to provide certain books and records to its investors and, in some extreme cases, investors may excessively exercise their information rights to visit the site of the target company and disturb the target company's business operations. Under certain cases, the investors may take advantage of exercising the information rights to collect relevant evidence for preparation of potential dispute between investor and the target company or transfer its shares in the target company. Investors are also subject to a confidentiality obligation for the information or materials received under information rights and forbidden to distribute it to third parties without the company's consent.

Disputes over corporate governance and investors' reserved matters

Investors tend to retain certain veto rights over major decisions by the target company, such as opening a new business line, disposal of core assets and amending the target company's articles. Investor veto rights are realised by listing a series of major actions by the target company that require a vote by an investor or a group of investors at the general meeting of shareholders, or a vote by a director nominated by an investor at the board level. Disputes are likely to arise where a target company takes certain actions without a proper shareholder resolution or board resolution or where a resolution is passed without proper investor participation.

Liquidation preference in a trade sale or target company's dissolution and liquidation

In case of a trade sale or a dissolution of the target company, investors are likely to invoke their liquidation preference right to allocate the sale or liquidation proceeds based on the allocation

method provided for in the financing documents. Liquidation preference rights give rise to disagreements among investors or between investors and founders because these rights are usually exercised in the 'final days' of the target company and it is unlikely the target company can generate further proceeds other than through a trade sale or liquidation. Rigid compliance of the liquidation preference clause may largely frustrate or curb the founders' willingness to maximise the company value or its prospect due to their disproportionate low return from the trade sale, and in some cases, it may also dampen early round investors' enthusiasm from the exit.

Comparing litigation and arbitration in terms of dispute resolution

Choosing between a court jurisdiction clause or an arbitration clause is often an important issue to consider in drafting an agreement. In addition to the general differences between the two resolution methods as to confidentiality, efficiency and decision-making mechanisms, the two methods may lead to different outcomes on certain substantive legal issues as judicial practices in mainland China continue to develop and the issues in dispute related to equity financing transactions become more and more subtle and complex. Therefore, it is necessary to have a better understanding of the above-mentioned procedural and substantive differences between litigation and arbitration to make an informed choice of dispute resolution method.

Procedure

Procedural differences exist between litigation and arbitration. Generally, litigation proceedings are conducted in two instances and the parties even have the right to request a retrial after the second-instance judgment is issued. Arbitral proceedings only have one instance and there is no appellate or retrial procedure. From the perspective of efficiency, arbitration is more efficient than litigation and is usually the preferred choice of investors.

Jurisdiction

There are complicated rules for determining which court has jurisdiction over a litigation case, and often parties in disputes would spend huge energy and resources to fight for the appropriate competent court. It is necessary to determine the court that has jurisdiction according to the types of the case and monetary amount claimed as well as whether there is any agreement on jurisdiction. When the parties have not agreed on which court has jurisdiction, the court located at the defendant's domicile or the place where the contract is performed usually has jurisdiction.

The jurisdiction of an arbitral institution is preconditioned on the parties expressly agreeing to arbitrate in that forum. Such agreements cannot contain any ambiguity regarding which arbitral institution is referenced. Otherwise, the entire arbitration clause could be considered invalid. In such cases, the dispute will be settled by the court with jurisdiction.

Preservation

Parties may apply for interim measures in both litigation and arbitration proceedings.

Litigation has more advantages than arbitration in terms of preservation measures. The advantage is that, in litigation, the judge in charge of hearing the case is usually also responsible for preservation, which might speed up the preservation process. Moreover, the judge will generally agree to deliver the complaint and other materials to the defendant after the preservation measures have been imposed, which reduces the risk that the defendant will transfer his or her property after being sued.

In arbitration, the preservation process is slower because arbitral institutions are unable to carry out preservation themselves; they need to transfer the preservation request to a court with jurisdiction. In this process, some arbitral institutions may not wait for the outcome of preservation by court and continue to advance their arbitral proceedings at the same time, which increases the risk that the preservation measures might be unsuccessful because the respondent has a chance to dissipate or hide its assets after receipt of the arbitration notice.

Decision-making mechanism

Litigation cases are generally decided by a sole judge or jointly by several members of a collegiate bench depending on different case scenarios. For complicated and controversial cases, the collegiate bench may submit the case to its internal judges' meeting or judicial committee for discussion and decision. The final decision of court judgment reflects the will of the judicial system rather than the individual judge.

Generally, the parties to an arbitration may select the decision-making mechanism for the case, which is usually either a sole arbitrator or three joint arbitrators. In cases where there are three arbitrators, the claimant and the respondent both have the right to appoint a co-arbitrator, and the presiding arbitrator is usually designated by the arbitral institution. When there is a disagreement among the arbitrators, the opinion of the majority arbitrators or the presiding arbitrator may be the basis for the final decision. Therefore, the final decision of arbitral award normally reflects the will of the arbitrator(s) rather than the institution.

Remedies

Litigation proceedings usually cover two instances of trials and a possible retrial supervision procedure. Therefore, any party who is not satisfied with the result of a trial may appeal to the higher-level court or apply for retrial after the second instance.

Arbitration cases usually follow the 'one award is final' rule. As such, if a party is not satisfied with an arbitral award, it has no right to appeal and can only apply for revocation of the arbitral award or to not enforce the arbitral award when there are material flaws in the arbitral proceedings. However, this judicial supervision mechanism is strictly limited to the supervision of procedural issues only, rather than the merits of the case.

Confidentiality

Litigation cases are generally heard by the court in public and, in principle, effective judgments are also made public. By contrast, arbitral tribunals hear cases and render awards in a private and confidential manner. In practice, confidentiality is a major reason why many parties choose arbitration.

Differences in adjudicating certain substantive legal issues

As judicial practice develops, it is worth noting the tendency for there to be differences in how certain substantive legal issues are adjudicated in litigation and arbitration. For example, for liquidated damages, courts tend to take a conservative view and generally adjust liquidated damages based on actual losses. By contrast, arbitral tribunals are more likely to respect the calculation method or number of damages pre-agreed upon by the parties to show respect to the spirit of the contract.

In another example, with respect to redemption disputes, according to the provisions of the internal guidance released by the Supreme Court, in litigation cases, courts generally tend to favour arrangements in which the shareholder is the redeemer, and do not support requests for the target company as redeemer unless it has completed the capital reduction procedures in advance. In arbitration cases, while arbitrators may refer to the judicial opinions in such guidance, they are not obligated to strictly follow such judicial guidance, and as a result, there is a possibility (though not high) that the arbitral tribunal may support the request by investor that the target company shall fulfil redemption obligations without requesting any preconditions, (ie, capital reduction).

In another example, court judgments and arbitral awards tend to differ in deciding whether joint and several liability should be imposed in cases where multiple founders are subject to the same redemption obligation in the absence of a more specified agreement on the share of such liability among the founders. In litigation cases, there is no consensus on this issue among the courts; it can be on a pro rata basis or a joint and several liability basis. However, in most arbitration cases, the tribunals hold that joint and several liability applies.

Feasibility and convenience of cross-border assistance and recognition

Litigation

Litigation is an act of the state to settle disputes by exercising its power. Therefore, service of legal documents and collection of evidence in litigation must be proceeded in accordance with the law. According to the Civil Procedure Law, a PRC court and a foreign court can, pursuant to international treaties concluded or the principle of reciprocity, request each other to serve legal documents, collect evidence and conduct other litigation actions in its own territory on the foreign country's behalf. The judicial assistance is based on provisions of the relevant treaties; in the absence of such treaty, the assistance must resort to diplomatic channels. The matter under request for judicial assistance shall not impair China's sovereignty, security, or social and public interests. Otherwise, the PRC court has the power to refuse this request.

The main applicable international treaty is the 1965 Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters. The core of the Convention is to regulate the methods of service by a central authority. A contracting state will designate a central authority to take the responsibility of receiving the requests for service from other contracting states and arranging for service within China, and sending requests to other contracting states for service outside China by its own judicial authorities. China has designated the Ministry of Justice as its central authority. The procedure of service by the central authority is relatively complicated and takes a relatively long time. For example, a foreign judgment to be served on a Chinese party needs to be forwarded by the relevant foreign court, the foreign country's embassy or consulate, the Ministry of Justice, the Supreme People's Court, and other relevant people's courts. Nevertheless, China basically makes reservation for other alternative service methods stipulated in the Convention, such as the service by mail.

In respect of the investigation and collection of evidence, according to the Civil Procedure Law, except that foreign embassies and consulates in China have the right to investigate and collect evidence from their own citizens, no foreign institute or individual may conduct investigations or collect evidence in China.

As for the recognition and enforcement of a foreign judgment, according to the Civil Procedure Law, the party or the court which has made the judgment may apply to the relevant

foreign court for recognition and enforcement according to the international treaty or the principle of reciprocity. When reviewing a foreign judgment, a court tends to apply a stricter standard of substantive review. Moreover, according to the Civil Procedure Law and relevant judicial interpretations, a foreign judgment, in order to be recognised and enforced in China, needs to meet relevant conditions including but not limited to: (1) the applicant has submitted proof of lawful summons for the default judgment; (2) the content of the foreign judgment does not violate China's public interests or sovereign interests; and (3) the case is not subject to the exclusive jurisdiction of China.

In 2019, dozens of countries, including China, ratified the Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, which adopts the principle of 'non-substantive review'. So far, six countries/regions (including the United States) have signed the Convention, but China has not signed it, and the conditions for the Convention's entry into force have not been met.

In addition, according to the Minutes of the National Court Symposium on Foreign-Related Commercial and Maritime Trial Work (2022), preservation rulings and other procedural legal documents made by foreign courts are not 'judgments or rulings' that can be recognised and enforced as provided in the Civil Procedure Law.

Arbitration

In contrast to litigation, arbitration is a remedy provided by non-governmental institutions by exercising non-public power, which is based on the parties' will and consent. Arbitration rules also significantly reflect the will and autonomy of the parties.

As for service, the non-public nature of arbitral institutions makes it difficult to serve notices by use of public power. According to current judicial practice, the validity of service in arbitration shall be judged in accordance with the rules of the arbitral institution and the laws of the seat of arbitration.

As for evidence collection in international arbitration, it mainly relies on the document discovery procedure. The procedure and the scope of document discovery are determined by the parties' arbitration agreement and the discretion of the arbitral tribunal. The arbitration rules of major international arbitral institutions explicitly permit the arbitral tribunal to order the parties to disclose documents and other materials during the course of evidence collection. Therefore, the parties can first agree on the document disclosure in the arbitration agreement or during the arbitral proceedings. If the parties fail to reach such agreement, the arbitral tribunal, upon the request, has the power to decide whether, when, and how to conduct the document disclosure. Where the responding party fails to produce the documents ordered by the arbitral tribunal and fails to object to the request for disclosure, or give reasonable explanations, in a timely manner, the arbitral tribunal may make adverse inference and presume that the documents requested to be produced but not produced are disadvantageous to the requested party, or even that the documents not produced are identical to what the requesting party claims.

As for the recognition and enforcement of foreign arbitral awards, the major current convention is the Convention on the Recognition and Enforcement of Foreign Arbitral Awards in 1958 (the 'New York Convention'). China joined the New York Convention in 1986 and become bound by the same in 1987. According to the New York Convention, a court can refuse recognition and enforcement of a foreign arbitral award only under special circumstances such as (1) the arbitration agreement is invalid; (2) the arbitral award exceeds the scope of the arbitration agreement;

(3) the respondent was not given notice of, or failed to make submissions to, the arbitrators or the arbitral proceedings; or (4) the constitution of the arbitral tribunal or the arbitral proceedings did not comply with the arbitration rules. According to article 2 of the Provisions of the Supreme People's Court on Issues Concerning the Reporting of Cases Involving Judicial Review of Arbitration for Examination and Approval, if a Chinese court intends to refuse recognition of a foreign arbitral award, it must report the decision to the High People's Court and the Supreme People's Court successively. Only after examination and approval by the Supreme People's Court will the decision not to recognise come into effect.

Interim measures issued by a foreign arbitral tribunal are generally considered not final and are therefore unenforceable by the people's courts. An exception to this is the Arrangement on Mutual Assistance in Court-Ordered Interim Measures in Arbitral Proceedings between the Courts of the Mainland and the Hong Kong Special Administrative Region (the Arrangement) concluded between mainland China and Hong Kong in 2019. Pursuant to the Arrangement, a party to arbitral proceedings in either mainland China or Hong Kong may apply for interim measures to the competent court in the other jurisdiction. If the requested court deems the application consistent with the law, it will issue a ruling or order for preservation.

Feasibility of choosing a foreign court or arbitral institution

Litigation

Chinese courts apply the principle of *lex fori* when reviewing the validity of a jurisdiction clause.

According to the Civil Procedure Law and its judicial interpretations, the parties to a dispute arising from a foreign-related contract or other property rights and interests may select a foreign court in the place which is actually associated with such dispute, such as the place where the defendant resides, the place where the contract is performed, the place where the contract is signed, the place where the plaintiff resides, the place where the subject matter is located, or the place where the infringement is committed, unless such dispute falls within the exclusive jurisdiction of the PRC courts (involving real property in China, Sino-foreign equity/contractual joint venture contract, or Chinese ports or sea areas).

Chinese courts will generally presume the exclusivity of a foreign jurisdiction designated in a foreign-related contract unless the contract expressly provides that jurisdiction is non-exclusive. Chinese courts will also generally recognise the validity of asymmetrical jurisdiction clauses, whereby one party may select from among multiple jurisdictions and the other party may select only one jurisdiction; however, Chinese courts may rule that these clauses are invalid where they involve consumers' rights or labour rights or violate the exclusive jurisdiction provisions of the Civil Procedure Law.

In addition, the Convention on the Choice of Courts Agreement, which China participated in the negotiation and discussion of, officially took effect on 1 October 2015. China signed the Convention in 2017, but it has not yet been ratified domestically.

Arbitration

The parties select an arbitral institution by entering into an arbitration agreement or clause, which is considered 'party autonomy'. However, judicial practice generally takes a negative attitude towards referring a non-foreign-related contract to an offshore arbitral institution for arbitration or ad hoc arbitration outside China, although there are no express legal provisions in China on this point.

Notably, there are exceptions to the general practice above. For example, wholly foreign-owned enterprises registered in the China (Shanghai) Pilot Free Trade Zone may validly agree to arbitrate commercial disputes outside mainland China and even if the dispute has no foreign-related factors, according to the Opinions of the Supreme People's Court on Providing Judicial Guarantee for the Development of Free Trade Zones (2016) (the 'Opinions'). The Opinions also provide that a wholly foreign-owned enterprise registered in the China (Shanghai) Pilot Free Trade Zone and a domestic enterprise registered outside the zone may agree to arbitrate commercial disputes offshore and that neither party may dispute the validity of a subsequent award, provided that the claimant voluntarily requested the offshore arbitration and the respondent raised no objection to the validity of the arbitration agreement.

Other ways of relief for resolving disputes

Sending attorney letters or official notification

In general dispute resolution cases, before resorting to formal litigation or arbitration proceedings, the parties can send attorney letters or official notification to the counterparty regarding the issues in dispute. The purpose of this letter is twofold: to fulfil the requirement of negotiation period that may exist in the contract and to temporarily suspend the statute of limitations period. In disputes relating to equity financing transactions, if the conflict is not serious, sending attorney letters or official letters may also bring some pressure on the counterparty, forcing it to consider the possibility of reconciliation and avoid unnecessary burden and cost incurred by potential litigation and arbitration. Timely delivery of such notification may also protect the party against the downside of the waiver and estoppel rule, though it is not fully admitted by PRC law yet.

Preservation

In litigation or arbitration, outside trial proceedings, the plaintiff or the claimant can usually apply for preservation against the property or specific acts of the counterparty. Depending on whether the preservation application is made before or during litigation or arbitration, there are two types of preservation: pre-litigation preservation and in-litigation preservation. In practice, since the judicial authorities' request for pre-litigation preservation is relatively strict (the pre-litigation preservation often only applies under special and highly urgent circumstances), the parties generally choose to file the preservation application together with the filing of a lawsuit or application for arbitration. Notably, the applicants generally have to provide a corresponding guarantee in accordance with the requirements of the court against the potential liabilities incurred by maliciously abusing the right of preservation.

Special remedy procedures

In addition to litigation and arbitration, the methods for dispute resolution also include some special alternative dispute resolution procedures, which often have the advantage of high efficiency and low cost, but the feasibility of which is often subject to certain conditions. For example, for cases concerning security interests, there is an expedited legal procedure to realise such rights. This procedure does not require a substantive trial and, if certain requirements are met, the court can directly decide to auction or sell the secured property. However, this procedure is subject to the precondition that there is no material dispute between parties on the

realisation of security interests. This procedure is mostly used in disputes where the bank acts as security holder.

For another example, for debt collection cases, there is a special legal procedure to expedite the payment. The applicant may use this procedure to apply to the court to issue a payment order to the debtor. If the debtor fails to raise any substantive objection within the statutory time limit, the payment order will become enforceable without further hearings. However, in case any substantive objection is raised, the payment order will be invalidated immediately. This procedure is mostly used in cases where the amount in dispute is small, such as credit card debts collection.

Mediation

Mediation procedures are efficient in resolving disputes. In litigation and arbitral proceedings, the court and the arbitral tribunal will also inquire of the parties about the possibility of mediation before moving on to the hearing phase. For the judge and the tribunal, mediation is the ideal way to resolve a case expeditiously, so the judge and the tribunal have an incentive to coordinate among the parties for a settlement solution. In addition to an enforceable civil mediation, part of the court acceptance fee or arbitration fee can be refunded as well. In disputes relating to equity financing transactions, if the facts involved in the disputes are clear and definite, the parties may consider closing the cases by mediation to save time and costs.

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Key considerations for shareholders of private companies in China to protect their information rights

Jushan Wang and Yufei Wang¹

Introduction

In M&A transactions, when negotiating transaction documents, investors tend to focus more on economic rights and clauses which have more direct impacts on their control over the company, such as the shareholders' reserved matters and board composition, and may not spend much time on the negotiation of information rights clauses. The rights to obtain and inspect information and documents in relation to the management, business and finance of a company lay down the foundation for a shareholder to protect its interests in the company and exercise its economic and other control rights as a shareholder. The information rights are particularly important to those shareholders (typically, minority shareholders and financial investors) who have relatively limited involvement in the daily operation and management of the company they have invested in.

Although many investors are aware of the importance of the information rights of shareholders, in practice they may tend to rely on the 'standard wording' of the information rights clause in their transaction documents, which may be drafted based on laws of a jurisdiction that is different from the one governing their current transaction, or merely rely on the statutory information rights under company laws of the current jurisdiction. Although the statutory rights provide a certain level of protection to the shareholders, without provisions in the articles of association of the company or the shareholders' agreements setting out detailed requirements in respect of the information they are entitled to obtain from the company, the shareholders may still find it difficult to enforce their information rights in practice.

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Key considerations for shareholders of private companies in China to protect their information rights

In China,² the information rights of shareholders are protected as statutory rights under the PRC Company Law (the Company Law) – article 33 of the Company Law (article 33) for information rights of shareholders of limited liability companies and article 97 for those rights of shareholders of companies limited by shares.³ The Supreme People’s Court of China (the Supreme Court), which is the highest court in China, further sets out interpretations of certain key issues in relation to disputes over the shareholders’ information rights in the Provisions on Some Issues Relating to Application of the PRC Company Law (IV) (the Company Law Application Provisions IV).⁴

In this article, we will discuss, based on our observations on previous court decisions,⁵ the following issues in respect of the shareholders’ information rights that investors in China usually dispute with the companies they have invested in:

- the type and scope of information a shareholder has the right to inspect and make copies of; and
- what constitutes an improper purpose based on which the company may reject the shareholder’s request to inspect the accounting books.

Statutory information rights under article 33

Article 33 consists of two paragraphs. The first paragraph sets out the documents of a company that a shareholder has the right to inspect and make copies of, which are as follows:

- articles of association;
- minutes of the shareholders’ meeting;
- resolutions of the board;
- resolutions of the supervisor or supervisors; and
- financial accounting reports.

The second paragraph of article 33 deals with a shareholder’s rights to have access to the company’s accounting books – a shareholder may also request to inspect the accounting books of the company if the following two conditions are met: (1) procedurally, the shareholder should make a written request to the company setting out reasons for the request; and (2) the company is reasonably satisfied that such request is not made for improper purposes. If the company has reasonable grounds to believe that such request of its shareholder is made for improper purposes and may harm the company’s legitimate interests, it may reject the request by replying to the shareholder in writing setting out the reasons within 15 days of receipt of the request. These requirements limit the shareholder’s information rights for the purpose of protecting the

2 For the purpose of this article only, China or PRC means mainland China and excludes the Hong Kong SAR, the Macao SAR and Taiwan.

3 For the purpose of this article, we will focus on the information rights of a shareholder of a limited liability company only, given that most of the private companies that investors invest in take the form of a limited liability company.

4 Issued on 5 December 2016 and effective from 1 September 2017.

5 Please note that China is not a case law jurisdiction, where decisions previously made by a PRC court do not have the same level of effect as precedents as those in a case law jurisdiction.

company's trade secrets and preventing malicious intervention to the company's normal business operation.

Article 33 is only intended to cover the fundamental information of a company that a shareholder has the right to inspect. In practice, a shareholder usually needs more information to get a more comprehensive picture of the business operations and financial status of the company it has invested in. In the next section below, we will discuss the types of information that usually gives rise to disputes between shareholders and companies, and solutions commonly adopted in practice. We will then discuss, based on the analysis of a number of court decisions, the defence of improper purpose of the shareholder that the company can use to protect its interests.

Types and scope of information – common issues

Accounting vouchers – whether within the scope for inspection?

The accounting vouchers include the original receipts, invoices, VAT invoices, etc, that provide the underlying information based on which the accounting books and financial accounting reports are drawn up. Where the shareholders have doubts in the accounting books or financial accounting reports of the company and would like to verify or audit the accuracy of certain numbers or entries, they would need to inspect the original accounting vouchers.

Due to the accounting nature of the vouchers, many investors tend to think the vouchers are part of the accounting books or financial accounting reports, and therefore should fall within the scope of the documents that article 33 entitles them to inspect. In their disputes with the companies, the legal ground that the shareholders usually rely on is article 15 of the PRC Accounting Law (the Accounting Law), pursuant to which the accounting vouchers are the basis and evidence based on which the accounting books are drawn up. In the absence of specific information rights clauses in the transaction documents covering the accounting vouchers, the defence that a company would usually use is that these documents are not specified under article 33 as documents that a shareholder has a statutory right to inspect.

The views of the people's courts on whether the shareholders should be allowed to inspect the original accounting vouchers vary on a case-by-case basis. In their judgments on disputes over the information rights in respect of original accounting vouchers, some courts have supported the shareholders' requests to inspect the original accounting vouchers on the ground that the shareholders in question would not be able to verify the information in the accounting books or financial accounting reports if they cannot inspect the accounting vouchers. The High People's Courts of certain cities and provinces, (eg, Beijing, Guangdong and Shandong) tend to support the view that the original accounting vouchers are part of the accounting books – which are illustrated in their respective guidance notes.⁶ However, the Supreme Court confirmed its view in its decision dated 26 March 2020 on a dispute relating to the information rights

⁶ Article 19 of Guidance of the High People's Court of Beijing on Some Issues Relating to the Trial of Company Dispute Cases (issued on and effective from 21 April 2008); article 3, section 9 of the Responses of the Second Civil Division of the High People's Court of Guangdong Province on Complex Legal Issues in the Trial Practice of Civil and Commercial Matters (issued on and effective from 7 March 2012); and Response to Question 10 of the Responses of the Second Civil Division of the High People's Court of Shandong Province on Some Issues relating to the Trial of Company Dispute Cases (issued on and effective from 17 July 2018).

of shareholders⁷ that accounting books do not include the original vouchers or accounting vouchers, on the ground that these documents are not part of the accounting books in accordance with the Accounting Law. The Supreme Court further emphasised in its decision that (1) a balance should be struck between the protection of the information rights of shareholders and the protection of the interests of the company, and therefore the scope of the information rights of shareholders should not be interpreted expansively; and (2) the Guidance of the High People's Court of Beijing on Some Issues Relating to the Trial of Company Dispute Cases does not have the effect of judicial interpretation.

After the Supreme Court handed down this important decision, certain courts (eg, Beijing Intermediate People's Courts)⁸ have changed their views and rejected the request of the shareholders to inspect the original accounting vouchers. However, this approach is not followed by all courts. Some courts (eg, Shanghai No. 1 Intermediate People's Court and People's Court of Siming District, Xiamen) upheld certain minority shareholders' requests to inspect the accounting vouchers,⁹ on the grounds that the accuracy and completeness of the accounting books of the company can only be verified by the accounting vouchers, and therefore, without the right to inspect such documents, the shareholders' interests will not be substantially protected.

That said, a draft revised Company Law issued for public comments on 24 December 2021 extends the scope of information to include accounting vouchers, and the right to inspect the accounting vouchers is subject to the same requirements as those currently applicable to the right to inspect the accounting books. We expect that the draft, if being adopted in its current version, would solve this long unresolved issue. However, this also means that the current provision of the existing Company Law is more likely to be interpreted as not including accounting vouchers.

Considering the different views of the people's courts on this issue, at least before the amendment of the Company Law, it is advisable for the shareholders to specifically have provisions in the shareholders' agreement and the articles of association of the company ensuring that the company should provide copies of the accounting vouchers to the shareholders or anyone designated by the shareholders at the reasonable requests of the shareholders.

Financial accounting reports – are they detailed enough?

A shareholder has the statutory right under article 33 to inspect and make copies of the financial accounting reports of a company. In accordance with article 20 of the Accounting Law, a financial accounting report consists of financial statements, notes to financial statements and financial fact sheets. In accordance with article 44 of the PRC Enterprise Accounting Guidelines – Basic Guidelines,¹⁰ a financial statement should at least include a balance sheet, an income statement and a cash flow statement. Article 44 further allows small-scale enterprises not to include cash flow statements in their financial statements.

A shareholder without the right to appoint a director would usually have to rely on the financial accounting reports to understand the financial status of the company, and therefore

7 [2019] Zui Gao Fa Min Shen No.6815.

8 [2020] Jing 03 Min Zhong No. 10087 and [2022] Jing 02 Min Zhong No. 6371.

9 [2020] Hu 01 Min Zhong No. 3559 and [2020] Min 0203 Min Chu No. 4844.

10 Effective from 1 January 2007, as amended on 23 July 2014.

it is important to ensure the form and contents of the financial accounting report are to its satisfaction. During the financial due diligence process, a new investor should be able to get a basic understanding about the form and contents of the financial accounting reports of the target company and the frequency (monthly, quarterly, half-yearly, etc) of its financial accounting reports including the various financial statements. The accounting rules and standards in respect of the form and contents of the financial statements vary in different jurisdictions. The investor should consider whether these financial statements which form part of the financial accounting reports of the company are sufficient for it to understand the financial status of the company in the future. If the investor has any specific requirements (eg, working capital statements and management accounts) in addition to the compulsory contents required by law or the frequency that this information should be provided, or both, to avoid disputes in this respect, it is advisable to specify those specific requirements in the shareholders' agreement and the articles of association of the company.

Information regarding subsidiaries of the company – is it the proper scope?

Article 33 covers the information rights of a 'direct' shareholder of a company and it does not extend to the information in relation to the subsidiaries of the company. If the potential target company already has subsidiaries or if can be foreseen that the potential target company will have subsidiaries in the future, experienced investors would usually expand their information rights to cover the subsidiaries of the company by specifying the rights in the articles of association of the company.

Shanghai No. 2 Intermediate People's Court upheld this approach in its judgment on a matter where the shareholder claimed that its information rights under the articles of association of the company covered various financial and corporate governance documents of both the company and its subsidiaries, while the company defended that the statutory information rights (with narrower scope) should prevail.¹¹ The court confirmed in its judgment that the articles of association of a company were a constitutional document of the company, and to the extent they did not violate mandatory provisions of laws, the provisions of the articles of association should be upheld. In the high-profile dispute between Zhengongfu restaurants and its shareholder Dabiao Cai in relation to the shareholder's information rights,¹² the Guangzhou Intermediate People's Court also upheld the shareholder's request for wider scope of information of the company, which was specifically set out in the articles of association of the defendant company.

In the abovementioned matter in Shanghai, the court further pointed out that the term 'subsidiary' was not defined in the articles of association of the company, and the parties to the claim failed to agree on the scope of the subsidiaries of the company. In order not to affect the rights of other shareholders of the subsidiaries of the company, for the purpose of such dispute, the court set the scope to only cover the wholly owned subsidiaries of the company. In transaction documents, a 'subsidiary' or a 'group company' is usually a defined term covering subsidiaries of the company by certain shareholding percentage or by other form of control. When reviewing the information rights clauses, the investors should also consider whether the proper scope of subsidiaries is covered.

11 [2013] Hu Er Zhong Min Si (Shang) Zhong Zi No. 51264.

12 [2017] Yue 01 Min Zhong No. 5896.

Accounting books – inspection only or making copies?

In accordance with article 33, a shareholder may require to inspect the accounting books, but article 33 does not mention making copies of the accounting books. From the perspective of a shareholder requiring access to the accounting books, it would be impractical if it is not allowed to make copies, as its team would not be able to memorise all the information by merely reviewing the documents.

To avoid future disputes with the company on this technical point, it is advisable for the investors to include wording in the articles of association of the company to ensure that the company should provide copies of documents (including the accounting books) reasonably required by the shareholders.

Company's defence – improper purposes of the shareholder

In accordance with article 15 of the Accounting Law, accounting books of a company consist of the general ledger, the subsidiary ledger, the cash journal and other ancillary ledgers. The accounting books contain business and financial information of the company which is sensitive and confidential – making access to the accounting books a double-edged sword. The books contain information that is crucial for the shareholder to understand the business status of the company it has invested in, but such information if being misused by the shareholder could also harm the interests of the company, and indirectly the interests of the other shareholders.

Therefore, article 33 sets higher requirements to the shareholders for the inspection of the accounting books of the company by giving the company a chance to assess the intention of the shareholders (by reviewing their written requests) and the right to reject the request if it has reasonable grounds to believe that this request is made for improper purposes, which may cause damages to the legitimate interests of the company. Where the company rejects the request, the shareholder may apply to a people's court for the access to the company's accounting books.

In practice, there are four considerations worth noting by a shareholder that intends to exercise its information rights under article 33 to inspect the company's accounting books.

Procedural preconditions

As mentioned above, when requiring to inspect the accounting books, the procedural precondition for the shareholder is to make a written request to the company setting out its reasons. A people's court will examine whether such precondition has been satisfied before it proceeds to the examination on the merits of the claim. In the dispute on shareholder's information rights between Ruiying Ni (as the shareholder) and Fuqing Dongmen Department Store Co, Ltd, Fujian Province,¹³ Fuzhou Intermediate People's Court did not support the individual shareholders' claim for the access to the company's accounting books for a certain financial year, for the reason that prior to bringing the claim against the company, the shareholder failed to make a written request to the company and therefore was not denied access to the accounting books of the company.

13 [2018] Min 01 Min Zhong No. 7296.

Burden of proof

In accordance with article 33, article 8 of the Company Law Application Provisions IV and the PRC Civil Procedure Law, the company shall bear the burden of proof with respect to whether the shareholder who requires to inspect the company's accounting books has 'improper purposes'. In the claim regarding information rights brought by the Affiliated High School of Peking University and Beijing PKU Yilin Co, Ltd (both as shareholders) against Beijing PKU Affiliated High School Education Investment Co, Ltd,¹⁴ Beijing No. 1 Intermediate People's Court confirmed this position by ruling against the company on the ground that it failed to prove the improper purposes of its shareholders' request for various information of the company.

What constitutes 'improper purposes' of a shareholder

The Company Law does not specify what constitutes an improper purpose under article 33. Prior to the effectiveness of the Company Law Application Provisions IV, the people's courts have seen various reasons used by the companies as 'improper purposes' to reject their shareholders' requests to inspect the accounting books. For example, in the dispute between Shanghai Lianhua Xinxin Supermarket Co, Ltd and its shareholder,¹⁵ the company used 'necessity' as the test for 'improper purposes'. The company claimed in its defence that since its shareholder had (1) been involved in the operation of the company; and (2) approved the audited financial statements of the company, it was not necessary for the shareholder to require to inspect the accounting books, and therefore its request was for improper purposes. Shanghai No. 2 Intermediate People's Court dismissed the company's appeal and pointed out that the fact that the shareholder had approved the audited financial statements of the company should not be used as a reason for the company to reject its shareholder's request to inspect the accounting books.

Article 8 of the Company Law Application Provisions IV fills the blank left in article 33 and sets out what the people's court will consider as 'improper purposes'. It provides that if a company can prove that its shareholder falls under any of the following circumstances, the court shall determine that the shareholder has the 'improper purposes' as mentioned in article 33 as follows:

- 1 the shareholder engages in any business of its own or for other persons which is in substantial competition with the main business of the company, except as otherwise specified in the articles of association of the company or agreed upon by all shareholders;
- 2 the shareholder requires to inspect the company's accounting books for the purpose of disclosing relevant information to any other person, and may damage the company's legitimate interests;
- 3 within three years prior to the date of its request for inspection, the shareholder has inspected the company's accounting books and disclosed relevant information to any other person, which has damaged the company's legitimate interests; or
- 4 any other circumstance showing that the shareholder has an improper purpose.

In practice, when claiming that the shareholder's request is made for improper purposes, the argument that the company usually adopts is section (1) above. Pursuant to article 8, section (1)

14 [2012] Yi Zhong Min Zhong Zi No. 5887.

15 [2010] Hu Er Zhong Min Si (Shang) Zhong Zi No.321.

of the Company Law Application Provisions IV, if the company can prove that the shareholder has engaged in the business, which substantially competes with the main business of the company, it will successfully establish its defence that the shareholder's request to inspect the accounting books is made based on an improper purpose. Therefore, the company is entitled to reject such request in accordance with article 33.

That said, neither the Company Law nor the Company Law Application Provisions IV specifies what constitutes substantial competition. In practice, when endeavouring to balance between the shareholders' exercise of the information right to protect their legitimate interests and the protection of the company's trade secrets and economic interests, the people's courts tend to adopt a higher standard when examining the 'substantial competition' claimed by the company.

In China, each company will register its business scope with competent governmental authorities and this registered business scope will be disclosed to the public. Some companies have argued that the similarity of the registered business scopes between the company that the shareholder works for and the company itself constitutes a proof of the 'substantial competition'. However, in recent years, the people's courts tend to hold the view that the similarity of the registered business scopes alone does not constitute a strong basis for proving the existence of 'substantial competition'. In a case¹⁶ selected by Beijing Chaoyang District People's Court in 2021 as one of 10 typical cases in relation to the protection of the interests of minority shareholders, the individual shareholder who required information from the defendant company was employed by another company, and the respective registered business scopes of the two companies overlapped. Based on the similar registered business scope, the defendant company claimed that its shareholder engaged in a business that was in substantial competition with itself, and therefore such request was made for improper purposes under article 33. The court pointed out in its judgment that, the registered business scope of a company was not specific, restrictive, or exclusive since it was filed by the company based on the national economy and industry categories. The mere overlap of the business scopes that were described by the standard wording was not sufficient to prove that the actual businesses of the two companies were the same or similar. The court further stated in its judgment that apart from the overlap of the registered business scopes of the two companies, the defendant company did not provide further evidence to prove that there was substantial competition between the businesses of the two companies. Therefore, the court ruled against the defendant company's defence that there was substantial competition between its main business and the business its shareholder engaged in.

To establish substantial competition between the business in which its shareholder engaged and its own business, another common argument of a company is that the shareholder who makes the request is a director, senior manager or shareholder of another company engaging in the similar business with the company. Since nowadays it is common for a person to take the role of director or senior management in one company and acquire minority shareholding in another company conducting similar business, it may be unjust to label such situation as 'substantial competition' and thereby 'improper purposes' of a shareholder requiring information of its invested company. In another dispute, which was selected by Xiamen Intermediate People's Court in 2021 as one of the 15 typical cases in relation to the protection of the interests

16 [2019] Jing 03 Min Zhong No. 12432.

of minority shareholders,¹⁷ the court confirmed that a higher standard should be applied for the proof of 'substantial competition' by the company. That is, the 'substantial competition' must be proved by solid evidence showing that there is actual competition between the two companies in question, such as competition in clients, bid projects or main regions in which business is carried on. The mere fact that the individual shareholder set up another company engaging in similar business is not sufficient to prove the existence of substantial competition between the two companies. In this case, the court found that the region (Xiamen, Fujian Province) where the defendant company carried on business was different from the one (Shanghai) where its shareholder carried on business (through his other company). As the defendant company failed to provide further evidence showing any competition between the two companies apart from the similar contents in the respective registered business scopes of the two companies, the court ruled against the defendant company's defence of improper purpose of its shareholder.

Possible damages versus actual damages

In terms of the damages which may be caused by the inspection of accounting books by a shareholder, should the company successfully establish improper purposes of the shareholder, the test for proving the damage is 'possibility'. The company only needs to prove that it has reasonable ground to believe there is a possibility that providing the shareholder with the company's accounting books may cause damages to the company. It does not need to prove that actual damages were suffered by it.

In the dispute between Yawen Luo and Wuhan Jinniu Economic Development Co, Ltd,¹⁸ Wuhan Intermediate People's Court pointed out that when balancing between the shareholders' right to inspect the accounting books and the company's reasonable ground to reject such request, the key was to determine whether there was a possibility that damages might be caused by the shareholder's exercise of such rights. The court further confirmed that article 33 did not require a company to prove the actual damages caused to it by its shareholders' inspection of the accounting books; the company only needed to prove the possibility that such damages might be caused.

Conclusion

Article 33 sets out the statutory information rights of the shareholders of limited liability companies in China. The Company Law Application Provisions IV supplement article 33 by providing clarifications for a number of issues in relation to the shareholders' information rights. In practice, merely relying on the statutory information rights may not be sufficient for an investor to understand and assess the business and financial status of the company and further protect its interests in the company. In respect of the types and scope of information that a shareholder is entitled to access, the issues that usually give rise to disputes between the shareholders and the company include, without limitation, the access to the accounting vouchers and the contents of the financial accounting reports and accounting books. To avoid misunderstanding and disputes, it is advisable for the investors to consider including specific requirements in respect of the information it requires from the company in the articles of association of the company. The wider

¹⁷ Published on 20 August 2021, the case reference of each case was not included in the selection.

¹⁸ [2016] E 01 Min Zhong No. 7824.

Key considerations for shareholders of private companies
in China to protect their information rights

and more detailed requirements in respect of the information to be provided by the company to its shareholders specified in the articles of association of the company have been upheld by the people's courts in various matters. The Company Law Application Provisions IV also cover other key issues such as the necessity of the plaintiff to maintain the status of being a shareholder for initiating a claim to protect its information rights, and confirming the statutory information rights under article 33 and article 97 of the Company Law must not be substantially deprived of by any provision otherwise agreed in the shareholders' agreement or the articles of association of the company.

As the accounting books contain confidential business information of the company, article 33 sets the bar higher for the access of such information, by (1) imposing the procedural precondition of making a written request to the company by the shareholder setting out its reasons and (2) granting the company the defence of improper purposes of the shareholders to reject such request. The Company Law Application Provisions IV provide helpful interpretations of circumstances that constitute improper purposes under article 33. From an academic perspective, allowing the company this defence enables the balance between the interests of the shareholders and the interests of the company.¹⁹ How to balance the protection of the shareholder's information rights with the interests of the company has been a question that the people's courts face in different cases. From the development of this matter in the litigated matters in the recent years, the shareholders have been reassured that the people's courts aim to protect and support the shareholders' information rights. However, the shareholders should also note that, this does not mean that they can abuse the information rights to spy on or misuse the confidential information of the company. In accordance with article 11 of the Company Law Application Provisions IV, if the disclosure of trade secrets of the company by the shareholder causes damages to the company's legitimate interests, the court should support the company's claim for the compensation for such damages.

19 Jianwei Li, The Interest Measurement of the Boundary of Shareholders' Right to Know (section 3, paragraph (1)), *Jinan Journal* (Philosophy & Social Sciences) No.6, 2022.

3

Impact of amendment to the PRC Anti-Monopoly Law on M&A transactions in China

Huanhao He and Qian Chen¹

Introduction

When designing deal structure and negotiating risk allocation in mergers and acquisitions transactions in China, investors need to take regulatory compliance analysis into consideration. In particular, it is critical to carefully assess whether the contemplated transaction constitutes a notifiable transaction under relevant merger control laws, and if yes, how the merger review procedures work in China. Further, in the event that relevant parties fail to notify the competition authorities in advance (failure-to-file) or implement the concentration without observing statutory waiting period or clearance requirements (gun-jumping), the corresponding legal implications are also a must-know for the parties.

China's merger control laws are largely set forth in the PRC Anti-Monopoly Law (the 2008 AML), which came into effect on 1 August 2008. The 2008 AML is further stipulated under a series of implementing administrative rules. On 24 June 2022, China's Standing Committee of the National People's Congress adopted the first amendment to the Anti-Monopoly Law, effective 1 August 2022 (the Amended AML). To further implement the Amended AML, China's highest-level antitrust authority, the State Administration for Market Regulation (SAMR), published the draft implementation rules on filing thresholds (the Filing Thresholds Rules) and merger review (the Merger Review Rules) on 27 June 2022. Notwithstanding that the two draft implementation rules remain subject to change as they are being finalised, these amendments and implementation rules have introduced significant changes to China's merger control regime. Investors in mergers and acquisitions transactions need to pay close attention to the aforementioned changes for compliance purposes.

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Adjustment to the existing turnover thresholds

Like most other jurisdictions, China has adopted a two-pillar test for a mandatory merger control filing: (1) meeting the turnover thresholds; and (2) triggering a change of control.

Currently, parties to a mergers and acquisitions transaction that satisfies the control test (also, a 'concentration of undertakings') are obligated to make a merger control filing in China if:

- the individual Chinese turnover of at least two undertakings in the concentration exceeds 400 million yuan in the preceding financial year; and
- the combined turnover of all undertakings in the concentration exceeds 10 billion yuan on a global basis or 2 billion yuan within China.

SAMR's draft Filing Threshold Rules intend to adjust the above turnover thresholds upwards as follows:

- the individual Chinese turnover of at least two undertakings in the concentration exceeds 800 million yuan in the preceding financial year; and
- the combined turnover of all undertakings in the concentration exceeds 2 billion yuan on a global basis or 4 billion yuan within China.

The overall economy and the amount and size of companies in China have significantly increased since the initial introduction of the existing turnover thresholds in 2008. According to the Annual Report on China's Anti-Monopoly Law Enforcement of 2019, 2020 and 2021,² the number of both filed and concluded concentration of undertakings cases in 2021 reached the highest point in history, which to some extent indicates a trend towards a heavier administrative workload of SAMR. We understand that the upcoming increased turnover thresholds reflect SAMR's intent to reduce the number of notifiable transactions and to concentrate on 'bigger' transactions that are more likely to affect the market competition in China.

Items	2019	2020	2021
number of cases received by SAMR	503	520	824
number of cases concluded by SAMR	465	473	727

Introduction of a new alternative 'market value' and 'turnover ratio' threshold

In addition to the existing turnover thresholds, China is also preparing to introduce alternative 'market value' and 'turnover ratio' thresholds. According to article 4 of the draft Filing Threshold Rules, even if the turnover thresholds are not met, a concentration of undertaking will still be notifiable to SAMR if the following conditions are met:

- the turnover of one of the undertakings in the concentration exceeds 100 billion yuan in China in the preceding financial year; and
- the market value (or valuation) of the other undertaking in the concentration is no less than 800 million yuan, and its turnover in China in the preceding financial year shall account for more than one third of its worldwide turnover.

² www.samr.gov.cn/xw/zj/202012/P020201224808232684415.pdf; <https://www.samr.gov.cn/xw/zj/202109/P020210903516952588333.pdf>; <https://www.samr.gov.cn/xw/zj/202206/P020220608430645470953.pdf>.

Under the current merger control regime in China, the acquisition of a start-up, an innovative enterprise or a nascent competitor of significant valuation but has not yet generated significant revenue, might constitute a change of control of the target company. However, if the turnover thresholds are not satisfied, the change of control generally would not trigger a mandatory merger control filing, unless the target company is controlled or jointly controlled by certain existing investors that meet the turnover thresholds. This is common in venture capital investments, particularly in companies with frontloaded capital expenditures before revenue generation, such as the companies in innovative biopharmaceutical industry, chip design or manufacture industry, new energy vehicles, etc.

The introduction of the alternative 'market value' and 'turnover ratio' thresholds is intended to capture transactions in which incumbent undertakings acquire innovative targets or nascent competitors, thereby pre-empting the emergence of future competition, or the 'killer acquisition', even if the turnover thresholds are not met. Although these transactions do not necessarily cause competition concern, the parties need to assess the impact of the merger control filing on the time frame, the documentations and even the deal structure in advance.

Potential 'call-in' of below-threshold transactions

The Amended AML formally authorises SAMR to 'call in' below-threshold concentrations, if there is evidence proving that the concentration has or may have effect of eliminating or restricting competition.

SAMR's draft Merger Review Rules have further set out the relevant procedures for SAMR to exercise the power to intervene in a non-notifiable transaction as follows:

- SAMR may notify the parties in writing and instruct them to make a merger control filing for the contemplated concentration;
- if the concentration has not been implemented, then once SAMR calls in the transaction, the parties cannot complete the transaction until they obtain clearance from SAMR;
- if the concentration has been implemented, SAMR can instruct the parties to supplement a merger control filing within 180 days, cease implementation of the transaction or take other measures necessary to restore competition; and
- if the parties concerned fail to follow SAMR's instruction to make a merger control filing for a below-threshold transaction, SAMR will initiate an investigation into the transaction.

These amendments do not change the rule that parties to a below-threshold transaction have no legal obligation to make a merger control filing in China, unless and until SAMR requires them to do so. Nevertheless, for parties pursuing concentrations with a nexus to China, these amendments mean that the China merger control analysis must go beyond the question of whether a mandatory filing is triggered. Instead, even if the mandatory merger control filing is not triggered, parties are recommended to conduct a preliminary competition assessment based on the circumstances (including but not limited to whether a priority sector is involved, the development stage and existing competition status of the relevant market, the industry policy, the market share held by each undertaking, the recent practices and policies, etc.) and, if necessary, formally consult with SAMR regarding the contemplated transaction.

Clarification of control test and gun-jumping

Under the AML, any of the following will be deemed a 'concentration of undertakings': (1) a merger; (2) an acquisition of control of another undertaking through an asset or equity acquisition; or (3) possession of control or 'decisive influence' over another undertaking, by contract or otherwise. Normally, control and decisive influence are interpreted collectively (for that reason 'control' together with 'decisive influence' are hereinafter collectively referred to as 'control'). However, unlike the turnover thresholds or the new alternative 'market value' and 'turnover ratio' thresholds, which are relatively black and white in most cases, it is not always easy to identify whether there is a change of control resulting from the contemplated transaction under China's merger control regime, particularly for minority investment transactions.

The existing implementing rules have stipulated the following non-exhaustive list of factors to be considered when determining whether an undertaking obtains control over another undertaking through a transaction:

- the purpose of the transaction and future plans;
- the shareholding structure of the other undertaking before and after the transaction and the changes thereof;
- voting matters and voting mechanism of the general meeting of shareholders of the other undertaking as well as its historical attendance and voting;
- composition and voting mechanism of the board of directors or board of supervisors of the other undertaking;
- appointment and dismissal of senior management personnel of the other undertaking;
- for the relationship between the shareholders and directors of the other undertaking, whether there is any exercise of voting right by proxy or any person acting in concert; and
- whether there is any material business relationship or cooperation agreement between the undertaking and the other undertaking.

SAMR's draft Merger Review Rules further enumerate several factors in article 4 that are indicative of control, including:

- holding voting rights or similar rights of other undertakings; and
- influence on the decision-making and management of other undertakings such as the appointment and removal of senior management personnel, financial budget, business plan, etc.

The draft Merger Review Rules also include a new definition of 'implementation of concentration', which refers to the act of obtaining control over other undertakings or exerting decisive influence on them, including but not limited to completing the registration of changes of shareholders or rights, appointing senior management personnel, actually participating in business decision-making and management, exchanging sensitive information with other undertakings, and substantially integrating business, etc.

Instead of altering the existing rules, we understand that these amendments have reflected SAMR's approach in previous practice towards the issue of control and gun-jumping and intent to provide clearer guidance to parties in mergers and acquisitions transactions in China.

Setting priorities: new classified and graded system for merger reviews

In order to improve the quality and efficiency of the merger control review regime, the Amended AML provides through a newly added article that 'the anti-monopoly law enforcement agency of the State Council shall improve the system for conducting classified and graded review of concentrations of undertakings, strengthen review of concentrations of undertakings that concern the national economy, the people's livelihood, or such other important fields in accordance with the law.' Although detailed rules of the classified and graded system have not been issued, it is reasonably expected that such system will be laid out in two aspects: one is the classification of the enforcement sectors, and the other is the delegation of the enforcement authority.

Setting up priority sectors

The Draft Amendment of Anti-Monopoly Law of the People's Republic of China (the Draft Amendment), which solicited public opinions in October 2021, mentions the 'important fields' and clearly specifies four sectors including 'people's livelihood', 'finance', 'science and technology', and 'media'. However, the Amended AML adopts a more general way by construing the important fields as 'concerning the national economy, the people's livelihood', which in fact broadens the scope of the priority sectors for merger review. Apart from the four sectors specified in the Draft Amendment, the fields involving start-ups, new business models or labour-intensive industries could also be among the priority sectors subject to strict scrutiny given these sectors are specifically called out as areas for strengthened merger control review in the State Council's Opinion on Accelerating the Building of a Unified and Nationwide Market published in April 2022. It is expected that mergers and acquisitions transactions in these areas will face more scrutiny and thus the undertakings in related areas should raise extra attention when conducting these transactions.

Delegating the enforcement power

In addition to the classified and graded review of specific sectors, we speculate that the Amended AML will also explore the classified and graded review system at the level of the enforcement authority. On one hand, the anti-monopoly enforcement agencies may draw on the previous experience of classifying and grading the regulation of internet platforms,³ classifying the merger control review according to factors such as industry sector, business type and transaction scale, formulating different regulatory measures and allocating enforcement resources accordingly. On the other hand, the classified and graded review system may also be an exploration of authorising local departments to conduct merger control reviews.

Along with the strengthening of the undertakings' compliance awareness, it can be foreseen that the number of the cases of concentrations of undertakings may also rise. Therefore, it is likely that SAMR may explore the delegation of the enforcement authority for merger control review by authorising its provincial level branches to review simplified-procedure cases that are smaller in scale or have less impact on market competition. This delegation can be beneficial in increasing the review efficiency, promoting the allocation of enforcement resources, and motivating local

3 See the Guidelines for Internet Platform Categorization and Grading (Draft for Comment) published by SAMR on 29 October 2021.

enforcement authorities, thereby allowing the central-level enforcement authorities to focus more on the complex cases or those with more impact on the market competition.

Echoing the classification and delegation mechanism introduced by the Amended AML, Article 6 of SAMR's draft Merger Review Rules clearly stipulates that SAMR may formulate specific review measures for the concentration of undertakings in important areas such as national economy and people's livelihood and shall regularly evaluate the implementation effects of the review system for concentration of undertakings and improve the quality and efficiency of the review. Moreover, several of SAMR's provincial branches have been chosen to test such delegation mechanism. On 15 July 2022, SAMR published the Announcement Regarding Pilot Delegation of Anti-Monopoly Review of Certain Concentration of Undertakings Cases (the Pilot Delegation Announcement), delegating part of its function on reviewing simplified-procedure cases to five local antitrust regulators, namely the respective Administrations for Market Regulation (AMR) of Beijing, Shanghai, Guangdong, Chongqing, and Shaanxi Province. The five local AMRs are expected to carry out the initial review of certain simplified-procedure cases where one of the notifying undertakings, the newly established joint venture, or the relevant geographical markets defined have nexus in the respective region for a trial period from 1 August 2022 to 31 July 2025. To strengthen the flexibility of such delegation regime, the Pilot Delegation Announcement establishes a mechanism regarding the termination of this delegation, which stipulates that local AMRs should inform SAMR in a timely manner and SAMR should terminate the delegation if any of the following circumstances occur: (1) the case no longer qualifies for the simplified procedure; (2) the case involves gun-jumping; (3) the notifying parties withdraw the filing due to not meeting the notification thresholds; (4) the notifying parties withdraw the filing due to the termination of, or material changes to, the contemplated transaction; or (5) the other circumstances as determined by SAMR. However, it is still subject to subsequent legislation to give more detailed guidance on how to classify and grade specific cases and how different levels of authorities for enforcement of the Amended AML will cooperate.

Introduction of the 'stop-the-clock' mechanism

Drawing on international practices, the Amended AML introduces a 'stop-the-clock' mechanism which will enable SAMR to suspend the merger review period with written notice under any of the following circumstances, and the review period resumes on the day when this circumstance ceases to exist: (1) the notifying parties fail to provide requested information or materials in a timely manner so that the merger review cannot proceed; (2) new circumstances or new facts that materially impact the merger review emerge and prevent the merger review from progressing without examining the new circumstances or facts first; or (3) the proposed remedies require further assessment, and the relevant undertakings request for suspension.

The 'stop-the-clock' mechanism is more likely a response to the lack of review time for complex cases with competition concerns in practice. The 2008 AML stipulated that the statutory review period should not exceed 180 calendar days, upon the case's initiation, and the parties can implement the concentration if the competition authority fails to make a decision within the time limit. In practice, such 180-day review period often appears to be quite tight for complex cases, especially those involving in-depth competition assessment, or heavy negotiation of restrictive conditions. In these scenarios, parties may be required to 'pull and refile' these cases by SAMR as it was not feasible for SAMR to clear a merger filing within the prescribed time frame. Through the 'stop-the-clock' mechanism, SAMR could gain more time and flexibility in

the merger control review process. In particular, for cases with material competition concerns, the procedural redundancy of the 'pull-and-refile' process may be eliminated.

However, it is clearly stated in the Amended AML that suspending the review clock at the notifying undertaking's request is available only when the proposed remedies require further assessment. In other cases, whether to stop the clock is at SAMR's sole discretion. Moreover, without detailed guidelines about how long or how frequently SAMR can stop the clock, there are actually no statutory restrictions on SAMR's such discretionary authority. This could be a potential downside of the 'stop-the-clock' mechanism as it may cause uncertainty in timing in certain merger filing cases, making it more difficult for notifying parties to predict the length of the review.

In sum, the new 'stop-the-clock' mechanism in merger control reviews will grant SAMR more flexibility in complex cases, but also could make the length of the review period less predictable. When pursuing mergers and acquisitions transactions with a nexus to China, parties are recommended to exert extra care when planning transaction timelines if Chinese merger clearance is required. Moreover, it could be foreseen that the completeness and the quality of the filing documents would be put to a higher standard, and thus it is advisable that the parties reserve sufficient time in advance to fully prepare the filing materials in the preparation stage, as well as maintain an active communication with law enforcement agencies during the review process.

More severe consequences for violations

Even if the parties have identified an undoubtedly notifiable transaction, under certain circumstances, they might still have incentives to assess the legal implications for violations before deciding whether to make a mandatory merger control filing as requested or proceed with the transaction first without obtaining the clearance from the competition authority. As the 2008 AML was previously considered to provide insufficient deterrence in terms of, among others, the merger control regime, the Amended AML has significantly strengthened the punishment regime, primarily in the following respects:

- Significantly increased fines for failure to file and gun-jumping: under the 2008 AML, the pecuniary penalty for failure to file and gun-jumping was up to 500,000 yuan. The Amended AML, however, has increased the maximum fines to (1) 10 per cent of group turnover of the concerned undertaking in the preceding financial year, if the transaction has or may have an effect of excluding or limiting competition; or (2) 5 million yuan, if no anticompetitive effect is found. These amendments have increased the legal liability for violations by 10 times or higher.
- Aggravated fines: according to article 63 of the Amended AML, the antitrust fines for a violation against the Amended AML (including failure-to-file, gun-jumping and other anti-trust violations such as anti-monopoly agreements and abuse of market dominance) can be further increased to a range between two and five times of the initial amount if the circumstances of the violation are 'particularly serious', with 'particularly egregious impact' and 'particularly serious repercussions.' In other words, in a worst-case scenario, an undertaking who fails to file a notifiable transaction or jumps the gun could be imposed on a maximum penalty of an unprecedented level of 50 per cent (ie, five times 10 per cent) of its group turnover in the preceding financial year. Although the Amended AML has not clarified more details of these standards and it is not clear how SAMR will apply these standards in

practice, the substantially lifted pecuniary penalties prove China’s resolution to enhance deterrence.

- Potential criminal liability: the Amended AML also introduces a new article 67 stipulating that, whoever violates the provisions of the Amended AML which is serious enough to constitute a criminal offence shall be subject to criminal liability in accordance with the law. The foregoing article, however, does not independently provide a cause of action apart from China’s Criminal Law. Nevertheless, it is reasonably expected that China might further amend its Criminal Law in the future such that certain serious anticompetitive conducts would be criminalised.
- Credit records impacted: according to article 64 of the Amended AML, where an undertaking is subject to administrative punishment for violation of the anti-trust provisions, such punishment will be reflected in its credit records in accordance with the relevant provisions of the state and will be announced to the public. Although it is unclear where the public announcements will be made, it can be foreseen that an undertaking who fails to make a mandatory merger control filing or jumps the gun and is consequently subject to administrative punishment might be further adversely affected due to the impact on credit records in various respects, including but not limited to the capability to obtain facility from financial institutions, the application for certain licenses or permits, the qualification to enjoy tax preferences or purchase land use rights, etc.

The following comparison table sets out more details on the punishment regime in terms of merger control filing under the 2008 AML and the Amended AML respectively:

AML violations	2008 AML	Amended AML
Failure to file/gun-jumping (without competition concerns)	Fine of up to 500,000 yuan; Other measures (including to cease the transaction, dispose of shares or assets, transfer the business, or take other necessary measures to restore the market situation before the concentration)	Fine of up to 5 million yuan
Failure to file/gun-jumping (with competition concerns)		Fine of up to 10 per cent of group turnover of the concerned undertaking in the preceding financial year. Other measures (including to cease the transaction, dispose of shares or assets, transfer the business, or take other necessary measures to restore the market situation before the concentration)
Aggravated fines	N/A	Two to five times the initial fine can be imposed if the violation is ‘particularly serious’, with ‘particularly egregious impact’ and ‘particularly serious repercussions’
Criminal liability	Applicable to obstruction of antitrust investigations only	Violations to the Amended AML, if constituting a crime, will be held criminally accountable

Obstruction of investigations - Individuals	Fine of up to 20,000 yuan. Fine of up to 100,000 yuan where the case is serious	Fine of up to 500,000 yuan
Obstruction of investigations - Companies	Fine of up to 200,000 yuan. Fine of up to 1 million yuan where the case is serious	Fine of up to 1 per cent of group turnover of the concerned undertaking in the preceding financial year. Fine of up to 5 million yuan if the undertaking has no turnover in the preceding financial year or it is difficult to calculate the turnover
Credit records	N/A	Antitrust punishments will be reflected in its credit records in accordance with the relevant provisions of the state and will be announced to the public

Conclusion

The Amended AML has opened a new chapter for China's anti-monopoly law enforcement, especially in the merger control area. Although these amendments are not likely to result in an immediate change to China's merger control review regime, it is a clear signal of the anti-monopoly law enforcement agencies' resolution to address the most significant substantive and procedural gaps experienced by the undertakings in the past 14 years. More detailed regulations and implementation rules are expected to see how those changes would play out in practice. Meanwhile, as China has become an increasingly important part of global antitrust clearance for cross-border transactions, multinational companies and institutional investors conducting mergers and acquisitions transactions in China are recommended to pay careful attention to the latest amendment to the PRC Anti-Monopoly Law and its implementation rules. Notably, large companies' investment in start-ups would be far easier to be caught by the new merger control rules. Previously, certain market players might decide not to file a notifiable transaction to SAMR after evaluating the potential legal liability. This will probably no longer be the case as the Amended AML substantially increases the cost of illegal acts from the perspective of not only the amount of penalties but also the potential for criminal liability.

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Impact of the proposed amendment to the PRC Company Law on M&A transactions in China

Sheng Zhang and Zezhou Xu¹

Background

The National People's Congress of the People's Republic of China (the PRC) published for public comment on 24 December 2021 a consultation draft of the Amendments to the PRC Company Law (the Amendment). The Amendment contains 70 substantive revisions and additions,² which impact more than one-third of the provisions in the PRC Company Law currently in force. Since its enactment in 1993, the PRC Company Law has undergone five rounds of amendments, among which the amendment in 2005 was a comprehensive amendment while the rest only focused on certain specific provisions. The Amendment, when it comes into effect, will be another overhaul to the PRC Company Law. As stated by the National People's Congress, the Amendment is drafted with the intention of reducing the burden of market entry by enterprises, lowering the cost of operations and governance, and ultimately optimising the business and investment environment.

In summary, the Amendment maintains the fundamental framework and principles of the current PRC Company Law, and takes a systematic approach to make amendments in certain key areas, such as allowing for greater flexibility in the form of capital contribution for both limited liability companies (LLCs, each an LLC) and joint stock companies, while imposing stricter requirements on the capital contribution obligation of shareholders. In addition, the Amendment introduces new governance structure and features, including share classes and preferential rights, and board meeting requirements, which are more adaptive to the prevailing corporate governance and investment practices in the international markets. In this chapter, we will discuss these changes with a focus on their potential impact on mergers and acquisitions

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² Paragraph 1, section 3, The Explanations about the Consultation Draft of the Amendments to the PRC Company Law, by the Standing Committee of the National People's Congress, on 24 December 2021.

(M&A) transactions in China, assuming that the Amendment will be passed and adopted in its current form.

Amendments to capital contribution and shareholder rights

Form of capital contribution

Article 43 of the Amendment stipulates that, in addition to cash, shareholders of an LLC may contribute registered capital in the form of non-monetary assets, such as tangible assets, intellectual property rights, land use rights, stock rights and creditors' rights, and that the value of any non-monetary assets used as capital contribution shall be assessed and verified, and shall not be either overestimated or underestimated. The same rules would also apply to a joint stock company.³ This will be the first time that stock rights and creditors' rights are recognised by the PRC Company Law as a form of registered capital contribution. These provisions in the Amendment will facilitate share swap or debt-to-equity transactions where the consideration for a share acquisition would be paid in the form of shares or creditors' rights. This new provision also reflects the provisions in article 12 of the newly published Implementing Rules for the Administrative Regulations of the People's Republic of China on the Registration of Market Entities (effective on 1 March 2022, the Implementing Rules), which implied that stock rights and creditor rights are allowed as a form of registered capital contribution. However, in practice, the formalities for debt-to-equity conversion are still not clear and are to some extent subject to the discretion of local company registration authorities. It is also not crystal clear whether the creditor rights includes third-party debts – if so, the capital contribution made in the form of third party debts would largely depend on the fulfilment of the repayment obligation by this third party and may lead to uncertainty as to the funding. The market may be expecting more specific implementing rules on the procedural requirements for debt-to-equity conversion and more guidance on any capital contribution disputes (particularly for third-party debts). Despite the lack of implementation details, based on the new provision in the Amendment and the Implementing Rules, investors do have more options to consider when they structure a capital investment, and it is reasonably expected to see more M&A transactions using stock rights or creditors' rights as consideration.

Capital contribution obligations

The Amendment imposes stricter obligations on shareholders to make capital contributions. If a shareholder defaults in making a capital contribution after a certain grace period, the overdue and unpaid registered capital could be transferred to a third party or cancelled by the company, resulting in the relevant shareholder losing its rights with respect to such unpaid registered capital.⁴ Under the current system, a shareholder can enjoy shareholder rights even if he or she does not contribute the full amount of subscribed registered capital. The PRC Company Law specifies that a company can only remove a shareholder's shareholder rights through a resolution by the shareholders' meeting if the relevant shareholder fails to contribute any amount of the subscribed registered capital or withdraws the entire capital contribution. This means that if

3 Article 100 of the Amendment.

4 Article 46 of the Amendment.

a shareholder partially satisfies its capital contribution obligation, it is not at risk of being kicked out as a shareholder. Under the new rules proposed in the Amendment, if an LLC discovers that a shareholder has failed to make its capital contribution in full, the LLC shall notify the shareholder and grant the shareholder a grace period of no less than 60 days. If the shareholder fails to make the required capital contribution upon the expiration of the grace period, the LLC has the right to notify the shareholder in writing and as of the date of such notice, the relevant shareholder loses its shareholders' rights with respect to such unpaid registered capital. Within six months of receiving such notice, the LLC must transfer the respective equity interests or reduce its registered capital accordingly. In addition to the above equity cancellation mechanism, the Amendment also reiterates the concept of acceleration on payment of registered capital contribution in insolvency cases to protect the interests of creditors and the LLC. Article 48 of the Amendment stipulates that if an LLC is unable to pay its debts as they fall due and manifestly lacks the ability to pay off all of its debts, the LLC or its creditors may request an accelerated contribution of unpaid registered capital by relevant shareholders, regardless of when the capital contribution is due.

The Amendment also mandates that additional information be recorded in an LLC's shareholder register.⁵ In addition to the name and capital contribution amount of each shareholder, the shareholder register of an LLC should also contain the date of the shareholder's capital contribution and the record of any historical change in the shareholder's status (including gaining or losing shareholder status). A shareholder has the right to review and make a copy of the shareholder register, as well as to request the LLC to update the register in the event of an equity transfer. The LLCs may consider updating the current form of its shareholder register, which is normally a closing deliverable in M&A transactions, to get aligned with these new rules.

In addition, the Amendment introduces a simplified path for capital reduction when a company has operating losses that cannot be recovered by the company's capital reserves, in which case the company is not required to notify its creditors or make a public announcement to allow the creditors to assert their respective creditors' rights against the company.⁶ The simplified procedure may reduce by 45 days or more the time required for the company to complete the entire capital reduction process, and could facilitate the company to carry out the capital reduction permitted under article 46 of the Amendment (as we discussed above) or as stipulated in the relevant transaction documents.

Joint and several capital contribution obligations in an M&A transaction

Article 89 of the Amendment stipulates further that, in the event of an equity transfer, the transferor and transferee of equity interests in an LLC are jointly and severally liable for the outstanding capital contribution obligations attached to the transferred equity interests at the time of the equity transfer, unless otherwise agreed in the respective equity transfer agreement. In light of the risk of joint and several liability and the introduction of the mechanism of losing shareholder rights, the transferee in an M&A transaction may wish to examine the status of the relevant transferor's capital contribution more closely during the due diligence phase. In addition, the parties are recommended to agree on and document in the transaction

5 Article 50 of the Amendment.

6 Article 221 of the Amendment.

documents a clear-cut arrangement regarding the payment of outstanding capital contribution, which may include the following: (1) in the case that the capital contribution pertaining to the equity interest has already been fully paid, the transferee may wish to request robust warranties from the transferor in this regard; and (2) in the case that the capital contribution pertaining to the equity interest has not yet been fully paid, the transferee may (a) request a closing condition that the transferor shall have paid the capital contribution on or before closing, or (b) agree to pay the outstanding capital contribution when due, which amount should be reflected in the overall consideration for the transferred equity interests.

Corporate governance and D&O liabilities

Governance structure and powers of the board

The Amendment introduces several changes to the governance structure of PRC companies. The current PRC Company Law only requires a state-owned limited liability company to have an employee representative on its board of directors. Further to that, the Amendment mandates the presence of one or more employee representatives on the board of directors for any company with more than 300 employees (regardless of whether it is state-owned or not).⁷ Such requirement also implies that a company with more than 300 employees must establish a board of directors, which is also a new requirement. These changes regarding employee representatives may pose a challenge for labour-intensive companies and may have an impact on the voting structure at board level.

The elimination of the requirement to appoint a supervisor represents another fundamental change introduced by the Amendment. Under the current law, each PRC company must have a supervisor or a board of supervisors with the authority to oversee the company's finances, to supervise the actions of the directors and officers, and to make a recommendation to the shareholders regarding the dismissal of directors or officers. If the board of directors fails to perform, the supervisor may also call a shareholders' meeting or file a lawsuit against the directors or officers. However, these supervisory powers and duties are rarely utilised in practice. Given that the supervisors are appointed by the shareholders, they normally represent the shareholders' or even the controlling shareholders' interests. In the event of a conflict of interest between a shareholder and the company, the supervisor tends to remain silent in the majority of instances. The Amendment provides that a company is not required to have a supervisor or a board of supervisors if it has established an audit committee subordinate to the board of directors to oversee the company's finances and accounting.⁸ The audit committee may also exercise any other powers and responsibilities specified in the articles of incorporation.

The Amendment further reduces the need for an LLC to have a board of director. In lieu of a board of directors, a small-scale LLC may appoint one director or even a general manager without any director.⁹ Under the current Company Law, a small-scale LLC is already permitted to have one executive director who can also serve as the general manager. Therefore, such an easement may not have a significant impact on the current governance structure.

7 Article 63 of the Amendment.

8 Article 64 of the Amendment.

9 Article 70 of the Amendment.

The Amendment also grants the company more flexibility in determining the powers and responsibilities of the board of directors and the general manager. Unlike the current Company Law, which specifically lists the respective powers and duties of the board of directors and the general manager, the Amendment replaces such detailed provisions with general statements that (1) the board of directors may exercise any powers and duties of the company, other than those reserved for the shareholders according to the Amendment or the articles of association;¹⁰ and (2) the general manager may exercise the powers and duties according to the provisions in the articles of association or the authorisation of the board of directors.¹¹

The aforementioned modifications to the governance structure and powers of the board of directors put the board more at the centre of the company's management and operations, which is a generally accepted concept in the international markets. The amendments allow for more flexibility for the company to either adopt a traditional 'two-board' governance structure (with the supervisory board overseeing the management of the board of directors), or a more efficient 'one-board' structure, which is more familiar to the foreign investors in particular. A well-designed and comprehensive articles of association would be required if a company were to embrace these changes and benefit from them. In particular, the powers and responsibilities of the board of directors and the general manager should be specified in the articles of association, as there will be no default rules to follow.

The Amendment also imposes new procedural requirements for board meetings. Article 68 of the Amendment stipulates that more than half of the board's directors must be present to constitute a quorum for a board meeting, and that more than half of the board's directors must vote in favor of a board resolution for it to be adopted. According to the Amendment, such mandatory requirements cannot be ruled out by the company's articles of association. Article 74 of the Amendment also stipulates that a resolution cannot be adopted if the quorum required by law or the articles of association is not met. It remains untested whether such quorum requirement can be overruled by the shareholders agreement as the commonly seen quorum provisions under a shareholders agreement provide that any number of directors present at a second adjourned board meeting may be deemed to constitute the quorum so as to prevent any director from obstructing a board meeting by simply not being present. All in all, with the proposed changes to the role and powers of the board of directors in the Amendment, investors considering an M&A transaction should give more thoughts to the appropriate board structure and proper representation of investors on the board.

D&O liabilities

The Amendment also clarifies and expands the liabilities of the company's directors and officers. The directors and officers of an LLC may be jointly and severally liable with a defaulting shareholders if (1) this shareholder fails to pay the subscribed registered capital in full in accordance with the capital contribution schedule; (2) the value of in-kind contribution made by the shareholder is substantially lower than the subscribed registered capital; or (3) the shareholder unlawfully withdraws the subscribed registered capital contribution, if such director or officer has or should have knowledge of such situation but fails to take necessary measures. The

10 Article 62 of the Amendment.

11 Article 69 of the Amendment.

Amendment, compared to the PRC Company Law, requires directors and officers to 'take necessary actions' in addition to performing their duties of loyalty and diligence. The directors and officers may also be held accountable for the unlawful reduction of registered capital or distribution of profits by the company. The Amendment also includes a catch-all provision stating that if a director or officer intentionally or through gross negligence causes any damage to a third party during the performance of his or her duties, that director or officer shall be jointly and severally liable with the company.¹²

The current PRC Company Law stipulates that a director or officer of a company owes the company a 'duty of loyalty' and a 'duty of diligence.' However, it does not define 'duty of loyalty' and 'duty of diligence.' The Amendment provides additional clarification on these terms. According to article 180, 'duty of loyalty' refers to the prohibition on seeking improper interest by using the powers or functions of directors or officers, which is a relatively passive obligation, whereas 'duty of diligence' refers to the obligation to exercise reasonable care for the company's best interests. Clearly, these interpretations impose a higher standard on the conduct of directors and officers and make the application of these provisions simpler and more transparent in the courtroom. The Amendment also clarifies the approval requirement for management related party transactions and expands the scope of related party transactions to include transactions entered into by a company with any of its directors, supervisors, senior management, their close relatives, or the entities directly or indirectly controlled by such persons and other affiliates of directors, supervisors and senior management having a related relationship with such person. The expanded scope necessitates increased vigilance on the part of directors and officers when approving and executing related-party transactions in order to avoid accidental violations of the applicable legal procedures.

As far as minority investors are concerned, the expansion of director and officer liability may need to be carefully considered when they determine whether a board seat is desired. To protect the investor directors from these potential personal liabilities, a comprehensive D&O insurance policy could be useful, which is expected to be a more frequent topic in the transaction negotiations.

Shareholding structure of joint stock companies

Joint stock company is another form of corporate that is established (or converted from LLC) mainly for listing purposes. The capital of a joint stock company is divided into shares, and each shareholder holds a certain number of subscribed shares. To facilitate the liquidity of its shares, the current legal framework subjects joint stock companies to fewer restrictions on the transfer of their shares, but imposes stricter rules on their incorporation, operation, and compliance requirements. Before applying for listing in the PRC, an LLC must convert into a joint stock company.

The Amendment introduces several substantial changes to the shareholding structure of joint stock companies. These modifications incorporate concepts similar to the legal framework of other offshore jurisdictions, such as Hong Kong and Cayman Island. Article 97 of the Amendment establishes a mechanism for authorised capital, allowing a joint stock company's board to authorise and reserve shares for future issuance in accordance with the authorisation

12 Article 190 of the Amendment.

of the company's articles of association or shareholders meeting. A joint stock company's articles of association or shareholders meeting can impose limitations on the term of future issuance or the number of reserved shares. This new authorised share capital regime empowers a joint stock company's board to issue additional shares based on the actual needs and development of the company without having to seek shareholders' approval, which may significantly simplify the procedure for share issuance of a joint stock company and facilitate its financing activities, especially in light of the fact that, in most cases, joint stock companies have numbers of shareholders and it could be quite burdensome and time-consuming to go through the shareholder approval formalities.

Joint stock companies may also issue different classes of shares with different rights attached,¹³ which is a fundamental change to the 'same right for same shares' principle under the current PRC Company Law. Shares with special rights are only permitted in limited circumstances under the current regime. For instance, high-tech innovative companies and companies listed on the Science and Technology Board of the Shanghai Stock Exchange may issue shares with special voting rights in accordance with listing regulations. The Amendment specifies for the first time that any joint stock company may issue different classes of shares other than ordinary shares, including (1) shares with special sequence on dividend distribution or liquidation preference; (2) shares with more or fewer voting rights than ordinary shares; and (3) shares restricted for transfer (eg, subject to company's consent). Such a mechanism would provide shareholders with greater flexibility to agree on special rights and could have a significant impact on pre-IPO investments in PRC companies. These amendments would afford pre-IPO investors enhanced protections for their preferred shares during the onshore IPO process. However, the Amendment only permits shares with special rights that have been specifically authorised under the Amendment or otherwise by the State Council. It remains to be seen whether other preference rights that are commonly seen in offshore transactions but not provided for in the Amendment, such as redemption rights, will later be permitted by the State Council.

It might be premature to say whether the aforementioned changes to the shareholding structure of joint stock companies will invigorate the market and encourage more M&A transactions. It would be reasonable to expect that an increasing number of LLCs will choose to convert into joint stock companies at an earlier stage in order to benefit from the new rules; some may choose to incorporate as a joint stock company from the beginning. Having said that, given the limited scope of special rights permitted for different classes of shares in the Amendment, the applicability of these provisions to M&A transactions is also debatable.

Conclusion

The Amendment was released for public comment until 22 January 2022. There is no definite agenda of its promulgation and we could expect further revisions. The practical impacts of the Amendment on M&A transactions remain to be seen. Nevertheless, the Amendment would be a comprehensive modification to the PRC Company Law since 2018 and proposes a lot of significant changes that are in line with international practices, which shows the intention of the legislator to streamline the corporate governance structure and to create a more levelled ground for M&A activities both domestically and internationally. The Amendment is also an alignment

13 Article 157 of the Amendment.

with the promulgation of the PRC Civil Code and a reflection of various latest rules and judicial practices. Supporting rules are also expected to facilitate the implementation and application of the new PRC Company Law once it is finalised and adopted.

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A practical guide for data compliance legal due diligence in an M&A deal

Ruina Liu and Leo Wang¹

Introduction

Data protection is one of the most active and dynamic legal practices in China recently. New rules are introduced at a rapid pace, which poses practical challenges in setting the parameters for compliance. As a world leading market with thriving growth of digital economy, these data laws have long lasting implications for doing business in China or with Chinese companies.

For international investors to invest in data heavy industries in China, such as smart device, new energy vehicles, cloud-based services, healthcare, large-scale manufacturing, etc, legal due diligence over the target company's data practice is of significant importance to a successful investment especially with the background of strengthened law enforcement for data compliance violations. Serious data violations may easily torpedo a company's market share and long-term development. Therefore, complete legal due diligence will provide a solid basis for investment decisions. In response to different categories or levels of potential risks, some remediation actions may be positioned as closing conditions while others as post-closing covenants.

In this article, we have summarised the legal framework for data protection, highlighted the buzzwords in a China data compliance context, elaborated on the recent *Didi* case as an example of enforcement trend, identified the common compliance gap areas based on our first-hand experience, provided legal due diligence strategy and potential implications to the transaction.

Overall legal framework

In recent years, China has adopted a series of data protection laws and regulations, such as the Cybersecurity Law (effective in 2017), the Data Security Law (effective in 2021) and the Personal Information Protection Law (effective in 2021). These three laws together form the pillars of the overall legal framework with respect to data compliance in China.

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The Cybersecurity Law is the first legislation in China to comprehensively regulate the country's cyber networks. It applies to the construction, operation, maintenance and use of networks, as well as to cybersecurity supervision and management within the territory of China. The Cybersecurity Law is wide in scope, containing an overarching framework targeting the regulation of network security, protection of personal data, and safeguards for national cyberspace sovereignty and security. It is the foundation of other laws, regulations and industrial rules related to cybersecurity and personal data protection. It relates more to data in general rather than focusing on personal data (although there are certain provisions in relation to personal data).

The Data Security Law is the first fundamental law on data security in China. It relates more to data in general rather than focusing on personal data. It sets out the overall principles and structure of China's data security legal regime from a national security and sovereignty perspective. A key concept under this law is the categorised and hierarchical data protection system. The specific scope and catalogues of 'important data' are required by this law to be formulated and published by regional and sectoral regulators. Cross-border transfer of such 'important data' is subject to specific requirements.

The Personal Information Protection Law (PIPL) is the first comprehensive law on personal data protection in China. It establishes rules for personal data processing, the protection of sensitive personal data, cross-border transfer, rights of personal data subjects, and obligations of personal data processors and their entrusted parties when processing personal data. The PIPL borrows many key concepts from the EU General Data Protection Regulation (GDPR), such as extraterritorial effect on overseas processing of personal data of China-based individuals for the purpose of offering products or services to, or for analysing and assessing the behaviour of, such individuals; more legal bases for the processing of personal data, in addition to consent, which used to be the only lawful basis under Chinese law; and the concept of data protection impact assessment but with lower triggering thresholds than GDPR. Meanwhile, the PIPL maintains an equal amount of unique features to reflect local regulatory and business needs. For example, legitimate interest is not included as one of the legal bases for processing personal data; it proposes restrictions on the cross-border transfer of personal data by the nature of the transferors.

A series of regulations, measures or rules which are of lower level legislation under the three pillar laws in terms of legal hierarchy in China are released to implement these laws, such as the Regulation on Protecting the Security of Critical Information Infrastructure, Measures for the Security Assessment of Outbound Data Transfer and Measures for Cybersecurity Review, which provide more detailed guidance from an implementation perspective. Further, there are other draft regulations, measures or rules currently published for public comments, such as the Network Data Security Administration Regulation and the Standard Contract for Personal Information Cross-Border Transfer (China SCC). Upon finalisation of these documents, new legal requirements therein will also govern data practices.

Buzz words

If understanding of convoluted legal languages in the data laws is better left to professionals, we believe the following buzz words are necessary takeaways for a foreign investor to grasp some fundamental concepts in the data protection regime in China.

In particular, 'important data' and 'Critical Information Infrastructure Operator (CIIO)' are generally subject to stricter rules than general personal information. However, the

implementation rules are yet to be released by regional and sectoral regulators. It is advisable to monitor legal updates in this regard to assess potential impacts.

Personal information

Personal information is any information that relates to identified or identifiable natural persons, whether electronically recorded or otherwise. Personal information does not include anonymised information. A notable difference of this definition against personal data in a GDPR context is that the personal information in China also includes deceased natural persons. In a scenario where a simple anonymisation of an individual's name while other remaining personal information can still be used to identify a specific individual, such information is still considered as personal information under the protection of PIPL and other relevant data laws.

Sensitive personal information

Sensitive personal information is any personal information that, once leaked or illegally used, is likely to cause harm to the personal dignity of the relevant natural person or potentially endangers the physical and property safety of the data subject, including biometric data, religious belief, special identity, medical data, financial account information and location tracking data, etc, and personal information of minors under the age of 14.

Processor

A data processor means any organisation or individual that determines in its own discretion the purpose and manner of the personal information processing activities. The 'data processor' under the PIPL is equivalent to the 'data controller' concept under the GDPR. The PIPL uses the term 'entrusted party' to refer to the party processing data on behalf of and at the instruction of the data processor, which is equivalent to 'data processor' under GDPR.

Cyberspace Administration of China

The Cyberspace Administration of China (CAC) and its local branches are the main regulator in charge of the supervision of overall data compliance in China. The CAC may form joint task forces with other government departments, for example, the police, to initiate investigations over data violations. In *Didi* for example, the CAC led a joint task force with seven other government departments (including police, national security agency, natural resources department, transport department, tax and market regulation authorities) to investigate Didi's data processing activities since July 2021. With respect to mandatory security assessment and China SCC filings, the CAC and its local branches are also the key regulator that a data processor will contact on a regular basis.

Mandatory security assessment for cross-border data transfer

Where a data processor that processes personal information of more than 1 million individuals is to transfer personal information out of mainland China; or where a data processor that has transferred personal information of more than 100,000 individuals or sensitive personal information of more than 10,000 individuals out of mainland China since 1 January of the previous year is to transfer personal information out of mainland China, mandatory security assessment by the CAC will be triggered. Failing to pass security assessment will effectively cause any continued cross-border data transfer to be illegal.

Important data

Important data means the data, once tampered with, destroyed, leaked or illegally obtained or used, may endanger national security and public interest. Processors of important data are required to conduct mandatory security assessment for cross-border data transfer, regardless of the volume thresholds otherwise applicable to ordinary data processors. However, the specific catalogues of important data will be formulated by regional and sectoral regulators.

Critical information infrastructure operator

Critical information infrastructure operator (CIIO) refers to important network facilities and information systems of key sectors such as public communication and information service, energy, transportation, water resources, finance, public service, e-governance and defence technology and industry, and other important network facilities and information systems of which the damage, dysfunction or information leakage may cause severe harm to national security, national economy, people's livelihood or public interests.

Similar to processors of important data, a CIIO is required to conduct mandatory security assessment for cross-border data transfer, regardless of the volume thresholds otherwise applicable to ordinary data processors. However, the designation of CIIO status is conducted through active government ruling. In other words, unless specifically identified as a CIIO by the government, it is safe to operate as an ordinary data processor where special rules governing CIIO will not apply.

Enforcement trend

Following the various implementation regulations and rules, law enforcement campaigns are strengthened by the regulators especially towards market players collecting and processing huge volumes of personal information. The *Didi* case is an obvious example of such enforcement efforts.

The hefty fine of 8 billion yuan issued by CAC in July 2022 against Didi, the dominant ride-hailing giant in China, for various data violations, showcases the importance of data compliance. In particular, the chairman/CEO and the president of Didi were each issued a personal fine of 1 million yuan for their roles in such violations. In press interviews, the data regulator highlighted the violation committed by Didi, including (1) refusal to take remediation actions under specific requests by the regulators; (2) a period of violations over a total of seven years since 2015 (and these violations continued to occur even after the Data Security Law and the PIPL took effect); (3) some personal information collected, for example, screen shots and family members have infringed upon the users' privacy; (4) the volume of illegally processed personal information reaches 64.7 billion items, including facial identification information, precise location, ID number; and (5) violations include excessive collection, compulsory collection, insufficient information provided to data subjects, failure to take data security measures, etc. Further, Didi's data practice also posed threats to national security, which, however, could not be publicly disclosed. The regulator did not specifically mention the calculation basis for the 8 billion yuan. But the PIPL sets a very high threshold of fines, up to 5 per cent of the annual turnover or 50 million yuan, whichever is higher. According to the 2021 annual report published by Didi, it seems the 8 billion yuan fine is close to the upper limit of 5 per cent annual turnover of Didi group. And the personal fines of 1 million yuan are also set at the upper limit under the PIPL. So far, Didi is in the

process of delisting from the US stock market. The PIPL also sets criminal liabilities for serious violations that seem not to be triggered in the *Didi* case.

The *Didi* case represents the enforcement trend for data protection. It is widely expected that the data regulators will strengthen law enforcement in cybersecurity, data security, personal information protection, which may include measures such as enforcement interviews or talks, remediation requests, warning, public condemnation, monetary fines, suspension of operation, website or app shutdown and personal fines to responsible individuals.

Commonly seen data compliance gaps

We have been instructed by many clients covering a wide range of industries to review and analyse their data compliance practices and identify gaps against the legal requirements. We believe, out of our first-hand experience, the following gap areas are more commonly seen in the processing of personal information, which, however, shall not be viewed as an exhaustive list. The identification and corresponding remediation of these gaps will help the investor to evaluate potential risks and consider appropriate response strategies in transaction documents.

Information to be provided to data subjects

The PIPL prescribes a comprehensive list of information which must be provided to data subjects, including: (1) the processor's identity and contact details (and, where applicable, the personal information protection officer's contact details); (2) the purposes for which personal information is processed, the manners of processing, the types of personal information to be processed and the retention periods; (3) the ways and procedures for the data subjects to exercise their rights under the PIPL, including the rights to withdraw consent to the processing; access their personal information or obtain a copy of it; request the correction or erasure of their personal information; object to the processing of their personal information; request data portability and request explanation of the processing; (4) where personal information is provided to third party processors, the identity and contact details of the recipients, as well as the purposes for which personal information is processed by the recipients, their manners of processing and the types of personal information to be provided; (5) where sensitive personal information is processed, the necessity of such processing and its impacts on the data subjects; (6) where personal information is to be transferred out of China, the identity and contact details of the overseas recipients, as well as the purposes for which personal information is processed by the recipients, their manners of processing, the types of personal information to be transferred out of China and how the data subjects may exercise their rights against the overseas recipients; and (7) any further information required by law.

The channels for a company to provide this information to data subjects, (eg, employees, job applicants and business contacts, etc) include privacy notices, the employee handbook and a website statement. However, most companies fail to provide sufficient and detailed information to data subjects in accordance with the PIPL requirements. Further, as new rules may be issued from time to time, it is also quite common to see existing documents that have not fully reflected updated requirements. Regular review and revision of existing documents are one area where there is a gap for many companies.

Consent

The PIPL provides several legal bases for a data processor to process personal information, including (1) the data subject's consent; (2) the processing is necessary for entering into or performing a contract to which the data subject is a party, or is necessary for human resources management under lawful labour policies and collective agreements; (3) compliance with legal duties and obligations to which the data processor is subject; (4) in response to public health incidents or to protect the vital interests of natural persons; (5) for news reporting and media supervision for the purpose of protecting public interest and within a reasonable scope; (6) the processing within a reasonable scope of personal information publicised by the data subject or otherwise lawfully made public; and (7) other situations provided by laws and administrative regulations.

Among these legal bases specified above, consent is the most often used one for a data processor. However, for a consent to be valid it must be a freely given, specific, informed and unambiguous indication of the data subject's agreement to their personal information being processed. A data processor should not seek consent to various processing using a general term, and must not induce or force data subjects to consent to bundled processing activities. Further, processing sensitive personal information (eg, financial account details) and sharing China-based client and employee personal information with overseas affiliates will trigger a different layer of 'separate consent'.

Many companies do not have a valid consent collection mechanisms for processing personal information of China-based internal and external data subjects, which shall cover separate consent required under the PIPL. In particular, an implied consent, such as by accessing or using a website, will not constitute a valid consent. And many companies do not retain consent records.

Cross-border data transfer

Cross-border data transfer refers to a two-way transmission of information, which means a foreign user accessing data within China from abroad is also considered as a cross-border transfer rather than a one-way transfer of data outside of China.

For a foreign invested company operating in China, cross-border data transfer may be a must in various scenarios, such as human resource management, global IT or software deployment, client relationship management, vendor support, etc. Therefore, cross-border data transfer rules will immediately affect normal cross-border data flow.

Once certain volume thresholds as set out in the Measures on Security Assessment for Data Exports (which was released by the CAC on 7 July 2022 and shall take effect from 1 September 2022) are met, mandatory security assessment will be triggered. A CIIO and processors of important data also need to conduct security assessment with the CAC regardless of whether the volume thresholds are met. In practice, for most companies, CIIO or important data rules may not be applicable.

Even if mandatory security assessment thresholds are met, to provide personal information to overseas recipients, a processor must either obtain security certification for cross-border processing of personal information by a professional agency designated by the CAC; or enter into a China SCC to be formulated by the CAC. The CAC published the Draft Provisions on the Standard Contract for Personal Information Cross-Border Transfer (China SCC) on 30 June 2022, including the draft form Standard Contract, seeking public comments until 29 July 2022.

As the mandatory security assessment rules are only recently released, certification and China SCC are not yet readily available to data processors, it is advisable to closely monitor latest legislative progress and market practice. Especially for those companies that may meet volume thresholds, proper data mapping and preparation for the security assessment needs to be initiated in order to meet the deadline of compliance within the grace period up to 28 February 2022 as specified in the Measures on Security Assessment for Data Exports. Some clients have already reached out to us to start preparing relevant assessment. For companies that may not meet the volume thresholds, it is advisable to closely follow up with the release of the final China SCC and negotiate with or at least inform overseas recipients (eg, affiliates or vendors) regarding execution of the China SCC, which needs to be filed to the CAC for records. Failing to execute the China SCC and filing with the CAC will result in non-compliance with respect to cross-data transfer.

Data protection impact assessment

According to the PIPL, prior data protection impact assessments (DPIAs) are required in the following scenarios: (1) processing sensitive personal information; (2) using personal information for automated decision-making; (3) entrusting a third party to process personal information, sharing with other personal information processors or publicising personal information; (4) providing personal information to overseas recipients; and (5) other processing activities that may have a material impact on the individuals. DPIA reports and processing records of these activities must be kept for at least three years.

However, most companies that we have interviewed have not conducted any DPIAs, especially for certain high-risk activities such as processing of sensitive personal information, entrusting a third party and providing personal information to overseas recipients.

Data retention

The PIPL requires that personal information should only be retained for a minimum period necessary to fulfil the purposes for which it is collected, unless it is required to be kept for a longer time under applicable law. Once the personal information is no longer required for such purposes or the retention period expires, the processor should delete such personal information.

Some companies that we interviewed keep personal information permanently, some other companies take quite simple technical solutions to anonymise personal information that could be easily restored. These practices are clearly against the legal requirement under PIPL.

Legal due diligence strategy and implications to transaction

The overall legal framework, key concepts and commonly seen gaps lay the groundwork for legal due diligence strategy for data compliance. It is advisable to focus on the gap areas and size the potential risks and consider options to address such risks in transaction documents as well as post-closing arrangements.

Further, it is also advisable that protection of personal information of the target company during the legal due diligence process itself is also important. To the extent possible, an investor shall only require the target company to provide information that will not be traced to any identifiable individuals. Some technical solutions, such as redacting of personal information of individuals, is recommended.

What to review

Typical documents relevant to data protection may include existing data protection policies (such as a data protection policy or data section in the IT policy; employee data policy or data section in the employee handbook; data retention policy; security incident contingency plan, etc), data transfer or sharing agreement, employment contract, vendor or customer contract, etc.

For target companies with large manufacturing background or of an international group that have significant EU presence or affiliates in the EU, GDPR compliant data protection documents may be used by affiliates in China. Although there are distinct differences between GDPR and PIPL, there are many shared concepts or rationale for certain legal requirements. A company that complies with GDPR is likely to have a high standard in complying with PIPL and other data laws in China although certain localisation work may be necessary to bridge the gap and differences.

Who to talk to

Employee and business contacts are the main sources of personal information that a processor may collect and process personal information from. Therefore, people or internal departments that need regular access to this information would be the right people to conduct interviews over data practice.

In a typical corporate structure, HR, sales and IT are the right departments to conduct interviews. Some companies may have outsourced certain functions to external vendors (which are entrusted parties in a PIPL context to process personal information), in which case, interviews need to be conducted with these vendors.

What to ask

As a direct response to areas that a data processor may typically have gaps against the legal requirements of PIPL, we believe the following questions should cover the key data practices of a target company, which, of course, is not an exhaustive list and customisation is required for specific targets:

- the business activities and main functions of China entities, and whether any expansion of business scope will be considered;
- the number of employees;
- whether overseas affiliates provide products or services to China based individuals;
- whether overseas affiliates provide support or services to Chinese affiliates. For example, many international group companies have centralised HR, IT, risk management, legal or marketing teams that provide global support;
- types of data subjects (eg, employees and temporary staff, individual clients, website and social media users, directors and ultimate beneficiary owners of corporate clients, service provider representatives, etc) that a processor may collect personal information from;
- whether personal information from minors below the age of 14 will be processed;
- types of personal information or sensitive personal information to be processed;
- how consent is obtained;
- whether personal information collected will be shared with third parties (with group and with external third parties) and whether there are data clauses or specific data sharing agreements;

- whether personal information will be transferred out of China (assessing the personal information remotely from outside of China also counts) and whether there are data clauses or specific data transfer agreements;
- whether there are any existing policies in relation to data protection;
- IT infrastructure in China;
- usage of group-deployed global systems;
- how data are retained or deleted; and
- whether there are any data breach incidents, data subject complaints or government investigations.

Implications to transaction

Subject to the exact legal due diligence findings of the gap areas in the target company's data compliance practices, it is advisable to categorise the practice gaps into different priority lists and address such gaps with proper actions accordingly, such as appropriate closing conditions, post-closing covenants, indemnifications, reduction of valuation, etc. The key factors in considering response actions include implementation time, severity of violation and available options to mitigate risks, among others.

Prior closing remediation

Some gaps may be easily bridged via update or preparation of certain documents. For example, to properly collect consent from employees and job applicants, consent forms meeting the PIPL requirements can be drafted and implemented into daily operations.

Post closing remediation

Some gaps, such as deployment of IT infrastructure, re-negotiation with core vendors (eg, HR or client relationship management software providers) on data protection clauses or agreements, could be considered as a post-closing covenant assuming in the case of a minority investment where existing sellers will stay with the target company post closing.

Some other gaps, such as mandatory security assessment with the CAC, can be dealt with in an orderly fashion. Considering the relevant rules are newly released and the capacity of CAC and its local branches to process applications, as long as the legal required actions (eg, self-assessment and remediation actions) are taken.

Proper indemnification

It is also important to request specific indemnification against non-compliance in data protection considering the huge potential monetary fines, disruption to essential data flows in daily operations, reputational damage or personal liabilities, or both, that may be triggered.

Reduction of valuation

If data violations may pose potential but manageable risks, it may be a good bargaining chip to request a lower valuation. If data violations are serious and unlikely to be remedied (eg, an illegal source of data that forms key or material assets of the target company that can not be replaced with legally obtained data) it is advisable to make decisive actions to terminate the project in light of this deal-breaker scenario.

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Addressing key stakeholder concerns for IBR projects in China

Jing Wang, Nicholas Cook and Felix Chan¹

Addressing key stakeholder concerns for IBR projects in China

The practice of international business reorganisations (IBR) involves the reorganisation of corporate groups, usually covering multiple countries and often on a large scale in terms of jurisdictions, entities and steps involved. These projects may also be referred to by alternative labels, such as 'corporate restructurings', 'group restructurings', 'solvent restructurings' or 'solvent group reorganisations'. The practice of IBR is distinct from 'restructuring and insolvency', which generally relates to distressed reorganisations in which a group's liabilities outweigh its ability to pay.

While the underlying business rationale(s) for each IBR project may vary (and these are explored further in the next section), they typically have a common intermediate goal: to effect changes to the ownership of entities or other assets of a corporate group by moving the group from a given starting structure to a pre-determined preferable end structure. A key to successful IBR projects is achieving this move in a tax-optimised, legally compliant and efficient manner.

Various mechanisms are used to achieve this goal, from simple share transfers for cash consideration (or debt), through to entity or business mergers, business divisions, contributions in-kind, distributions in specie, returns of capital and share buybacks, to name but a few. Other corporate mechanics may need to be invoked as preliminary or incidental steps to allow such transactions to occur. Examples include incorporation of new entities, share swaps, capital reductions, amendment of articles of association (or equivalent constitutional documents) (hereafter referred to as 'articles') and even the creation, assignment or novation of loan receivables and payables.

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In any case, the overall complexity of an IBR project increases with each additional step, entity or jurisdiction involved (often exponentially). Large IBR projects can involve hundreds of legal documents, and the project management of such projects is not without its own challenges.

This article looks at some of the key stakeholders involved in a typical IBR project, with a particular focus on issues that affect IBR projects in the mainland People's Republic of China (PRC or China), and offers advice and suggestions as to how best go about satisfying the interests of all concerned stakeholders.

Typical rationales for IBR projects

Tax considerations

Multinational organisations will invariably have established local entities operating in various geographies. Each entity will have its own flow of revenues and costs. Revenue may be booked in one entity while costs are incurred in another. Dividends and loans flow through the corporate structure from entity to entity and may be subject to different tax regimes in different jurisdictions, generating different types and amounts of tax. Meanwhile, intra-group payments are subject to transfer pricing considerations, particularly in the BEPS 2.0 world in which we now find ourselves.

An organisation's group structure and geographic footprint can have a profound impact on its overall tax exposure. Periodically, a corporate group may choose to consider their current structure in view of then-prevailing tax rules (such rules also being subject to change from time to time), and assess whether their business or operational needs may be better served through an alternative structure, thereby incidentally deriving material tax benefits in the process. Tax considerations are often a key factor when carrying out IBR projects, and tax analysis of the end structure should invariably be conducted at an early stage of every IBR project.

At the same time, each intended transaction and movement of assets and liabilities in the course of an IBR project will also generate a separate set of tax implications that needs to be carefully weighed and balanced. There is often more than one way to move from the given initial structure to a given end structure. However, the type and quantum of tax generated by each approach may differ and can be a key consideration in choosing the preferred approach. Likewise, legal considerations for each step will differ and potentially contradict certain tax drivers. In such cases, it may be necessary to holistically balance countervailing risks and benefits.

Seeking professional tax and legal input at an early stage will help navigate the tax and legal minefields to avoid potentially expensive blunders or impermissible actions that may be difficult, costly or even practically impossible to rectify.

Changes to legal regimes and compliance

Alterations to a group's structure may sometimes be necessitated by changes in local and global legal regimes. These laws may apply due to a given entity being incorporated in the relevant jurisdiction, the group making business decisions in a particular location or the group having operational business (profits or costs) in a particular market. For example, changes in global taxation regimes may cause certain existing fund flows to be problematic or unlawful unless additional reporting and tax obligations are complied with.

A topical example would be that, at the time of writing, many corporate groups are considering whether they will need to restructure as a result of Hong Kong's planned introduction of a foreign source income exemption regime for passive income. These rules are set to come into

effect by the end of 2022 and will affect, in particular, Hong Kong entities holding equity interests and intellectual property (IP), by potentially exposing related income flows to Hong Kong profits tax for the first time (unless the exemption applies).

Pre-spin-off structuring, carve-out transactions and China exits

From time to time, a group operating multiple business lines may decide to dispose of a certain line or lines of business. This can potentially unlock value for shareholders as it provides each business line within the larger group with greater management flexibility and independence to pursue focused strategies for growth.

However, because corporate group businesses often operate in a highly integrated way by sharing premises, assets, systems, people and customer contracts, a pre-divestment reorganisation may be necessary to prepare the relevant business for sale in an efficient and attractive structure.

Pre-spin-off reorganisations can be complicated for larger groups, and sufficient analysis and planning time will need to be given in advance of any intended spin-off as this can add significantly to the transaction timeline. Integrating entities from various jurisdictions under a common holding structure can also have significant tax implications (and may not even be permissible under certain local laws). For example, in China, onshore business may only be conducted by PRC incorporated/registered entities. It is, therefore, important that proper legal and tax advice is sought during the process.

In the current geopolitical and economic climate, we have seen some overseas-headquartered corporate groups seek to exit or step away from their China businesses. This trend began during the covid-19 pandemic and has been reinforced by ongoing 'COVID-Zero' policies in China. For example, it can be difficult for foreign individuals to travel to China, get visas and residence permits and go through local quarantines, generating practical difficulties for foreign-headquartered businesses to operate on the ground in China. Local lockdowns and other restrictions have also played their part in generating practical challenges to operating a successful business in China.

Post-deal integration

An organisation may choose to expand by acquiring new businesses from third parties, to be held within its existing corporate structure. This is usually achieved by way of an asset transfer, business transfer or transfer of shares in a holding entity from the relevant seller. Any acquired entity may themselves hold numerous group companies.

After such an acquisition, it is often desirable to undergo a restructuring to integrate any newly acquired corporate entities, businesses and assets into the organisation's existing structure to better capture shareholder value, minimise duplication of layers (for example, where there are multiple operating entities performing the same or similar functions in the same jurisdiction or territory) and achieve better operational and management efficiencies.

Entity rationalisation and simplification

For multinational companies, an inflated corporate structure is usually inadvertent and not by design. As a corporate structure grows, so too does the complexity of management, the distribution of dividends and profits, intra-group activities and tax considerations as well as ongoing maintenance fees for the structure (auditors, company secretarial, registration fees, legal

adviser fees, etc). IBR can be a means of simplifying a structure to minimise complexity and ongoing costs.

There can be different degrees of corporate rationalisation, categorised into three levels of complexity:

- The first level is the elimination of legacy entities or other 'low hanging fruit', by removing companies that add the least value to the structure. This is often the case where entities are defunct and no longer used.
- The second level involves legal entity simplification. For example, a group may aim to retain one operating entity per country or territory or consolidate the structure based on the nature of operations. Multiple businesses in a single jurisdiction could thereby be consolidated.
- The third level involves making more radical changes to group structure and entails business and operational transformation. For example, a group may convert international subsidiaries to a single entity with 'branches' or consolidate administrative functions across territories or areas of business in regional hubs. Such projects require an appetite for transformational change.

Pre-IPO restructuring

Where an initial public offering (IPO) is contemplated, it is common for a restructuring to be carried out in advance to prepare for the group's listing. This can be the case whether the listing is anticipated to be on a stock exchange in China or abroad.

It is common for such a restructuring to entail the consolidation of multiple operating vehicles under a single intended listing entity (ListCo). Often the intended ListCo will be a newly incorporated special purpose vehicle, set up in the preferred listing jurisdiction. Indeed, as of the date of this publication, ListCo entities must be incorporated in China for China local-board listings.

The group's management must consider which business divisions are to be included in the listing and how business operations will be divided within the corporate structure. Any such restructuring will also need to be considered against the backdrop of the applicable listing rules and requirements.

Other practical and operational rationales

There may be other practical and operational rationales for embarking on an IBR project. These may include aligning corporate structure to a new operating model, moving into new geographical markets or establishing new manufacturing facilities, call centres or other outsourcing operations (or their consolidation), each of which may necessitate the establishment of subsidiaries or branches to achieve the underlying objectives of the project.

Government

For most IBR projects in China, government agencies at a central or local level play a vital, and sometimes decisive, role in the design and implementation of the overall restructuring plan. Some commentary on the key authorities is set out below.

Industry-specific regulators

China maintains 'negative lists' for certain industries in respect of which investors are required to obtain approval before they may participate (these 'negative lists' are updated from time to time). Corporate groups contemplating a restructuring should familiarise themselves with the

relevant regulators involved. For example, if a pharmaceutical company wishes to spin off its drug-packaging business to a third party, the intended purchaser must first obtain approval from the National Medical Products Administration.

We list below some examples of industry specific regulators.

Industry	Business scope	Regulator
Banking and insurance	Banking, insurance and insurance agency or brokerage services	China Banking and Insurance Regulatory Commission
Education	Running for-profit private schools	Ministry of Education
Finance	Operating financial holding companies	People's Bank of China
Healthcare	Production and distribution of drugs, medical devices, food and cosmetics	National Medical Products Administration
Telecommunications	Basic telecoms services and value-added telecoms services	Ministry of Industry and Information Technology
Transportation	Road freight or road passenger transportation	Ministry of Transport
Tourism	Travel agency services	Ministry of Culture and Tourism

Development and reform commissions

In China, infrastructure and large construction projects must be approved by the government agencies in charge of capital investment. These agencies include relevant local Development and Reform Commissions (DRC) and the National DRC (NDRC), those in charge of urban planning, land use, environmental protection (which may require the preparation of an environmental impact assessment report), energy conservation and state-owned assets (if any state-owned enterprise (SOE) is involved).

The NDRC or local DRC plays a leading role in reviewing project applications. If the restructuring entails a division or material change to a previously approved project (such as reduction in size, or relocation), the restructuring itself and any new entities that will inherit the project or the bulk of the project will need approval from the DRC that approved the original project.

Administration for Market Regulation

The local Administration for Market Regulation (AMR) and the State AMR (SAMR), are also important government agencies when carrying out China IBR projects. The primary role of SAMR/AMRs in restructurings include:

- handling the registration of newly established companies and companies emerging from a business division or merger after the restructuring;
- reviewing the PRC merger control filing and granting clearance from the perspective of anti-trust law if the restructuring triggers the merger filing threshold;
- handling registration of certain changes to the company, including change of shareholders, shareholding structure, corporate governance, business scope, etc; and
- overseeing non-compliance that a company may exhibit in its operations, such as acting beyond its approved business scope or acts in violation of laws such as advertising laws.

In most regions of China, requirements from local AMRs are fairly consistent in terms of documentation and timeline. However, it is still common for the local AMR official in charge to raise

questions or make comments, and these comments may not be entirely consistent with the intended commercial terms of the transaction. For example, some AMRs insist on using their template articles and will not accept alternative form articles that a company may otherwise wish to adopt.

During the IBR feasibility phase and before any concrete timeline is confirmed, it is strongly recommended that advisers consult with the relevant local AMR to minimise the risk of unexpected issues. Alternatively, the parties will need to adopt practical measures to accommodate any unexpected requests, such as the granting of special powers of attorney to representatives in order to allow them to make any requisite changes onsite when the documents are submitted to the AMR for review. This may constitute a concern for some multinational companies, as it may side-step corporate governance and internal controls and can lead to uncertainty and unexpected last-minute changes.

Administration of Foreign Exchange

Where a Chinese entity involved in a restructuring has outstanding foreign debt, which is intended to be assigned to another Chinese entity as part of the restructuring, or where additional funding will be made to a Chinese entity in the course of the restructuring, it is necessary to communicate with and obtain approval from the relevant local Administration of Foreign Exchange (AFE) or the State AFE (SAFE) and the relevant processing bank.

This process may entail hidden complexities, as local AFEs and banks may have their own mandatory procedures to follow. These procedures are seldom published or freely available to the public. Therefore, prior consultation needs to be made during the legal feasibility study or assessment stage to determine exactly what steps will be required. These steps can vary depending on the local Chinese region (and the relevant AFE) involved.

Intellectual property authorities

As part of an IBR project, an investor may need to reshuffle their IP mapping in China to follow their global IP policies or to align with the new post-restructuring business model depending on the group's IP strategy (and based on both tax and legal considerations). New licences and IP assignments may be needed. For licences and assignments of IP such as patents, trademarks and registered software copyrights, there will be a requirement for recordals and approvals by various Chinese authorities. This is particularly the case where non-Chinese parties are involved in the IBR project. For an example, if a Chinese software company is to grant a licence to a new group company in Singapore to use certain of its technologies, the licence must be recorded and approved by multiple Chinese regulators. In cases where approvals for the licences or assignments are needed, it cannot be taken for granted that approvals will be granted and hence parties need to strategise and plan for different eventualities. The time taken for the recordal and approval process must be factored into the project timeline.

While written transfer agreements are required for all such transfers, the effective date of a transfer will vary by the category of IP involved, potentially affecting the timeline. For example, a patent transfer is effective as of the date of recordal or approval by the Chinese Ministry of Commerce, depending on the type of technology covered by the patent. In addition, the effective date of a patent transfer may also depend on the date of recordal by the Chinese patent authority. Conversely, a trademark transfer is effective only upon the approval of the transfer by the trademark authority, which in practice may take six to eight months from the date of application for

approval. Corporate groups should be aware that they may have only limited control over the timeline of such IP transfers in China, and should plan accordingly.

Other local government authorities

Some Chinese local governments have been known to offer foreign investors attractive preferential investment policies, including lower tax rates, delayed tax collection, land use right grants for below-market prices, financial subsidies or bonuses, and so on. In return, the investors are expected (and required) to meet certain performance targets, including investment commitments up to a certain dollar/yuan amount, achieving revenue targets within a prescribed period or creating a certain number of jobs in the local region. If the company fails to meet these targets, the company or its investors may be asked to pay a penalty or to disgorge the tax or financial benefits that were granted.

As a matter of Chinese law, a local government does not have the authority to stop a company from effecting its restructuring plan, but the extra time required to coordinate with local government should be taken into account when the project timeline is being developed.

Directors, supervisors and management

Almost all IBR projects with China elements will need to involve the local directors, supervisor(s) and management (DSM). Even if decisions on the restructuring are made by the headquarters or investors outside of China, the affected Chinese entity or entities may need to take actions or make decisions in accordance with its articles and, if there is more than one shareholder, any shareholders' agreements.

Directors

The board of directors is an important corporate organ for all Chinese companies. For Sino-foreign joint ventures, the board of directors used to be the highest authority of the company. This may still be the case if the company was established under the Sino-Foreign Equity Joint Venture (EJV) law and has not updated its corporate governance structure (although this update is required to be completed by the end of 2024).

The directors (and indeed other DSMs) of a Chinese company have a duty of care and duty of loyalty to the company as a matter of law. For companies with multiple shareholders, major shareholders often have the right to appoint directors (who will likely act in accordance with the interests of that shareholder). This means that if the restructuring requires a majority approval or super-majority approval at the board level, consensus or alignment between the shareholders must be achieved first (even in the absence of approval provisions in any agreement between the shareholders).

Supervisors

It is mandatory for all Chinese companies to appoint a supervisor (or a supervisory board). The supervisor oversees the performance of the board of directors and the senior management on behalf of the shareholders. In most cases, they act as a kind of passive check and balance on the directors of the company (a supervisor cannot concurrently be a director or senior manager of the same company).

Normally, appeasing supervisors in respect of an IBR project is not as critical as the sign-off of directors and senior management (as directors are the persons signing off on transactions),

but a disgruntled supervisor is certainly capable of disrupting a restructuring timeline if they do not buy into the restructuring plan.

Legal representatives

The concept of a legal representative is unique to Chinese law. A legal representative is treated as the embodiment of the company and is authorised by law to represent and bind the company. Strictly speaking, a legal representative does not have to be a Chinese national or be permanently based in China. However, by law he or she is the primary point of contact for any major decisions or events in respect of a Chinese company. For example, in bankruptcy proceedings, the legal representative should be readily available for in-person government or court proceedings.

Normally, the company's legal representative will be expected to sign external and internal documents relating to a restructuring. If a legal representative is not based in China, he or she could give a power of attorney to an authorised representative for the execution of certain documents. It is also not unheard of for a legal representative to refuse to sign documentation if he or she is not agreeable to the terms of the restructuring plan.

Foreign investors often underestimate the importance of the legal representative's chop (a kind of stamp or seal), which has the power to bind the Chinese company. In the event that a legal representative is uncooperative, a foreign investor would be well advised to consider immediately replacing the legal representative or take steps to obtain custody of the legal representative's chop, or both.

Under Chinese law, the legal representative may also be the chairperson of the board of directors, the executive director or the general manager. If the restructuring will result in more than one company with different core businesses, then it is not advisable for the same person to be legal representative of both companies.

Senior management

The senior management of a Chinese company includes a general manager and any other senior positions as may be set out in the articles of the company. Most or all of the senior managers will also be employees of the company. Their role in a restructuring project is sometimes tricky.

For example, where a company is splitting or spinning off a business, a decision will need to be made as to whether each senior manager will remain with the pre-existing or surviving company, or will move to a new divestment company. Each senior manager may have their own ideas and preferences as to which role they wish to take up.

Each senior manager may need to be appeased to prevent them from deciding to leave the group altogether. If he or she chooses to join a competitor, the company will have to worry about competition, breach of confidentiality and the leakage of trade secrets (which is, unfortunately not uncommon in China). Retaining the senior management, or at least the key senior managers, requires effort and consideration of their respective personal interests.

Common issues encountered in respect of China DSMs

Correction of missing corporate records

In China, any change to the directors, supervisors or legal representative must be filed with the company registration authority, the AMR, within 30 days after the change is made. Failure to complete this registration or record-filing is theoretically subject to penalties imposed by the

AMR. In practice, this rule is not strictly enforced, and the AMR seldom sanctions companies for not making registrations in good time.

However, during an IBR project, companies involved may need to pass resolutions or issue certain documents in the name of the company (affixed with the company chop or signed by the legal representative or other authorised representatives). If the names of directors, supervisors and the legal representative are not consistent with the records kept by an AMR, some AMRs may ask the company to rectify and 'catch up' on any missing filings before the AMR will accept the current filing or registration. If the replaced or retired directors are not readily available to sign these filings, then the overall restructuring process may be disrupted or delayed. The status of AMR filings should be checked and taken into account during the feasibility stage of an IBR project when considering the overall project timeline.

Concurrent positions

As mentioned above, where a restructuring is between affiliates (as is often the case), or a new company will emerge as part of the restructuring, the shareholders will need to consider whether the persons serving in DSM positions in the pre-restructuring company should retain their roles in the new company(ies) as well, at least for an interim transitional period.

DSMs have a duty of care and a duty of loyalty to the company they serve, so it may be problematic (from a technical perspective at least) for a DSM to occupy the same position in respect of multiple group companies. This is particularly the case for a senior manager who is also a full-time employee of one or more relevant companies.

Conflicts of interest

Unfortunately, it is possible that DSMs may seek to undermine the interests of their company by means of connected transactions or to exploit business opportunities contrary to the interests of the company. These conflicts of interest are more likely to occur in the course of a restructuring.

We have seen a restructuring project in which the Chinese local management team persuaded the overseas corporate headquarters to relocate its Chinese business to Vietnam, ostensibly for cost control and related reasons. However, it later became apparent that some of the DSMs would not move with the company to Vietnam and had instead set up their own competing business in China to step into the shoes of the outgoing company following the restructuring.

Employees

Overview

In a typical IBR project, be it an equity transfer, asset transfer or business spin-off/divestment, employees can be generally categorised into three groups:

- employees who will remain with the pre-restructuring entity or the surviving entity following the restructuring (company A);
- employees who will be transferred from company A to company B; and
- employees whose employment will be terminated.

Termination

Difficulties can arise if there is a desire to terminate employees. Chinese law is generally favourable to employees, and only permits the dismissal of employees on limited grounds. In the case

of a restructuring, the most relevant ground is likely to be a 'major change in the objective circumstances on which an employment contract was based'.²

A 'major change in objective circumstances' means *force majeure*, or any other event that frustrates all or a material part of the employment contract, such as relocation of the employer, transfer of all or part of the employer's assets to a third party or merger in which the employer ceases to exist (or similar circumstances).

Although an employer may terminate employees based on a 'major change in the objective circumstances on which an employment contract was based', they are not entirely free to do so. Local government is often concerned over any potential 'disruption to social stability'. Therefore, in practice, the employer will likely have to offer a compensation package that is higher than the bare minimum required by law. In other words, a mutual termination agreement is often adopted to settle the employee separations and transfers. This will, once again, require advance and careful planning, calculation of costs and communication with employees and local government.

Business transfer

Unlike the laws in some other jurisdictions, Chinese law does not provide for the automatic transfer of employees along with the business in a business transfer. In practice, the seller entity must terminate each existing employment contract with each relevant employee, and the buyer entity must enter into a new employment contract with each employee who is to be 'transferred'.

Severance pay will be payable to each transferred or terminated employee unless the buyer entity agrees to grant continuity of service to the employee. Granting continuity of service to an employee means that an employee's deemed accrued term of service with the new employer will include the term of service pre-transfer. The restructuring group should be prepared to offer employees the choice of carrying over their service period or cashing out on accrued severance benefits.

Trade unions

While employees in China have the right to set up workplace trade unions, not all companies have a trade union in place. It will be necessary to involve the trade union (or, if no trade union has been formed, all of the company's employees) if more than 20 employees or 10 per cent of the total staff are to be dismissed.

The trade union or employees must be given at least 30 days' advance notice of a proposed business transfer. The notice must include an explanation of the situation and seek the opinion of the trade union or the employees (as the case may be), with respect to the transfer.

In practice, a trade union does not have the right to block a transfer. However, if the employee retrenchment plan is not aligned with, or is challenged by the trade union, then it is likely that the local labour bureau will not accept the retrenchment plan. If the trade union reports its reluctance to local government, it is likely that the local authorities will ask the company to revisit the employee arrangement plan so that local social stability is not disrupted.

2 Article 40(3), Labour Contract Law of the PRC 2012 [2012 Labour Contract Law].

Third party employment and payroll agencies

It is quite common in China for a third-party service provider to be the legal employer of a company's de facto employees and for the third party to dispatch such employees to work in the relevant group company's business. If this is the case, and if these dispatched employees are needed by another group company after the restructuring, then the original labour service agreement with the third party must be terminated and a new contract entered into with the new company. Allocation of service fees should also be taken into account in the cost calculation for the restructuring.

Expatriate employees

A foreign national employee can only work for the employer stated in their work permit. If such an expatriate employee holds a valid work permit from the original employer but is transferred to a new entity after the restructuring, he or she must apply for a new work permit with the competent local labour authority. In addition, the original work permit must be deregistered. The foreign employee will also need to visit the local Public Security Bureau (PSB) office within 10 days in order to amend his or her worker residence permit.

Obtaining a work visa or residence permit for an expatriate employee is not straightforward in China, particularly given that covid-19 restrictions remain in place. If foreign employees cannot travel to China to perform their duties, the employer may also need to consider local hires or redesign its working protocol or model to accommodate remote working arrangements.

Summary in respect of employees

In summary, arrangements in respect of employees require careful planning and can be crucial to the feasibility, timeline, and implementation of an IBR project in China (far more so than in many other jurisdictions). The IBR project may entail costs such as the payment of severance to terminated employees and dispute settlement costs if the intended project leads to a dispute with the employee or their trade union. The IBR project may also run into potential delays in implementing a business transfer or separation and lead to costs and other consequences that will need to be borne by the post-restructuring entities. Careful planning and coordination among different functions and outside advisers is important.

As a warning, we are aware of a case where a Chinese company wished to relocate to another city and announced the plan to the employees before it had reached a workable plan with the local governments of both regions. A significant number of employees chose to leave the company during the time taken to implement the relocation.

Shareholders

IBR projects can involve the transfer of shares in an entity that is not wholly owned by the group. In such a case, it is important to consider whether there are any agreements between the shareholders that may regulate the transfer of shares in such entity (whether on an onshore or offshore level). These may include shareholders' agreements (SHAs), joint venture agreements (JVAs) or similar agreements under other names or even under the articles of the relevant company or companies.

Quite often, the transfer of shares may be entirely prohibited unless the other shareholders give consent, or the transfer may be subject to the exercise or waiver of a right of first refusal or similar pre-emptive rights enjoyed by the other shareholders under Chinese law or as provided

for in a relevant SHA/JVA. In this case, there is little that can be done other than aligning with the other shareholders.

There may also be other provisions in SHAs, JVAs or articles that require detailed review, particularly if the consent of the other shareholders to the restructuring will not be sought.

Business partners and key contracts

Transfer of group companies and change of control clauses

Entities within a corporate group will no doubt have entered into agreements with different business partners (eg, licensing agreements, service contracts, leases, etc). Prior to an intended IBR project, existing material contracts should be reviewed to determine whether any terms would be an impediment to the intended restructuring. The main risk to guard against is any terms of a contract that may give the counterparty the right to terminate the contract as a result of the restructuring.

Where entities are moved across the group, the issue of change of control often arises. The meaning of 'control' depends on how it is defined in the relevant documents. It could relate to ultimate control (ie, the ultimate shareholder), but it frequently covers change of intervening controlling entities. Sometimes these clauses go even further and restrict changes in direct (or even indirect) shareholdings that do not represent a controlling stake.

Taking a step back, where a transfer of shares is conducted with the aim of spinning off or divesting the business line or exiting their China operations, the intended subsequent transfer to a third party is very likely to be caught by any relevant change of control clauses.

If a change of control clause is triggered (or is arguably triggered), and the group wishes to preserve the contractual relationship, it may need to reach out to the business partner well in advance to test the water, obtain consent or allow itself sufficient time to make corresponding adjustments to the steps plan (eg, if the business partner is adamant about termination, the group should explore whether there are alternative arrangements that can replace the contract and build those into the intended plan, and if not, reconsider whether to go ahead with the restructuring or limit its scope). The group may wish to, in any event, inform its business partners before the restructuring occurs to manage expectations going forward.

We also sometimes see clients taking a commercial view on change of control clauses, in the expectation that the relevant third party is unlikely to exercise their termination rights under such clauses (or, if the restructuring is only intra-group, may not find out about the technical trigger of these clauses). Of course, nothing is for certain, and such risks need to be quantified and considered against the benefits that the restructuring is expected to bring.

The above issues can also flow through the commercial transaction documents with third parties in the event of a spin-off, for example, in the relevant warranties or disclosures that are given or made (for example where the seller group is aware of contracts that may be terminated in the course of the spin-off).

Assignment versus novation

When transferring or consolidating business and contracts currently spread across multiple entities, from a common law perspective, a group can typically either assign or novate contracts. In general terms:

- An assignment transfers only the rights and benefits of the parties and the consent of counterparties may or may not be required depending on the drafting of the contract.

- A novation, on the other hand, transfers both the rights and obligations of the parties and the consent of counterparties is required.
- The concepts of assignment and novation do not have exact counterparts in Chinese law, but similar mechanisms do exist under the Chinese Civil Code and according to judicial practice. In the case of an 'assignment' under Chinese law, the assignor must notify the obligor (although in practice this is usually done anyway in common law systems to ensure a legal assignment is effected rather than a mere equitable assignment).
- In practice, most commercial contracts, and certainly 'important contracts', are likely to have a clause prohibiting both assignment and transfer or novation without consent.

Practical issues

If the group decides to approach a business partner (being the counterparty to a contract), they should give such partner ample time to consider its request. We have, on occasion, seen this process take weeks or months. Moreover, the group company should be prepared to satisfy any accrued obligations (or provide credit assurances) and to deliver reasonable releases in favour of the business partner. Sometimes approaching a business partner can backfire and prompt the business partner to try to renegotiate the terms of a contract – once again, a balancing exercise of risk/reward must be carried out. If this happens, the group may need to weigh the cost of continuing the arrangement provided under the relevant contract against its amendment or termination.

If, upon a holistic review of all the circumstances, the group decides that the best course of action is to allow the termination of a particular contract, it may find utility in clauses that grant a unilateral right of termination. For example, the right could be exercised upon the business partner's failure to meet minimum targets for turnover or commission of material breaches (which could, depending on the contract, be as simple as a failure to pay bills as they fall due). This approach may help to avoid counterparty's claims for payment of damages and also provide more leverage to the group in the course of seeking to negotiate consent.

Chinese personal data protection

Under Chinese law, pursuant to the Personal Information Protection Law (PIPL), 'data processors' (who would be called 'data controllers' in the West) are individuals or organisations who independently determine the purposes and methods of data processing activities.

With the development of mobile technology and mobile devices, data, including personal information of individuals located in China, is immensely valuable to many businesses and products. In an IBR project, it is becoming increasingly common for corporate groups to consider personal data privacy issues. When contemplating an IBR project, the following helpful questions can be asked:

- Is there any personal information that needs to be transferred during the business restructuring?
- Who are the personal information processors?
- How should the transfer of personal information be conducted?
- What legal issues does this generate that need to be addressed?

Transferring personal data to another party requires the individual's consent even if the transferor and transferee are both in China. Hence, parties need to set aside time for handling such notice and consent procedures in the course of an IBR project.

Data processors sometimes need to be reminded that they may ultimately bear liabilities in regard to other data processors and, more importantly, in respect of data subjects. When all or part of a business is transferred in China, this transfer normally entails changes to the identity of the data processor, the processing method or methods and the purpose of the processing. Particular attention should, therefore, be paid to any potential transfer of personal data in an IBR project.

For example, where a personal information processor provides other personal information processors with the personal information of an individual it processes, the PIPL requires that the individual must be informed of the name and contact information of the recipient, the purpose and method of processing and the type of personal information involved. Moreover, the individual's 'separate consent' must be obtained. The recipient must only process personal information within the scope of the permitted purpose, method of processing and the type of personal information. The processor must also obtain the consent of the individual anew, in accordance with the PIPL, if there are any changes to the purpose and method(s) of processing.

If personal information is to be transferred overseas, it is necessary to also provide information on how an affected individual can enforce their rights against the overseas party. Even if only a small volume of personal information is provided overseas, an impact assessment needs to be carried out, a record of the impact assessment needs to be kept for at least three years, and proper notice and consent ('separate consent') needs to be given and obtained. In addition, in some situations, Chinese government approval (referred to as a 'security assessment' in China) is needed. Again, parties involved in IBR projects need to set aside time for such processes and plan for different eventualities.

In addition, if the data processor is a critical information infrastructure operator, personal information and important data that the operator generates or collects within China must be stored onshore within China. If there is a genuine business need to transfer this data abroad, the transfer must pass a security assessment by the Cyberspace Administration of China (CAC) unless the law, administrative regulations and the rules of the CAC exempt the transfer. This rule is taken seriously in China and the following fines may apply:³

- Data processors who fail to comply with personal information protection obligations may be subject to fines of up to 1 million yuan for the processor, and up to 100,000 yuan for each individual responsible.
- In serious cases, the fines can be increased to up to 50 million yuan or 5 per cent of the previous year's turnover for the processor, and up to 1 million yuan for each responsible individual.
- Chinese law continues to be supplemented and enhanced in respect of personal data privacy issues, and the relevant regulators are becoming increasingly aggressive in seeking redress in respect of compliance violations.

3 Article 66, 2021 PIPL.

Offshore and intra-group considerations

Overseas holding structures

When corporate groups restructure with the intention of holding investments in subsidiaries incorporated in China, it is necessary to consider whether to use a direct or indirect investment structure (eg, to hold the Chinese subsidiary directly or to use an intermediate overseas special purpose vehicle (SPV), which will, in turn, hold the investment in the China subsidiary). If the SPV route is used, the group will also need to decide on the jurisdiction of incorporation of the SPV.

Some of the key factors in determining whether to use an SPV (and its jurisdiction of incorporation) include tax saving benefits, long-term objectives of the group, any preferential investor treatment, industry qualification requirements and the level of protection afforded by the relevant overseas legal system.

Tax saving benefits

Tax benefits may be available through an SPV structure, including lower tax withholding rates on the remittance of dividends, interest and royalties from the Chinese subsidiary⁴ and lower capital gains tax on transfers of interests (if any).⁵ However, there are likely to be added direct and administrative costs (and management time costs) as a result of an SPV structure. The introduction of 'economic substance' requirements in a number of overseas jurisdictions, including the British Virgin Islands (BVI), Bermuda and the Cayman Islands, has resulted in the need for additional attention when using overseas jurisdictions in a holding structure. As these rules continue to evolve, a cost benefit analysis should be conducted while deciding on the incorporation jurisdiction of the SPV and, indeed, whether one should be used at all.

Long-term objectives of the group

For example, on the one hand, there may be lower immediate tax costs if a group intends to reinvest profits generated in China, rather than repatriating profits overseas on a regular basis. On the other hand, there may be benefits in setting up an overseas holding structure if the intention is to list the China business in the future. Jurisdictions such as the BVI, Bermuda and the Cayman Islands are generally regarded as offering benefits as IPO ListCo entities. Specific tax and legal analysis should be sought on a case-by-case basis.

Preferential investor treatment

Chinese government authorities may offer preferential treatment to entities incorporated in certain jurisdictions based on bilateral agreements. For example, companies and residents from Hong Kong and Macau benefit from preferential access to certain sectors in China that are restricted in whole or in part to foreign investors, under the Closer Economic Partnership Arrangement. For example, subject to meeting specified qualification requirements, Hong Kong service providers investing in the construction of port facilities and the operation of port cargo

4 Dividends, interest and royalties paid by a Chinese entity are typically subject to a 10 per cent withholding tax in China per articles 3 and 27, Law on Enterprise Income Tax 2008 and article 91, Regulations on the Implementation of Enterprise Income Tax Law 2007.

5 For example, Hong Kong companies can be exempted from capital gains tax in China when they sell their directly held equity interest in a China subsidiary if specific conditions are met.

handling yards and warehouses in mainland China are eligible for benefits such as equal treatment to domestic Chinese enterprises in terms of minimum capital requirements and criteria for establishing regional branches within China.

Industry qualification requirements

The Chinese government may impose certain qualification requirements, such as a specified time of prior experience in a relevant industry or minimum capitalisation or turnover, which a new SPV entity may not be able to satisfy.

Protection afforded by an overseas legal system – the use of an SPV may afford certain advantages such as flexibility and legal remedies offered by the relevant overseas legal systems, particularly where there are multiple shareholders. While the Chinese legal system is rapidly developing as it adapts to market-driven forces, various aspects of the Chinese legal system may still have an impact on transparency and predictability. Chinese laws are often drafted in general terms and require further implementing regulations and interpretations. The Chinese legal system is a hybrid system but is primarily a civil law system. This means that Chinese courts are not bound by case precedents, and a previous court ruling generally cannot provide compelling guidance as to how a particular legal provision will be interpreted in the future. In China, there are also prohibitions and restrictions affecting certain contractual arrangements that may be common internationally, such as the use and exercise of put and call options, convertible preference shares, warrants, convertible and exchangeable debt and options. Establishing an overseas SPV structure may, therefore, offer a higher level of certainty, transparency and flexibility.

Chinese indirect equity transfer tax and PN7

Historically, Chinese enterprise income tax (EIT) could only arise on a direct transfer of ownership of shares or equity in a Chinese entity. This changed in February 2015 when the Chinese State Administration of Taxation (SAT) implemented tax public notice 7 (PN7).⁶ PN7 effected a new anti-avoidance regime. Chinese tax authorities may now impose EIT on an effective transfer of China taxable assets as a result of a change in ownership of an overseas company that owns those assets, either directly or indirectly through a chain of holding companies. This Chinese taxable assets include shares or other equity interests in a resident enterprise, any real estate located in China, or assets attributed to a non-resident enterprise's (NRE) permanent establishment in China.

The relevant test is whether the transfer of China taxable assets was carried out with the aim of avoiding paying EIT or whether the transaction had a 'reasonable commercial purpose'. In determining whether an indirect transfer structure has a reasonable commercial purpose, PN7 provides some guidance by indicating that the SAT will consider:

- whether the main value of the shares of the intermediary NRE is directly or indirectly derived from China taxable assets;

⁶ 'State Administration of Taxation's Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises [State Administration of Taxation Bulletin [2015] No. 7]' issued by the Chinese State Administration of Taxation.

- whether the assets of the intermediary NRE are mainly comprised of investments made in China and whether the income of the intermediary NRE is mainly sourced from China (directly or indirectly);
- whether the functions actually performed and the risks assumed by the intermediary NRE and its subsidiaries that directly or indirectly hold China taxable assets can justify the economic substance of the organisational structure;
- the length of time the shareholders, business model and relevant organisational structure of the intermediary NRE has been in existence;
- what foreign taxes are payable on the indirect transfer of China taxable assets;
- whether it would have been possible for the seller to directly invest in and transfer China taxable assets rather than to indirectly invest in and transfer them;
- whether there is any tax treaty or arrangement applicable to the indirect transfer of China taxable assets; and
- any other relevant factors that might be reasonably considered from time to time at the discretion of the SAT.

PN7 also provides for safe harbour rules that may be highly relevant to an intra-group restructuring. Companies are recommended to seek further advice as to whether these apply to a proposed IBR structure (or whether the structure can, and should, be tweaked to ensure that the safe harbour applies).

Practical and documentary considerations

Implementing an IBR project in respect of a complex group structure spanning multiple jurisdictions will require careful planning and consideration of applicable laws and requirements of the entities involved. Different jurisdictions and territories will have different requirements and formalities that must be complied with, particularly when it comes to the transfer of assets and shares.

Practical considerations can arise where the management responsible for signing the documents are situated across different locations geographically and whether originals, or even notarised, legalised or apostilled documents, are required. This will vary depending on the relevant laws applicable. Further, in the case of documents executed in Hong Kong for use in mainland China, they may even need to be certified by a China appointed attesting officer rather than a notary. These documentary considerations can add significant time to the overall IBR timeline. Obtaining territory-specific advice and appointing an overall coordinator is therefore important in these situations.

Related party balances

To avoid large cash flows during an IBR project, it is often desirable for parties to provide consideration for intra-group transfers in the form of loans rather than cash. Simple loan note documents can be entered into between intra-group entities to provide such consideration, thereby creating a balance of receivables and payables. Such receivables represent assets (and the payables represent obligations) that can then be transferred, distributed, contributed, assigned or novated between group entities.

These loans may need to be made in different currencies or be subject to interest to comply with applicable local requirements, or both. See also our comments above in respect

of SAFE approvals required where loans are made onshore or offshore between Chinese and foreign entities.

It is usually advisable to go through additional steps to tidy up any loans generated in the course of a restructuring rather than leaving them outstanding. Where necessary, multiple loans may be set off or combined, or a single loan may be bifurcated to facilitate the tidying up of intra-group debt.

Conclusion

While carrying out an IBR project can offer many benefits and allow a corporate group to hit multiple objectives (and in some cases may actually be necessary for compliance or viability of the underlying business), these projects are not to be undertaken lightly. If a particular project is complex, it may end up consuming management attention for a protracted period of weeks or months and may entail substantial adviser fees to ensure all relevant tax and legal risks are identified and properly mitigated.

As illustrated above, IBR projects with China elements may entail considerations that are not necessarily as relevant to restructurings in other jurisdictions. It is therefore vital to ensure that adequate time is given to feasibility and planning, and that IBR projects are not rushed to implementation. Picking an adviser based on their raw cost is usually a false economy. Corporate groups should be aware of the potential complexities that may be involved and pick their advisers on the basis of their depth of IBR experience and breadth of offering (both in terms of international and local capabilities) and by reference to their ability to provide solid legal, tax, accounting and even valuation advisory services and input on the issues that are likely to arise during the whole life cycle of the project.

7

Employment and labour

Caroline Berube and Ralf Ho¹

Introduction

Employment in the People's Republic of China (PRC) is primarily governed by:

- the Labour Law of the PRC, which was enacted on 5 July 1994 and came into force on 1 January 1995 (the Labour Law);
- the Labour Contract Law of the PRC, which was enacted on 29 June 2007 and came into force on 1 January 2008 (the Labour Contract Law); and
- the Regulation on the Implementation of the Labour Contract Law of the PRC, which was enacted and came into force on 3 September 2008 (the Regulation of the Labour Contract Law).

The Labour Law and the Labour Contract Law are applicable to all employment relationships between individuals and companies in the PRC. Furthermore, local governments of provinces, autonomous regions and municipalities issue detailed measures and rules for the implementation of the Labour Law considering the local conditions, especially when it comes to social insurance and employee welfare.

From 1 November 2021, employers should also be aware and comply with the relevant provisions of the Personal Information Protection Law such as regularly training employees on the employer's data processing obligations.²

Employers may process personal information concerning their employees where necessary for human resources management purposes.³

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2 Article 51(iv) Personal Information Protection Law 2021.

3 *ibid*, article 13(ii).

Labour contracts versus contracts of service

Labour contracts

As is common practice worldwide, an employee's employment relationship with his or her employer in the PRC is governed under the terms of a labour contract.

The sources of law governing a labour contract are as follows.

The Labour Law

The Labour Law governs, among other things, an individual's working conditions, working hours, rest days and health and safety.

The Labour Contract Law

The Labour Contract Law specifically focuses on the labour contract itself. It governs, among other things, the creation, terms, modification and revocation of labour contracts.

Miscellaneous regulations

Several state and municipal regulations have been passed that govern the more intricate and industry-specific areas of the Labour Law.

The Labour Law applies equally to foreign and local workers.

In the PRC, the definition of 'employer' includes companies incorporated by local or foreign shareholders and that are governed by the Company Law. Representative offices or individuals cannot legally enter into a labour contract with either a local or foreign employee.

Consultancy agreements

Consultancy agreements or service agreements may be used to obtain the services of an individual on a one-off or project basis. This is especially the case for inspection services, consulting services and other similar types of work.

These agreements are subject to the Contract Law of the PRC (the Contract Law). The beneficiary of the services employs an outsourced service provider – the contractor.

Consultancy agreements are set for a fixed term irrespective of the number of times they have been renewed.

In a consultancy agreement, the service provider must remain independent. As a result of its independence, the service provider takes responsibility for the quality of the services rendered and the payment of its social charges and taxes on its revenue to the relevant Chinese authorities. As the consultant is personally responsible for these charges, the fees paid to the service provider are generally higher than those paid to an employee under a labour contract who is performing similar services. In the latter case, the employer bears the responsibility to make payment of social charges to the relevant Chinese authorities.

The legal minimum salary governing the terms of a labour contract are not applicable to a consultancy agreement.

Consultancy agreements are often used by foreign entities (if they do not have a subsidiary incorporated in the PRC) to receive services from a local individual based in the PRC. A consultancy agreement between a foreign company and a foreign individual is unlikely because the foreign individual must be a work permit holder or resident permit holder who is able to live and work in the PRC.

As mentioned above, the contractual terms of a consultancy agreement or service agreement must be governed by the Contract Law (and not by the Labour Law or the Labour Contract Law), to avoid any issues with the local authorities.

If a company defined as 'employer' (as defined by the Labour Law) hires a consultant, the company will be held to a higher standard. The terms of the consultancy agreement will have to be very clear regarding the consultant's terms, to avoid any inference by third parties that the consultant is an employee.

The consultancy agreement should explicitly state that the contractor is independent when performing his or her work, and the fees paid to him or her are not comparable to a salary or termed a salary.

It is also recommended to require the contractor to prove that he or she pays his or her income tax, and to clarify his or her legal status under Chinese law (for example, he or she could provide his or her business registration particulars).

Even if a local individual is not subject to any limitation for receiving foreign currency, and while foreign currency can mainly be remitted from abroad,⁴ an individual cannot convert more than US\$50,000 (or its equivalent in another foreign currency) to yuan in any given year.

Working hours

The Labour Law stipulates the maximum working hours of employees as eight hours per day and 44 hours per week.⁵ Employers may extend their employees' working hours in accordance with either the production or business needs of the employer; however, such extension to the daily and weekly working hours of the employee must be arrived at by mutual consent between the employer and employee.⁶

Generally, the extended working hours should not exceed one hour per day. If, for special reasons, a further extension is required for overtime, the additional hours of overtime should not exceed three hours per day and should not harm the employee's health. The total number of hours in overtime may not exceed 36 hours each month.⁷

The Labour Law provides regulations for remuneration for overtime work.⁸ If the overtime occurs on weekdays, the remuneration must be no less than 150 per cent of the employee's existing salary. If the overtime occurs on holidays and no replacement holidays are arranged, the remuneration must be no less than 200 per cent of the employee's existing salary. If the overtime occurs on statutory holidays, the remuneration must be no less than 300 per cent of the employee's existing salary.

Salary

All employees are entitled to a minimum salary, determined on the locality where the employee performs services for the employer.

4 Chinese yuan is not a convertible currency for these purposes.

5 Labour Law, article 36.

6 *id.*, article 41.

7 *id.*

8 *id.*, article 44.

The table below indicates the minimum monthly salaries for major cities within the PRC.⁹

City	Minimum monthly salary (yuan)	Approximate equivalent in US\$
Beijing	2,320	350
Shanghai	2,590	383
Shenzhen	2,360	349

Pensions and insurance

It is mandatory for all employers to take out social insurance for each of their employees. The mandatory insurance schemes that all employers must obtain for their employees cover the following matters:

- pensions;
- unemployment;
- work injury;
- medical/maternity; and
- housing fund insurance.

The tables below summarise the levels prescribed by each of the major cities within the PRC for contributions by the employer and employee.¹⁰

Shanghai¹¹

Type of insurance	Rate for employer (%)	Rate for employee (%)
Pension	16	8
Unemployment	0.5	0.5
Work injury	0.16–1.52	n/a
Medical (including maternity)	10.5	2
Housing fund	5–7	5–7
Total % contribution	32.16–35.52	15.5–17.5

Beijing¹²

Type of insurance	Rate for employer (%)	Rate for employee (%)
Pension	16	8
Unemployment	0.58	0.52
Work injury	0.2–1.9	n/a
Medical (including maternity)	9.1	2–3

⁹ Correct as at 5 November 2021.

¹⁰ Rates shown apply to resident employer or employee. Alternative rates apply for non-resident employer or employee. Rates are accurate as at 5 November 2021.

¹¹ Rates are accurate as at 5 November 2021.

¹² Rates are accurate as at 5 November 2021.

Type of insurance	Rate for employer (%)	Rate for employee (%)
Housing fund	5–12	5–12
Total % contribution	32.8–40.2	15.3–22.5

Shenzhen¹³

Type of insurance	Rate for employer (%)	Rate for employee (%)
Pension	14.5 for non-resident, 16.5 for resident	8
Unemployment	0.7	0.3
Work injury	0.14–1.14	n/a
Maternity	0.45	n/a
Medical	6.5	2
Housing fund	5–12	5–12
Total % contribution	26.49–36.49	16.3–22.3

When an employer fails to take out the above social insurance for its employees, the employer faces the prospect of being fined by the social insurance administrative department for up to three times the overdue amount outstanding.

Paid leave

Employees who have worked continuously for more than one year are entitled to paid annual leave.¹⁴

An employee who has consecutively worked for one full year, but less than 10 years, in the same company is entitled to five days of annual leave. An employee who has worked for the same company for 10 full years, but less than 20 years, is entitled to 10 days of annual leave. An employee who has worked for 20 full years or more in the same company is entitled to 15 days of annual leave.

Pursuant to the 23 January 2020 notice of the Ministry of Human Resources and Social Security of Beijing on employment measures, employers have been given authority to require employees who are currently not permitted to enter the workplace to exhaust the remainder of their annual leave entitlement.

Maternity leave¹⁵

Female employees are entitled to 98 days of maternity leave, including 15 days of antenatal leave. Extra maternity leave of 15 days shall be granted in the case of dystocia. Female employees who give birth to twins or triplets shall be granted extra maternity leave of 15 days for each additional baby born.

In the case of abortion, female employees are entitled to 15 days of maternity leave when the female employee's pregnancy period was less than four months, and maternity leave of 42 days where the pregnancy period was more than four months.

¹³ Rates are accurate as at 5 November 2021.

¹⁴ Labour Law, article 45.

¹⁵ *id.*, article 19.

For any female employee with a baby under the age of one year or if the female employee's pregnancy period was more than seven months, the employer must not extend her working time or arrange any night shift labour.

Female employees are entitled to a breastfeeding period of one hour feeding time during their working hours each day. Female employees who have given birth to twins or triplets are entitled to have one additional hour of feeding break each day for each additional baby born.

In addition, if a female employee meets certain requirements, she is entitled to extra maternity leave subject to local regulations (which vary from city to city). For example, in Beijing and Shanghai this is 30 days and in Guangdong Province (including Guangzhou and Shenzhen) this is 80 days and an extra 30 days for a caesarean section.

Probation

The probation period of an employee is also governed by the Labour Contract Law.¹⁶ When the term of the labour contract is between three months and one year, the probation period must not exceed one month; when the term of the labour contract is between one year and three years, the probation period must not exceed two months; and when the term of the labour contract is for more than three years, the probation period must not exceed six months.

No probation period needs to be specified in a labour contract with a term that expires upon completion of a certain project, or a labour contract with a term of less than three months.

Dismissal

There are several circumstances outlined within the Labour Contract Law whereby an employer may dismiss an employee with immediate effect and without paying any compensation. This includes where:

- it has been proved that the employee does not meet the job requirements of the employer during the probation period;
- the employee has violated the internal rules of the employer and such violation is considered sufficiently serious;
- the employee has caused severe damage to the employer owing to his or her gross negligence in carrying out his or her duties;
- the employee has simultaneously established a labour relationship with another employer, which has seriously influenced the completion of his or her work for his or her respective employer, or he or she refuses to correct the situation even though the employer has learnt of the circumstances;
- the labour contract is invalid because the contract was signed by way of deception, coercion or force on the part of the employee; or
- the employee is subject to criminal liabilities according to law.¹⁷

¹⁶ *id.*, article 39.

¹⁷ Following the enactment of the Notice on Properly Handling Labour Relations During the Prevention and Control of the COVID-19 Outbreak, an employee serving a quarantine or stay at home notice shall be paid his or her salary by the employer and shall not terminate the employment contract during this period.

An employer may dismiss its employee by giving 30 days' written notice or payment (equivalent of one month's salary) in lieu of notice to the employee and by compensating the employee with the equivalent of one month's salary for each year the employee has served, in the following three instances:

- if the employee demonstrates an incapacity to handle the work assigned, and this remains the case after training or after an adjustment of position;
- if there is a change in circumstances, making the performance of the contract between employer and employee impossible (it should be noted that the covid-19 pandemic will not be a valid justification for termination of an employment contract); or
- if the employee, who falls ill or is injured for a reason that is not related to work, is not able to bear the original post after the expiry of the medical treatment period as prescribed, nor can he or she assume any other position as arranged by the employer.¹⁸

If there is a trade union established in the employer while the employer fails to notify such trade union of the above two dismissals (immediate dismissal and dismissal by giving notice or payment in lieu of notice to the employee and by compensating the employee), the terminated employee is entitled to file a claim with the court on the grounds of illegal dismissal and claim for the damages unless the employer takes steps to fulfil the notification procedure prior to the filing of the claim.

An employer is forbidden from dismissing an employee in the following circumstances:

- if the employee contracts an occupational disease or hazard and has not gone through an occupational health check before leaving his or her position;
- if the employee contracts an occupational disease or has lost or partially lost his or her capacity to work due to a job-related injury sustained during his or her employment with the employer;
- if the employee is pregnant, during the confinement period or is nursing; and
- if the employee has been working for the employer for at least 15 consecutive years and is less than five years away from his or her legal retirement age.

The employer, however, is entitled to terminate an employee under one of the points above if the employee falls within one of the categories for immediate dismissal. An employer must also abide by additional laws and local regulations concerning restrictions from dismissing any employee.

Severance payment scheme

In general

Employers terminating labour contracts must pay the employee a severance package (except for instances referred to above, under article 39 of the Labour Contract Law).

A severance package is payable:

- when the economic circumstances under which the labour contract was concluded have materially changed, making performance of the contract impossible, and the employer and employee fail to reach an agreement modifying the contract;

¹⁸ Labour Law, article 47.

- upon the expiry of the contract;
- when the employee wishes to renew the contract but the employer refuses to do so;
- in the event that the employee falls ill or is injured for a reason not related to his or her work, is not able to resume his or her original position after the completion of the medical treatment period, and cannot take up any other position assigned by the employer;
- when the employee is incapable of doing his or her job after undergoing training or adjustment of his or her position;
- when the employer undergoes restructuring in accordance with the Insolvency Law of the PRC;
- when the employer is experiencing serious difficulties in production and business operations and needs to dismiss its personnel;
- when there is a change in the employer's production, the employer undergoes a material technical makeover or adjusts the modus operandi of the business operations and, after having amended the labour contract in accordance with the business model, the employer still needs to dismiss its personnel;
- when the employer is declared bankrupt by a Chinese court in accordance with relevant laws;
- when the term of the employer's business licence has expired and the employer decides not to renew its business licence;
- when the employer's business licence is revoked;
- when the employer is ordered to close down; or
- when the employer decides to dissolve prior to the expiry of its operational term.

Calculation of severance payment

The formula for the calculation of severance payment is as follows:

$$\text{Severance payment} = \text{years of service} \times \text{monthly salary}$$

(one month's salary will be paid for every year of service)

A period of service of not less than six months but less than one year will be considered as one year. For a period of service of less than six months, the employee must be paid half a month's salary as severance payment. For the purposes of the above formula, 'monthly salary' means the employee's average salary during the last 12 months of his or her employment. If the monthly salary of an employee is three times greater than the average monthly salary of the employees in the region of that employee's workplace in the preceding year, as published by the municipal government, the severance payment will be calculated on the basis of three times the average monthly salary and for a maximum period of not more than 12 years.¹⁹

Double severance payment

If an employer violates the Labour Contract Law in terminating a labour contract, and if the employee chooses to not resume the labour contract or the labour contract can no longer be fulfilled, the employer is required to pay double the severance to the employee.²⁰

¹⁹ id., article 48.

²⁰ Labour Law of the PRC, article 48.

Termination of a pregnant employee if she is going to give birth in breach of the state's policy
In China, the birth control policy has been implemented for many years. The two child policy has been in force since 29 October 2015, but the employer may still face a situation whereby a female employee plans to give birth in breach of the birth control policy.

Is the employer entitled to legally terminate the pregnant employee who is in breach of the birth control policy?

Under the current policies and local regulations, a pregnant employee who is in breach of the birth control policy is still entitled to maternity leave without maternity salaries and relevant allowances.

There was a PRC Supreme Court case regarding an employer who had inserted a clause within the company's by-laws stating that giving birth in breach of PRC birth control policy would be regarded as serious misconduct and a ground for termination with cause. A pregnant employee breached the said company's by-laws and was dismissed by her employer. The Supreme Court of the People's Court of the PRC ruled that the termination of the employee constituted unfair dismissal.

Labour dispatch

On 1 March 2014, the Interim Provisions on Labour Dispatch (the Provisions) came into force. The Provisions aim to solve matters in relation to labour dispatch and are outlined below.

Principle of equal pay for equal work

Before the implementation of the Provisions, one of the issues concerning labour dispatch was that dispatched employees' salaries were lower than those of an individual who had a direct employment relationship with his or her employer. This led to a trend of employers hiring dispatched employees at a higher rate for the purpose of saving costs, which, in turn, resulted in a lowering of the living wages of employees.

Under the Provisions, employers are now required to pay the same salaries to both labour dispatched personnel and direct employees.

The rationale behind the implementation of the principle of equal pay for equal work under the Provisions was to deliver the outcome of social fairness for all employees.

Positions where labour dispatch applies

The Provisions state that labour dispatch may only apply for individuals employed in the following three circumstances:

- temporary positions of less than six months; for example, seasonal positions (eg, temporary farmers or agricultural workers);
- substitute positions where employees are absent due to study, maternity or sick leave, etc; and
- auxiliary positions such as drivers or janitors.

Percentage of company's workforce

A company's workforce may not comprise more than 10 per cent of labour dispatched employees. Companies whose employment quotas did not meet the 10 per cent requirement for labour

dispatched employees prior to the passing of the Provisions on 1 March 2014 were given a two-year grace period to ensure compliance with the 10 per cent quota on or by 28 February 2016.

Conversion of labour dispatch

There are two options for companies wishing to hire employees directly:

- convert the dispatched employees to normal employees with a labour contract; or
- service outsourcing.

The differences between labour dispatch and service outsourcing are given below.

	Labour dispatch	Service outsourcing
Counterpart	Labour agency	Service provider
Content of service	Labour dispatch	Project, consultancy, contracting, etc
Return of the employee	The employer is responsible for the employees' severance pay	Subject to the service contract
Term	Not less than two years	Subject to the service contract

Non-compete

The principle of non-compete was first introduced in the Labour Contract Law, but unfortunately brought considerable confusion for the courts and the labour arbitration commission in the interpretation and enforcement of such clauses.

Key points to non-compete clauses are stipulated in the Labour Contract Law as follows:

- non-compete shall be limited to senior managers, senior technicians and other personnel who have the obligation to keep secrets related to the employer;
- the term of the non-compete clause shall be limited to two years; and
- compensation for the non-compete shall be paid monthly to the employee for the duration of the clause.

On 1 January 2021, the Supreme Court of the PRC sought to clarify and interpret the above issues, as follows.

Minimum compensation for non-compete

If the non-compete compensation was not stipulated by the employee and the employer within the labour contract, the non-compete clause or agreement remains valid notwithstanding. The general rule is that the employee who did not compete may claim a compensation equivalent to 30 per cent of his or her average salary for the 12 months prior to the termination of the employment. In addition, the compensation shall not be less than the local minimum monthly salary based on similar employment contracts within the locality.

Termination of non-compete clause or agreement

If the employee has been in compliance with the non-compete clause for more than three months but has not been paid any compensation, he or she has the right to terminate the clause or agreement and claim for the compensation.

During the term of the non-compete clause or agreement, the employer has the right to terminate the clause or agreement by paying three months' compensation to the employee.

Prior to the effectiveness of the non-compete clause or agreement (namely prior to the termination of the employment relationship), the employer has the right to notify the employee not to fulfil his or her non-compete obligations thereafter under the non-compete clause or agreement without paying any compensation to the employee.

If the employee breaches the non-compete clause or agreement, he or she shall pay the default penalty to the employer and is still bound by the non-compete clause or agreement.

Relevant requirements on M&A transactions

Special requirements on cross-border M&A are outlined below.

- If Company A + Company B = Company C (and Company A and Company B no longer exist): the employment entitlements and relevant benefits of the employees of Company A and Company B shall be borne by Company C.
- If Company A is absorbed by Company B and Company A still exists: the employment entitlements and relevant benefits of the employees of Company A shall still be borne by Company A.
- If Company A + Company B = Company B, and Company A no longer exists: the employment entitlements and relevant benefits of the employees of Company A shall be borne by Company B.

Labour dispute and resolution

The first compulsory step in a labour dispute is for an agreement to be reached amicably between both employer and employee. If this is not possible, the next stage is for the employer and employee to submit their case by way of arbitration proceedings with the labour arbitration commission.

If arbitration is not successful for either party, the employer or employee can appeal to the people's court for a final judgment on the matter.

Case study

Termination during the breastfeeding period

An employee had been working for a company in Shanghai for four years under a labour dispatch agreement between the company and an agency. Her monthly salary was 25,000 yuan and the average monthly salary of Shanghai in 2018 was 7,832 yuan. She had a baby who was less than one year old. Renewal of the employee's fixed-term contract fell during the breastfeeding period.

The renewal had to be postponed until the end of the breastfeeding period. If this is not respected, the employer must pay double compensation (it is considered a termination initiated by the employer).

After calculation, in this case, paying double compensation was cheaper for the employer than postponing the renewal until after the breastfeeding period.

Option 1: to pay double compensation

$$\begin{aligned} & (\text{local average monthly salary} \times 3) \times \text{working years} \times 2 \\ & = 7,832 \text{ yuan} \times 3 \times 4 (\text{number of years}) \times 2 = 187,968 \text{ yuan} \end{aligned}$$

In this case, the employee's monthly salary was three times higher than the local average salary and the base is capped at three times the local average salary; '2' means double compensation.

Except for the double compensation, the female employee may also be entitled to her salaries and relevant maternity allowances during the pregnancy period, perinatal period and breastfeeding period subject to local regulations. For example, the courts in Guangzhou and Jiangsu Province support female employees' claiming for the salaries and relevant maternity allowances during the three periods after the illegal termination, while it is the opposite in Shenzhen.

Option 2: to postpone the renewal until the end of the breastfeeding period

$$\begin{aligned} & (\text{local average monthly salary} \times 3) \times \text{working years} \times 2 \\ & = 7,832 \text{ yuan} \times 3 \times 4.5 \times 2 = 211,464 \text{ yuan} \end{aligned}$$

Postponing the term resulted in a higher number of working years (more than four years but less than four and a half years) and extra salaries and relevant maternity allowances up to the end of the breastfeeding period.

The employee's salary was more than three times the local average salary and the compensation was 23,496 yuan (7,832 yuan x 3) per year of employment, doubled for each year owing to the circumstances.

The employee misinterpreted the law and did not agree that the compensation basis for higher salary (more than three times the local average salary) was not calculated on the actual salary but on three times the local average salary.

The employee insisted on getting more, and the agency pushed the client to pay to avoid going through a labour arbitration claim or to terminate the contract (the agency is the legal employer of dispatched employees, and refused to sign the settlement or termination papers).

Our client had to pay 225,000 yuan to obtain a final settlement, while the real compensation due amounted to 187,968 yuan for four years of employment under these specific circumstances.

Appendix 1

About the Authors

Caroline Berube

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Caroline Berube is the managing partner of HJM Asia Law, a boutique law firm with offices in China and Singapore. She is admitted to practise in New York and Singapore, and holds a BCL (civil law) and an LLB (common law) from McGill University (Montreal, Canada) and studied at the National University of Singapore with a focus on Chinese law. Caroline worked in Singapore, Bangkok and China for UK and Chinese firms prior to establishing her own firm 13 years ago. Based in Asia since 1998, Caroline represents SMEs, MNCs, foreign banks and private equity firms in the Asia Pacific region, dividing her time between offices in China and Singapore. She focuses on M&A cross-border transactions, commercial law and intellectual property matters such as licensing and technology transfer, areas in which she has developed a respected expertise and understanding of the challenges and advantages of most Asian jurisdictions. Caroline advises clients in various industries, including manufacturing, technology, entertainment, agriculture, trading, e-commerce and services. She is an arbitrator approved by the Chinese European Arbitration Center (CEAC) and a foreign arbitrator appointed by the China International Economic and Trade Arbitration Commission (CIETAC).

Caroline has been featured in numerous magazines and newspapers, including Bloomberg titles, the *Straits Times*, the *Business Times*, *Les Affaires* and *La Presse*, and is a regular speaker at international conferences. She has twice lectured a 45-hour course on Chinese law at Laval University (Canada), and currently lectures annually at Bocconi University and at the Sorbonne Assas Law School on legal corporate structures, M&A, IP/technology and employment law in Asia. In 2015, Caroline was selected as a Young Global Leader by the World Economic Forum.

Caroline was secretary general of the Inter-Pacific Bar Association between April 2017 and April 2019. She is co-chair of the China Working Group of the International Bar Association (IBA) and former co-chair of the IBA Asia Pacific Forum. Caroline is also an officer of the IBA Intellectual Property Committee and has been appointed to serve as an IBA legal practice development officer from January 2019 to December 2022. A firm believer in entrepreneurship, Caroline formed her own international foundation to work with young entrepreneurs of between

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Felix Chan focuses on advising private and public listed companies on mergers and acquisitions, disposals, joint ventures, international business reorganisations and other corporate needs. Felix also provides clients with general corporate and commercial legal advice for their day-to-day operations, including advising Hong Kong-listed entities on connected transactions and other listed company compliance matters under the Hong Kong Listing Rules.

Prior to joining Tiang & Partners, Felix was at Reed Smith Richards Butler for five years. He qualified as a solicitor in New South Wales (Australia) in 2012 and in Hong Kong in 2015. He holds a double degree in commerce and law from the University of New South Wales, Australia and a PCLL from City University of Hong Kong. He is fluent in English, Mandarin and Cantonese.

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Nicholas Cook advises on cross-border mergers and acquisitions, joint ventures, private equity transactions, as well as international business reorganisations (IBR) and solvent group restructurings, focusing on the Greater China and Asia Pacific regions. He frequently negotiates, drafts and advises on shareholders' agreements, share purchase agreements and business transfer agreements as well as all matters of corporate and commercial law, including matters with technology and/or digital elements.

Nicholas serves as co-chair of PwC's Global IBR Emerging Leaders Network. He is also an examiner for the commercial and company law paper of the Hong Kong Overseas Lawyer Qualification Examination (OLQE).

Prior to joining Tiang & Partners, Nicholas worked at Mayer Brown Hong Kong for nine years. He holds a bachelor and master of arts in law from the University of Cambridge, as well as a PCLL from the University of Hong Kong. He also holds a master of Chinese studies degree, jointly awarded by the University of Edinburgh and University of Glasgow, with exchange to Nankai University.

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Ralf Ho is of counsel and focuses on labour dispute and civil cases. He earned his bachelor's degree in economics from South China Normal University. Prior to joining HJM Asia Law & Co LLC, Ralf was an associate at a Chinese law firm specialising in corporate compliance and employment law. In addition to his corporate practice, Ralf has assisted clients on a variety of litigation and arbitration matters, including the resolution of redundancy and class action labour disputes before various courts and arbitration commissions in China.

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Ruina Liu is a PRC qualified lawyer and a partner in our corporate and commercial group. She specialises in private equity, venture capital, merger and acquisition, foreign direct investment and wider compliance in the telecoms, media, and technology (TMT) and life science sectors. Ruina holds a Master of Laws from Peking University and Oxford University.

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Jing's areas of expertise include cross-border mergers and acquisitions, foreign direct investment, commercial transactions and compliance. Jing has been involved in all stages of cross-border transactions, including due diligence, regulatory advice, structuring, documentation, negotiation and closing. His experience covers a wide array of sectors with a focus on healthcare, food, automotive and manufacturing. He also advises clients on compliance, in particular cybersecurity and data protection. Jing is listed as a recommended lawyer in corporate, M&A and TMT by *The Legal 500*.

Jing obtained master of law and bachelor of law degrees from Peking University Law School and an LLM from the School of Law of the University of Washington. He is a New York State admitted attorney and has passed the China National Judicial Examination. Jing is a native Chinese speaker and is fluent in English.

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