Practice Guides

CHINA M&A

Fifth edition

Contributing editor
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About the Editor

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Introduction

Richard Pu[1]

In the aftermath of the pandemic, the recovery pace of China's M&A market remains gradual. It has continued to be profoundly influenced by ongoing legal reforms within the country this year. One of the most significant legal reforms undoubtedly pertains to the definitive release of new regulations governing overseas listings. In conjunction with these new regulations, a comprehensive set of detailed guidelines governing the filings of overseas listings and revised rules governing confidentiality and archive administration in the context of overseas listing have also been released. In the area of data and personal information protection, as in previous years, various implementing measures have been released to ensure the implementation of frameworks established by the Cybersecurity Law, Data Protection Law and Personal Information Protection Law. Notably, there is now clear guidance on another legitimate method for exporting personal information through the execution and filing of standard contracts for export of personal information. Furthermore, China introduced its first-ever regulation on artificial intelligence generative content (AIGC) in July 2023. This positions the nation among the first jurisdictions globally in regulating AIGC. Additionally, although recent years have not seen

1 Richard Pu is the joint general counsel at Tencent.

significant changes in China's tax regulations, the thriving capital market environment has boosted local business mergers. This trend presents new topics for China's tax landscape and challenges for those involved in such deals.

These recent legal reforms have the potential to affect various stages of the M&A process. This includes due diligence investigations, evaluation, post-deal company operations and strategic considerations for exit strategies, including overseas IPOs.

New regulations on overseas listing

Undoubtedly, one of the most significant legal changes this year is the final release of new rules governing overseas securities offering and listing by Chinese companies. This has tremendously changed the landscape of regulation of this area in China. On 17 February 2023, the China Securities Regulatory Commission (CSRC) introduced the Trial Administrative Measures of Overseas Securities Offering and Listing by Domestic Companies (the Overseas Listing New Regulation), which took effect on 31 March.

Under the new regulation, there have been substantial alterations. Previously, the direct overseas offering and listing of Chinese companies' securities (such as H Shares listing) required CSRC approval. However, the new regime not only covers direct offerings but also includes indirect overseas offering and listing by Chinese companies (such as those involving a red-chip structure), which now require filing with the CSRC. Furthermore, both the direct overseas offering and listing of securities for Chinese companies and indirect overseas offering and listing of securities for foreign companies with major business operations and/or assets within China are now subject to the same filing process. In tandem with the Overseas Listing New Regulation, comprehensive guidelines were issued, outlining specific requirements for the documents required for the filing applications.

The Overseas Listing New Regulation explicitly permits filings submitted by companies listed overseas or seeking overseas listing using a variable interest entity (VIE) structure, as long as they comply with applicable laws and regulations. According to the new regulation, as well as its accompanying detailed guidelines, companies seeking overseas listing using a VIE structure must explain to the CSRC reasons for adopting the VIE structure. Unless specific

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laws and regulations explicitly prohibit the use of a VIE structure in certain industries, in which case the CSRC will reject the filing, the CSRC will consult the relevant sector's regulatory authority before approving the filing.

In tandem with the Overseas Listing New Regulation, the CSRC, the Ministry of Finance, the National Administration of State Secrets Protection and the National Archives Administration have jointly revised the Provisions on Strengthening Confidentiality and Archives Administration for Overseas Securities Offering and Listing by Domestic Companies. These revised provisions replace the 2009 version. The updated version extends its scope of applicability to encompass both direct and indirect securities offering and listing. It offers clear guidance to stakeholders concerning confidentiality and archives administration within the context of overseas listing. Moreover, it improved pertinent arrangements to establish a robust institutional framework for secure and efficient cross-border regulatory collaboration. Such collaboration, for instance, involves coordination with the US Public Company Accounting Oversight Board for Chinese companies listed or seeking to be listed on stock exchanges in the United States.

The fresh CSRC filing framework streamlines both direct and indirect overseas listing for Chinese companies and resolves several uncertainties confronting relevant stakeholders. While its practical implementation remains to be seen, these new regulations signify a promising stride in advancing Chinese companies' participation in overseas capital markets.

Continuing enhancement of legal framework on data and personal information protection

China has been steadily refining its legal landscape for data and personal information protection since the introduction of the Cybersecurity Law in 2016, followed by the Data Security Law and the Personal Information Protection Law in 2021 (collectively the PRC Data Laws). This ongoing effort has involved the issuance of a variety of detailed rules, guidelines and national standards to effectively implement the diverse provisions introduced by the PRC Data Laws.

This year, a notable stride has been taken in the realm of personal information export. China has introduced comprehensive rules and guidelines concerning the standard contract for the cross-border transfer of personal information,

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offering an additional lawful way for personal information export alongside the existing security assessment route. On 24 February 2023, the Cyberspace Administration of China (CAC) unveiled the Measures on Standard Contract for Cross-Border Transfer of Personal Information (the SCC Measures) and the finalised Standard Contract on Cross-border Transfer of Personal Information, with these measures taking effect on 1 June. Subsequently, on 30 May 2023, the CAC released the Guidance on Filing Standard Contract for the Cross-Border Transfer of Personal Information (First Edition), offering operational guidance to enterprises intending to transfer personal information from China to overseas recipients through standard contracts. This marks a significant step forward in facilitating personal information export through standard contracts arrangement.

In addition to these rules and guidelines concerning personal information export, several draft regulations have been presented for public comments. The Administrative Measures of Compliance Audit on Personal Information Protection (Draft for Public Comments) was released by the CAC on 3 August 2023, aiming to enforce compliance audit requirements outlined by the Personal Information Protection Law. Furthermore, in the domain of safeguarding sensitive personal information, the Provisions on Administration of Security on Application of Facial Recognition Technology (Trial) (Draft for Public Comments) were issued by the CAC on 8 August 2023. This initiative seeks to curtail the use of facial recognition technology and safeguard sensitive personal information, particularly facial images.

As of now, China has established a relatively comprehensive and intricate legal framework to protect data and personal information protection. Stakeholders involved in M&A transactions with Chinese companies that handle personal information should be mindful of these developments. For instance, rigorous review of data and personal information compliance during due diligence investigation is essential. Additionally, when evaluating target companies, consideration should be given to potential costs associated with cross-border data transfers or the localisation of data as an alternative.

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New regulation on AIGC

This year, the rapid development of AIGC has emerged as a prominent sector in China. Despite a notable decrease in the total count of venture capital investment deals, there remains active venture capital investment in AIGC startups.

China achieved a significant milestone by introducing its first regulation on AIGC in July. This move has positioned China as one of the pioneering jurisdictions globally to oversee AIGC. On 10 July 2023, the CAC and six other departments jointly issued the Interim Measures for the Management of Generative Artificial Intelligence Services (the AIGC New Rule). Effective from 15 August 2023, the AIGC New Rule established the foundational framework for AIGC regulation within China. It is expected that additional supportive rules and guidelines will follow in the upcoming months. Notably, compared with the draft released for public comments in April, the final AIGC New Rule displays a more lenient stance. This adjustment signifies the efforts of the Chinese government to nurture the healthy growth of the AIGC industry while maintaining security.

The scope of the AIGC New Rule encompasses the provision of AIGC services (including through programmable interfaces) to the 'public within China', regardless of whether the service provider is based in China or overseas. Research endeavours and internal application of AIGC, however, fall outside the purview of the AIGC New Rule. Importantly, the AIGC New Rule does not impose specific licences or foreign investment restriction on the AIGC service providers, provided they comply with licensing requirements and are subject to foreign investment restrictions stipulated by other applicable laws and regulations.

The AIGC New Rule proposes to establish a 'category and class-based' regulatory framework, structured around the features of AIGC technologies and their application. This approach may, to some extent, be inspired by the categorisation of AIGC technologies based on varying risk levels, as outlined in the EU's AI Act. It is anticipated that pertinent authorities will subsequently release detailed rules or guidelines to effectively implement this 'category and class-based regulatory system.

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Tax challenges for corporate combination between local companies

Over the past decade, notable combination transactions always happen between offshore companies with China business, such as two US company or Cayman company merger as one business group, with such entities holding Chinese operation assets. However, due to the reduced availability of US dollar private equity financing, an increasing number of Chinese companies now opt for local corporate structure to attract yuan investors, while foreign investors remain prevalent in specific sectors such as bio-pharmacy and advanced manufacturing. When these companies are contemplating merger or consolidation deals with competitors or other players within the same industrial sector, it is more likely that such deals be structured as a local amalgamation or share swap deal based on Chinese law. In such local corporate combinations, the participants (including but not limited to the merger parties, their Chinese or foreign investors, etc) will find they are facing greater tax challenges compared with an offshore deal as before.

For the two target companies involved in such combinations, equity is usually the consideration, rather than a cash buyout. Generally, the target companies can enjoy a tax-free reorganisation for income tax purpose, regardless of whether the transaction takes the form of an amalgamation or share swap. However, in an amalgamation, which involves the merger of two companies into one, such transaction involves asset transfers, especially for immovable property or intellectual property, then evaluation of non-income tax implications can be more complicated compared with the above income tax analysis and may have a considerable impact on the deal structuring. There are various special non-income tax treatments for corporate reorganisations, including but not limited to tax exemption for VAT, Land Appreciation Tax, Deed Tax, but all such exemptions and/or deferrals come with specific conditions.

For the investor of the target companies, generally there are only income tax implications. A local corporate investor might benefit from tax-free reorganisation for tax deferral, while an individual investor could only be subject to tax deferral for a maximum of five years. Foreign investors, however, are not subject to any tax preference for a local amalgamation or share swap. There is no specific tax rule for a local investor as a partnership (which is very common for yuan funds, some local tax authorities may accept similar treatments as a local corporate investor).

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Addressing such tax challenges can be one of the most important topics in a transaction for principals as well as their counsel. Usually, there should be experienced tax counsel commenting on the deal structure, performing tax estimation, raising planning ideals, addressing compliance obligations, asking review or consent from signification stakeholders, then inputting the planning ideals into the transaction documents and finally submitting the amalgamation or share-swap plan to the competent tax authorities. It is very common that each participant in a transaction has its own tax counsel or adviser, technical discussion on such tax topics may block the negotiations and delay the closing, the principals and their counsel need to offer a fair tax structure and persuade other parties to sign off. After closing, in connection with the uncertain tax treatments noted above, written and professional communication with the tax officers is essential (even the tax authority will not reply in writing). In addition to the tax authority in charge, since the merged group will go public in the future, the CSRC may also consider tax compliance (especially on the combination, such an important capital transaction in the corporate history) during the IPO registration. This written record will help the issuer in the future from the perspective of both tax law and securities law.

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1

Tax Issues Arising from M&A Transactions and Certain Mitigations

Jiachen Li and Kexiao Sun[1]

Introduction

In M&A transactions, taxation is an eternal topic. The parties design transaction structures and negotiate deal terms around taxation, aiming to maximise tax efficiency while ensuring compliance. In recent years, the PRC government has continuously promulgated new tax rules and policies that are applicable to M&A transactions in the PRC. This chapter introduces typical tax issues arising from M&A transactions in the PRC and certain mitigations, by taking onshore direct investments as examples, and discussing from both pre-deal and post-deal management perspectives. For this chapter, the terms 'China' and the 'PRC' are used interchangeably and do not include Hong Kong SAR, Macau SAR nor Taiwan, which have their own taxation systems.

We set out below a rate table applicable in an equity deal for private companies for easy reference and details will be further discussed in the chapter:[2]

1 Jiachen Li and Kexiao Sun are senior legal counsel at Tencent.

2 Asset acquisition deals are not discussed in this chapter.

Tax rates in equity deals for private companies*

	PRC tax-resident		Non-PRC tax-resident
	Individual	Enterprise	
Income tax (including dividends and capital gains)	20%	25%[1]	10%[2]
Stamp duty	0.05% of the total contract price for each party[3]		
Value added tax	n/a[4]		

** A limited partnership is tax flow-through entity, and the partners shall report income and other tax items on their own tax returns.*

[1] *Different preferential tax rates apply to companies that enjoy tax benefits, including high and new technology enterprise, integrated circuit (IC) design enterprise, software enterprise and/or small low-profit enterprise, etc; dividends paid by another PRC tax-resident enterprise may be tax-free.*

[2] *Different preferential tax rates apply to dividends and capital gains under applicable bilateral tax treaties.*

[3] *Due at the time the relevant contracts are executed; a reduced rate may apply to individual or certain qualified taxpayers until 31 December 2027.*

[4] *For transfer of shares of a public company, an individual seller is VAT-exempt, while an enterprise seller is subject to a VAT at 6% on capital gains received from such disposal.*

Pre-deal perspective

Tax due diligence and tax warranties

For M&A transactions in the PRC, the historical tax risks of the target group are often assumed by the buyer. Therefore, as the first step in a M&A transaction, investors will engage professional tax advisers to conduct tax due diligence over the target group, to effectively identify tax compliance issues and risks. Material tax non-compliance found during the tax due diligence will significantly affect the transaction price, or be regarded as a 'deal killer' under extreme scenarios. When drafting the transaction documents, investors normally ask for provisions regarding representations and warranties, rectifications, covenants, and indemnification clauses concerning historical tax non-compliance or potential tax-related issues identified in the tax due diligence, so as to avoid future disputes and provide sufficient protections for the buyer.

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Tax warranties are usually categorised as fundamental warranties in the transaction documents. Compared with the non-fundamental/commercial warranties, fundamental warranties, including tax warranties, appear to have a longer survival period and higher liability cap. To elaborate further, unlike other warranties that might have a survival period of a fixed term, tax warranties are commonly tied to the statutory limitation period. Moreover, liability cap under 100 per cent of the purchase price for commercial warranties can be negotiated on a case-by-case basis, while the buyer normally sticks to 100 per cent or even unlimited cap for tax warranties. In some cases, the buyer may further ask for the right to unwind the transaction in the event of material breach of tax warranties or obligations.

Choice of investment vehicles

Once an investor decides to proceed with a M&A transaction, choosing an appropriate investment entity will help to achieve the optimal tax strategy and close the transaction smoothly. Assuming that investors have entities both onshore and offshore to choose from, the following types of entities are most commonly seen.

Overseas entities

The prerequisites for choosing an overseas entity include: (1) the target group does not fall within an industry that is restricted from receiving foreign investment; and (2) the fact that the target group is foreign-invested does not affect the application for or continuity of those qualifications or licences required for its business. Moreover, from a business development perspective, the target group may sometimes not prefer an overseas entity to become its shareholder.

If the aforementioned issues are not concerned in the M&A transactions, using an overseas entity is often the most tax-efficient solution. According to the PRC Corporate Income Tax Law and its implementing regulations, non-resident enterprises' dividend and property transfer income are subject to a reduced 10 per cent tax rate on corporate income tax.

Among all overseas entities, Hong Kong entities have unique advantages due to the bilateral tax treaty between Hong Kong and the PRC. For dividends, a

general 10 per cent tax rate applies; however, if a Hong Kong company directly holds 25 per cent or more of a PRC company's shares, the tax rate for dividends can be reduced to 5 per cent. Moreover, the capital gains a Hong Kong company receives from transferring its shares in a PRC company are exempted from paying PRC income tax under specific conditions (such as the PRC company's property being mainly non-real estate and the transfer ratio being less than 25 per cent) according to the tax treaty, thus only Hong Kong taxes apply. While on the Hong Kong side, in general, it has a tax exemption mechanism for capital gains; however, under Hong Kong's newly revised foreign source income exemption regime (effective from 1 January 2023),[3] certain criteria need to be met before Hong Kong entities enjoy such tax exemption.

Similarly, investors may also consider using an entity that resides in a more favourable treaty territory with the PRC[4] or a region inherently having a large number of tax incentives, such as the British Virgin Islands, which is well-known as a tax haven. In summary, from a tax perspective, overseas entities, especially Hong Kong entities, are often the preferred choice for investors.

Onshore entities

If the target group has foreign investment restrictions or concerns as mentioned in the previous section, investors can only choose onshore entities as investment vehicles. Onshore entities include wholly foreign-owned enterprises (WFOEs) directly established by foreign investors in the PRC, and purely domestic-funded enterprises established by domestic investors or foreign investors through nominee holdings or other arrangements. There is no substantial difference in tax treatments between the two types of onshore entities, both of which fall within the definition of resident enterprises under the PRC Corporate Income Tax Law and thus are subject to corporate income

3 The Hong Kong government is working on further amendments to the foreign source income exemption regime, which is expected to come into effect from 1 January 2024. The upcoming revisions may further tighten the circumstances applicable to tax exemptions for capital gains.

4 For instance, Singapore also has a favourable bilateral tax treaty with the PRC and tax exemption policies for capital gains, both of which are similar to the ones of Hong Kong.

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tax at a rate of 25 per cent (unless such entities are eligible to apply for a preferential tax rate).

For investors, the pros and cons for choosing a WFOE or a purely domestic entity are as follows:

- Foreign investment attributes: although a WFOE is established in China, it still has foreign investment attributes when tracing its ownership structure through layers of shareholders and revealing its ultimate beneficial owners, which renders a WFOE unsuitable for investment in a few industries that are extremely sensitive to foreign investment. For example, we once encountered a target company that engages in businesses related to China's human genetic resources, which was required by the former PRC Human Genetic Resources Management Office (now supervised by the Ministry of Science and Technology) to clear all shareholders with foreign investment attribute, including WFOEs. Purely domestic entities have no industry restrictions or limitations on investment, thus are more flexible.
- Funding sources and exits: the funding source for purely domestic entities is usually domestic renminbi (RMB) funds, and it requires domestic entities or nominee holders as shareholders to set up such domestic entities, which poses certain operational difficulties for investors with a purely foreign-funded background. In addition, without making special funding arrangements beforehand, the investment proceeds will be retained in RMB within China.

  Although foreign exchange regulations historically did not allow non-investment foreign-invested enterprises' registered capital to be used for equity investment, this restriction was abolished several years ago. Therefore, theoretically, WFOEs are now free to invest in foreign currency or RMB funds,[5] and the investment proceeds obtained can be smoothly remitted overseas, subject to the non-resident income tax policies and bilateral tax treaties introduced in the previous sections.

5 Local banks may still take a more conservative and cautious attitude in approving the use of registered capital for equity investments.

Selected transaction scenarios and analysis

In this section, we select two common tax-related scenarios in share purchases and/or disposals to introduce current practices. In summary, to protect investors' interests, it is advisable that tax clearance be obtained prior to payment of the purchase price and the buyer shall be cautious about its withholding obligations.

Onshore entities acquiring shares from PRC resident individuals

According to the PRC Individual Income Tax Law, income derived from transfer of property by domestic resident individuals is usually calculated and declared for individual income tax on a per-transaction basis, which is subject to a proportional tax rate of 20 per cent. The buyer, as the payer of such taxable income, is the withholding agent. Therefore, the buyer is particularly concerned about whether the individual seller pays his or her income tax in full and on time. To ensure the tax compliance of individual sellers, buyers may consider using the following transaction structures as safeguards:

- The share purchase price is paid to the individual seller in at least two instalments. The second instalment should cover the amount of individual income tax that the seller needs to pay. Given that the buyer may not accurately confirm the seller's cost, the simplest solution is to set the second instalment at 20 per cent of the total share purchase price.
- As a condition precedent for the buyer to pay the second instalment, the seller should declare his or her income tax and obtain a tax clearance certificate issued by the competent tax authority and other proof that may be required by the buyer. We recommend that the buyer also request the seller to provide the tax declaration forms prepared during the tax filing to verify whether the declared information is consistent with the transaction details. In addition, currently many local market supervision and administration bureaux, such as certain districts in Beijing and Shanghai, require individual sellers to complete tax clearance before applying for the registration for shareholder change. Accordingly, we recommend that the investors make both tax clearance and registration for shareholder change closing conditions, so as to avoid disputes between buyers and sellers after payment of the purchase price.

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- Considering that the buyer is the withholding agent for the seller's tax payment, in the event the individual seller fails to pay his or her income tax, the buyer can also declare and pay the tax to the competent tax authority using the reserved second instalment, in order to fulfil the buyer's withholding obligation.
- If the buyer has stronger bargaining powers, in addition to the above payment mechanisms, the buyer can ask for specific indemnification clauses or further retain a portion of the purchase price in an escrow account to cover any tax-related losses, so as to ensure that the buyer does not assume any liability due to the seller's tax non-compliance.

Onshore entities acquiring shares from offshore entities

In this case, the onshore buyer needs to make cross-border payments to the seller. The income tax of the overseas seller is subject to withholding at source, and the onshore buyer is the withholding agent. The buyer should withhold the corporate income tax of the overseas seller from the share transfer price and pay the withheld tax to the competent tax authority. Given that the buyer usually cannot accurately confirm the seller's cost and favourable tax treatment (if any), it is common practice for the buyer to require the seller to declare and pay corporate income tax on its own,[6] as a condition precedent for payment of purchase price. If the seller does not need to pay any tax as it enjoys tax treaty benefits, the seller should then report such tax treaty benefits with PRC tax authorities and obtain their approval or clearance for tax exemption.

After receiving from the seller its tax clearance certificate or proof of tax exemption, the buyer needs to fill in a tax filing form and complete tax filing before making the payment. Once the competent tax authority finishes review and stamps the tax filing form, the buyer can go to the bank to process with the foreign exchange payment procedures.

6 Onshore branches or representatives of the seller can help with the tax payment. If the seller does not have such presences in China and as a result has difficulties in making the payment, it may seek assistance from tax agencies, the target company or the buyer.

Normally, the bank should handle the remittance once the aforementioned tax-related materials and other basic information (such as share transfer agreements) are received and complete. However, local banks may have additional requirements in implementing foreign exchange regulations and policies. We once had an M&A transaction where two remittances were processed in different cities. The bank in one city completed the payment quickly and smoothly, while in another city, the bank was very cautious when handling the remittance owing to fewer and lower amounts of foreign exchange payments processed previously. This bank requested us to provide additional materials to prove the value of the acquired shares so as to verify the authenticity of the payment amount. After we provided the bank with the asset valuation report with respect to the share transfer, it finally agreed to make the remittance. To conclude, it is crucial for the investors to maintain close communication and collaboration with tax and foreign exchange authorities during M&A transactions.

Post-deal management perspective

Overview of red-chip reorganisation

The red-chip structure is a common corporate structure adopted by Chinese companies when they plan to go public overseas. During the construction of the red-chip structure, investors of the domestic company (the OPCO) need to dispose of their shares in the OPCO through transfers of shares or share buybacks (ie, capital reduction), then wire the proceeds from such disposal to an offshore company incorporated usually in the Cayman Islands (the Cayman Company). Such proceeds are used as the consideration for the subscription of new shares in the Cayman Company, the class and number of which correspond to the investors' shares in the OPCO. In this section, we will select three key concerns of investors from a tax perspective and discuss certain mitigations being taken during the red-chip reorganisation.

Tax burdens during the red-chip reorganisation

As one step for investors to exit from the OPCO, they need to dispose of their shares in the OPCO through a transfer of shares or share buyback. Consequently, income tax and stamp duty may be incurred. Regarding income

tax, onshore investors who are PRC tax residents shall pay corporate income tax or individual income tax according to their tax status, while offshore investors who are non-PRC tax residents shall pay a withholding tax at a rate of 10 per cent on their equity transfer income (if there is a tax treaty between the country or region where the offshore investor is a resident and the PRC, such treaty will apply). As for stamp duty, it will be calculated at a rate of 0.05 per cent of the contract amount for disposal of shares of private companies.[7] Under the circumstance of red-chip reorganisation, the stamp duty is usually borne by the target group. For completeness, the value added tax is not applicable for equity transfer transaction of a private company.

Compared with stamp duty, the income tax generated from the disposal of OPCO shares, due to its large amount, attracts more attention from investors during the reorganisation. Taxable income is calculated as the equity transfer income minus the original value of such equity (usually the original cost plus reasonable expenses). Specifically, for enterprise sellers who are PRC tax residents, the transfer income is regarded as an income of the enterprise and subject to income tax after certain deduction at the end of the fiscal year. As a result, investors will face a high tax burden if the transfer price is significantly higher than their original investment cost. On the other hand, if the transfer price is lower than the fair market value without reasonable grounds,[8]

7 If the shares to be transferred are shares of a listed company, the seller shall pay a securities transaction stamp duty at a rate of 0.1 per cent.

8 According to the announcement of the State Administration of Taxation on the issuance of the 'Individual Income Tax Management Measures for Equity Transfer Income (Trial)', if any of the following situations are met, the equity transfer income is considered to be significantly low:
(1) The declared equity transfer income is lower than the corresponding net asset share of the equity.
(2) The declared equity transfer income is lower than the initial investment cost or lower than the price paid for acquiring the equity and related taxes and fees.
(3) The declared equity transfer income is lower than the equity transfer income of the same shareholder or other shareholders of the same company under the same or similar conditions.
(4) The declared equity transfer income is lower than the equity transfer income of enterprises in the same industry under the same or similar conditions.

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the competent tax authorities may subsequently assess and adjust the equity transfer income, resulting in additional tax liabilities for the sellers. During the red-chip reorganisation, ideally the incomes of the investors from disposing of OPCO shares shall equal their original investment costs, so that the investors can avoid additional tax liabilities and also retain as much of their tax base as possible during the process of transferring funds overseas (tax base is a separate topic discussed below). However, in practice, it is difficult to achieve this ideal state for various reasons. In order to reduce the tax burden of disposing of OPCO shares, investors and their transaction lawyers may explore exiting plans from the following aspects:

- In the case of exiting through a share transfer, the transfer price shall be specially negotiated based on the types of investors and their historical capital contributions, to minimise the tax burden. For example, shareholders who have already made actual capital contributions can explore a reasonable valuation of the shares from a professional appraiser to support the transfer price. In practice, the transfer price determined based on the corresponding net asset of the OPCO is generally acceptable to tax authorities, which may in fact be lower than the valuation of the OPCO's most recent round of financing. This plan is suitable for investors who invested in the company at an early stage, so as to avoid bearing excessive tax burdens due to the high valuation of up-round financing. For shareholders who have not yet made actual capital contributions, the capital contribution obligation is deductible from the valuation of the shares, which allows the shares being transferred at a zero consideration or a nominal price. Under this scenario, such shareholders could save extra income taxes and stamp duties. In practice, if the OPCO has several rounds of financing with different valuations, the share transfer is usually done step by step, with the investors with the highest valuations exiting first.
- Share buyback through capital reduction is another common method of disposing of OPCO shares in practice. According to PRC tax laws and regulations, the return of capital to enterprise shareholders is not subject to PRC income tax as it is considered the original capital investment, which

(5) Unreasonable gratuitous transfer of equity or shares.

(6) Other situations determined by the competent tax authorities.

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is deductible for income tax calculation purposes.[9] In practice, a foreign investor may meet some obstacles when wiring out via a PRC bank the proceeds received from share buybacks that exceed the registered capital subscribed by it. Thus such foreign investor may first covert the portion of the capital reserve (equivalent to its investment funds minus the registered capital held by it) into the OPCO's registered capital, and then require the OPCO to buy back all shares it holds. If the buyback proceeds exceed the original investment amount, the seller shall pay income taxes for the premiums, the applicable tax rate of which varies depending on whether the proceeds are categorised as dividends or capital gains on a case-by-case basis. For individuals, the tax treatment for share buybacks is similar to share transfers, therefore the return of capital is not subject to PRC income tax as it is deductible. In light of this, investors prefer to exit from OPCO through share buybacks, as the tax risk exposure is lower compared to share transfer.

- Even though parties try to explore possible tax planning strategies and structures to minimise tax liabilities, there could still be certain tax exposure during the reorganisation. As a bottom-line protection, the investor shall consider negotiating with the target group to share or assume part of the tax burden resulting from the reorganisation. Additionally, it is recommended that investors consult the opinions of the competent tax authorities before making important decisions in investment activities.

Potential tax base losses during the reorganisation

Potential loss of tax base under PRC tax laws is another issue that investors need to consider and discuss during the red-chip reorganisation. The tax base, or the basis for taxation, refers to the taxable income from the transfer of equity, which is the gross balance of equity transfer income minus the net

9 *Notice of State Administration of Taxation on Several Tax Collection Issues Pertaining to Implementation of Corporate Income Tax Law* Guo Shui Han (2010) No. 79 and *Public Announcement of State Administration of Taxation on Several Corporate Income Tax Issues* Announcement (2011)No. 34.

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value of such equity. The total tax liability is calculated by multiplying the applicable tax rate by the tax base.

During the red-chip reorganisation, investors usually use the income from disposing of OPCO shares (after deducting taxes and fees as agreed) as the consideration for the subscription of shares in the Cayman Company. Due to tax planning, ODI approval quota and various other factors, the consideration may be lower than the actual investment cost originally paid by such investor to the OPCO. This will affect the tax base for such investors when they dispose of the equity of the Cayman Company in the future, resulting in a situation where they face additional tax liability.

For RMB investors, as PRC tax residents, the tax base for future equity transfers is calculated based on the actual investment cost paid to the Cayman Company when the investor subscribes for such shares (or the cost paid to the seller when purchasing such shares). If there are multiple rounds of subscriptions with different prices, the weighted average method is usually used for calculation.[10] At this point, the potential tax base loss faced by the investor is the difference between the actual investment cost and the subscription price paid to the Cayman Company. In practice, subject to the ODI approval quota and tax planning, a RMB investor may subscribe for shares in the Cayman company at a nominal price or a price lower than its actual cost. In doing so, such investor's actual investment cost will not be deductible from the taxable income, resulting in tax liabilities far higher than the amount that should incur.[11] As a mitigation, such RMB investor can take advantage of the loss realised from disposing of the OPCO shares.[12] The capital gain received from disposing of shares in the Cayman Company can be offset by the above-mentioned loss to reduce the consolidated taxable income. However, it should be noted that the feasibility of this plan in the future cannot be guaranteed, as the interval between the occurrence of the loss and gain and the linkage have more

10 This principle is clearly stipulated for individual income tax, while temporarily unclear for corporate income tax.

11 There are certain exemptions or reliefs available, which shall be discussed case by case.

12 For the avoidance of doubt, for an individual seller, such loss may not be realised and deducted.

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restricted requirements, and sometimes it is subject to the discretion of competent tax authorities.

For foreign investors, according to Announcement No. 7[13] and other regulations,[14] the seller's income from the equity transfer, which constitutes indirect transfers of equity or other properties of a PRC-resident enterprise through an arrangement without a reasonable commercial purpose, should be taxed on the portion attributable to the properties located in the PRC.

In general practice, the seller's taxable income shall be calculated as follows:

> *the taxable income attributable to the PRC properties = (transfer income + overseas liabilities - overseas assets) - investment cost in the WFOE*[15]

There are two points that investors and their transaction lawyers must pay attention to in connection with the formula:

- First, the overseas liabilities and assets shall be calculated pro rata based on the percentage of the shares being transferred. Investment funds remaining in the accounts of the Cayman Company and other overseas group companies (if any) will be deducted when calculating the taxable income. However, such deductions depend on the target group's cooperation in providing relevant supporting documents (such as bank statements, accounting details, etc). This cooperation obligation should be incorporated into the transaction documents so that the Cayman Company

13 *Announcement of the State Administration of Taxation on Several Issues Relating to Enterprise Income Tax on Transfer of Assets between Non-resident Enterprises* State Administration of Taxation Announcement [2015] No. 7.

14 If a non-resident enterprise indirectly transfers equity or other properties of a PRC-resident enterprise through an arrangement without a reasonable commercial purpose, it is deemed as directly transferring equity or other properties of a PRC-resident enterprise. The transferor's income from the equity transfer should be taxed on the portion attributable to the properties located in China. For non-resident individuals, similar principles shall apply.

15 Ci Zhang and Yingjie Yang, *Indirect Transfer Announcement No. 7: Key Points of Tax Supervision Practice*, King & Wood Mallesons. https://mp.weixin.qq.com/s/V37RnnfKo_MQNecMzxZSng.

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as well as other group companies can cooperate with investors in future tax filings.

- Second, the investment cost in the WFOE is usually calculated by multiplying the shareholding percentage in the WFOE corresponding to the transferred shares of the Cayman Company by the investment amount indirectly injected into the WFOE by the Cayman Company. In this situation, one investor's deductible cost in the WFOE may be diluted by other investors due to their subscription for shares of the Cayman Company at a nominal consideration (or consideration much lower than their original investment cost in the OPCO). Even if all the investment amounts are fully injected into the WFOE, the investment costs of later-round investors may be diluted by earlier-round investors due to the valuation gap, and thus cannot be fully deducted. Besides, investment amounts that have not been fully injected into the WFOE could not be deductible when calculating taxable income (for the avoidance of doubt, the overseas cash is deductible while the non-cash assets may not be equal to the consumed cash dollar to dollar, thus not fully deductible).

In response to the above situation, the following measures could be taken to minimise the tax base loss:

- When negotiating the reorganisation plan, investors and their professional advisers shall pay attention to the cashflow arrangement during the reorganisation and calculate potential tax implications. In the reorganisation plan, foreign investors usually require each shareholder to subscribe for shares in the Cayman Company based on their respective actual investment cost in the OPCO (multiple rounds of capital flow can be carried out to realise the target group's reorganisation plan), but this may be limited by the ODI approval quota and thus not practicable.
- Additionally, the investment proceeds paid to the Cayman Company shall be injected into the WFOE in the form of paid-in capital as much as possible to increase the tax base of applicable shareholders under Announcement No. 7. The target group may argue that it has overseas business and needs funds overseas. As a compromise, investors could try to negotiate a minimum percentage of funds flowing into the PRC based on the deal dynamics and future business plan of the target group.

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- As a bottom-line protection, investors usually require the target group (sometimes with the founders being jointly liable) to compensate the tax base loss incurred due to the red-chip reorganisation, including all fees and penalties incurred thereof. This term is difficult to negotiate in practice and not all investors can successfully obtain similar compensation clauses in every deal. In some deals, the tax base compensation for investors may be subject to various conditions and limitations, for example, the target's liability is subject to a fixed cap amount. In other deals, investors may not be able to obtain any tax base compensation, which means the potential tax base loss in future disposal will be solely borne by the investors. Therefore, investors need to fully consider various aspects during the red-chip reorganisation, such as the selection of investment vehicles, the establishment of intermediate layer SPVs, the loss and gain of itself on a consolidated basis, and the cashflow process, etc. We have discussed the choice of investment vehicles above, and below we give more details about the tax implications of the ODI path company.

Tax implications of the ODI path company

For RMB investors who want to invest in red-chip structure companies, it is required to get ODI approval from relevant governmental authorities before being registered as a shareholder in the Cayman Company. Establishing an intermediate layer company (the SPV) can increase the flexibility of disposing of shares of the Cayman Company, while the tax implications may vary under different scenarios. This shall be considered in combination with the target group's future listing plan.

If the Cayman Company plans to list overseas, including listing on the Hong Kong Stock Exchange, and the investors intend to exit after the listing, the domestic ODI entity typically sets up an offshore SPV to hold the shares of the Cayman Company. Based on our prior practice, the disposal of shares in the public market by the SPV is usually not subject to taxation under Announcement No. 7. If the ODI entity holds the shares directly, the entity, as a PRC tax resident, needs to pay a 6 per cent value added tax on the taxable income from the disposal of the listed company's shares.

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If the RMB investor proposes to exit through an acquisition or a trade sale of the target group, it is more tax-efficient for the domestic ODI entity to hold the shares directly. In the case of holding shares through an SPV, the SPV is required to pay a 10 per cent withholding tax under Announcement No. 7, resulting in a double tax burden for such RMB investors. Directly transferring the shares of the SPV can avoid double taxation while it loses some of the flexibility in exiting, as RMB investors need to transfer all shares indirectly held by them in a one-time transaction.

For completeness, it should be noted that companies with red-chip structures are currently permitted to list on the Science and Technology Innovation Board (the STAR Market) in the PRC. In this case, it is recommended that RMB investors hold their equity interests directly, rather than through an offshore SPV, to avoid the withholding tax under Announcement No. 7 and double taxation. However, the transfer of shares may still be subject to a 6 per cent value added tax on capital gains as required by PRC tax laws. The specific tax burden in the exit scenario of the STAR Market still needs to be further observed in practice.

Conclusion

Tax is a comprehensive topic and in this chapter we only select several topics that are commonly seen and discussed in M&A transactions. This chapter can serve as an introductory note to various tax issues in M&A transactions. As the PRC taxation system continues to develop, investors, together with their transaction counsel, must monitor changes in PRC tax laws and regulations, design and adjust the transaction structure and pricing strategy accordingly to optimise the tax outcome.

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2

New Filing Regime for Overseas Offering and Listing

Lishi Feng, Yufei Wang and Jushan Wang[1]

It has been more than three decades since the first PRC[2]-based company was listed overseas. With the increasing number of PRC-based companies seeking overseas listing, to advance the healthy and sustainable capital market activities of these companies, on 17 February 2023, the China Securities Regulatory Commission (CSRC) issued the Trial Administrative Measures of Overseas Securities Offering and Listing by Domestic Companies along with five supporting guidelines[3] (collectively, the Trial Measures), which came into effect on 31 March 2023. The Trial Measures have established a new filing regime covering a wide range of overseas offering and listing of securities involving PRC-based companies. This chapter provides a brief overview of the Trial

1 Lishi Feng, Yufei Wang and Jushan Wang are senior legal counsel at Tencent.

2 The People's Republic of China, which, for the purpose of this chapter, means mainland China and excludes the Hong Kong SAR, the Macao SAR and Taiwan.

3 In addition to supporting guidelines No.1 to No. 5, which was issued on 17 February 2023, the CSRC further promulgated a supporting guideline No. 6 on 16 May 2023 with respect to the overseas offering of global depositary receipts by domestic listed companies.

Measures and discuss selected topics that might be of interest to an investor shareholder.

Overview of the Trial Measures

The Trial Measures include five key components, including the principal, filing entities, the filing procedures, ongoing compliance and enforcement actions, details of which are as follows.

Filing entities

The scope of application of the Trial Measures is broad, as both direct and indirect overseas offering and listing activities are governed. Direct overseas offering and listing refers to the overseas offering and listing of companies limited by shares incorporated in the PRC. Indirect overseas offering and listing refers to the overseas offering and listing by a non-PRC incorporated entity where the listing entity (issuer)[4] meets two conditions:

- any of the operating revenue, total profits, total assets or net assets of the PRC operations of the issuer for the most recent accounting year accounts for more than 50 per cent of the corresponding financial indicator of the issuer as reported in its audited consolidated financial statements for the same period; and
- the issuer's business activities or operations are mainly conducted in the PRC, its main place of business is located in the PRC, or a majority of its senior management are PRC citizens or are domiciled in the PRC.

That said, where the issuer does not meet both conditions, if it submits an application for offering and listing to an overseas exchange in accordance with the regulations of that overseas exchange applicable to a non-domestic issuer and the risk factors to be disclosed are mainly related to the PRC, the Trial Measures specify that a 'substance over form' approach should be adopted

4 It refers to a listing applicant or a listed issuer as the case may be, unless otherwise specified.

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to determine whether such issuer should be regarded as seeking an indirect overseas offering and listing and therefore subject to the Trial Measures.

The Trial Measures provide a negative list, which clearly enumerates those types of PRC companies that would be prohibited from overseas offerings and listings:

- where such securities offering and listing is explicitly prohibited by laws or regulations;
- where competent authorities of the State Council have determined that the intended securities offering and listing may endanger national security;
- where a domestic company of the issuer, its controlling shareholder or its de facto controller has committed certain economic crimes within the past three years;
- where a domestic company of the issuer is under investigation for criminal or serious violations of laws and regulations, and no definitive conclusion of the investigation has yet been made; and
- where there is a material ownership dispute over equity interests held by controlling shareholders, or by other shareholders who are controlled by the controlling shareholder or de facto controllers.

If a PRC company involved in an overseas listing falls under any of the above situations, such overseas listing shall be postponed or terminated, and the issuer shall give timely and regular updates to the CSRC.

Filing timeline and filing events

Pursuant to the Trial Measures, the issuer, or a main PRC operating entity designated by the issuer in the case of an indirect overseas listing, should carry out the filing procedures with the CSRC by submitting relevant materials, which include (1) a filing report, (2) relevant undertakings of the issuer, its sponsors and PRC legal advisers, (3) a PRC legal opinion, (4) where applicable, regulatory opinions, filings or approvals on national security review and/or industry regulation granted by applicable PRC authorities, and (5) the listing document and other relevant documents.

Filing should be made with the CSRC by the issuer in the designated time period. For example, applications for initial public offerings (IPOs) or listings

on an overseas exchange should be filed with the CSRC within three working days after the submission of overseas offering and listing application by the issuer. The CSRC may request supplemental information or amendments within five working days if the filing documents do not meet all requirements of the Trial Measures, and the applicant should provide supplemental information in response within 30 working days thereafter. Where the filing documents are complete and meet all requirements of the Trial Measures, the CSRC will conclude the filing process and publish the result on its official website within 20 working days. After the completion of overseas offering and listing, the issuer is also required to submit reports to the CSRC in certain circumstances, such as change of control, investigation or penalty imposed by overseas securities authorities, or delisting, within three working days from the date of announcement and/or the date of occurrence of such changes.

The Trial Measures have also considered the features of filing regimes in other jurisdictions when mapping the filing related procedures and have provided alternatives in terms of disclosure, which facilitates listing applicants to better plan its listing application process. For example, If an overseas offering and listing application is submitted to an overseas exchange or a regulatory body on a confidential or non-public basis, the issuer may elect to submit an explanation at the time of filing with the CSRC to apply for deferred disclosure of the filing information. After such election, the listing applicant would be required to report to the CSRC within three working days after the overseas offering and listing application documents are disclosed to the public.

In addition to events such as IPOs or listings on an overseas exchange, the Trial Measures also apply to post-listing fund raising or M&A activities. The filing procedures would be required in such circumstances as IPOs, listings involved in restructurings, secondary listings, special purpose acquisition company listings, follow-on issuances of shares and full circulation of H shares.

The Trial Measures do not apply retroactively, which means that in general companies that were already listed overseas as at 31 March 2023 are not required to carry out any filing procedures until they undertake further fund-raising activities or other activities governed by the Trial Measures.

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Key issues to note

Shareholder structure, agreements among shareholders, pre-IPO investments and variable interest entity (VIE) arrangements are usually key topics examined by regulators as well as working parties in a listing process. The Trial Measure have shed some light on some of these areas.

Shareholder structure and nominee shareholding

The Trial Measures concern not only listing applicants and listed issuers but also their shareholders. Multiple issues should be considered by investor shareholders of a listing applicant, among which most notably is the information on the shareholders to be submitted to the CSRC. Above all, for a listing application, the filing report and the accompanying PRC legal opinion should include, among other things, detailed information on shareholders holding 5 per cent or more of the total issued shares or voting power of the listing applicant, which should trace all the way up to natural persons or listed companies. As the Trial Measures do not specify or recommend a method of gathering the required information, in practice, the working parties would likely follow the practice in an A-share listing. For the purpose of efficiency, it is advisable for an investor shareholder holding 5 per cent or more of the total issued shares or voting power to frontload this workstream, especially if the investor shareholder has multiple shareholders and there are layers of shareholding structures within the investor shareholder per se. Information on shareholders holding less than 5 per cent of the total issued shares or voting power of a listing applicant should also be submitted, but the level of detail is lower and the focus is mostly on whether the shareholders are holding shares on behalf of third parties, whether the shareholders are entitled to special rights, whether the shareholders are affiliated or concerted parties, and the like. In the case where a shareholder is holding any amount of shares on behalf of a third party that does not wish to make its name known, the Trial Measures have specified that the PRC legal adviser should conduct due diligence on this situation and deliver a clear view in its legal opinion, which should address the reason for such shareholding arrangement, changes in and developments of such shareholding arrangement, the legality of such shareholding arrangement, whether there are any disputes, and the like. If the concerned parties will continue such shareholding arrangement as aforesaid, it remains to be

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seen whether this would implicate the filing process. As such, under the Trial Measures, a shareholder holding shares on behalf of a third party should plan ahead to clear with the CSRC or to unwind the relevant shareholding arrangement. In addition, in the case of a VIE structure with foreign shareholders, the PRC legal adviser is required to check whether the foreign shareholders are involved in the business operations of the listing applicant in any manner, for example, by way of appointing a representative to the board. Though further practical guidance from the CSRC is expected, the Trial Measures have not yet specified on how this might affect the filing process, and one concern is how likely foreign shareholders' involvement in the business operations would be seen as some kind of influence on or even control over the listing applicant, which will then lead to the question on whether foreign investment review is triggered. Considering the complexity and uncertainty of this issue, a foreign shareholder that is by any means involved in the business operations of a VIE structure should think and plan ahead for the next steps. Similar to the requirement by the Hong Kong Stock Exchange on disclosure of pre-IPO investors, the Trial Measures require the PRC legal adviser to conduct due diligence on investors who became shareholders of the listing applicant within the 12 months preceding the CSRC filing application and deliver a clear view in the PRC legal opinion, which should cover, among other things, the investment rationale, the amount of consideration paid, the basis of determining the consideration paid, etc. In particular, it should be ascertained whether those investor shareholders have any affiliation or relationship with the listing applicant, its directors, supervisors and management, as well as the professional parties working on the listing application.

Shareholders' special rights

While what is discussed in the previous paragraph might mostly be disclosure issues for investor shareholders, shareholders' special rights would surely be another topic of serious consideration. In most investments, shareholders' special rights (eg, weighted voting rights (WVR), investor consent rights, redemption rights) are important tools for investor shareholders of a private company to protect their interests in the company. The listing rules of certain major stock exchanges usually require a listing applicant to terminate certain

privileges or special rights that are not extended to all shareholders at certain points, for example, upon listing or upon submission of the listing application.

Before the promulgation of the Trial Measures, in respect of any existing special rights of shareholders, the issuer of a direct overseas listing (typically, H shares) would usually be required by the CSRC typically on a case-by-case basis to disclose details of the existing arrangements and might further be required to terminate those special rights before it submits its listing application to the overseas stock exchange. Differently, an issuer of an indirect overseas listing would usually only need to focus on the compliance with the listing rules of the listing venue as to whether and when to terminate those special rights. The new requirements in respect of shareholders' special rights introduced by the Trial Measures are the disclosure by the issuer (of both direct and indirect overseas listing) to the CSRC details of such special rights. Particularly, if the issuer has WVR or similar arrangements among its shareholders, it is required to disclose in its filing application details of such arrangements, including without limitation the scope of matters subject to the WVR, matters that the WVR is not appliable to, potential impacts of the WVR on the change of control risk or the corporate governance of the issuer. The Trial Measures do not specifically require the issuer to terminate the shareholders' special rights at certain point from a PRC law perspective. The issuers will primarily have to comply with the listing rules of the listing stock exchange in respect of the termination of these special rights. For those issuers who apply for their listings on stock exchanges where certain special rights of shareholders are allowed, the market is keen to learn from future filings the authority's view in practice in respect of maintaining shareholders' special rights.

VIE structure and foreign investment

When it comes to overseas offering and listing, one indispensable component is the VIE structure. The VIE structure has enabled foreign investors to invest or participate in business (for example, value-added telecommunication business) where foreign direct investments are otherwise not allowed. In the past, the indirect overseas listings of PRC-based companies via a VIE structure were not particularly subject to any domestic review or filing procedures in the PRC. After the promulgation of the Trial Measures, the overseas listing

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via a VIE structure is now subject to the supervision and administration of the CSRC. In its response in a press interview[5] regarding the promulgation of the Trial Measures, the CSRC confirmed that it will consult the relevant governing authorities for their opinions, and filing application of a company seeking overseas listing via a VIE structure will be accepted if the relevant compliance requirements are met. Such confirmation was considered as a positive signal to the market and has been widely welcomed. As such requirements under the Trial Measures roll out, the market is likely to see further guidance and details of the consultation procedures and compliance requirements to be met by a listing applicant with a VIE structure.

Certain new challenges to issuers with VIE structures are reflected in the new requirements introduced by the Trial Measures in relation to the matters to be included in the PRC legal opinion. In accordance with the Trial Measures, the issuer's PRC legal adviser is required to provide legal opinion in respect of the VIE structure, including without limitation, foreign investors' involvement in the management and operation of the issuer (eg, through appointing directors), whether the issuer engages in any businesses or holds any licences or qualifications that are specifically prohibited by the relevant laws and regulations to be engaged or held via a VIE structure, whether any VIE entities are subject to the foreign investment security review, and whether any VIE entities have engaged in businesses that are restricted or prohibited to foreign investors. This means that details of the VIE arrangements between the shareholders and the issuer, which were previously not required to be disclosed to the CSRC, will now be presented to the CSRC.

Accommodating rule amendments of relevant stock exchange

Promulgation of the Trial Measures has prompted regulators of other jurisdictions to revisit their existing regulatory frameworks, and the Hong Kong Stock Exchange, being one of the preferred listing venues for PRC-based companies, is one of the fastest to react. On 24 February 2023, the Hong Kong Stock Exchange issued a consultation paper to introduce proposed amendments to

5 Published by the CSRC on 17 February 2023 (csrc.gov.cn).

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the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Hong Kong Listing Rules), reflecting changes in the Trial Measures announced by the CSRC discussed above. The consultation conclusion was issued on 21 July 2023, and the amended Hong Kong Listing Rules took effect on 1 August 2023. With the effectiveness of the Trial Measures, the Mandatory Provisions for Companies Listing Overseas (the Mandatory Provisions) have been repealed simultaneously, and most significantly for PRC-incorporated listed issuers, H shares and domestic shares are no longer deemed as different classes of shares.

In the past, if a PRC-incorporated listed issuer intended to issue or repurchase shares, it should have obtained the approvals by special resolutions of shareholders in a general meeting and of H shareholders and domestic shareholders at separate class meetings. Under the amended Hong Kong Listing Rules, where a PRC-incorporated listed issuer intends to issue or repurchase shares, class meetings and special resolutions are no longer required, and the issuance or repurchase of shares would just be subject to ordinary resolutions in general meetings. That said, PRC-incorporated listed issuers must still adhere to the class meeting and special resolution requirements prescribed in their existing articles of association for issuance and repurchase of shares, because the repeal of the Mandatory Provisions and the effectiveness of the amended Hong Kong Listing Rules do not automatically render the existing articles of association void, which means that the class meeting and special resolution requirements in the existing articles of association should remain valid and binding on PRC-incorporated listed issuers until they amend their articles of association to remove these requirements. To put into practice, under the amended Hong Kong Listing Rules, if a PRC-incorporated listed issuer intends to amend its articles of association to remove the class meeting and special resolution requirements for issuance and repurchase of shares, it should still obtain approvals by special resolutions from H shareholders and domestic shareholders at separate class meetings in accordance with its existing articles of association. It is expected that some PRC-incorporated listed issuers would convene shareholders' meetings in the near future to remove the class meeting and special resolution requirements, with a view to streamlining and simplifying the process for issuance and repurchase of shares. As such, if a shareholder holds a relatively large amount of shares in a PRC-incorporated listed issuer and wishes to keep its shareholding percentage

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within a certain range, it should vote wisely in the relevant shareholders' meetings of the PRC-incorporated listed issuer on the proposals relating to approval requirements for issuance and repurchase of shares. Shareholders of a PRC-incorporated listed issuer should also exercise caution when considering and voting on other amendments to the articles of association which might concern their interests.

The Securities and Futures Commission of Hong Kong (SFC) takes a different view on categorisation of different classes of shares when it comes to disclosure of interests under Part XV of the Securities and Futures Ordinance. In an FAQ, the SFC has emphasised that H shares and domestic shares trade on separate exchanges and cannot be transferred between exchanges and therefore interests in H shares and domestic shares of a PRC-incorporated listed issuer should continue to be calculated as a proportion of the numbers of issued H shares and issued domestic shares, respectively. Simply put, the current practice of reporting H shares and domestic shares under the disclosure of interests regime remains unchanged. In line with the rationale of removing the class meeting requirements for issuance and repurchase of shares for PRC-incorporated listed issuers, under the amended Hong Kong Listing Rules, the limit on a general mandate for issuance of new shares at 20 per cent and the limit on a scheme mandate for share schemes at 10 per cent for PRC-incorporated listed issuers should be calculated with reference to the total issued shares, instead of referencing to each of H shares and domestic shares. This allows PRC-incorporated listed issuers more flexibility to decide how to use their general mandates and scheme mandates between H shares and domestic shares. This amendment on calculation of general mandates and scheme mandates is automatically effective and binding on all PRC-incorporated listed issuers since 1 August 2023.

The Hong Kong Stock Exchange has also introduced other amendments to the Hong Kong Listing Rules to align the requirements for PRC-incorporated issuers with those applicable to non-PRC-incorporated issuers. For example, under the amended Hong Kong Listing Rules, shareholders of a PRC-incorporated listed issuer are no longer required to enforce their claims arising out of the articles of association by arbitration, there are no longer specific provisions on sponsors and compliance advisers for PRC-incorporated issuers in designated Chapter 19A of the Hong Kong Listing Rules, certain requirements relating

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to online display and physical inspection of documents for PRC-incorporated issuers are removed, requirements on disclosure of certain topics for listing documents of PRC-incorporated listing applicants are removed, and the like. All these amendments are expected to streamline the listing application process and the post-listing compliance for PRC-incorporated issuers.

In addition, before the implementation of the Trial Measures, during preparation for the Hong Kong listing application, a PRC-incorporated listing applicant needs to rush to obtain the CSRC acknowledgement receipt on its CSRC filing and submit such acknowledgement receipt to the Hong Kong Stock Exchange together with its listing application. Obtaining such acknowledgement receipt is usually demanding for a PRC-incorporated listing applicant when it is at the same time swamped with the Hong Kong listing application. After the implementation of the Trial Measures, a PRC-incorporated listing applicant is no longer required to obtain a CSRC acknowledgement receipt or similar documents before submitting a listing application to the Hong Kong Stock Exchange. In other words, submission of a listing application to the Hong Kong Stock Exchange is not subject to the obtainment of a CSRC acknowledgement receipt or similar documents. With the rules changing from time to time, listing applicants, listed issuers and shareholders should stay abreast of further legal updates of relevant stock exchanges that relate to the Trial Measures.

The way forward

Listing is usually considered one of the most significant events during the lifespan of a company, and the listing process involves various regulatory bodies, professional parties and vast public investors, which calls for a delicate and comprehensive system governing and navigating the whole process. The process of an overseas listing is no doubt more complicated as it encompasses interaction and interpretation of rules by regulatory bodies in different jurisdictions. It is encouraging to see that the CSRC is taking a pragmatic approach and has introduced the Trial Measures which serve as a pathfinder in response to the fast-changing market. The Trial Measures seek to align the regulatory requirements for all overseas offerings and listings by PRC-based companies and represent a significant advance by the CSRC on the regulation of overseas securities offering and listing by PRC-based companies.

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Investors, as well as listing applicants planning for overseas listings, will need to prepare for the new changes and new requirements under the Trial Measures. As discussed, certain information of shareholders of PRC companies seeking indirect overseas listings (eg, the shareholding structure of the shareholder itself, whether it is holding shares on behalf of a third party, its involvement in the management and operation of listing applicant) that was not required to be disclosed to the CSRC in the past is now required to be disclosed under the new regime. The VIE structure is officially mentioned by the CSRC and the Trial Measures, which has been interpreted as a positive signal for shareholders of VIE structures and boosted their confidence. This also comes with workloads to the listing applicants and their shareholders, as details of the VIE arrangements will need to be disclosed to the CSRC and the relevant authorities that the CSRC may consult. In respect of shareholders' special rights, the Trial Measures unify the disclosure requirements for both direct and indirect overseas listings. While there remain issues to be clarified and coordinated, the Trial Measures mark a firm and positive step forward to pave a clearer way for PRC-based companies to overseas capital markets and have laid a solid foundation for continuous improvement and standardisation of regulatory procedures.

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3

Refreshed Confidentiality and Archives Administration Requirements

Chen Qiu, Ruihua Feng, Yulan Ouyang and Ge Zeng[1]

Introduction

The China Securities Regulatory Commission (CSRC), together with the Ministry of Finance, National Administration of State Secrets Protection and National Archives Administration of China jointly issued on 24 February 2023 the revised Provisions on Strengthening Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Companies (Regulation 44 (2023)) (the New Confidentiality and Archives Provisions), which superseded the 2009 version (Regulation 29 (2009)) (the 2009 Version) and became effective from 31 March 2023. The New Confidentiality and Archives Provisions clarify requirements and procedures regarding how China-based companies seeking overseas listings shall deal with confidential information if their overseas listing requires disclosure of state secrets or information jeopardising national security or the public interest.[2] They also provide for a mechanism with respect to

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2 For the purpose of this chapter, China means mainland China excluding Hong Kong, Macao and Taiwan.

cross-border regulatory-audit oversight cooperation, in accordance with which the investigation, inspection and evidence collection by overseas securities regulators shall be carried out. The release of the New Confidentiality and Archives Provisions paves a clearer path for China-based companies' overseas listings and provides guidance on provision and disclosure of certain regulated information during the overseas listing and post-listing process.

Background on issuance of the New Confidentiality and Archives Provisions

The New Confidentiality and Archives Provisions appear to be part of a package of supporting rules to the Trial Administrative Measures of Overseas Securities Offering and Listing by Domestic Companies (Regulation 43 (2023)) (the Trial Measures), which were also released in February 2023 and took effect from 31 March 2023. The Trial Measures seek to align and unify the PRC regulatory requirements for all overseas offerings and listings by China-based domestic companies, including, notably, expanding the application to explicitly cover indirect overseas offering and listings of China-based domestic companies. Consistent with this principle, the New Confidentiality and Archives Provisions were issued to expand the scope of the 2009 Version and broaden PRC regulatory scrutiny regarding secrets protection and archives management in the context of overseas offering and listings.

The release of the New Confidentiality and Archives Provisions is also an official response, on the implementation level, to the longstanding cross-border audit oversight stalemate between China and the United States with respect to US listing by China-based companies. The Public Company Accounting Oversight Board of the United States (PCAOB), the body overseeing the audits of companies listed on stock exchanges in the US, has exerted extraterritorial oversight power over all accounting firms that audit US-listed companies, including foreign accounting firms. However, for more than a decade, the PCAOB had encountered obstruction to its request to be given access and inspect audit work papers and practices of accounting firms in mainland China and Hong Kong that service China-based companies listed on US stock exchanges. Tensions lay where PCAOB requests to conduct unrestricted inspections of audit firms of China-based companies in accordance with US regulatory rules,

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including on-site inspections within China and unrestricted access to audit papers, while restrictions set out under Chinese laws generally prohibit foreign securities regulators from engaging in any inspection activities in China or any person from providing any documents relating to capital-markets activities to foreign parties without the approval of the Chinese authorities due to concerns over national security and data security relating to the audit process. In particular, the 2009 Version required that any on-site inspection of audit firms in mainland China or Hong Kong must be led by the Chinese regulatory authorities or foreign parties must rely on the inspection results of Chinese regulatory authorities.

Such tensions intensified and escalated in recent years as US legislative and regulatory authorities promulgated a number of measures to exert increasingly heightened scrutiny of China-based US listed companies, especially after several China-based US listed companies were embroiled in a series of high-profile financial fraud scandals. Among the measures promulgated, the Holding Foreign Companies Accountable Act (HFCAA) was signed into law in December 2020, which threatened to cause delisting of China-based US listed companies from US stock exchanges and prohibit trading of their securities in the US over-the-counter market by 2024, if not earlier, if the PCAOB has determined that it has been unable to inspect the company's accounting firm for three consecutive years because of a position taken by an authority in the company's jurisdiction. The targets at risk to be delisted under the HFCAA are not a small subset of companies; as of September 2022, there were 249 China-based US listed companies with a total market cap of approximately US$915 million.[3]

Meanwhile, China has been working on the scrutiny of data security and network information security. In September 2021, the PRC Data Security Law came into force, which strengthens the protection of data security and control of outbound data transfer from legislative perspective. In January 2022, the revised Measures for Cybersecurity Review (the Revised Cybersecurity Review Measures) require Chinese firms that hold personal information of

3 Stock Market MBA, List of Chinese Companies that trade on US stock exchanges.

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1 million or more individuals to seek a government cybersecurity review before listing abroad.

Amid the backdrop of continuing regulatory conflicts between the Chinese regulations and the HKCAA, in March 2022, the US Securities and Exchange Commission identified and determined five China-based US listed companies as issuers not in compliance with the HFCAA with delisting risks, which led to a significant decline of market values of China-based US listed companies. Following such determination, US and Chinese regulators proactively engaged in discussions seeking solutions satisfactory to both sides that would prevent numerous China-based US listed companies from eventually being delisted from US stock exchanges. On 26 August 2022, the CSRC and the Ministry of Finance finally reached consensus and signed a Statement of Protocol Agreement with the PCAOB regarding cooperation in the oversight of PCAOB-registered public accounting firms in China and Hong Kong, which could prove to be a monumental step forward in the cooperation between the authorities. Substantial progress was made in December 2022 when the PCAOB announced that it had obtained full access to inspect and investigate China-based US listed companies in Hong Kong, removing the risk that more than 200 China-based US listed companies being expunged from the US capital market.

Against this background, the New Confidentiality and Archives Provisions were promulgated by Chinese regulatory authorities on 24 February 2023, with a view to accommodate the US listing process and remove legislative obstacles to the cross-border audit oversight that the PCAOB demands during the overseas listing process, while at the same time for Chinese regulatory authorities to continue to ensure enhanced oversight on outbound data transfer. Specifically, on the one hand, the New Confidentiality and Archives Provisions further clarify obligations of the interested parties in the overseas listing process and retain the requirements for China-based companies and securities service providers (including accounting firms) to follow the relevant approval, clearance or filing requirements before providing documents or materials to overseas securities regulators. On the other hand, it lays a solid institutional foundation for secured and efficient cross-border cooperation for overseas regulatory enforcement action with regard to overseas listing by China-based domestic companies. With these amendments, the New Confidentiality and Archives Provisions aim to develop a gatekeeping mechanism in the provision

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of information or materials by China-based companies to the relevant securities companies, securities service providers, overseas regulatory authorities or any other entity or individual, so as to prevent sensitive information from leakage and prescribe protective protocols for any residual sensitive information that still has to be provided.

Scope and key points of the New Confidentiality and Archives Provisions

Applicable activities

The New Confidentiality and Archives Provisions regulate the confidentiality and archive management in the process of 'domestic companies seeking direct or indirect overseas offering and listing', including the following activities.

Direct or indirect overseas listing of domestic companies

Compared with the 2009 Version, the New Confidentiality and Archives Provisions expand coverage to explicitly apply to both direct overseas listing by joint-stock company incorporated domestically in China and indirect overseas listing, which effectively means an indirect listing of domestic companies via the typical variable interest entity (VIE) structure[4] or red-chip[5] structure. Furthermore, China-based companies seeking listing in other overseas exchange markets after their initial overseas listing (such as Hong Kong secondary listing) is also in scope. As mentioned above, such amendments are primarily to align with and implement the regulatory principle laid down in the Trial Measures.

4 A VIE structure refers to a structure whereby the listed entity (an offshore holding company) is incorporated and controls the interests of the relevant PRC domestic operating entities through a suite of structured contracts.

5 A red-chip structure refers to a structure whereby the listed entity (an offshore holding company) is incorporated and injected with all assets of the relevant PRC domestic companies by holding the ownership and becoming the holding parent of these PRC domestic companies.

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Issuance of other securities in overseas markets

Other than initial public offering, the issuance of additional shares, convertible bonds, issuance of shares to purchase domestic assets, reverse takeover (including listing through SPAC), and H-share full circulation are also subject to compliance with the New Confidentiality and Archives Provisions;

Information disclosure and accounting management of China-based overseas listed companies

The New Confidentiality and Archives Provisions also apply to China-based overseas listed companies, in the sense that any provision of information or materials by these companies to any overseas regulator or third-party securities intermediaries during their post-listing periodical public disclosure or overseas compliance/investigation process should also comply with the requirements on confidentiality and archive management set out in the New Confidentiality and Archives Provisions.

Cross-border cooperation for overseas regulatory enforcement actions

With regard to overseas regulatory requests for inspection and investigation during overseas listing process, the 2009 Version provides that any such onsite inspection must be carried out primarily by the Chinese regulatory authorities or the overseas regulators must rely on the results of inspection conducted by Chinese regulatory authorities. The New Confidentiality and Archives Provisions remove such requirements; Instead, they provide for a cross-board cooperation mechanism whereby CSRC and the relevant regulatory authorities will provide necessary assistance pursuant to the relevant bilateral and/or international cooperation mechanisms. Completion of the PCAOB's inspections of China- and Hong Kong-based audit firms back in December 2022 is a successfully execution of such cooperation mechanism for the first time ever in history.

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Applicable parties

The New Confidentiality and Archives Provisions adopt a dual-responsibility approach with respect to the various stakeholders' responsibilities during the overseas listing process. On the one hand, it is made clear that Chinese domestic companies, whether offering and listing securities overseas directly or indirectly, must strictly abide by the applicable laws and regulations, and must take necessary measures to implement the confidentiality and archives management responsibilities when providing or publicly disclosing, either directly or through their overseas listed entities, documents and materials to securities services providers (such as securities firms and accounting firms) or overseas regulators in the process of their overseas offering and listing. On the other hand, in addition to China-based domestic companies seeking overseas listing or China-based overseas listed companies, the securities companies and securities service providers (both onshore and offshore) serving these companies are also required to comply with the confidentiality and archives management requirements under the New Confidentiality and Archives Provisions.

Scope of regulated information

The New Confidentiality and Archives Provisions mainly scrutinise the following four categories of information.

State secrets and working secrets of government agencies

Compared with the 2009 Version, the New Confidentiality and Archives Provisions broaden their scope to cover not only state secrets, but also working secrets of government agencies. It is stipulated that provision and disclosure of state secrets and working secrets of government agencies by domestic companies to any individuals, securities companies, securities service providers or overseas regulators shall be approved by the competent authorities in accordance with applicable law, and filed at the secrecy authorities at the same level.[6]

6 Article 3 of the New Confidentiality and Archives Provisions.

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The question arises as to what constitutes 'state secrets' and 'working secrets in government agencies' respectively. For state secrets, it is stipulated in the Law of the People's Republic of China on Guarding State Secrets (the Secrets Law) that state secrets are matters that have a vital bearing on state security and national interests and, as specified by legal procedure, are entrusted to a limited number of people for a given period of time.[7] Matters involving national security and interests shall be determined as state secrets if the divulgence thereof may cause damage to the national security and interests in the political, economic, national defence, foreign affairs and other fields, such as secrets concerning important decisions on state affairs, secrets in the building of national defence and in the activities of the armed forces, secrets concerning diplomatic activities and in activities related to foreign countries and those to be kept secret through commitments to foreign countries, etc.[8] The Secrets Law further stipulates that state secrets shall fall into three categories: most confidential, confidential and secret,[9] and the specific scope of state secrets and their classification levels shall be stipulated by State Secrecy Administration together with the Ministries of Foreign Affairs, Public Security, and State Security, and other relevant central organs concerned. The specific scope of state secrets related to national defence shall be stipulated by the Central Military Commission.[10]

Compared with state secrets, which are expressly defined and categorised under applicable law, there is no clear definition of working secrets of government agencies in PRC laws or regulations. Rather, it is determined by the government authorities that generate or issue such information. Generally, documents marked or labelled by government agencies as 'internal materials/reference', 'for internal use only' or 'not to be disclosed' are considered working secrets of government agencies. Notwithstanding, in the absence of such mark or label, it is widely understood that working secrets of government agencies also refer to any matters or information generated in or relating to the activities of government agencies, which are not state secrets but the

7 Article 2 of the Secret Law.
8 Article 9 of the Secret Law.
9 Article 10 of the Secret Law.
10 Article 11 of the Secret Law.

leakage or disclosure of the same will affect or be detrimental to the normal operation of government agencies.

Information, if disclosed, that may be detrimental to national security or public interests (together with state secrets and working secrets of government agencies – Regulated Information)

It is stipulated and further clarified in the 2009 Version that provision and disclosure of information by domestic companies to any individuals, securities firms, securities service providers or overseas regulators, the disclosure of which may have adverse effect to national security or public interest, shall comply with applicable national laws and procedures.[11] It is, however, unclear in the New Confidentiality and Archives Provisions what the 'applicable laws and procedures' one should refer to for interpretation of what information would fall under such category and what procedure should be followed. General market consensus is that this general and catch-all provision is likely to capture, among other things, the information categories under the Revised Cybersecurity Review Measures (which focus on network products and services that might have security implications) and the Outbound Data Transfer Security Assessment Measures (which focus on outbound data transfer that might have security and public interest implications). Nevertheless, there is no exhaustive list of laws and regulations that could possibly be applicable, and determination need to be made on a case-by-case basis, depending on the nature of the domestic company as well as the information involved.

Accounting archives or copies

It is stipulated that provision of accounting files or any copies thereof by domestic companies to any individuals, securities companies, securities service providers or overseas regulators shall follow the due process in compliance with applicable national laws and regulations.[12] From a textual reading, this rule is applicable whenever accounting files or their copies are

11 Article 4 of the New Confidentiality and Archives Provisions.

12 Article 8 of the New Confidentiality and Archives Provisions.

to be provided, regardless of whether such files may contain any Regulated Information. In the absence of clear stipulation in the New Confidentiality and Archives Provisions, it is, however, generally believed that one may refer to the Provisional Regulations on CPA Practices Carrying Out Audit Services Relating to the Listing of Mainland Enterprises Outside Mainland when interpreting this provision.

Working papers produced in China during the listing process

It is stipulated that working papers produced in China by securities companies and securities service providers during the listing process shall be retained in China, and any outbound transfer of the same shall go through the examination and approval procedures in accordance with the relevant national regulations.[13]

Regulatory bodies

The CSRC, the Ministry of Finance, the State Administration of Confidentiality, and the State Archives Administration are the principal supervising authorities under the New Confidentiality and Archives Provisions. They will establish a collaborative mechanism and exercise their respective powers.

In addition to the above-mentioned regulatory bodies, depending on the type of confidential information involved, certain other authorities also have the administrative powers to supervise implementation under the New Confidentiality and Archives Provisions, including the relevant industrial administrative authority in charge, national archives management departments, cyberspace administration departments, national security management departments, finance departments and securities regulatory departments, etc.

13 Article 9 and Article 10 of the New Confidentiality and Archives Provisions.

Legal consequences

The New Confidentiality and Archives Provisions are silent on the legal consequences of a direct breach of the provisions themselves. Instead, according to article 12, if any entity or individual violates the State Secrets Law, the PRC Archives Law and other applicable laws and regulations during the overseas offering and listing process, such party will be held legally liable by the competent authorities, and will be transferred to judicial departments for investigation if suspected of committing any crime.

Key implications and practical tips

The gist of the New Confidentiality and Archives Provisions is that they set out a set of specific requirements in connection with secrets protection and archive management in the context of direct or indirect overseas listings by domestic companies. As such, it is vital for the relevant parties to structure and manage an appropriate internal control and compliance system designed to ensure continuous compliance with the relevant requirements, and to detect and prevent potential non-compliance with the New Confidentiality and Archives Provisions.

From domestic companies' perspective, when planning and preparing for an overseas listing, it is advisable for them to formulate an internal guideline and protocol in writing in connection with provision of documents or materials to any other third parties. The following measures may be considered.

Assessment and clearance procedures

Assessment should be made by such domestic company to determine if the documents or materials to be provided or disclosed constitute or contain any Regulated Information. To start with, a domestic company may consider putting in place a documentation management system, in which an identification mechanism is built in so that it may promptly identify any Regulated Information retained in its documents. The identification mechanism may involve both by-hand and by-machine processes, for example, it may require the relevant staff to manually identify the Regulated Information in the document or material from the date it is originally generated in a document or

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material, and it may also carry out periodical keyword searches in all documents or materials retained in its system, in order to ensure no Regulated Information is inadvertently missed out.

If there is any Regulated Information identified, proper government approvals, clearance or filing should be obtained or made (as applicable) by such domestic company. As mentioned earlier, with respect to certain types of Regulated Information, there may lack clarity in the New Confidentiality and Archives Provisions on which regulatory authority to turn to, and specific government approval, clearance or filing requirements may also vary from case to case. Depending on the nature of business and industry in which such domestic company operates, the relevant industrial laws may also be applicable. The New Confidentiality and Archives Provisions do not specify how it interrelate with these various laws and regulations, or whether there will be a coordination mechanism or streamlined procedure implemented among the competent authorities for securing approval, clearance or filing (as applicable). In practice, these various applicable approvals, clearance or filings may need to be obtained or made through separate procedures, which would likely increase the complexity, uncertainty, and cost of an overseas listing. Therefore, it is advisable for domestic companies to seek professional advices as soon as possible when such a need arises.

Safeguarding procedures

Once the necessary approval, clearance and/or filing procedures have been completed, the domestic company shall provide a written statement outlining its compliance with the regulatory requirements with regard to any identified Regulated Information to the third-party securities firms and securities service providers to which it intends to provide documents or materials containing such Regulated Information. Although the New Confidentiality and Archive Provisions have not specified specific content requirements for such written statement, one would expect that the statement would usually describe the confidential nature of the information to be provided, the fact that the necessary approval and clearance procedures have been followed and completed, and that the recipient shall also comply with the applicable legal requirements regarding confidentiality for such Regulated Information.

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The domestic company shall make it an explicit mandatory internal policy that a non-disclosure agreement must be signed with third-party securities firms and securities service providers before any document or material containing Regulated Information may be provided thereto, which agreement shall clearly set out the confidentiality obligations and liabilities applicable to the parties.

The domestic company shall also put in place an appropriate process to continually monitor its handling, use and provision of any document or material containing Regulated Information. It could, for example, set up a tracking system to follow up with the status of such document or material periodically, so as to promptly detect and prevent any potential non-compliance or leakage of information, and to take remedial action quickly.

Last but not least, if a domestic company's business or operation inevitably involves generating or collecting Regulated Information, it is advisable to handle such information properly from the outset, for example, to ensure its in-house information infrastructure is in compliance with the relevant PRC regulations on storing, processing and transmitting Regulated Information, or to partner with a certified third-party vendor that is qualified to provide such services.

Post-event remedial measures: reporting for information leakage

Domestic companies should formulate a written protocol to clearly set out applicable remedial measures for any actual or potential non-compliance or information leakage. This could include, for example, setting out certain red flags and scope of a potential triggering event, the personnel in charge and a clear reporting line, internal and external remedial actions to be considered and taken, and the specific reporting procedure to the relevant government authorities.

Internal record-keeping system

Domestic companies should also put in place an internal record-keeping system specifically for noting actions taken by it in compliance with its internal rules and guideline above (including pre-event assessment and safeguarding actions and post-event remedial actions), and for safekeeping any supporting

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documents. This intends to serve as a robust documentation and paper trail, which could act as a shield in the event of unforeseen circumstances where the company's accountability and liability is at stake.

From securities firms and securities service providers' perspective, as noted above, the New Confidentiality and Archives Provisions apply equally to them. As such, these third-party agents should also strengthen their internal control system to incorporate the relevant compliance requirements. This could be managed in three ways:

- As a receiving party of any documents or materials containing any Regulated Information from the domestic companies, they should ensure: (1) specific non-disclosure agreement is in place before receiving any such document or material; and (2) proper safekeeping of any document or material and written statement so provided by the domestic companies. They should also ensure its information infrastructure is in compliance with the relevant PRC regulations on storing, processing and transmitting any such Regulated Information.
- As a disclosing party of any documents or materials containing any Regulated Information to any overseas regulator or any other third party, they should strictly comply with the requirements to obtain necessary government approval, clearance and/or filing, as noted above.
- Promptly take remedial actions and notify the relevant authorities in the event of an actual or potential leakage.

Finally, it is also important, on an execution level, for both the domestic companies and the securities firms to clearly define the scope of the relevant personnel in charge of and responsible for the above confidentiality and archive management system. This includes clearly defining and identifying the frontline staff, the compliance officer in charge, the reporting line and the internal approval matrix, etc. It is equally important to provide management and employees with regular training to help keep them abreast of these internal policies and guideline.

Conclusion

The New Confidentiality and Archive Provisions, which have been in effect since 31 March 2023, clarify the specific PRC regulatory requirements for secrets

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protection and archive management, and pave the way for cross-border regulatory cooperation with regard to inspection and investigation, in the context of overseas listing by China-based domestic companies. It is also important to note that these new rules are applicable to the relevant parties throughout pre-listing and post-listing stages, and as such, completion of listing does not mean the end. Rather, it is perhaps the end of the beginning. As a result, it is advisable for all domestic companies that are preparing for a direct or indirect overseas listing, together with the securities firms and securities service providers along the process, to attach great importance to getting themselves familiar with these new requirements and structuring and managing an internal compliance system designed to comply with the rules, as well as to detect and prevent any potential non-compliance along the way.

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4

Rescinding Executed Investment Contracts for M&A Transactions

Zhouyu Tan and Chenwei Cai[1]

Because of the unique nature of M&A transactions, the delivery of equity and the payment by the investor (closing) typically do not occur simultaneously with the signing of the investment contract. Instead, closing usually takes place only after all closing conditions (closing conditions) set by the transaction parties have been met. As a result, during the transitional period from signing to closing (transitional period), various factors and changes may arise that lead the parties to consider rescinding the investment contract and terminate the transaction. Even after the transaction has been completed, the investors may have grounds to rescind the contract for various reasons. This article aims to explore the possibilities, paths, and consequences of rescinding investment contracts in such situations, primarily from the perspective of investors.

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Legal analysis of rescission rights

Nature of the right

According to Article 565[2] of the Civil Code of the People's Republic of China (the Civil Code), the right to rescind contracts is a formation right, which allows one party to create, alter or extinguish a civil juristic relationship through its unilateral expression of intent. In an investment transaction, if the conditions for rescinding the investment contract are met, one party can notify the other party to rescind the contract.

When to exercise the right

According to articles 199[3] and 564[4] of the Civil Code, the exercise of the right to rescind contracts is subject to a predetermined period. Once the exercise

2 Article 565 of the Civil Code: 'Where one of the parties requests to rescind the contract in accordance with law, the other party shall be duly notified. The contract shall be rescinded at the time the notice reaches the other party, or, where the notice states that the contract shall be automatically rescinded if the debtor fails to perform his obligation within a specified period of time, the contract shall be rescinded when the debtor fails to perform the obligation upon expiration of such specified period of time. Where the other party has objections to the rescission of the contract, either party may request the people's court or an arbitration institution to determine the validity of the rescission. 'Where one of the parties, without notifying the other party, requests the rescission of the contract by directly filing a lawsuit or applying for arbitration in accordance with law, and the people's court or arbitration institution confirms such request, the contract shall be rescinded when a duplicated copy of the complaint or the application letter for arbitration is served on the other part.'

3 Article 199 of the Civil Code: 'The time period within which a right holder may exercise certain rights, such as the right to revocation and the right to rescission, which are provided by law or agreed by the parties shall begin, unless otherwise provided by law, from the date when the right holder knows or should have known that he has such a right, and the provisions on the suspension, interruption, or extension of the limitation period shall not be applicable. Upon expiration of the time period, the right to revocation, the right to rescission, and the like rights are extinguished.'

4 Article 564 of the Civil Code: 'Where a time limit for exercising the right to rescind the contract is provided by law or agreed by the parties, if the parties have not exercised such right upon expiration of the period, such a right shall be extinguished. Where no

period expires, the right to rescind will be extinguished, and the provisions regarding suspension, interruption or extension of the limitation period do not apply. If the contract does not specify the time limit for exercising the right to rescind and the other party does not demand a final decision, the statutory exercise period is one year (starting from the date on which the person with the right to rescind knows or should have known the causes for rescission). After being demanded by the other party, a reasonable period applies, which is usually considered to be three months or at the discretion of the court.

How to exercise the right

According to Article 565 of the Civil Code, a party may exercise the right to rescind a contract by notifying the other party or filing a lawsuit or arbitration. In the case of notifying the rescission of the contract, rescission notices shall be given based on the contract provision. If the contract does not have such a provision, both oral or written notices are effective (though oral notifications may be more difficult to prove). In the case of rescinding the contract by filing a lawsuit or arbitration, if it is supported by the court or an arbitral tribunal, the rescission of the contract takes effect when a duplicated copy of the complaint or the application letter for arbitration is served on the other party.

Types of right

According to the Civil Code, the right to rescind a contract mainly includes the agreed rescission right (which refers to rescinding a contract by reaching a new agreement upon discussion and negotiation), contractual rescission right (which refers to rescinding a contract by exercising the pre-agreed rescission rights stipulated in such contract) and statutory rescission right. In equity investment-related disputes, contractual rescission and statutory rescission

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time limit for exercising the right to rescind the contract is provided by law or agreed by the parties, such a right shall be extinguished if the party with the right to rescission does not exercise such right within one year after he knows or should have known the causes for rescission, or within a reasonable period of time after being demanded by the other party.'

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are more common. The second part of this chapter will focus on these two situations and provide detailed analyses.

Main situations for rescinding investment contracts

Rescission of the contract based on statutory rescission rights

Article 563[5] of the Civil Code outlines the provision on statutory rescission rights, specifying the circumstances under which one party can exercise the statutory rescission rights. Generally, the main provisions related to investment contracts include: (1) Article 563(2): prior to expiration of the period of performance, one of the parties explicitly expresses or indicates by his or her act that he or she will not perform the principal obligation; (2) Article 563(3): one of the parties delays his or her performance of the principal obligation and still fails to perform it within a reasonable period of time after being demanded; and (3) Article 563(4): one of the parties delays his or her performance of the obligation or has otherwise acted in breach of the contract, thus making it impossible for the purpose of the contract to be achieved.

Articles 563 (2) and 563 (3) are based on actions where one party directly refuses to perform the principal obligations through his or her action or language, or fails to perform the principal obligations. The key issue is determining what constitutes the principal obligation. Article 563(4) is based on results and

5 Article 563 of the Civil Code: 'The parties may rescind the contract under any of the following circumstances:
(1) the purpose of a contract is not able to be achieved due to force majeure;
(2) prior to expiration of the period of performance, one of the parties explicitly expresses or indicates by his act that he will not perform the principal obligation;
(3) one of the parties delays his performance of the principal obligation and still fails to perform it within a reasonable period of time after being demanded;
(4) one of the parties delays his performance of the obligation or has otherwise acted in breach of the contract, thus makes it impossible for the purpose of the contract to be achieved; or
(5) any other circumstance as provided by law.
For a contract under which the debtor is required to continuously perform an obligation for an indefinite period of time, the parties thereto may rescind the contract at any time, provided that the other party shall be notified within a reasonable period of time.'

serves as a fallback provision. The main point is that such delayed performance or breach of contract results in the inability to achieve the purpose of the contract, so it is necessary to determine what constitutes the 'purpose of the contract'.

What constitutes the 'principal obligation'?

The prevailing opinion in judicial practice is that obligations that affect the realisation of the purpose of the contract should be considered the principal obligations. When an investor evaluates whether it has the right to exercise statutory rescission rights and to rescind the investment transaction, it is crucial to assess whether the other party's breach of contract may result in the inability to achieve the purpose of the contract. The following case provides an example.

Case No.	Relevant court's ruling
(2020) Yue 03 Min Zhong 1199	A general breach of contract by one party does not necessarily lead to the rescission of the contract. Only a fundamental breach of contract that makes it impossible to achieve the purpose of the contract can result in the rescission of the contract. In this case, the purpose of Xiangxue Company (the investor) to subscribe new shares in Nanyue Company (the target company) was to indirectly participate in the industrial application of high-quality biotechnology projects of the Institute of Biophysics, Chinese Academy of Sciences through Nanyue Company and accelerate its business transformation and upgrading. Currently, Xiangxue Company has become a registered shareholder of Nanyue Company and participated in its operation and management. The purpose of Xiangxue Company's contract has been achieved, and there is no issue of unfairness in continuing to perform the contract.

What constitutes the 'purpose of the contract'?

In judicial practice, if the contract terms do not clearly specify the purpose of the contract and the investor cannot provide other sufficient evidence, the court generally adopts a cautious approach and determines that the investor's purpose of the contract is to obtain equity in the target company. The criteria for determining whether equity has been obtained typically include whether business registration (which refers to the registration of investor's equity with competent administrative department for industry and commerce) has been

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made and whether the investor has substantive shareholder rights, such as participating and voting in shareholder meetings and being registered as a shareholder in the shareholder register book. Normally, the purpose of the contract will not be expanded to include the realisation of the target company's business objectives or the increase of the equity value (except for some extreme cases). However, for control deals, in addition to obtaining equity, the investor's purpose of the contract tends to expand to include the right to operate and manage the business of the target company (especially when the contract includes provisions for transferring the company seal, accounts, etc). The following cases provide several examples.

Case No.	Relevant court's ruling
(2022) Jing 01 Civil Final Ruling No. 7212	Business registration of equity transfer is neither a registration of creation of rights nor a condition for the effectiveness of equity delivery. Instead, it is only a condition for the delivery of equity to assert against a bona fide third person. According to relevant provisions of the Company Law of the People's Republic of China, the company is the obligor of business registration, and whether the company completes its obligation to do business registration does not affect the effectiveness of the equity transfer contract or the investor's acquisition of equity. The fact that Bingzi Company (the investor) has not been registered as a shareholder of Wende Company (the target company) does not result in the inability to achieve the purpose of the Equity Transfer Contract, and in fact, Bingzi Company has already participated in the operation and management of Wende Company as a shareholder. Bingzi Company's request for rescission of the contract lacks a corresponding factual and legal basis, and its request for a refund of the equity transfer payment cannot be supported.

Case No.	Relevant court's ruling
(2019) Yue 03 Civil Final Ruling No. 26244	If the purpose of the equity transfer contract is not clearly specified in the contract terms and the transferee does not provide other sufficient evidence, the court generally adopts a cautious attitude and determines that the transferee's purpose of the contract is to obtain company equity and will not expand to include the realisation of the target company's business objectives.

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Case No.	Relevant court's ruling
(2020) Ji Civil Retrial Ruling No. 91	The purpose of Chu Yanchun and five other transferees' purchase of the equity of the target company held by Lu Tianli and Lu Tianxue was to operate the target company. According to the Tax Administrative Punishment Decision, the target company should have settled the outstanding tax payment of 7,912,756.33 yuan before 4 March 2017. The amount of this tax payment is several times the price of the equity transfer, directly affecting the normal operation of the target company, resulting in the inability to achieve the purpose of the equity transfer agreement.

Rescission of the contract based on contractual rescission rights

Depending on the specific circumstances of each investment case, the conditions for exercising the right to rescind as agreed in the contract may vary on a case-by-case basis. The most common situations include two types.

If closing conditions not fulfilled within a specific time period (by long-stop date), investor has right to rescind contract

Common closing conditions include:

- the investor's internal investment committee has approved the transaction, the signing and performance of the transaction documents (investor's internal approval);
- the investor is satisfied with the due diligence results of the target company's legal, business and financial aspects, and any significant issues discovered in the due diligence have been resolved or a satisfactory solution has been reached (satisfactory due diligence results);
- no event or events with a material adverse effect have occurred on or before the closing date, and there is no evidence to suggest that events that may cause a material adverse effect will occur (no material adverse effect). A specific definition of material adverse effect is usually provided, such as setting a specific financial data threshold, and there is usually a catch-all clause;
- the representations and warranties made by the warrantors (mainly the target company and its founders) in the investment contract are true,

accurate, complete and not misleading (true and accurate representations and warranties);

- the target company has completed the relevant business registration or submitted application materials to the competent administrative department for industry and commerce for the capital increase (completion of business registration); and
- the target company has obtained any and all approvals, consents and waivers necessary for consummation of the transactions contemplated by the investment contract, including, but not limited to, all permits, authorisations, approvals, consents or permits of any government authority or regulatory body; and the executed waiver by any third party if applicable (external approval and consent).

In judicial practice, to determine whether the investor can rescind the contract due to the non-fulfilment of closing conditions, four principal points should be considered. The following provides a detailed analysis of these four points in conjunction with the aforesaid common closing conditions.

Whether the investor can prove that the closing conditions are indeed not fulfilled

For some closing conditions, such as the investor's internal approval, satisfactory due diligence results, completion of business registration and external approval and consent, it is relatively easy to objectively prove that such closing condition has not been met, as there is a clear cut-line or several criteria (eg, the investor can provide a resolution to prove that the investor's investment committee does not approve the transaction). However, for other closing conditions, such as no material adverse effect, proving these closing conditions are not met can be challenging.

To prove that no material adverse effect has not been fulfilled, the investor needs to demonstrate the existence of an event that has already caused or is likely to cause losses to the target company, and such losses fall within the definition of the material adverse effect in the investment contract. In addition, other factors, such as whether there is a reasonable calculation logic to determine the amount of such losses and whether the evidential materials have

sufficient probative force, may all affect the court's judgment. The following case provides an example related to no material adverse effect.

Case No.	Relevant court's ruling
(2016) Supreme Court Civil Final Ruling No.12	Jinzhou Company (the investor) has not provided evidence to prove that Liujiapo Company (the target company) had already overstepped the boundary of mining during the transitional period, nor has it provided evidence to prove that Zhenxiong County Land and Resources Bureau has made a factual determination of overstep the boundary of mining and that Dahaizi Company (the third party) has already claimed compensation against Jinzhou Company. The loss calculation submitted by Jinzhou Company in the second instance only contains the total amount of the loss but without any supporting evidence or any statement from Dahaizi Company requesting Liujiapo Company to compensate based on this amount. The factual basis is insufficient.

Whether the investor can prove that the failure to fulfil the closing conditions is the target company's or the founder's fault

If the target company's or the founder's action or inaction leads to the non-fulfilment of a closing condition, the likelihood of the court supporting the investor's claim to rescind the investment contract may increase. However, if the non-fulfilment of the closing condition is due to the investor's own action or inaction, and the investor refuses to pay the investment funds or requests to rescind the investment contract, the court may apply article 159[6] of the Civil Code and determine that the investor improperly prevented the fulfilment of the closing condition, which instead deems the closing condition as having been fulfilled.

The most typical example is the closing condition of investor's internal approval. Although it is relatively easy to prove the non-fulfilment of this closing condition objectively (by providing internal decision-making documents), in practice the court intends to pay more attention to the reasons why

6 Article 159 of the Civil Code: 'Where a condition is attached to a civil juristic act, if a party, for the sake of its own interests, improperly obstructs the fulfilment of the condition, the condition is deemed as having been fulfilled; if a party improperly facilitates the fulfilment of the condition, the condition is deemed as not having been fulfilled.'

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the investor's investment committee does not approve the investment and whether such decision is caused by the target company's or founder's actions or inaction. If the investor has difficulty in proving causation between the target company's or the founder's behaviour and the investor's non-approval decision, it may be deemed as the investor improperly promoting the non-approval result, and therefore the court considers such closing condition as having been fulfilled. The following cases provide several examples related to investor's internal approval.

Case No.	Relevant court's ruling
(2018) Zhe 01 Civil Final Ruling No. 7293	The Resolution of the Investment Committee of Shanghai Yusha Enterprise Management Consulting Center (Limited Partnership) stated that: (1) Without the consent of Yusha Center (the investor), the registered capital of Mo Cheng Company (the target company) was increased from 1 million to 10 million yuan and (2) the management team of the company used funds for purposes unrelated to the company's main business, which may cause significant adverse effect on the company's financial situation. The committee decided not to invest in Mo Cheng Company. The court believes that the capital increase is a material decision of the company, which will affect the shareholding ratio of Yusha Center. The capital increase of Mo Cheng Company will result in the contract purpose of Yusha Center to hold 10 per cent of Mo Cheng Company's equity not being realised, and the capital increase and share expansion contract cannot be continued to perform. Therefore, Yusha Center has the right to unilaterally rescind the contact according to article 15.2.2 of the capital increase and share expansion contract.

Case No.	Relevant court's ruling
(2016) Jing 03 Civil Final Ruling No. 12797	After the signing of the share transfer contract, both parties should actively fulfil their contractual obligations. Considering that Su Xihong and Zhang Hongbo (both transferors) are still the sole shareholders of Northern Kecheng (the target company), controlling the target company and serving as members of the board of directors and the board of supervisors respectively, the board of directors and supervisors' resolutions of Northern Kecheng, which disapproved the share transfer, are deemed as Su Xihong and Zhang Hongbo improperly preventing the fulfilment of the share transfer condition. According to the law, it should be considered that the condition has been fulfilled.

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Whether the investor can prove that the non-fulfilment of such closing conditions substantially affects the performance of the investment contract, even the realisation of the purpose of the contract

Most courts may require the investor to prove that the severe consequences caused by such non-fulfilment may affect the performance or the achievement of the purpose of investment contracts. Exceptionally, some courts incline to strictly stick to the closing conditions agreed upon by both parties in investment contracts.

In general, if an investor can demonstrate that the failure to fulfil a specific closing condition would prevent them from obtaining legal ownership of the target equity, the court is likely to support their claim for rescission of the investment contract since the contract's purpose cannot be achieved. For instance, suppose an M&A transaction triggers the parties' obligation to file for antitrust approval, but they fail to obtain clearance from the regulatory authority. In that case, it is evident that the external approval and consent closing condition cannot be met, leading to the transaction's failure. Therefore, the court is likely to support the rescission of the investment contract. On the other hand, if it is only a minor breach and has been remedied in a timely manner, the likelihood of the court supporting the investor's claim to rescind the contract could be relatively low. The following cases provide several examples related to the completion of business registration and the true and accurate representations and warranties.

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Case No.	Relevant court's ruling
(2018) Yue 0305 Civil First Instance Ruling No. 20802	According to the provisions of the capital increase contract, prior to the plaintiff's (the investor) payment of the capital increase funds to the target company, the defendant Gao Si Company, the three defendants should actively promote the implementation of a series of closing conditions, including but not limited to the completion of business registration. After the investor pays the first instalment of the capital increase funds, the three defendants should promptly fulfil the delivery obligations, complete the business registration and update the business licence to reflect the actual contribution of the investor. However, until the plaintiff sued on 21 June 2018, the equity structure of Gao Si Company had not been changed. Although the plaintiff had actually invested, it could not become a shareholder or exercise shareholders' rights, resulting in the complete failure of the contract purpose of investing in Gao Si Company.

Case No.	Relevant court's ruling
(2019) Xiang 01 Civil Final Ruling No. 12367	The capital increase contract clearly stipulates the closing conditions for Chutian Company (the investor) to invest, including the requirement that the shareholding of Wang Kai (the founder) in the holding platform, Juxing Company, cannot be less than 40 per cent. However, in reality, Wang Kai's shareholding in Juxing Company is only 39 per cent. Business activities should strictly abide by the contract. Wang Kai's shareholding ratio in the holding platform does not meet the threshold of 40 per cent stipulated in the capital increase contract. Chutian Company's rescission of the capital increase contract with the appellant in accordance with the rescission conditions stipulated in the contract complies with the terms of the contract, and does not violate mandatory legal provisions. The first-instance court, therefore, determined that the capital increase contract between Chutian Company, Juxing Company, Zhang Hao, Wang Kai and Wei Hongjiang had been rescinded on 10 August 2017, the date when the rescission notice was served by Langliwei Company (the target company), Juxing Company, Zhang Hao, Wang Kai and Wei Hongjiang, and there was no impropriety.

Case No.	Relevant court's ruling
(2019) Supreme Court Civil Final Ruling No. 527	In this case, the land use right of Subject C does not comply with the agreement in the equity acquisition contract signed by both parties. The representations and warranties of Li Guolin, Li Min, Guangli Company and Guangli Real Estate Company (the transferors and the target company) are untrue and inaccurate. Moreover, the nature and current status of Subject C land have been changed, so the purpose of Aiwan Company (the investor) signing the equity acquisition contract can no longer be realised.

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Case No.	Relevant court's ruling
(2022) Jing 01 Civil Final Ruling No. 4915	Although Huirong Intelligent Company (the target company) and its shareholders promised that they had fulfilled their capital contribution obligations when signing the equity transfer contract, which was inconsistent with the actual situation at the time of signing, the capital contribution has been subsequently paid in full. The warrantors have effectively taken remedial measures. The claim of Pinghe Defense Enterprise (the investor) to rescind the contract based on this reason does not comply with either the contract provisions or the laws and regulations, so the court does not support such a claim.

Whether the investor raises objections in a timely manner when knowing that the closing conditions have not been fulfilled

If a closing condition has not been fulfilled, the investor is aware of this but still takes some actual actions to proceed with the transaction (such as continuing to make payments), the investor's actions may lead the court to believe that the closing conditions have actually been changed, even if the parties have not amended the contract in writing. The following cases provide several examples related to satisfactory due diligence results and true and accurate representations and warranties.

Case No.	Relevant court's ruling
(2016) Supreme Court Civil Final Ruling No. 224	The transferee has paid several tranches of equity transfer considerations according to the payment schedule, indicating that Qingniao Company (the investor) made such payment decisions because of being satisfied with the results of the due diligence. The nature of the mine and whether there are major safety production issues should be the focus of the due diligence investigation. However, at that time, Qingniao Company did not raise any objections but fulfilled its obligation to pay part of the equity transfer considerations according to the agreement, which should be considered as an acknowledgment of the mine's condition at that time. The appeal reason now raised by Qingniao Company and Qingneng Energy Company lacks a factual basis.

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Case No.	Relevant court's ruling
(2022) Jing 03 Court Civil Final Ruling No. 4623	Before signing the equity transfer agreement, Perfect Company (the investor) was aware of the financial data issues of Yuelihui Company (the target company), and there is no evidence showing that Perfect Company had raised any objections to the financial data issues after signing the equity transfer agreement. Therefore, the financial data issues of Yuelihui Company do not constitute a breach of contract.

Investor exercises contract rescission right due to company's breach of contract

Investment contracts typically stipulate that if one party breaches the contract and fails to take remedial measures within a certain period, the non-breaching party has the right to rescind the contract. In this situation, the investor should also be aware that not any breach of contract allows it to rescind the investment contract.

Article 47 of the Minutes of the Civil and Commercial Trial Work Conference of National Court[7] stipulates that when the rescission conditions agreed in the contract are met, and the non-breaching party requests to rescind the contract on this basis, the court shall, based on the principle of good faith, review whether the breaching party's breach is substantially minor and affects the realisation of the non-breaching party's purpose of the contract. If the breaching party's breach is substantially minor and does not affect the realisation of the non-breaching party's purpose of the contract, the court will not support the non-breaching party's request to rescind the contract; otherwise, the court will support the request to rescind according to the law.

7 Minutes of the Civil and Commercial Trial Work Conference of National Court is a legal document that provides guidance on various aspects of civil and commercial litigation. It is a compilation of opinions and interpretations from the Supreme People's Court. The document aims to unify the understanding and application of laws and regulations in civil and commercial cases across the country. This document covers a wide range of topics, including contract law, property rights and other areas of civil and commercial law. It serves as a valuable reference for judges, lawyers and other legal professionals when dealing with disputes in these areas.

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According to the view of the Second Civil Division of the Supreme People's Court,[8] when determining whether the agreed rescission conditions are met the court cannot mechanically determine whether the contract is rescinded solely based on the contract text. Instead, it should comprehensively examine three aspects in good faith.

Aspect	Rescission conditions being met	Rescission conditions not being met
Fault of the breaching party	Gross negligence or intentional	Slight negligence
Acts of breach	Material breach of the contract, such as failure to perform the principal obligation	Breach of ancillary obligations
Consequences of breach	Affecting the realisation of the contractual purpose	The principal obligations of the contract have been performed, and the substantially minor breach by the breaching party does not affect the realisation of the purpose of the contract

Consequences of rescission

Rescission of the agreement is supported

If the investor is ruled to have the right to rescind, the investor does not need to continue fulfilling the payment obligation. If the investor has already paid part of the investment funds but has not been registered as a shareholder of the company through appropriate business registration, the likelihood of being supported by the court to get the investment funds reimbursed could be relatively high. If the business registration is completed and the investor has been registered as a shareholder, the reimbursement of the funds is subjected to the implementation of the capital reduction process under the Company Law (in the event of the investor purchasing primary shares).

8 See: The Supreme People's Court Second Civil Division (Editor): *Understanding and Application*, People's Court Press 2019 Edition, pages 314–315.

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Rescission of the agreement is not supported

If the investor is ruled to have no right to rescind the contract, the investor may be required to continue to pay the investment funds and will be liable for breach of contract for its overdue payment of investment funds, including but not limited to the following:

- Overdue payment penalty (if stipulated in the contract) or interest loss (if no overdue payment penalty is agreed upon in the contract): in practice, if the no overdue payment penalty is agreed upon in the contract, the court has its discretion on the interest rate, and a generally accepted standard to calculate the overdue payment loss is the one-year LPR, or the one-year LPR plus an additional 30 to 50 per cent of this rate.[9]
- Compensation for other losses: in the case of overdue payment by the investor, other losses generally include legal expenses such as attorney fees and litigation costs.

9 According to article 18 of the Interpretation of the Supreme People's Court on the Application of Law in the Trial of Disputes over Sales Contracts (2020 Amendment), for breaches of contract that occurred before 19 August 2019, the People's Court may calculate the overdue penalty interest rate based on the benchmark interest rate for the same type of yuan loans by the People's Bank of China during the same period. For breaches of contract that occurred after 20 August 2019, the People's Court may calculate the overdue payment loss based on the one-year loan prime rate published by the National Interbank Borrowing Centre authorised by the People's Bank of China at the time of the breach, plus an additional 30 to 50 per cent.
Article 32: 'If there are provisions in laws or administrative regulations on the transfer of contracts for the assignment of claims, equity transfer, and other rights, such provisions shall be followed; if there are no provisions, the People's Court may refer to the relevant provisions of the sales contract in accordance with articles 467 and 646 of the Civil Code. When referring to the relevant provisions of the sales contract for the assignment of rights or other onerous contracts, the People's Court shall first quote the provisions of article 646 of the Civil Code and then quote the relevant provisions of the sales contract.

Conclusion

When investors plan to exercise their right to rescind a contract, they must carefully evaluate the specific circumstances of each case. This includes deciding whether to use statutory rescission or contract rescission rights, and determining if the reasons for rescission are likely to be supported by the court or arbitral tribunal, and investors should also consider the potential consequences of rescission. By understanding the complexities of investment disputes and contracts rescission, investors can better navigate these challenging situations and strive for a favourable resolution that aligns with their objectives.

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5

China ESG Regulations and their Impact on M&A Transactions

Ruina Liu and Yanyu Lai[1]

Introduction

With the publication of the United Nations Principles for Responsible Investment (PRI) in 2006, countries have become increasingly aware of the importance of environmental, social, and governance (ESG) in the investment area and have started implementing ESG-related guidelines and regulations. General standard ESG requirements include reducing carbon emissions, treating stakeholders fairly and equally, developing efficient corporate governance, etc. Albeit a late starter, China (for this chapter, China refers to mainland China excluding Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan region) has been actively promoting its ESG regulations in recent years.

We set out below the global ESG regulations trend, followed by major measures under China's ESG regulation framework and the duties of different stakeholders under such regulatory framework. We then examine the implications

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of China ESG regulations on mergers and acquisitions (M&A) transactions in general.

Global rise of ESG regulations

ESG regulations have now permeated the global economy. On one hand, as more and more investors and companies recognise the value of ESG considerations, ESG-related investments continue to thrive. According to Bloomberg's forecast, global ESG assets are on track to exceed US$53 trillion by 2025, representing more than a third of the US$140.5 trillion in projected total assets under management.[2]

On the other hand, the ESG regulatory framework is actively evolving universally to further incentivise as well as regulate ESG-related investments. For instance, the Hong Kong Stock Exchange launched its ESG Reporting Guide in 2013. Initially, listed companies were encouraged, but not obliged, to disclose their environmental and social responsibility. In 2020, these disclosure requirements became mandatory, requiring listed companies to publish the report simultaneously with their annual reports. According to a survey by Goldman Sachs, by August 2021 there were 1,021 ESG policies in place worldwide, with the Asia-Pacific region accounting for about 20 per cent of those policies.[3]

As these regulations and investments contribute to the rise of ESG regulations globally, China has also aligned itself with these international standards, proactively advancing in this field by introducing relevant new laws, regulations, policies and standards.

China's ESG regulatory framework

Similar to many parts of the world, China has yet to enact a unified ESG law or establish a specialised ESG regulator. The ESG regulatory framework is largely

2 www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.

3 www.goldmansachs.com/intelligence/pages/gs-research/gs-sustain-our-analysis-of-apac-esg-regulation/report-new-era.pdf.

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driven by policy incentives and laws that are fragmented across industries or government departments.

ESG laws, regulations and policies

ESG-related rules can be found dispersed across various laws, regulations, policies and standards, including, but not limited, to the following.

Environmental Protection Law and other related laws

The Environmental Protection Law seeks to synchronise economic and social development with environmental protection and establishes clear requirements for the construction of an ecological civilisation. It imposes strict obligations on enterprises regarding pollution prevention and control and provides for severe penalties for non-compliance. The Environmental Protection Law also specifies that the state shall support the development of the environmental industry and encourage enterprises to take environmental protection measures.

Other major ESG-orientated laws that focus on environmental protection include, but are not limited to: Environmental Impact Assessment Law, Law on Prevention and Control of Atmospheric Pollution, Law on Soil Pollution Prevention and Control, Law on Prevention and Control of Water Pollution, Measures for the Administration of the Law-based Disclosure of Environmental Information by Enterprises, etc.

Company Law

The Company Law requires companies established in China to comply with social morality, uphold business ethics, maintain honesty, be transparent, undergo governmental scrutiny and fulfil their societal roles. Notably, in December 2022, the National People's Congress of China released a second round of draft revisions to the Company Law for public feedback. A key proposed amendment is the emphasis on companies' social responsibilities. Under Article 20 of the draft, a company engaging in business activities shall 'fully consider the interests of the company's employees, consumers, and

other stakeholders, as well as social and public interests, such as ecological and environmental protection, and assume responsibilities'. Further, it stipulates that the state 'encourages companies to participate in social welfare activities and publish social responsibility reports'. The changes are in line with China's other developmental policies and goals, such as the dual carbon climate initiatives.

Listing rules

China Securities Law requires listed companies to fully disclose the requisite information to assist investor decision-making. In 2018, the China Securities Regulatory Commission (CSRC) formulated the Code of Corporate Governance for Listed Companies, which applies to companies listed on stock exchanges in China. It emphasises the development of the concept of 'innovation, coordination, green development, sharing' and establishes the basic framework for China listed companies' ESG information disclosure.

In 2021, CSRC issued the Standards Concerning the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 2 – Contents and Formats of Annual Reports. The provisions related to environmental protection and social responsibility are set out under Section 5 – Environmental and Social Responsibility, which impose detailed requirements on listed companies. For instance, listed companies are encouraged to voluntarily disclose the measures and results of reducing their carbon emissions during the reporting period.

Furthermore, the Shenzhen and Shanghai stock exchanges have also established their own ESG-specific frameworks for listed companies. For example, Shenzhen Stock Exchange issued the Self-Regulatory Guidelines for Listed Companies No. 1 in 2022 to requires listed companies to include their construction and implementation of social responsibility systems, such as employee protection, environmental pollution, product quality and social community relationships in the social responsibility reports.

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Green finance

In 2016, the People's Bank of China (PBOC), jointly with six other Chinese state ministries, issued Guidelines for Establishing the Green Financial System (Green Finance Guidelines). Under these guidelines, green finance is defined as financial services provided for economic activities that are supportive of environment improvement, climate change mitigation and more efficient resource utilisation. In particular, these guidelines call for: (1) boosting green investments, such as establishing a policy framework for green lending, and promoting securitisation of green loans; (2) intensifying the role of the securities market in green funding, such as reducing the financing cost of green bonds, unifying the domestic green bond standards, and actively supporting qualified green enterprises to obtain financing through IPO and secondary offerings; (3) fostering green insurance and trading of environmental rights, and the development of various carbon finance products; and (4) emphasising the importance of the role of local governments in supporting the development of green finance. Following the Green Finance Guidelines, regulators across China's financial sectors have begun to develop green finance guidelines for their respect fields, including, but not limited, to the following

- Bonds: in 2017, the CSRC issued the Guidelines for Supporting Green Bond Development, emphasising mechanisms such as guarantees, credit enhancement mechanisms, disclosure requirements and third-party verification to establish the green bond market.
- Banking and insurance: in 2018, the Insurance Asset Management Association of China issued the Initiative on Green Investment in China's Insurance Asset Management Industry to advocate the insurance institutions to play an active role in the reform of the supply side of financial services and promote the establishment of a new system of green investment in insurance funds.

  In 2022, the China Banking and Insurance Regulatory Commission (CBIRC) issued the Guidelines for Green Finance in the Banking and Insurance Industries (B&I Guidelines) to advance the development of green finance by banking and insurance institutions. The guidelines require banking and insurance institutions to promote green finance at a strategic level, reduce the carbon intensity of their asset portfolios gradually and in an orderly way, and eventually achieve carbon neutrality of asset portfolios.

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- Funds: in 2018, the Asset Management Association of China (AMAC) issued the Green Investment Guidelines (for Trial Implementation) (AMAC Guidelines). The guidelines aim to induce fund managers and funds to carry out green investments, cultivate a long-term value investment orientation and practice ESG responsible investments.

ESG regulatory bodies

Given the dispersed nature of ESG-related regulations, a range of institutions and bodies, such as national ministries, self-regulatory organisations and industry associations are involved in their implementation.

Primary government authorities

The Ministry of Ecology and Environment (MEE) is responsible for formulating and implementing policies and regulations related to environmental protection. In 2021, it issued the Plan to Reform the Law-based Disclosure System of Enterprise Environmental Information (Environmental Information Disclosure Measures). To support this initiative, the MEE has also circulated new disclosure rules requiring domestic entities to disclose various environmental information annually.

CSRC regulates China's securities and futures industry and ensures listed companies' compliance with various disclosure requirements. It also plays a pivotal role in introducing ESG-related amendments to the disclosure rules applicable to listed companies.

Self-regulatory organisations

Stock exchanges also play an essential role in developing environmental information disclosure systems for listed companies. For example, the Shanghai Stock Exchange and the Shenzhen Stock Exchange have promulgated various rules and guidelines relating to ESG information disclosure and monitor the disclosure by listed companies following these rules and procedures.

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Industry associations

Industry associations emphasise ESG disclosure and propagate various guidelines and opinions on related investments. For example, the AMAC released Research Report on ESG Evaluation System of Chinese Listed Companies constructing a core indicator system for measuring the ESG performance of listed companies, which is of value and significance to investment institutions, listed companies, as well as regulators.

Major measures under China's ESG regulatory framework

There are two main types of measures under current China ESG regulatory framework, namely mandatory disclosure requirements and policy incentives.

Mandatory disclosure requirements – listed companies

Listed companies in China must adhere to general ESG disclosure requirements under relevant securities laws and listing rules, including, but not limited, to the following.

Environmental information disclosure

Any listed company or its major subsidiary that is a key emission unit as determined by the MEE should disclose in its annual report environmental information, including: (1) data on emissions; (2) construction and operation of pollutant pollution prevention control facilities; (3) environmental impact assessment of construction projects and other environmental protection administrative licences; (4) environmental self-monitoring programme; (5) administration penalties imposed due to environmental issues during the reporting period; and (6) other relevant environmental information that should be made public.[4]

4 Article 41 of Standards Concerning the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 2.

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Social responsibilities

A listed company shall disclose its efforts to fulfil social responsibilities, such as the purpose and philosophy of the company in fulfilling its social responsibility; protection of the rights and interests of shareholders, creditors, employees, suppliers, customers; public relations, public welfare; etc.[5]

Corporate governance

A listed company shall include its corporate governance status in its disclosure reports, such as any material differences between the actual state of corporate governance and the legal requirements; employee situation; internal control system development and implementation; the independence of the controlling shareholders and actual controllers in respect of company's assets, personnel, finances and etc.[6]

According to the Securities Law, a listed company that fails to comply with the disclosure requirements may be subject to a fine of up to 10 million yuan. The directly responsible executive in charge may also face warnings and fines of up to 5 million yuan.

Mandatory disclosure requirements – environmental impact heavy enterprises

Certain types of security issuers, key pollutant-discharging entities and enterprises undergoing compulsory cleaner production examination designated by MEE (Environmental Impact Heavy Enterprises) are subject to mandatory disclosure requirements set out in the Environmental Information Disclosure Measures, including, but not limited, to the following.

5 Article 42 of Standards Concerning the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 2.

6 Articles 27 to 39 of Standards Concerning the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 2.

General disclosure

An Environmental Impact Heavy Enterprise shall include the following in its annual environmental information report:[7]

- basic corporate information including production and ecological and environmental protection measures;
- environmental management-related information including information on ecological and environmental administrative licensing, environmental protection tax, environmental pollution liability insurance and environmental protection credit evaluation;
- generation, control and discharge of pollutants information including pollution prevention and control facilities, discharge of toxic and hazardous substances;
- carbon emission information including emission load and emission facilities;
- violations of ecological and environmental laws; and
- disclosure of temporary environmental information as required by law.

Special disclosure

If a security issuer conducts financing (eg, by issuance of stocks, bonds and asset securitisation products), it shall, in its annual report, disclose the amount, direction of investment and the appropriate ecological and environmental protection measures in respect of this financing, in addition to the general disclosure. If an enterprise is subject to compulsory cleaner protection examination, it should also disclose the reason for conducting the compulsory cleaner production examination, as well as the results of implementation, assessment and final inspection of the compulsory cleaner production examination in the annual report, in addition to the general disclosure.[8]

7 Article 12 of Measures for the Administration of the Law-based Disclosure of Environmental Information by Enterprises.

8 Article 15 of Measures for the Administration of the Law-based Disclosure of Environmental Information by Enterprises.

An enterprise failing to comply with the requirements under the Environmental Information Disclosure Measures will be ordered to take corrective action or be circulated on a notice of criticism or subject to a fine of 10,000 to 100,000 yuan. If the breach concerns: (1) disclosing environmental information that is not up to the standard as required by MEE; (2) failing to disclose environmental information within the specified period; or (3) failing to upload environmental information to the system for disclosure, then the MEE may take corrective action, circulate a notice of criticism or impose a fine of not more than 50,000 yuan.

Under the Environmental Information Disclosure Measures, security issuers obliged to disclose environmental information disclosure encompass the China-listed companies and bond issuers that meet one of the following criteria: (1) they are held criminally liable for any violation of ecological or environmental laws; (2) they have received fines of 100,000 yuan or more for violation of ecological or environmental regulations; (3) they have incurred daily penalties for violation of ecological or environmental laws; (4) their production is restricted or suspended for legal rectifications for its violations of ecological or environmental laws; (5) their relevant ecological and environmental licences and permits have been revoked due to non-compliance with ecological or environmental laws; or (6) their legal representatives, primary persons in charge, directly responsible persons in charge, or other directly responsible persons have been placed under administrative detention due to breaches of ecological or environmental laws.

Policy incentives – financial institutions

In 2016, the Green Finance Guidelines were published, which act as the cornerstone of the Chinese green economy. With the view of building a green financial system, the guidelines set out directions and policies to support and incentivise green investment.

Banking and insurance institutions

The CBIRC issued the B&I Guidelines in 2022 to provide practical directions for banking and insurance institutions to further green finance, with the following key provisions:

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- Corporate governance: the board of directors of the institutions should assume primary responsibility for green finance. Senior management should be responsible for setting green finance goals, conducting internal supervisions and evaluations, reporting the development of green finance to its board annually and disclosing the relevant green finance circumstances to CBIRC or the public according to the applicable requirements. A designated officer should be responsible for coordinating green finance work and providing support to the relevant green finance departments.
- Policy formulation and capacity building: institutions should estimate and enhance their ESG performance, establish a working mechanism for green finance innovation, develop relevant business standards and statistical systems and review ESG risks. Moreover, institutions should also adjust and enhance their lending and investment strategies to support energy efficiency, pollution and carbon emissions reduction and sustainable growth.
- Customer risk assessments: institutions should formulate ESG risk assessment standards for customers, conduct classified management and dynamic assessment of customer risks, and use the risk assessment results as one of the basis for customer ratings. Banking institutions should use these ratings to determine a customer's ability to access credit, measures in relation to 'pre-lending investigation, examination of loan applications, and post-lending inspection', loan pricing and allocation of economic capital, etc. Insurance institutions should use these ratings for underwriting management and investment decisions and implement differential premium rates concerning the customer's risk appetite.
- Internal controls and disclosure: institutions should establish policies for green finance evaluation, appraisal and incentives systems. Furthermore, they should also ensure their green finance strategies and policies are accessible to the public.

According to the Green Finance Evaluation of Banking Financial Institution (PBOC Notice) by PBOC in 2021, the PBOC will conduct a comprehensive evaluation of 24 major banking institutions' development of green finance business under the PBOC Notice on a quarterly basis. This evaluation will be conducted with the following four green finance indicators: the ratio of the green financial service assets to the total domestic assets of such bank; the ratio of such bank's green finance service assets to the total green finance service assets of

all participating banks; the annual growth rate of green finance service assets; and the risk ratio associated with these services. The PBOC will implement incentives and constraints on banking institutions based on the evaluation results. Furthermore, these results will be incorporated in the policies and prudential management tools of the PBOC, influencing the institution ratings assigned by the PBOC.

Fund managers

In 2019, AMAC promulgated the AMAC Guidelines to encourage fund managers to focus on environmental sustainability and provide guidance for fund managers on green investment. The AMAC Guidelines apply to publicly and privately offered securities investment funds, as well as managers of asset management plans and their products. Private equity investment fund managers and professional investors may also take reference from the AMAC Guidelines when making green investments.

The fund managers governed by the AMAC Guidelines should conduct an annual self-assessment of green investment and submit in writing their self-assessment report of the previous year and the Fund Manager's Green Investment Self-Assessment Form to AMAC by the end of every March. This self-assessment report should cover the company's green investment philosophy and system construction, operation of green investment products, environmental risk control in green investment, and disclosure of information related to green investment. It is imperative for fund managers to remain compliant with the AMAC Guidelines consistently, given that AMAC will conduct spot checks on an irregular basis.

Key implications of ESG compliance on M&A transactions

As the demand for ESG compliance evolves in China, it significantly influences the practice of M&A transactions in various ways.

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Incorporation of ESG compliance in M&A investment decisions

As ESG investments continue to gain attention globally, a target company's ESG metrics have become crucial considerations in investment decisions. Buyers not only improve their image by choosing ESG-compliant companies but also adhere to regulatory mandates and incentives. Another factor would be the force of the regulators by imposing policy incentives or requirements on financial institutions. For example, AMAC encourages fund managers to establish long-term green or ESG investment mechanisms and requires them to submit an annual self-assessment of green investments.[9]

Impact on target company valuation

Companies with strong ESG credentials may command a higher price, while those with weak ESG performance may be devalued due to perceived future risks and liabilities. According to a 2020 study by McKinsey & Company,[10] 83 per cent of senior management and investment professionals believed that ESG projects would create more shareholder value from 2021 to 2025. These professionals are also willing to pay around a 10 per cent premium for companies with strong ESG records, highlighting the significant impact of positive ESG metrics on a company's financial and performance results, including its valuation from in an M&A transaction.

ESG due diligence

In addition to the traditional financial and legal due diligence, more and more buyers are requesting ESG performance due diligence on the target companies in order to assess ESG risks. According to a market survey report of ESG investments in China in 2019 by AMAC,[11] 87 per cent of the investment entities

9 Article 4(8) Matters Concerning Financial Equity Investment with Insurance Funds.

10 www.mckinsey.com/capabilities/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance.

11 www.amac.org.cn/researchstatistics/report/zgsmjjhyjxshzrbg/202003/P020200330707184043402.pdf.

that participated in this market survey expressed their interest and demand of ESG due diligence for their investment activities.

Compared with the legal due diligence typical of M&A transactions, ESG due diligence not only emphasises laws and regulations but also focuses on the soft laws, such as industry standards, international conventions, etc, which leads to the broad scope of ESG due diligence. Based on the PRI and other relevant guidelines and standards, we have summarised the following common ESG due diligence dimensions.

Environment

Climate change, such as carbon emissions, product carbon footprints; efficient use of resources, such as raw material sources, land use; pollution and waste, such as effluent discharges; etc.

Society

Human resources, such as employee health and safety, employee diversity, supply chain labour situation, employee protection; product responsibility, such as product safety and quality; social opportunities, such as social community relationship, equal job opportunities; etc.

Governance

Corporate governance, such as director diversity, executive remuneration, shareholder rights, stable corporate governance; corporate conduct, such as anti-corruption, anti-unfair competition, tax transparency; etc.

Pre-conditions or post-closing covenants

Subject to the risk level and the time required for correction, in response to ESG issues identified during the due diligence that are not substantial enough to halt the deal but can be mitigated, buyers may require the target company and the sellers to address these ESG issues prior to or within a certain period of time after the closing date. For example, if the ESG due diligence

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results identify minor workers by the suppliers of the target company, given the severe legal consequences of employing minor workers in China and the compliance management of supply chain labour in ESG, we may recommend as a pre-condition of the closing that the target company shall have checked and revised relevant business agreements with such suppliers to clarify the target company's requirements for lawful employment of the suppliers. If the suppliers refuse to do so, the target company shall conduct supplier compliance due diligence or consider replacing such suppliers within a certain period after the closing date.

Representations and warranties

In China ESG transactions, representations and warranties related to a target company's past ESG compliance are typical. According to the white paper on China ESG Practices[12] co-issued by China Central Depositary & Clearing Co Ltd and the International Capital Market Association, pre-transactional covenants or negative pledges are the most commonly used investor protection clauses in ESG bond transactions.

In ESG M&A transactions, buyers may require the target company and the sellers to provide representations and warranties ensuring the accuracy, completeness and truthfulness of the provided ESG-related information. Additionally, buyers may require the target company and sellers to confirm there are no major ESG violations or risks related to the target company before the closing date. Considering many ESG compliance requirements are derived from soft laws that currently are not legally mandatory, and some ESG indicators do not have quantifiable measurement standards, such as employee sexual diversity, we understand that it can be challenging for both the buyers and sellers to specify the scope and boundaries of ESG-related representations and warranties in the transaction documents. We recommend that each party involve its lawyers in the negotiation of this matter at an early stage of the transaction.

12 www.icmagroup.org/assets/Whitepaper-on-ESG-practices-Chinese-version-January-2023.pdf.

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Indemnification and insurance

Indemnification is a standard mechanism for buyers to seek remedies when breaches by sellers or the target company take place. However, due to the broad concept of ESG and the fact that not all ESG issues can be financially quantifiable, we understand it can be challenging for buyers to prove the amount of losses and draw a direct causal link between the losses and breach of ESG compliance. For instance, demonstrating the adverse impact of unstable corporate governance on a target company's business operations. For buyers, we recommend that, to the maximum extent practicable, specific ESG requirements be set out in the transaction documents and that, in the event of a breach, buyers shall be compensated for actual losses or by fixed damages, whichever is higher. For sellers, warranty and indemnity (W&I) insurance can be an option to mitigate their indemnity risk, as W&I insurance is gradually becoming a customary feature in larger M&A transactions. It is worth addressing ESG early in the discussions with W&I insurers including the availability and scope of the coverage, pricing, exclusions and other key features of W&I insurance. In addition, sellers may consider limiting the maximum compensation to the consideration received.

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Employment and Labour

Caroline Berube and Ralf Ho[1]

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), and the latest amendment, which came into force on 29 December 2018;
- 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 latest amendment, which came into force on 1 July 2013; and
- the Regulation on the Implementation of the Labour Contract Law of the PRC, which was enacted and came into force on 18 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

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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]

It should be noted that employers may process personal information concerning their employees where necessary for human resources management purposes.[3]

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.

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

3 ibid, article 13(ii).

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

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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

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

5 Labour Law, article 36.

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.

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	2,420	335
Shanghai	2,690	372
Shenzhen	2,360	326

6 ibid, article 41.

7 ibid.

8 ibid, article 44.

9 The minimum monthly salary for Beijing will take effect on 1 September 2023. The minimum monthly salary for Shanghai took effect on 1 July 2023. The minimum monthly salary for Shenzhen remains the same as in 2022.

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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]

Shanghai[11]

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

Beijing[12]

Type of insurance	Rate for employer (%)	Rate for employee (%)
Pension	16	8
Unemployment	0.5	0.5
Work injury	0.2–1.9	n/a
Medical (including maternity)	9.8	2
Housing fund	5–12	5–12
Total % contribution	31.5–40.2	15.5–22.5

10 Rates shown apply to resident employer or employee. Alternative rates apply for non-resident employer or employee. Rates are accurate as at 11 August 2023.

11 Rates are accurate as at 11 August 2023.

12 Rates are accurate as at 11 August 2023.

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Shenzhen[13]

Type of insurance	Rate for employer (%)	Rate for employee (%)
Pension	14 for non-resident, 15 for resident	8
Unemployment	0.7	0.3
Work injury	0.14–1.14	n/a
Maternity	0.5	n/a
Medical	6.2	2
Housing fund	5–12	5–12
Total % contribution	26.54–35.544	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.

Maternity leave

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

13 Rates are accurate as at 11 August 2023.

14 Labour Law, article 45.

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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.

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.[15] 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.

15 ibid, article 19.

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.[16]

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

16 ibid, article 39.

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treatment period as prescribed, nor can he or she assume any other position as arranged by the employer.[17]

Note that 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.

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.

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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;
- 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 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

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- 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:

- Severance payment = years of service x 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.[18]

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.[19]

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.

18 Labour Law, article 47.
19 ibid, article 48.

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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:

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- 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

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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 be still borne by Company A.

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- 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

Does the employer have the right to terminate the labour contract if the employee rejects overtime in accordance with the relevant labour laws?

Employee A joined Company B in June 2022. In accordance with the bylaws of Company B, employees shall work from 9am to 9 pm from Monday to Saturday. In November 2022, Employee A refused to comply with such arrangement because the overtime had exceeded the limit in accordance with the relevant labour laws. Consequently, Company B dismissed Employee A.

Employee A filed a claim with the local labour arbitration commission against Company B for illegal dismissal. The labour arbitration commission issued an award to support the claim of Employee A based on article 43 of the Labour Law – an employer must not extend the working hours of employees against the law.

Is the clause regarding the employee's waiver of overtime salary effective?

Employee C joined Company D in March 2022. There was a clause under the labour contract stipulating that Employee C would take part in the company's striver programme to voluntarily waive overtime salary. Several months

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later, Employee C resigned and requested the relevant overtime salary from Company D. Company D rejected the request.

Consequently, Employee C filed a claim with the local labour arbitration commission against Company D for the overtime salary. The labour arbitration commission issued an award to support the claim of Employee C based on article 31 of the Labour Contract Law – the employer must pay the overtime salary should it arrange the employee's overtime, and the relevant waiver clause is invalid as it is against the mandatory provisions of the law.

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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 in 2007. 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

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