stake in the development of SOEs. According to the Peterson Institute for International Economics, SOEs now account for 25 per cent of China's industrial output. The top 100 or so SOEs dominate critical industries including banking, telecommunications, steel, transportation and electricity. Besides, around 100,000 local-government-owned SOEs are competing with private firms in a wide range of industrial sectors including real estate and hotels.[26]

The government has a strong interest in safeguarding tax payers' assets, but it does not necessarily mean that management of the SOEs are more focused on building a healthy corporate governance system. The state control over SOEs is exercised through the appointment of senior executives in SOEs. Appointments of SOEs' senior officials are usually determined by the Communist Party Committee or by subordinate units of government at or above county level, even if it is formally subject to the control of a specific line of industrial ministry. They aim to achieve certain social objectives rather than solely focus on the commercial benefits of shareholders. This is different from the concept that a business corporation is voluntarily taking on social responsibilities; part of an SOE's major business objective is actually to assist the state in implementing government policies. And, this creates several problems. Firstly, business goals cannot be easily measured and there is no obvious way to determine the priority of such goals, which creates monitoring difficulties. Secondly, there is a conflict of interest between the state as the controlling shareholder and other shareholders. The state exploits minority shareholders by achieving policy goals rather than shareholders' value maximisation. And, ironically, legal protection for minority shareholders could mean constraints on the state's ability to perform its duties in promoting government policies.

1.4.2 *SOE reforms: policy and legislative moves*

2.016 One of the most distinctive features of China's economic growth and transition may be the government's gradualist approach to reforming the SOEs. Until the late 1970s, there was no legal private ownership. Family businesses emerged during the early and mid-1980s in some parts of China, despite their illegal status.[27] In the early 1980s, the central government and its ministries controlled 2,500 or so large enterprises with 30 per cent to 50 per cent share of gross value of industrial output. Provincial and city governments controlled 30,000 to 40,000 or so small and medium-sized enterprises with 25 to 30 per cent share of gross value of industrial output. County and prefectural governments controlled around 40,000 to 50,000 enterprises with 13 to 15 per cent share of gross value of industrial output.[28]

2.017 The main trigger for the SOE reform was the chronic unprofitability of the SOE sector. "SOE" had over time become a term associated with gross inefficiency: often, SOEs were wasting resources, recruiting more employees than needed, and producing more

[26] Davis B, "China's State-owned Sector Gets a New Boost" (24 February 2014) The Wall Street Journal at A2.
[27] Watts J, "In China's Richest Village, Peasants Are All Shareholders Now – by Order of the Party", *The Guardian* (10 May 2005) p 12.
[28] Wong CPW, "Between Plan and Market: The Role of the Local Sector in Post-Mao China" (1987) 11 Journal of Comparative Economics at 385–398.

goods for which there was no market. Large SOEs were even responsible for the housing, medical and educational expenses for workers and their family members. SOEs were not able to compete against other market players when market competition intensifies.

2.018 The separation of government and enterprise in China started in the mid-1980s. In October 1984, the government announced the decisions of the Central Committee on Economic Structural Reform and ordered the separation of government intervention from enterprise operation. It also granted more autonomy to SOEs on business decision making so that SOEs could be more profit-driven.[29] The reforms continued. According to the State Council's Decisions on Deepening Enterprise Reform and Invigorating Enterprises later announced in December 1986, a SOE could retain extra profit after fulfilling the fixed remittance target.[30] As some empirical studies indicated, this resulted in an increase in marginal profit retention rates. Meanwhile, SOE managers gradually obtained considerable freedom in management.[31]

2.019 The better-aligned incentive system has helped improve the efficiency of SOEs. It is estimated that between 1980 and 1989, over 87 per cent of growth in total factory productivity resulted from improved incentives, intensified market competition, and improved resource allocation.[32] However, SOE losses started to spin out of control in the mid-1990s.[33] The debt-to-asset ratio of the whole industrial SOE sector increased from 18.7 per cent in 1980 to about 67.9 per cent in 1994.[34] Such high financial gearing seemed to suggest that firms were too reliant upon short-term profit and loss account performance. 1995 witnessed for the first time a zero absolute growth in employment in the state-owned sectors.[35] Total losses as a ratio of the net output of all industrial enterprises increased from 2.43 per cent in 1980 to 8.24 per cent in 1997.[36] Loss-making became worse in 1997, which was evidenced by the fact that one fourth of all enterprises suffered from losses in 1997, as opposed to one eighth in 1980.[37] Losses in loss-making enterprises relative to profits in profitable enterprises rose from 7.64 per cent in 1978 to 45.92 per cent in 1997. Meanwhile, the ratio of profits to investment dropped to 8.63 per cent of investment in 1997.[38] The continuous drop lasted throughout the reform period.

[29] Zhang YW, "China's SOE Reform: A Corporate Governance Perspective, Guanghua School of Management" (Working Paper, Peking University, 1998).
[30] Yuan JT and Zhang W, "Understanding State Enterprise Reform from a Firm Theory Perspective: Past Experiences and Future Study Directions" (2003) 25(5) Journal of Guangxi University (Philosophy and Social Science).
[31] Groves T, Hong YM, McMillan J and Naughton B, "Autonomy and Incentives in China State Enterprises" (1994) 109 Quarterly Journal of Economics at 183–209.
[32] Li W, "The Impact of Economic Reform on the Performance of Chinese State Enterprises, 1980–1989" (1997) 105(5) Journal of Political Economy at 1080–1106.
[33] Lardy N, *China's Unfinished Economic Revolution* (Brookings Institution Press, 1998).
[34] Wu X and Xie P, *Debt Consolidation in China's State-Owned Economy* (China Financial Publishing House, 1997).
[35] *See:* China Statistical Yearbook.
[36] Li HB and Rozelle S, "Privatizing Rural China: Insider Privatization, Innovative Contracts and the Performance of Township Enterprises" (2003) 176 The China Quarterly at 981–1005.
[37] *Ibid.*
[38] Holz CA, "Economic Reforms and State Sector Bankruptcy in China" (2001) 166 The China Quarterly at 342–367, 359.

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	EJVs	CJVs	WFOEs
Time limit for capital contribution	Contributed by instalments: the first instalment must be at least 15% of the registered capital and must be contributed within 90 days upon the issuance of the business license and the last instalment should be paid within 3 years The balance of the contribution shall observe the following timetable upon the issuance of the business license: <u>Registered capital (US$)</u> — <u>Deadline (years)</u> Less than 0.5 million — 1 0.5–1 million — 1.5 1–3 million — 2 3–10 million — 3 over 10 million — set by the approval authority		
Duration of the project	For restricted projects: duration must be fixed and shall be no more than 30 years For encouraged or permitted projects: duration can be fixed or not be fixed; if fixed the duration shall be no more than 50 years	Same as EJVs for those with legal person status Those without legal person status, the duration should be shorter, usually 5–10 years	Same as EJVs
Profit and loss sharing	Fixed and is based on the share of registered capital among partners	Based on the provision of the JV contract and the ratio may vary over the duration of the project	If there is only one shareholder, sharing is not an issue. Among multiple shareholders, same as EJV
Profit distribution	Cannot be distributed unless the loss of the previous years has been made up Remaining profit from the previous year can be distributed together with that of the current year The foreign investor of a CJV may recoup its investment during the life of the joint venture		

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	EJVs	CJVs	WFOEs
Major reserve funds	Reserve fund Staff welfare and bonus fund Enterprise expansion fund	Same as EJV but is applicable to those with legal person status only	Reserve fund Staff welfare and bonus fund

2.4 Foreign-invested Companies Limited by Shares (FICLSs)

2.090 "FICLS" refers to a foreign-invested company limited by shares, which can be established either by all foreign investors or by way of a Sino-foreign JV. An FICLS is a hybrid between an FIE, subject to the fulfilment of certain preconditions, and a company limited by shares. In principle, an FICLS should be treated as a separate type of investment vehicle. China has authorised the use of FICLSs since 1995 when it issued the Certain Questions on the Establishment of Foreign-invested Companies Limited by Shares Tentative Provisions.

2.091 As the name indicates, an FICLS issues shares, and, for the first time, it closely resembles major corporate organisations used by international foreign investors. Therefore, an FICLS is the only form of FIEs that can be listed on the PRC or overseas stock exchange. For this reason, an FICLS is also referred to as a joint-stock company. Other forms of FIEs must be converted into the FICLS before they can be listed in China.

2.4.1 *Governing law*

2.092 FICLSs, except for certain aspects of its establishment, are subject to both the Company Law and the FICLS Regulations (rather than the FIE Laws).[132] FICLS regulations encourage the establishment of technologically advanced production-type companies.[133] The statutes that regulate FICLSs have similar characteristics to company laws of industrialised countries.

2.4.2 *Use or function of FICLSs*

2.093 For many years, foreign investors were only able to adopt one of three vehicles for their investment projects in China, i.e. a(n) EJV, CJV or WFOE. One of the disadvantages of these three structures is that they can only sell self-manufactured products. As multinational companies grew in China, they began looking for a more flexible legal vehicle to satisfy their business needs such as general trading rights to sell all imported finished products in China, the ability to provide comprehensive services for

[132] The Interim Provisions on Certain Questions Concerning the Establishment of Foreign-invested Companies Limited by Shares (the FICLS Provisions) (issued by the Ministry of Commerce of People's Republic of China (the MOFCOM) on 10 January 1995).

[133] Foreign-invested Company Limited by Shares Provisions (FICLS Provisions), Art. 4.

resorting to the veil-piercing doctrine as a shareholder may have committed a tort of intentional indemnity *contra bonos mores* against creditors. An aggrieved creditor may obtain compensation through a tort action against the defaulting shareholder where the company is unable to discharge its debt due to abusive conduct by the defaulting shareholder.

3.016 As a matter of fact, even prior to the formal adoption of the veil-piercing doctrine by the Company Law of 2005, a number of local courts had affirmed equitable procedures and legal claims to serve "justice" in some veil-piercing cases. These local courts directly "made" law and granted remedies in the interest of vague principles of "fairness", rationality" or "appropriateness". The all-purpose and catch-all "good faith and fair dealing" doctrine in the GPCL[15] was often cited as a strong basis for equitable resolution of company law cases. The "good faith and fair dealing" doctrine codified in the GPCL was merely an outmoded, simplified and commodious slogan, which was not even built into the statutes to govern corporate law matters. The GPCL itself was promulgated nearly one decade before the Company Law was passed in 1993. Notwithstanding these obstacles, some local courts were creative and autonomous enough to handle some challenging veil-piercing cases by applying a less formalistic but more intervening approach.[16]

3.017 Compared to a veil-piercing claim, the cause of action in tort may offer a more effective means of protecting the company's creditors against shareholders' abusive activities. This is because the veil-piercing case may ignore the corporate form of the company and suspend the operation of the separate entity principle, but the tort law may make the errant shareholder directly liable to the creditors. Even in more advanced jurisdictions such as the UK and the US, the courts have not identified a consistent set of veil-piercing rules. In China, uncertainties surrounding the veil-piercing doctrine are still high.

2.2 Codification and Ambiguities of the Veil-piercing Doctrine

3.018 The Company Law of 2005 provided that the corporate veil can be pierced in certain instances. The statutory examples are:

1. where a shareholder abuses his or her privileges of incorporation as a shareholder and causes loss to the company or other shareholders, he or she may be liable for damages;[17]
2. where a shareholder abuses the company's independent legal person status or his or her limited liability as a shareholder to evade and repudiate debts harming the interests of the company's creditors, he or she may be liable for damages;[18] or

[15] GPCL, Art. 4.

[16] Howson N, "Corporate Law in the Shanghai People's Courts, 1992–2008: Judicial Autonomy in a Contemporary Authoritarian State" (2010) 5 East Asia Law Review at 303, 350.

[17] Company Law, Art. 20, para 1.

[18] *Ibid*, para 2.

3. where a controlling shareholder, *de facto* controller, director, supervisor or senior officer uses his or her relationship to damage the interests of the company causing it loss, he or she may be liable for damages to the company.[19]

3.019 Accordingly, Chinese courts may, for example, ignore the existence of the corporate form, and treat a company's debt as the debt of the company's shareholders. In doing so, courts "pierce the corporate veil".

3.020 Based on the Company Law, three elements need to be satisfied when a court pierces the veil: (i) intent – the abusive behaviour is intended to evade the debt payment; (ii) misconduct – the principle of separate legal personality and limited liability is abused by the shareholder; and (iii) consequence – the abuse of the corporate veil causes serious damages to the creditor's interests. Among these elements, the misconduct element is the most complicated one. The other two are probably more straightforward and less decisive in the court's evaluation on whether the veil should be pierced or not. The intent element can be inferred from the behaviour of the defendant while the seriousness of the damage caused to the creditors' interests becomes less important when misconduct can be established by the court.[20]

3.021 In the statutory examples 1 and 2 above, the shareholder is held liable, although such liability is owed to the company and to the other shareholders, or to creditors. In the second example, only persons specified are liable, but only to the company.

3.022 The central provision in the Company Law still leaves some ambiguities.

3.023 First, fraud is not a necessary prerequisite under the Anglo-American system. Plaintiffs can strive to pierce the corporate veil even in circumstances where the corporation did not try to defraud its creditors. Germany, Japan and several other civil law jurisdictions have adopted a similar line. The prerequisites are that the shareholder of the company was knowingly involved in an unlawful action, tried to deliberately hide the nature of the transaction, or was intentionally involved in fraudulent behaviour regarding the company's separate existence.[21] China's Company Law does not appear to require proof of fraud. However, instead of strictly being bound by Art. 20 of the Company Law, Chinese courts seem to have the flexibility to require the presence of fraud as a factor in adjudicating the "abuse" element.

3.024 Second, if the factors listed in Art. 20 are the only factors to be considered, it can raise other concerns. The Company Law explicitly only mentions the rights of creditors and demands to pierce the corporate veil in non-creditor situations are bound to occur. Article 20's scope, if interpreted literally, applies only in debt situations. A narrow interpretation of the Company Law suggests that the Company Law's veil-piercing provisions may not cover litigants beyond those in debt cases. As a result, China's veil-piercing provisions are very narrow in their applicable range: only creditors can bring

[19] Company Law, Art. 21.

[20] Huang H, "Piercing the Corporate Veil in China: Where Is It Now and Where Is It Heading?" (2012) 60(3) American Journal of Comparative Law at 743, 759.

[21] Presser SB, *Piercing the Corporate Veil* (West, 2007) para 5:4.

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3.057 Article 8(8) of the PRC Legislation Law provides that the "fundamental economic system and basic fiscal, tax, customs, financial and foreign trade systems" can only be formulated into law by the legislature, that is, the NPC or its Standing Committee. According to the interpretation of Art. 8 of the Legislation Law provided by the NPC, the Company Law is a piece of legislation that regulates the "basic economic system".[45] As a company's separate legal personality is the cornerstone of the Company Law, it lays the foundation of the modern economic system.[46] Thus, basic company law doctrines such as the veil-piercing norm must be included in law other than regulations, a fact which has been clarified in Art. 8 of the Legislation Law. The nature of Circular 698 is to lift the veil of a company even though that company is incorporated in an offshore jurisdiction. Thus, the rules in Circular 698 touch upon the separate legal personality and limited liability principles, the fundamental core principles of modern company law. Following this line of analysis, the rules outlined in Circular 698 should be legislated by the NPC or its Standing Committee. To implement these rules, it is the State Council that can enact administrative regulations with the delegated authority from the NPC or its Standing Committee.[47] In any event, without due delegation of power from the NPC or the State Council, the State Administration of Taxation has no legislative or regulatory power to make these rules in the form of an administrative notice.

3.058 The State Administration of Taxation may argue that its power to promulgate Circular 698 originates from Art. 47 of PRC Enterprise Income Tax Law, which reads, "where enterprises implement other arrangement without reasonable business objectives to reduce the payable income or income, the tax authority has the right to adjust in accordance with reasonable methods".

3.059 According to Art. 120 of the Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China, the term "without reasonable business objectives" means "the main purpose is to reduce, exempt or defer the payment of taxes". That is to say, a foreign company indirectly transfers the Chinese company's equity through an offshore holding company to avoid the Chinese enterprise income tax may possibly constitute an "arrangement without reasonable business objectives". This way of defining "without reasonable business objectives" is a black or white approach, which may oversimplify the complexity of commercial transactions. A typical transnational company has a high degree of discretion over its financial structure so that it can devise optimal routes for internal transactions within the firm through its chains of affiliates. To form intermediary entities in convenient jurisdictions is a critically important part of this overall discretion, which is generally protected by basic modern company law principles. Setting up an intermediate entity in a convenient jurisdiction is often specifically for the purposes of reducing tax liability. A transnational company has a natural right to adopt such techniques so as

[45] *See: Falu Wenda yu Shiyi* ("Interpretation of Legislative Affairs Commission of the National People's Congress (the NPC) Standing Committee on Legislation Law") http://www.npc.gov.cn/npc/flsyywd/xianfa/2001-08/01/content_140407.htm (viewed 11 May 2012).

[46] Vandekerckhove K, *Piercing the Corporate Veil* (Kluwer Law International, 2007) pp 3–4, 70.

[47] *Zhonghua Renmin Gongheguo Lifa Fa* (The Law on Legislation of the People's Republic of China) (promulgated by the NPC 15 March 2000 and effective as of July 1, 2000), Art. 5.

to take advantage of the limitations of the tax treaty system and hence reduce its cost of capital, making it gain a substantial competitive advantage. Arguably, these are important and reasonable business objectives and strategies. The scenario caught by Circular 698 is quite unique: it may be a concrete manifestation of adjustments made by the tax authority in accordance with authorisation under Art. 47 of the Enterprise Income Tax Law, but the adjustments are, on the other hand, related to the veil-lifting doctrine, which in turn affects the cornerstone principle under modern company law. Additionally, the extraterritorial impact improperly steps into the realm of "foreign trade systems". The power exercised by the State Administration of Taxation, apparently, is *ultra vires* – an act beyond its scope of authority or power under the PRC Legislation Law.

3.060 China's tax authority has been given greater autonomy from the government, as well as targets and performance plans to meet those targets, with the overall aim of achieving "efficiency gains". However, such autonomy has not been put in a defined remit. While administrative autonomy may lead to some improvements in collecting taxes, these improvements tend to be short term. Further, taxpayers may complain of overzealous enforcement. The challenge here is whether an autonomous tax regime itself can be generally accepted as fair and desirable in a world where the structures of social solidarity binding citizens together and to their state have become increasingly fragmented.

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3.061 In summary, the State Administration of Taxation has no power to either create new rules or to implement changes to the veil-piercing doctrine by denying the separate legal personality rule – particularly when the affected enterprise is an offshore company. A Chinese court will likely invalidate any administrative action taken by the tax authority on the basis of Circular 698 according to the Legislation Law[48] if an offshore company challenges the legitimacy of Circular 698.

3.062 China formally introduced the veil-piercing doctrine into the Company Law in 2005.[49] However, Chinese law only draws very narrow boundaries.[50] Article 20(3) of the Company Law provides, "[w]here any of the shareholders of a company evades debts by abusing a company's independent status as a legal person or shareholders' limited liability, thus seriously damaging the interests of any creditor of the company, it shall be held jointly liable for the debts of the company". Article 64 of the Company Law provides that if the assets of a company and the single shareholder are integrated and indivisible, then the shareholder and company will be jointly liable for the debts of the company. Article 18 of the second piece of judicial interpretation, that is, the Provisions of Certain Issues Concerning the Application of the Company Law, published by China's Supreme People's Court on 12 May 2008, effective as of 19 May 2008, covering a variety of issues related to the dissolution and liquidation of Chinese

[48] *Zuigao Renmin fayuan Guanyu Yinfa Guanyu Shenli Hang Zheng Anjian Shiyong Falu Guifan Wenti De Zuotan Hui Jiyao de Tongzhi* (Circular of the Supreme People's Court on Printing and Issuing the Summary of the Symposium on Issues Concerning Applicable Legal Norms for the Trial of Administrative Cases, Fa [2004] No. 96) (promulgated on and effective as of 18 May 2008).

[49] Company Law, Arts. 20(3) and 64.

[50] Huang H, "An Empirical Study on the Veil-piercing System in China" (2012) 1 Chinese Journal of Law 10.

4.007 Where possible, however, the scope of production and related activities (such as sales and services) should be clearly defined to allow for the largest expansion of activities without the need to amend the FIE documentation and seek further approval. Some inherent rights such as the right to export its self-manufactured products must also be included in the business scope. If the scope of operation is to be expanded in the future, the articles of association must be amended in order to broaden the scope of business. Amending the scope of business may allow the FIE to have more flexibility to manufacture new products or vary the product line in order to suit market conditions, or to engage in the trading of third party products.

4.008 Approval of importing for resale may be implicit rather than explicit and is done under the guise of treating such imports as "raw materials". If it is possible to characterise the processing of a product partially manufactured outside China as a legitimate production activity inside China, it will be desirable to have this expressly approved. Foreign investors must avoid giving the impression that the FIE will act as a trading company (selling products which are not manufactured by the FIE) as no approval will be granted for such trading activities.

4.009 Generally, it is not possible to obtain a general scope of business for a company in China. Recently, some local authorities have issued business licenses on a case-by-case basis with a broader scope of business, typically: (i) prohibiting business activities that are prohibited by PRC laws, regulations and state policies regarding foreign investment industries; (ii) prohibiting business activities that require special approval prior to obtaining the special approval; and (iii) permitting any and all business activities that are not subject to special approval as provided by PRC laws and regulations and are not classified as "restricted" according to PRC foreign investment industry regulations. However, whether the broadening of the approved scope of business will develop into a more widely adopted practice remains to be seen.

4.010 In connection with the business scope and level of approval (which is discussed below), the PRC authorities from time to time published or updated the Foreign Investment Industrial Guidance Catalogue (the Catalogue) to serve as general indications of the current policies governing foreign investment in various industries. The Catalogue group all industrial sectors into "encouraged", "permitted", "restricted", or "prohibited".[3] An investor investing in an "encouraged" industry may enjoy some benefits in the approval process. By contrast, if the investment is in the "restricted" industry, it may be subject to additional scrutiny by a higher-level approval authority. More importantly, such an investment may have to have a Chinese partner holding majority equity in the enterprise. A number of profitable and strategically important industries such as telecommunications, banking and petroleum are all listed in the "restricted" category.

4.011 As far as the scope of business is concerned, the latest Catalogue provides guidance as to what restrictions may apply to the scope of business. For instance, it is not feasible to change the scope of business of an FIE to include activities falling within an industry where the Chinese party to the joint venture (JV) is required to have a majority stake.

[3] The Catalogue was first published by the PRC National Planning Commission in June 1995.

4.012 The Catalogue is updated every few years by the Chinese government in accordance with its macro-economic development plan, which involves guiding foreign investments to serve China's needs. For instance, in the revised Catalogue published in December 1997, the "encouraged" category of investments indicated a heightened emphasis on high technology – for some types of projects high capacities of output were added as requirements and other activities were moved to the "restricted" category. With the implementation of China's WTO commitments, more and more industries are gradually opened to foreign investors. For instance, foreign investors are now allowed to set up wholly foreign-owned wholesale, retail and franchise enterprises. The liberalising trend was even more pronounced in the revised Catalogue in 2002 and 2007. The 2007 Catalogue demonstrated the new policy switch. The 2007 version of the Catalogue addressed environmental, regional development, and trade imbalance concerns by decreasing support for export-oriented industries or by placing new restrictions on industries that previously welcomed foreign investment such as manufacturing and mining. The 2011 Catalogue further opens some restricted industrial sectors to foreign investment. Therefore, the Catalogue is particularly relevant to the general market entry, and must be referred to from time to time in planning merger and acquisition (M&A) deals.

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1.3 Consequences of Breach of Business Scope Rule

4.013 For FIEs, the articles of association need to be approved by the approval authority first. The penalties for the breach of business scope are severe. A company is liable for carrying out activities beyond its approved scope and, more importantly, its legal representative may be subject to administrative sanctions, a fine or criminal liability if a criminal offence is committed.[4] An FIE that flagrantly acts outside its permitted business scope is liable to be forcibly shut down by the SAIC, to have its business license revoked, and to eventually be liquidated.[5]

4.014 Previously, contracts made by an FIE could be voided due to the failure to comply with the business scope in the course of business. These contracts will now be deemed void only if they "violate state laws or administrative regulations which prohibit such activities, or which restrict the operation of, or require permits to be issued in order to operate such businesses".[6]

1.4 Business Scope of a Domestic Limited Liability Company (LLC)

4.015 The business scope of a domestic limited liability company is one of the required items in the articles of association.[7] The business scope must be duly registered with the SAIC.[8] Where the business scope includes any restricted item, approval from the competent government authority must be secured before the registration of the company.

[4] General Principles of Civil Law (GPCL), Arts. 49 and 110.
[5] Company Law, Art. 181(4).
[6] PRC Supreme People's Court Interpretation of the PRC Contract Law.
[7] Company Law, Art. 25(2).
[8] *Ibid*, Art. 12.

- it can at least provide a sound and clear legal basis for legal action if disputes actually arise and cannot be resolved by the parties to the JV via mediation or friendly consultation.

4.079 A JV contract, no matter how skilfully drafted, may not save a JV from failure. However, a JV contract should be able to ensure that relevant parties have sufficient protective measures and an exit strategy. The JV contract should also provide sufficient safeguards or leverage to the parties in case problems arise at a later stage. The JV contract also needs to put the corporate governance mechanism in place to secure the success of the JV.

4.080 In essence, a joint venture contract is a shareholders agreement, which is subject to approval by relevant authorities. The court has expressed its clear position that joint venture contracts only come into effect upon approval and that the approval date is the effective date of the joint venture contract.[49] In practice, a joint venture contract is signed by the parties but may not be approved by the competent government authority afterwards. The determination of validity of a joint venture contract is provided in Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises I (Provisions I). According to the Provisions, where approval has not been obtained, the court will hold that the contract has not yet become valid.[50] The court will also reject a party's request to hold such a contract to be invalid.[51] Before the release of Provisions I, courts would often rule contracts invalid if they had not been examined and approved by the competent approval authority. However, the courts are not permitted to rule such contracts invalid. Instead, it would be more appropriate for the courts to rule that the contracts are not yet valid. This is a subtle but important distinction as the PRC Contract Law does not provide a legal foundation for the claim that the contract is "not yet valid".

4.081 Provisions I also provides for the severability of the "duty to apply for approval" from the entire contract. The effectiveness of the contract itself (which is subject to approval) should not affect the validity of the provision under which the relevant party is obliged to submit the contract for approval.[52]

4.082 The next question is whether the court can grant specific performance as a remedy in order to make the default party perform its duty. Specific performance is available as a form of remedy under the Contract Law but is rarely granted to enforce personal obligations. Provisions I only allows the court to grant specific performance so that the transferee in an equity-transfer deal can bring a lawsuit against the transferor for its failure to perform its obligation to submit the approval application.[53] Provisions I does not explicitly mention whether specific performance is available in other scenarios where approval is needed to effect a transaction. These scenarios include forming the FIE and increasing registered capital. Since uncertainty remains, it becomes more

[49] Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises I (Provisions I), Art. 1.
[50] *Ibid.*
[51] *Ibid.*
[52] *Ibid.*
[53] *Ibid*, Art. 6.

difficult for the non-breaching party to make amends for the breaching party's failure to perform its obligation to submit the application. The Contract Law excludes the availability of specific performance when a non-monetary remedy is considered inappropriate or impractical for enforcement.[54] This suggests that the court may rule out the possibility of granting specific performance as a remedy if making an application for approval is possibly no longer feasible or equitable. A certain level of flexibility enjoyed by the court in this regard is in line with the stance taken by the SPC in its judicial interpretations of the Contract Law. The SPC's Judicial Interpretations of the Contract Law states that the court "under actual circumstances" may grant specific performance to the non-breaching party to apply for approval or registration of contracts by himself or herself, if the original party failed to do so.[55] This provision also leaves discretion to the court on a case-by-case basis.

4.083 The other question is whether a liquidated damages clause may be enforced by the court in order to compel the duty to apply for administrative approval. The SPC's position, based on its Judicial Interpretations of Contract Law, is to group the breach of duty in order to put an application into the scope of pre-contractual liability, which is mainly governed by Art. 42 of the Contract Law. A fair view may be that the amount of compensation for breach of pre-contractual liability is limited to actual and direct losses, which is much less than that for a breach of an effective contract. Provisions I follow this approach by providing that only compensation for actual losses shall be granted in situations where a transferee requests the termination of the contract based on the transferor's failure to submit the contract for approval.[56]

4.084 More remedial measures such as the payment of the equity's price disparity may be available in cases where the transferor of equity and the FIE fail to perform their obligations to obtain the approval and the transferee brings a lawsuit to request specific performance of the approval application obligation. The Contract Law and the Judicial Interpretations of the Contract Law grant the breaching party a right to an appropriate reduction of the amount of liquidated damages when it is more than 130 per cent of the actual losses incurred. The non-breaching party may receive less than the liquidated damages as agreed even though the contract clause itself is valid.

4.085 The other remedy is for the transferee to submit the documents for approval and the court may grant such a remedy. Provisions I, however, are unclear as to whether the transferee will be entitled to terminate the contract directly without recourse to the self-help remedy and to claim the loss if the transferor or FIE refuses to perform its obligation to make an application for approval ordered by the court.

3.3.6 *Use of supplementary agreement*

4.086 In terms of the approval procedure, a further practical question is regarding the legal nature and validity of the supplementary agreement(s) that transacting parties use to circumvent the legal requirement of approval or registration, especially when the

[54] Contract Law, Art. 110.
[55] Judicial Interpretations II on Contract Law, Art. 8.
[56] Provisions I, Art. 5.

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company without cash contribution after 1 March 2014. Nevertheless, investors are still required to evaluate the non-monetary assets and determine the contribution amount accordingly.

5.028 Capital in kind contributed to a company limited by shares or a LLC can also be in the form of land use rights, machinery, equipment and other moveable or immoveable properties.

5.029 According to the amended Company Law 2013, where a promoter contributes non-monetary property as capital, he or she shall go through the formalities required for the transfer of his or her rights in those properties to the company according to law. The amended Company Law, however, offers little guidance concerning legal formalities.

5.030 Previously, under the Company Law of 1994, only five kinds of assets were permitted to be contributed to the registered capital of a company limited by shares or an LLC - cash, tangible assets, industrial property rights, non-patented technology and land use rights. For other kinds of property-related rights such as equity interest, receivables or copyright, government practice varies from place to place. The Company Law of 2005 provides a clear-cut rule on the available contribution methods by allowing contribution of any non-cash asset that can be monetarily valued and legally transferred, which covers tangible and non-tangible assets. The new Company Law specifically uses the concept of "intellectual property" as a contributable asset, in lieu of the "industrial property rights and non-patented technology", which means that intellectual property such as copyrights will now be allowed to be contributed under the Company Law.

5.031 Labour, credit, goodwill, franchising rights and secured assets are still prohibited from being contributed as capital under Chinese law.[17]

5.032 The Company Law of 2005 is silent on the permissibility of human capital contributions. The Regulations on the Administration of Company Registration 2005 forbid the contribution of labour services.[18] Some local courts such as the Shanghai Higher People's Court forced the Shanghai legislature to issue the Pudong New District Provisional Measures on Human Capital Contributions, which set forth two legal mechanisms for the valuation of human capital contributions, one being evaluation by a third party certified appraiser and the other being agreement by the entire shareholders' meeting. Local courts have been cautious about very obvious defects in human capitalisation.

5.033 The Company Law is still highly conceptual and declaratory and fails to provide standards and procedures for non-cash contribution. There remains a controversial issue under Chinese law as to how to determine whether a non-cash capital contribution obligation has been duly performed.

5.034 The SPC on 16 February 2011 issued the Provisions Regarding Certain Issues Concerning the Application of the Company Law III (Provisions III), which provides clarification of various widely disputed issues in practice, including equity contribution and verification of equity interests.

[17] PRC Administration of Company Registration Regulations, Art. 14.

[18] *Ibid*, Art. 14(2).

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5.035 It is clarified in Provisions III that, as to certain kinds of non-cash property which are subject to registration requirement for transfer of ownership, the completion of ownership change registration and actual delivery of such property are both required for equity contribution.

5.036 If the property has been delivered to the company for use but the formalities of title transfer have not been completed, the court may order the contributor to transfer the title to the company within a specified period of time. The contributor will be deemed by the court to have fulfilled its capital contribution obligation from the time when the property is actually delivered to the company for use if the title is transferred within the specified period.[19]

5.037 Where a capital contributor makes a non-cash capital contribution and has transferred the title but failed to actually deliver it to the company for use, if the company or any other shareholder claims that the capital contributor should deliver the property to the company and should not enjoy the corresponding shareholders' rights prior to the actual delivery, the court should support such a claim.

1.3 Fulfilling Non-cash Contributions

5.038 Under the Company Law, for a domestically incorporated company, all non-cash capital contributions must be evaluated by qualified appraisal institutes and verified and certified by an independent accounting or auditing firm designated by the SAIC before the application for registration is made.[20] The Company Law will impose liabilities on a shareholder if the value of the contributed non-cash capital is less than the stipulated value in the articles. The shareholder will need to make up the difference if the actual value of the non-cash capital contribution is significantly lower than what is provided in the articles, and all the other founding shareholders bear joint liability for the gap.[21]

5.039 The Company Law addresses the joint and several liabilities of other shareholders to make up the difference in the event that a single shareholder's in-kind contributions are deficient or initially overvalued. Joint and several liabilities have also been extended by the Shanghai People's Courts to other shareholders to contribute the difference when a cash-contributing investor does not make its contribution in a timely manner.[22]

1.4 Capital Withdrawal

5.040 Corporate assets include the capital contribution made by shareholders. Capital contributions, according to Chinese law, cannot be withdrawn by shareholders once they are made. Withdrawal of capital contribution constitutes an infringement of corporate property rights.

[19] Provisions Regarding Certain Issues Concerning the Application of the Company Law III (Provisions III), Arts. 8 and 10.

[20] Company Law, Art. 29.

[21] *Ibid*, Art. 31.

[22] Howson, n 16 at 303, 355.

5.101 The valuation rules are not necessarily helpful when it comes to contributing equity interest in a listed company to the registered capital of another company. Since the stock price in the market fluctuates all the time, the market needs to have more practical rules in this regard.

2.11 Approval Requirements and Other Requirements

2.11.1 *Approval authority*

5.102 The MOFCOM or its provincial-level counterpart at the location of a target FIE is the approval authority in charge of approving any capital contribution made by an investor in the targeted FIE using an equity interest of an equity source company except for those specifically required to be approved by the MOFCOM in accordance with relevant regulations concerning approval and admission of foreign investment.

5.103 If the equity source company is the FIE and is subject to approval by an approval authority different from that for the target FIE, the approval authority for the target FIE shall refer to the opinions of the provincial approval authority where the equity source company is located before making a decision.

2.11.2 *Approval procedure*[51]

5.104 To obtain the requisite approval, the contributing investor or the target FIE needs to submit an approval application.[52] If the approval authorities deem it appropriate, they will first grant a conditional approval (with "equity contribution not paid" marked on the certificate) to the target FIE. After completing the approval procedure with respect to the equity transfer in relation to the equity source company and the actual injection of the concerned equity interests into the target FIE, the contributing investor and the target FIE will then apply to the relevant approval authorities for final approval and the approval authorities will grant a final FIE approval certificate.

2.11.3 *Time frame*

5.105 No time frame is outlined in the Interim Provisions for the completion of the entire approval process relating to the contribution of equity interests into a target FIE. It is noted that, the contribution of equity interest for the purpose of establishing a new company is required to be completed within one year from the establishment date of such company, a requirement that will presumably apply to FIEs.[53] The approval procedures for contributing equity interests to an existing FIE are generally far more complicated than those for contributing equity interests for establishing a new FIE and, as a practical matter, may take more than one year to complete.

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[51] Interim Provisions, Arts. 11–17.

[52] Together with the application, other documents which need to be submitted include an equity contribution agreement, a certificate of the equity contributor's legal holding of the equity, proof of the business license of the equity source company, the approval certificate of the FIE, the certificate of passing the annual inspection (in the case of an FIE), an equity appraisal report issued by an evaluation institution, a legal opinion issued by the law firm on the approval certificate, and an annual inspection report.

[53] Interim Provisions.

2.11.4 *Impacts on the ability to borrow foreign debts or acquire duty-free equipment*

5.106 Under the current FIE laws, an FIE may borrow foreign debt in an amount up to or equal to the difference between its approved total investment amount and registered capital. An FIE is entitled to import equipment on a duty-free basis up to the approved total investment of the FIE. The contributed equity interest in the equity source company is excluded from the total investment of the target FIE when determining the target FIE's borrowing capacity for foreign debt or the amount of duty-free equipment.[54]

2.11.5 *Impacts on onshore merger and acquisition (M&A) transactions*

5.107 With the Interim Provisions, the MOFCOM effectively permits an onshore merger or acquisition transaction to include an equity-swap deal, thereby reducing the cash flow needs of the relevant parties and offering more flexibility to investors in structuring their transaction model. Any transaction involving contributions of equity interests of another company to the FIE would be subject to a set of complex approval procedures, which need careful transaction planning.

5.108 The shareholder may exit the company by transferring his or her equity capital to other existing shareholders or new investors. Administrative penalties are imposed against false capital registration and unlawful withdrawal of capital.[55] In a more severe case, criminal liability is imposed on shareholders who form the company with false means and false capital contribution, which may result in a punishment of three to five years' imprisonment.[56]

5.109 In both FIEs and domestic companies, shareholders share profits and bear risks in proportion to their respective capital contributions. Each party is liable to a JV for the amount of registered capital he or she has agreed to contribute. For a domestic company, similarly, shareholders are entitled to the dividends in proportion to their respective capital contributions. As this is a default rule in the Company Law, shareholders are free to agree upon the split of dividends in a ratio different from the equity percentage between them. However, if a shareholder only partially paid for its capital, he or she will only be entitled to the dividends according to his or her actually paid-in capital contribution.[57]

3. Equity Financing

3.1 Preferred Shares

5.110 One of the principal components of a typical venture capital or private equity transaction is that investors expect to be issued preferred shares,[58] together with an enhanced

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[54] Interim Provisions, Art. 18.

[55] The SAIC's Provisions on Administration of Company Capital Registration 2006.

[56] Criminal Law (amended in 2006), Arts. 158 and 159.

[57] Company Law, Art. 36.

[58] The term "preference shares" or "preferred shares" usually refers to a separate class of shares possessing unique rights and privileges. These rights usually go well beyond the rights enjoyed by ordinary shareholders.

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5.232 Similarly, the onshore debtor in type 2 structure would be restricted from borrowing any new loan backed by security until the security provider is fully reimbursed by the debtor after enforcement of a cross-border security.

d. Derivative transaction

5.233 In type 1 structure, a derivative transaction can be secured provided that the underlying derivative transaction is entered into by the debtor for hedging purpose, in line with its business scope and is duly authorised by its shareholder(s).

e. Bond issuance

5.234 An onshore security provider can secure offshore bond issuance provided that (i) the issuer is directly or indirectly owned by an onshore entity; (ii) the proceeds of the bond issuance shall be used for an offshore project in which the onshore parent of the issuer has an equity interest; and (iii) the issuer and such offshore project have been duly approved by, registered and filed with, the relevant authorities in charge of outbound investment.

5.235 The removal of quota or approval requirement for type 1 security is a positive change in the context of an offshore bond issuance, as a direct guarantee by the onshore parent of the offshore issuer would be a better solution than the current market practice of obtaining keep-well letters from the onshore parent.

5.236 It remains to be seen whether the restriction on the usage of funding to a particular project (other than the widely seen "general corporate purpose" type of usage), which is not required under the existing SAFE regime, would reduce the appetite of the issuer's group to adopt this structure.

5.6.2 *Uncertainties*

5.237 The New SAFE Rules are likely to change the landscape of any financing involving onshore credits and onshore assets. The New SAFE rules brought much needed legal certainty to the validity and enforceability of cross-border security. This may help multinational companies to access more funding options and to tap into less expensive funding sources.

5.238 However, it is yet certain if the New SAFE Rules also apply to cross-border security denominated in Renminbi. It remains to be seen to what extent the restriction on repatriation of proceeds will apply in transactions where the proceeds are not used towards any of the restricted purposes explicitly set out in the New SAFE Rules but are used to replenish the borrower's own funds which may have been directly or indirectly repatriated onshore.

5.7 Corporate Bonds

5.239 Industrial companies often issue bonds as an alternative to borrowing from banks to ensure or support the company's liquidity. Corporate bonds are generally not backed by additional securities. Therefore, the creditworthiness of an issuing company is of particular importance. The rating of the issuer should be considered because the creditworthiness of individual firms affects the rate of the interest rate on the issued bond. The rating will influence the condition of future bonds, in particular, the level of return. In this case, company bonds with top ratings have a lower return than the ones with lower ratings.

5.240 More companies now issue company bonds. One reason for this is that banks can thus shift the risk to an investor. If there were no company bonds, the company would get the necessary capital from banks rather than the investor. In that case, banks would have to bear the risk of default. Ping An Insurance, for example, placed RMB26 billion convertible bond for sale within China, which was the biggest sale in the world in 2013.[94] Convertible bond sales can be split into two parts under Chinese law, one part of the deal being sold to the existing shareholders and the other part open to bids from any investor. Foreign investors holding Ping An's Shanghai-listed shares have been active in both parts of the deal. Ping An has constantly been needing financing to support its expansion. In the past four years, Ping An has raised RMB115 billion through a combination of share and bond sales. Chinese banks including Bank of China and Minsheng Bank issued convertible bonds. PetroChina also issued convertible bonds. Unlike rights issue, companies selling convertible bonds do not need to specify timing, making it a more flexible financing option. On the other hand, companies must meet tougher standards to receive approval for convertible bonds. For example, they are required to have paid cash dividends over the past three years.

5.241 The issuing of bonds is also affected by the credit markets. For instance, China Development Bank has been recently forced to cut the size of its proposed bond issues by 60 per cent. Baidu, a US-listed company, in 2012 sold bonds to US investors that were priced without the extra that emerging market borrowers usually pay.[95] These cases confirm the tightening-up of China's credit markets.

5.242 The Chinese bond market is worth approximately US$4 trillion. This places the Chinese bond market fourth in size, after the US, Japan and France. It is even larger than Shanghai's equity market of US$2.4 trillion.[96] Currently, China's bond market is not open to foreign investors, limiting opportunities to small offshore markets either in US dollars or in Renminbi. A small number of Chinese companies chose to borrow. With the Chinese market opening up, China's bond market will become one of the most important capital markets in the world.

5.243 Compared to offshore markets, the onshore bond market can produce higher yields. Offshore rates are more closely linked to international bond markets, Renminbi appreciation expectations, and the ebb and flow of often-tight liquidity. Typical coupons are 100 and 150 basis points lower offshore for similar credits, making the domestic market an easy sell for yield hunters.[97] In addition, the domestic bond market has a larger pool of bonds with longer durations. This can be a selling point for pensions

94 Noble J and Rabinovitch S, "Ping An Completes $4.3bn Convertible Bond Deal", *Financial Times* (28 November 2013) http://www.ft.com/intl/cms/s/0/1f801e92-5723-11e3-9624-00144feabdc0.html#axzz38ukEjofe.
95 Davies PJ, "Blind Eye to Fording Devices in China's Financial River", *Financial Times* (27 November 2013) p 16.
96 Noble J, "China Bond Market Emerges from the Shadows", *Financial Times* (23 October 2013) http://www.ft.com/cms/s/0/4f0950da-3b98-11e3-87fa-00144feab7de.html#axzz38ukEjofe.
97 *Ibid.*

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allocated by the state, to a so-called socialist market economy, which relies more upon corporations and entrepreneurs to pursue economic efficiency and success.

6.010 A cultural angle also exists in the study of corporate governance. There should be a gentle reminder to the audience against cultural or psychological explanations of corporate governance models. A pure cultural or psychological perspective of corporate governance is likely to remain incomplete without interpreting the institutions that shape corporate governance in the broader context of a national economic and legal system. To complete the analytical tools in researching the subject, a political approach would also seem necessary.[15] This line of thinking would be able to help readers understand the multinational corporations' anti-social manners, policies and practices, i.e. externalisation of costs onto society, evasion of laws and rules, transformation of citizens to consumers, and privatisation of the public sphere, all of which often create a severe democratic deficit. The subject can be a highly political one that may change the conclusion we may draw from the "nexus of contracts" conception, cost-benefit analysis or ownership theory. For instance, shareholder power may amount to governance by wealthy elites and bear no resemblance to genuine democracy. In line with this political logic, corporations can be well positioned between individuals and states so as to enhance public interests and democratic values.

1.2 Corporate Governance of Chinese Companies

6.011 Corporate governance of Chinese companies, either small privately-held corporations or large corporatised SOEs, is still functioning. Private firms have been fertile grounds for fraud, looting, asset stripping, minority shareholder oppression, and firm mismanagement. Public companies are no better, even if they are under the threat of foreign securities class action suits and under the scrutiny of Chinese regulators and exchanges. Public companies have been largely used as instruments to attract passive capital from the stock markets and to serve the needs of a controlling shareholder and/or his or her insider appointees. The operation of public companies is inhibited or dictated by conflicted transactions or outright stealing of assets.

6.012 Better corporate governance is a vital factor for bringing capital into China, creating jobs, increasing tax revenues, generating shareholder wealth and promoting fair wealth distribution, all of which can increase the standard of living. Corporate governance is critically important to a country's economic stability and continuous growth because it provides credibility and confidence, which are fundamental to capital markets.[16] No single enterprise in today's China can ignore the ramifications of globalisation and its implications for corporate governance. According to a survey by GovernanceMetrics International in 2010, China continues to be one of the countries to achieve the lowest rating in terms of corporate governance.[17] Corruption premium in China ranges from

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15 *See*: Roe MJ, *Political Determinants of Corporate Governance: Political Context and Corporate Impact* (Oxford University Press, 2006); Hutchinson AC, *The Companies We Keep: Corporate Governance for a Democratic Society* (Irwin, 2005); Bakan J, *The Corporation: The Pathological Pursuit of Profit and Power* (Viking, 2005).

16 China Corporate Governance Survey, Centre for Financial Market Integrity (2007).

17 "Global Corporate Governance Country Rankings 2010", GovernanceMetrics International (2010).

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20 per cent to as high as 50 per cent for non-transparency.[18] China may present a unique "high risk-high reward" scenario in global corporate governance.

6.013 The pattern of ownership and control in Chinese companies has important implications for China's corporate governance regime. The state's dominant role in controlling interest in companies leads to a dilemma in Chinese corporate governance. The state wants to control the company in many aspects, i.e. maintaining urban employment levels, directing control over pillar industries, controlling prices in a given sector, and extracting profits for politically-orientated purposes, all of which may not be in line with the shareholder wealth maximisation principle. From a company law perspective, all these non-profit-centred considerations may cause the exploitation of minority shareholders. The pattern of ownership and control also suggests a realistic conflict between majority and minority shareholders as well as a distorted allocation of corporate power between shareholders and management. Accordingly, protecting minority shareholders may directly constrain the ability of majority shareholders (often the representatives of the state) to achieve their separate agenda. The business operation of a company may also be dominated by the majority shareholders' agenda, since the board of directors may be easily bypassed and the controlling shareholders may directly step in and get involved in the daily decision-making process. The concentrated ownership in Chinese companies also means that the main agency problem is not vertical between shareholders and management but horizontal between majority and minority shareholders. As majority shareholders have more powerful political connections, a dispute between majority and minority shareholders may turn political, which may affect decisions made by the judiciary.

2. Corporate Structure of Foreign-invested Enterprises (FIEs)

6.014 The corporate management structures of FIEs and domestic companies are different as the governing laws, that is, the FIE Laws and the Company Law, vary in terms of corporate structures.

2.1 Management Structures in FIEs

6.015 The board of directors is the highest authority of an FIE and shall decide all major issues concerning the FIE. The general manager (or the president in some cases) is in charge of day-to-day operations and management of the FIE and the implementation of the decisions made by the board of directors. In parallel, there is a board of supervisors whose key duty is to supervise the performance of duties by the board members and senior management.

6.016 The general manager is supposed to report to the board, and both the deputy general manager(s) (or vice president(s)) and the chief financial officer report directly to the general manager. The general manager is required to consult with the deputy

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18 Transparency International Country Study Report, China by Transparency International, National Integrity System (2006) p 8, http://www.transparency.org/policy_research /nis/regional/asia_pacific China_nis_2006.pdf.

6.090 The good-faith-acquisition rule is also applicable to a scenario where the initial shareholder has transferred his or her equity but the registration of such transfer is not duly completed by the registration authority, that is, the SAIC.

6.091 In the context of FIEs, the SPC's Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises I also recognise the use of the nominee structure, provided that the contracts are not invalid pursuant to other laws and regulations.[97] The court will not grant a request by the actual investor for confirmation of his or her identity as a shareholder in the FIE or for a change to the shareholder registry, unless:

- the actual shareholder has made an investment into the FIE;
- the shareholders (other than the nominee shareholder) recognise the actual shareholder's identity as a shareholder; and
- the court or the parties receive consent from the competent authority for the change of the actual shareholder into the shareholder registry while the legal action is still pending.[98]

6.092 It appears that the court may have to rely on the approval authority for a final decision.

6.093 The court will not allow one of the parties to claim that a contract is invalid or has yet to become valid simply because it has not been approved by the competent approval authority.[99] Where the parties have not reached an agreement regarding the distribution of dividends, the court will allow the actual shareholder to request that the nominee shareholder pay him or her the earnings received from the FIE. To ensure equality, the court is empowered to allow the nominee shareholder to request that the actual shareholder pay necessary remuneration to the nominee shareholder after the court takes into account actual circumstances.[100]

6.094 The court also has the authority to uphold an actual shareholder's claim for the termination of a contract in the event that the nominee shareholder in the FIE fails to perform the contract.[101] However, the court will not support an actual shareholder's claim against the FIE for the distribution of profits or its exercise of other rights as a shareholder on the basis of its agreement with the nominee shareholder.[102]

6.095 Although the SPC's Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises I (Provisions I) made some clarifications, some questions remain unanswered. What if a nominee shareholder makes partial contribution to the registered capital? What happens if only some but not all the other shareholders give consent?

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[97] Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises I (Provisions I), Art. 15.
[98] *Ibid*, Art. 14.
[99] *Ibid*, Art. 15.
[100] Provisions I, Art. 15.
[101] *Ibid*, Art. 16.
[102] *Ibid*, Art. 17.

6.096 Valuation is a tricky issue in a nominee structure. If a contract between an actual investor and a nominee shareholder is held to be invalid, and the value of the shares held by the nominee shareholder is higher than the actual amount invested, the court will allow the actual investor to request that the nominee shareholder return his or her investment and also allocate the benefits he or she received from its participation in the management and business operations of the FIE.[103] If the contract between the actual investor and the nominee shareholder is held to be invalid, and the value of the shares held by the nominee shareholder is lower than the actual amount of investment, the court will allow the actual investor to request that the nominee shareholder return an amount equal to the current value of the shares.[104]

6.097 Where a nominee shareholder in an FIE clearly indicates that he or she wishes to give up his or her equity or refuses to continue to hold it, the court may order that the actual investor's investment be returned to him or her through the proceeds of an auction or forced sale of the nominee shareholder's equity in the FIE. Based on the investment of the actual investor and on the nominee shareholder's involvement in the operation and management of the FIE, the court will undertake a reasonable distribution of the equity earnings between the parties. Where the actual investor requests that the nominee shareholder compensates it for losses, the court will determine whether the nominee shareholder is liable for compensation and the amount of any compensation based on the existence and extent of any negligence on the part of the nominee shareholder.

6.098 The court is given the power to requisition or return any property obtained by the parties where the contract between the actual investor and the nominee shareholder in the FIE is deemed invalid on the grounds of malicious conspiracy, or on the grounds of harming the state or the interests of any collective or individual.[105] As discussed above, in practice, many nominee investor arrangements were set up to escape the limitations on the types of industry in which an FIE can conduct business. This raises a potential issue – are violations of China's industrial policy deemed as damaging the state interest and therefore invalidate contracts between nominee investor and actual investors? This question remains unanswered.

6.099 Fraud occurs if an FIE or one or more of its shareholders engages in fraudulent behaviour (such as providing false materials to apply to the approval authority to change the shareholders specified in the FIE's approval certificate) that causes the other shareholders in the FIE to lose their status as shareholders or their original shareholding percentage.[106] In that case, the court will uphold a claim by the other shareholders confirming their status as shareholders or confirming their original shareholding percentage or compensation, unless a third party has already obtained the shares without fault on its part.

6.100 In summary, the principle underlying the nominee investment rules is to respect the contract between the actual investor and the nominee investor when settling disputes. As these contracts are not covered by the FIE Laws, the court applies the general

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[103] Provisions I, Art. 18.
[104] *Ibid*, Art. 19.
[105] *Ibid*, Art. 20.
[106] *Ibid*, Art. 21.

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6.163 Supervisors are entitled to propose interim shareholders' meetings and put forward resolutions at such meetings, as well as to attend the meetings of the board of directors, raise concerns and to make proposals at the meetings. In dealing with unusual circumstances in its company's operations, the board of supervisors is granted the power to engage an external accounting firm to investigate the matter (with the expenses being born by the company).[194] These powers enhance the board of supervisors' ability to get information about the company, help the board better understand corporate information, and set priorities for supervision.

6.164 Supervisors can even make requisition to the board of directors for an extraordinary general meeting[195] and to convene the meeting by itself[196] if the board of directors fails to do so. These powers strengthen the board of supervisors' role as a watchdog, making it possible for the board of supervisors to be involved in the business decision-making process. The power to propose, convene and reside over a shareholders' meeting and report what it has found augments the links between the board and the shareholders. The board of supervisors or individual supervisors have the power to initiate legal action against the directors and senior managers. The power to sue provides greater deterrence to illegal behaviour by management and fortifies the protection for minority shareholders.

6.165 As FIE Laws are silent about the supervisory board: it has long been the practice that FIEs do not form a board of supervisors. The SAIC released an interpretation in September 2006 indicating that FIEs formed on or after 1 January 2006 must establish either a board of supervisors or must appoint individual supervisors (depending on the size of the FIE) in accordance with the Company Law. The interpretation stemmed from an earlier implementing opinion jointly issued by the SAIC, Ministry of Commerce (the MOFCOM), State Administration of Foreign Exchange (the SAFE) and General Administration of Customs that requires the corporate structure of the FIEs to comply with the Company Law. According to the SAIC's interpretation, all FIEs established on or after 1 January 2006 must set up boards of supervisors or appoint individual supervisors. Meanwhile, the SAIC leaves the companies with the discretion to decide whether to establish a board or to name individual supervisors, whether supervisors will be appointed or elected, the length of their term, and the scopes of their authority. A small FIE may appoint or elect one or two individual supervisors. An FIE is deemed small if the FIE has a small number of investors or small investment. The satisfaction of these requirements is evidenced by the articles of association. If the articles of an FIE do not contain any provision in relation to the board of supervisors, the SAIC may demand that the application for the establishment of the FIE be amended. The SAIC has the discretion not to register the FIE if the legal requirement of forming a board of supervisors or naming one or two supervisors is not satisfied.

6.166 The next problematic area in China's corporate governance is weak supervisory boards in listed firms.[197] The two-tier board structure in China resembles the German model, where a management board makes decisions on daily operations and an supervisory board oversees the management board and approves major business decisions. By implication, the challenge is in making supervisory boards effective and functioning. This difficulty rests on supervisory boards' lack of appointment or removal power, which starkly differs from the German system in which a board of supervisors has the statutory power to appoint or remove the members of the management board. Under the Chinese Company Law, the oversight function is delegated to the board of supervisors but the board is without meaningful powers. This again confirms the relatively stronger managerial role played by the board of directors in Chinese Company Law, and dictates the destiny the board of supervisors, as an institution, a decorative creature with no teeth.

6.167 The Code of Corporate Governance clarifies the duties and responsibilities of a supervisory board.[198] The supervisory board of a listed company shall be accountable to all shareholders. The supervisory board shall supervise the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and shall protect the company's and the shareholders' legal rights and interests. However, it only has a loosely defined monitoring role over the board of directors and managers. Given the overwhelming influence of the governmental authorities on boards of directors, the supervisory boards in China have yet to play a significant and effective governance role.[199] A 1999 survey shows that the board of supervisors in some companies had difficulty in performing their supervisory duties.[200] Supervisors have little authority in major corporate decisions, particularly when their responsibility to oversee the board of directors has been only vaguely defined in the PRC Company Law. Moreover, no law gives supervisors the right to take civil action against board directors or senior managers when company misconduct is detected, and supervisors often lack the knowledge and experience to make contributions. These difficulties make the monitoring role of an supervisory board illusionary.[201]

6.168 To strengthen the role of supervisors, Art. 61 of the PRC Corporate Governance Code states that a listed company shall adopt measures to ensure supervisors' right to learn about the company's matters and shall provide necessary assistance to supervisors for the normal performance of their duties. No one shall interfere with or obstruct the supervisors' work. The supervisory board may report directly to securities regulatory authorities as well as other related authorities, and may report to the board of directors and shareholders' meetings when the supervisory board learns of any violation of laws, regulations or the company's articles of association by directors, managers or other senior management personnel.

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[194] Company Law, Arts. 54, 55 and 119.
[195] *Ibid*, Arts. 40 and 101.
[196] *Ibid*, Arts. 41 and 102.
[197] Kang Y, Shi L and Brown ED, "Chinese Corporate Governance – History and Institutional Framework", RAND Corporation (2008).

[198] Code of Corporate Governance, Chapter 4.
[199] Tam OK, "Ethical Issues in Evolution on Corporate Governance in China" (2002) 37(3) Journal of Business Ethics at 303–320.
[200] Tenev S, Zhang CL and Brefort L, "Corporate Governance and Enterprise Reform in China – Building the Institutions of Modern Markets", World Bank and International Finance Corporation (12 October 2002).
[201] Schipani C and Liu JH, "Corporate Governance in China: Then and Now", University of Michigan Davidson Institute Working Paper Series (2001).

obstacles, long-standing legal traditions or practical deficiencies of the judiciary, is a dramatic turn away from China's civil law discourse.

7.004 Prior to the Company Law, Chinese legislature and regulators adopted the "shareholder orientated" model and the concept of "fiduciary duty" – the former lays down a formal separation between ownership and management being assigned by the owners to a board and then to a management team supervised by the directors, whilst the latter makes the management accountable to the owners. Under the old Chinese Company Law, directors, supervisors and managers were under a general duty "faithfully to perform their duties and to protect the interests of the company". This regulatory provision is close to the duty of care and duty of loyalty in American Corporation Law. Nevertheless, there are no statutory or judiciary standards in Chinese law determining whether a director is in breach of these duties. The Company Law of 2005 appears to raise the standards of conduct and competence to a higher level. The relevant provision in the Company Law reads:

> "[d]irectors, supervisory board members and high-level management personnel should abide by laws, administrative regulations and the company articles of association, and have a duty of loyalty and duty of care to the company".[6]

7.005 As such, the fiduciary duty framework for directors and the management, consisting of the duties of loyalty and care, resembles that of a common law jurisdiction. The Company Law of 2005 introduces fiduciary concepts that can be illustrated by: (i) the incorporation of a defining obligation of the fiduciary doctrine; (ii) the inclusion of various specific directors' duties under the framework of the fiduciary doctrine; and (iii) the introduction of remedies available to redress fiduciary breaches.

7.006 The formalisation of the concept of fiduciary duty is embedded in a more functional procedural context: the availability of shareholders' direct actions (against directors, supervisors and executive) and derivative action mechanisms; and the veil-piercing doctrine. The pre-formalisation period, however, already witnessed Chinese courts' bold invocation and application of fiduciary duties. The transplant (or formal convergence) of fiduciary duty into the Chinese legal system prior to the formal legislation of the concept was attributable to the lack of an equivalent concept (or substitute) of fiduciary duty in Chinese law. The closest concept serving a similar function at that time, before the corporatisation program of state-owned enterprises (SOEs), was probably ethical practice, more or less a tradition or notion of altruism either in China's bureaucratic system or kinship business associations such as township enterprises or sole proprietaries. Thus, it is not surprising to see Chinese courts apply the notion of fiduciary duty in an innovative manner even without any statutory basis from a positive law point of view.

7.007 This obligation applies to foreign-invested enterprises (FIEs) and is an important consideration for international investors and other investors conducting business in China. This duty has also been incorporated into other areas of Chinese law.

[6] Company Law, Art. 148.

For example, the China Securities Regulatory Commission (the CSRC) in March 2006 revised its Guidelines for the Articles of Association of Listed Companies, in which Art. 97 similarly introduces an obligation of loyalty for directors of PRC-listed companies.[7] The increasing prevalence of the duty of loyalty in Chinese law necessitates a closer examination of the nature of this obligation. It is important to understand the theoretical basis for this obligation and its practical significance.

7.008 The duty of care as a legal concept has not been thoroughly articulated by the Company Law nor clearly elaborated and effectively enforced by Chinese courts. It is not yet clear how regulators or judges employ a business judgment rule for duty of care inquiries. This has led to some unexpected consequences in implementing the Company Law. For example, no derivative actions in China have ever touched upon a claim involving the breach of the duty of care.[8] Without comprehending and enforcing the underlying corporate law concepts such as the duty of care, the rationale behind designing various corporate governance instruments such as derivative actions and fiduciary duties will remain unrealised.

7.009 The Company Law imposes an obligation of loyalty (together with the obligation of fidelity) on directors so that directors' statutory duties can be further clarified. However, the Chinese Company Law does not specify the exact nature and extent of this obligation of loyalty. A possible hurdle to characterising directors' duty of loyalty as fiduciary in nature is that under civil law jurisdictions, including China, directors' duties are often analysed on the basis that they are agents of their company.[9] The concept of fiduciary duties, which is a common feature of a trust institution, is still relatively new to China: it was only introduced the Trust Law roughly one decade ago.[10] The Trust Law imposes fiduciary duties upon a trustee as a result of the division of ownership between the trustee, who holds the legal title and the beneficiary, who reserves the equitable title. Under Art. 25 of the Trust Law, a trustee shall handle trust affairs in the beneficiary's best interest and shall fulfil the duties of honesty, trust, prudence, and effectiveness; the bedrocks of fiduciary duty.[11]

7.010 While the agency theory remains prevalent in Chinese law (for example in the Contract Law), this theory alone has proven insufficient in promoting directors' accountability since the interests of directors and shareholders do not always coincide. Indeed, the risk that directors may be swayed from the performance of their primary duties owed to the company may partly explain why the Chinese Company Law has also put in place a set of negative duties to prevent directors from having any conflict of interests or making any secret profits. Further, an agency theory of directors is not irreconcilable with its fiduciary nature. As it stands, directors are agents standing in a fiduciary relationship

[7] *CSRC Guidelines for the Articles of Association of Listed Companies*, Art. 97 (effective Mar. 2006).

[8] Clarke DC and Howson NC, "Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China" in Puchniak D. *et al* (eds), The Derivative Action in Asia: A Comparative and Functional Approach (Cambridge University Press, 2012).

[9] Pisto K and Cheng-Gang X. "*Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons From the Incomplete Law Theory*", in Milhaupt CJ (ed) *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (Columbia University Press, 2009) pp 77–106.

[10] PRC Trust Law.

[11] Trust Law, Art. 25 (2001).

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Company Law or the Supreme Court can explicitly involve non-initiating shareholders in the demanding process so that they are given the chance to voice their opinions.

5.2.10 *To whom a demand is served*

8.075 One uncertainty of derivative actions is to whom demand should be made when a shareholder seeks corporate action against non-insiders (or, "others"). The shareholder can make a demand to the board of directors and then the board of supervisors, and expect a response from each after 30 days. The relevant question is whether the courts will be overly engrossed in the fulfilment of this demand requirement when faced with cases involving derivative claims against "others". Either the amended law or the SPC should clarify upon whom demand must be made when the action demanded is against a non-insider. Leaving this tiny technicality untouched risks giving courts more excuses not to address derivative actions.

5.2.11 *Emergency circumstances*

8.076 The other uncertainty surrounding this demand requirement is that "the plaintiff may proceed with the suit if … the company would suffer irreparable damage if the suit could not proceed immediately". It is not clear whether the demand can be excused under this extreme circumstance which is not well defined. The above-quoted seems to support the view that the demand requirement cannot be waived but what can be waived is the waiting period. A more supportive or tolerant court may give a demand waiver.

8.077 For the sake of clarity, the exact scope of urgent or emergency circumstances should be either defined or exemplified by the legislature or the SPC (in the form of judicial interpretations) so that the uniform approach can be taken by all the courts in waiving the demand requirement or the 30-day waiting period requirement. According to the current wording in the Company Law, the determination of the existence of "irreparable damage to the interests of the company" involves judicial interpretation and evaluation, which in turn triggers judicial discretion and potential uncertainty.

5.2.12 *Directors' duty to reject*

8.078 One thing which has not been mentioned anywhere is whether a director or supervisor is under any fiduciary duty to or not to reject a demand. This involves judicial evaluation on whether a director or supervisor's refusal is in conformity with the fiduciary duty. The complexity here is that the Chinese Company Law does not incorporate the business judgment rule which otherwise may excuse the refusal and avoid any judicial interference.

5.2.13 *Why demand?*

8.079 A demand requirement and a 30-day waiting period highlight the importance of the board of directors in the exercise of corporate power. The rule re-emphasises the basic principle that the board of directors, other than shareholders, manages a company, thereby protecting the board from harassment by litigious shareholders. The demand requirement, minimum shareholdings and posting of bonds as security for the expenses of litigation are all necessary components in derivative suits in other countries.

8.080 The demand requirement seems more like a hurdle as the exhaustion of intro-corporate remedies seems irrelevant as neither the board of directors nor the board of supervisors can really stop a shareholder from bringing suit except the board itself. The side effect of these procedural hurdles is the loss of opportunity to obtain a remedy in a timely manner.[56]

5.2.14 *Functionality of derivative actions*

8.081 A shareholder derivative action is viewed as a necessary part of China's effective corporate governance system and a tool for the protection of company shareholders, especially minority shareholders. Codifying shareholder derivative actions in the Company Law is reflective of a formal shift from conventional reliance upon *ex ante* supervision by administrative agencies to a greater emphasis on judicial power and *ex post* remedies. The rules of derivative actions provide minority shareholders with the means to oust directors who injure overall company rights by favouring the majority shareholders, thereby discouraging majority shareholders from abuse controlling power. The derivative suit can prove to be a useful weapon for minority shareholders to protect their interests and deter majority shareholders' oppressive behaviour. On the other hand, minority shareholders may abuse a derivative action by initiating groundless "strike suits" for the purpose of compelling settlement offers. The procedural hurdles are codified in the Company Law in order to strike a balance between protecting minority shareholders and saving majority shareholders from "strike suits". Although derivative actions are a critical development made by the amended Company Law, it remains to be seen how Chinese courts apply the procedural requirements and whether a company can join in proceedings. The weakness of shareholders' suits has been apparent: minority shareholders need to bear the costs of a suit and have the burden of proof in the civil proceeding. This is the reason that there appear to be very few lawsuits initiated by minority shareholders but more cases where majority shareholders overrode minority shareholders' interests notwithstanding shareholder rights to sue, a board with independent directors, and the monitoring of the board of supervisors.

8.082 The SPC issued the Provisions on Several Issues Concerning the Application of the PRC Company Law (I) on 8 April 2006, the purpose of which is to clarify certain procedural issues in connection with the standing requirement for shareholders who seek to initiate derivative actions. to the clarification directs the courts to apply new rights from the Company Law of 2005 in cases involving transactions occurring before the new law came into effect.

8.083 Apart from the directors, supervisors or senior officers, shareholders are also allowed to initiate derivative actions against any other persons who encroach upon the lawful rights and interests of a company, thereby causing losses to the company.[57] This rule may be interpreted broadly to cover an outsider who does not pay a debt to the company on time and is not sued by the directors and the supervisors. This

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[56] In most legal systems, company law requires that before shareholders can sue derivatively or on their own behalf they must make an explicit written demand that the board of directors take appropriate legal action to safeguard the company and shareholders' interests. The demand can be excused if doing so would be futile.

[57] See n 51 above.

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approval from the approval authority is always a must. Neither the Company Law nor the Enterprise Bankruptcy Law, however, provides for any practical guidance in this regard.

9.067 As an alternative to the liquidation of a JV entity upon termination, one party may have the right to buy out the other party at a fair market value in order to keep the business intact. If the parties cannot agree on who should succeed the business of the JV in such a buyout, a compromising approach should be considered and documented so that liquidation or succession issues are not left unresolved until the termination of the JV. The parties to the FIE are entitled to repurchase the assets on liquidation. Upon liquidation, the assets of the JV are distributed to the parties in proportion to their equity contribution. The parties may wish to consider the appropriate distribution of assets upon dissolution of the JV (without a buyout as described above), and the inclusion of a provision providing for the allocation of certain specified assets to one party.

4.3 Liquidation

9.068 Termination is followed by liquidation and dissolution of a JV.

9.069 Liquidation is a process whereby an enterprise collects any outstanding debts owed and then settles any outstanding creditor claims out of working capital and/or through realisation of its available assets. Liquidation needs a unanimous resolution of the board and approval of the original approval authority.[63] The requirement for a unanimous vote of the board in favour of a proceeding to liquidation may easily result in a deadlock and conflict between the parties to the JV, while the approval authority may also refuse to grant its consent to liquidation.

9.070 While investors may avoid the unanimous consent requirement by filing a unilateral application to the approval authority in cases of serious breach,[64] it appears impossible to bypass the need for approval from the approval authority to liquidate a JV. The JV parties, supposedly holding more than 10 per cent or more of the total voting rights in the company, may have to rely upon the Company Law to petition the court for dissolution of the company.[65] However, the court is likely to consult with the approval authority before making such a ruling.

9.071 Liquidation can be standard or special.[66]

9.072 In a standard liquidation, the board unanimously appoints a liquidation committee and this committee follows the regulatory procedures and the JV's articles of association to liquidate the JV. A creditors' meeting is not required. By contrast, a special liquidation applies in cases where the board of a JV cannot reach a consensus on the dissolution or composition of a liquidation committee, or the JV encounters serious difficulties during the normal liquidation process. In such

[63] For example, CJV Law Implementing Rules, Art. 29(3); EJV Law Implementing Rules, Art. 33(2).
[64] CJV Law Implementing Rules, Art. 48(3); EJV Law Implementing Rules, Art. 90(3).
[65] Company Law, Arts. 181(5) and 183.
[66] The FIE Liquidation Procedures, Art. 3.

cases, the liquidation can be triggered by an application to the original approval authority.

9.073 The difference between the standard and special liquidation is that the liquidation procedure is no longer in the hands of the JV parties in a special liquidation. Instead, the approval authority will organise a liquidation committee consisting of shareholders, representatives of relevant government departments and relevant professionals[67] to exercise the powers of the board,[68] to report directly to the approval authority, to appoint the head of the liquidation committee to take over the functions of the legal representative[69] and to confirm the liquidation committee's liquidation plan and report.[70] In addition, a creditors' meeting will be called. Alternatively, the liquidation committee may discuss details of the liquidation with the FIE's board of directors.[71]

9.074 Upon liquidation, the JV is to complete dissolution by filing the liquidation report with the approval authority. The JV ceases to exist, however, only after the completion of the de-registration of the JV with the tax, customs and company registration authorities, and a public announcement of de-registration in a national and local newspaper. As termination, liquidation and dissolution can be expensive and time-consuming, the parties to a JV will usually prefer a buyout instead.

4.4 Dissolution

9.075 Dissolution is the final stage in the process whereby an FIE's business license is submitted to and cancelled by the SAIC. Dissolution takes place only after the liquidation stage is completed and prior clearance is obtained from the tax authority. Once the FIE is dissolved, the FIE ceases to exist and is no longer a legal person under Chinese law.

9.076 Under the Company Law, either the FIE or the domestic capital company may be dissolved on the following grounds:[72]

1. upon expiry of the term, or any other dissolution events, as stipulated in the articles of association;
2. the shareholders' general meeting or shareholders' meeting has resolved in favour of dissolution. This, however, conflicts with the FIE Laws under which the board of directors is the highest governing body;
3. the enterprise needs to be dissolved following a merger or split;
4. the enterprise's business license has been revoked, or has been annulled, or it has been ordered to close down in accordance with law; or

[67] The FIE Liquidation Procedures, Art. 36.
[68] *Ibid*, Art. 37.
[69] *Ibid*.
[70] *Ibid*, Art. 42.
[71] *Ibid*, Art. 38.
[72] Company Law, Art. 181.

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(a) equity transfer price: generally, the price for a transfer of state-owned equity interests shall be paid in a lump sum. If the equity transfer price is paid on a lump sum basis, the total amount of such equity transfer price shall be paid to the account of the Exchange Center first. However, if the transferee has difficulties in paying the equity transfer price in a lump sum given the large amount, the equity transfer price may be paid in instalments. In this case, the first instalment shall be no less than 30 per cent of the whole price which shall be paid to the account of the Exchange Center first. For the remaining price, the transferee shall provide guarantee to the transferor and directly pay to the transferor within one year. All the payment paid to the Exchange Center's account will be transferred to the specific foreign exchange account of the Chinese Party after the business license reflecting the proposed equity transfer is obtained. It is advisable to pay the equity transfer price in a lump sum in order to make the payment procedure more straightforward and simple; and

(b) service fee payable to the brokers and the Exchange Center: the service fee is decided based on the amount of equity transfer price, roughly at 2 to 2.5 per cent of the equity transfer price. Assuming the equity transfer price is RMB24 million, the transferor and transferee shall respectively pay the Exchange Center approximately RMB510,000 as the service fee. Normally, the service fee will be paid to the Exchange Center first, and then the Exchange Center will internally allocate a part of the service fee (roughly, 80 per cent) to each broker.

6. If the foreign investor pays the equity transfer price by using the funds in US dollars rather than using its Renminbi proceeds earned in China, the Chinese Party shall apply to the State Administration of Foreign Exchange (the SAFE) for opening a specific foreign exchange account for the purpose of receiving the equity transfer price after it obtains the approval. However, if the foreign investor plans to pay the equity transfer price by using its Renminbi proceeds earned in China, there is no need for the Chinese Party to open the specific foreign exchange account, but the Foreign Investor shall obtain approval from the SAFE for the use of such Renminbi proceeds.

4. Acquisition of Listed Companies

10.051 Acquisition of shares in a listed company is largely governed by the Securities Law rather than the Company Law.

10.052 Acquisition of listed companies can be conducted through the purchase of shares in a target company on the stock exchange or via the purchase of shares by private agreements.[64] A shareholder should report to the China Securities Regulatory Commission (the CSRC) and the stock exchange and notify the listed company within three days if his or her shareholding is more than 5 per cent.[65] Such a shareholder is not

[64] Securities Law, Art. 85.
[65] *Ibid*, Art. 86.

allowed to trade shares during the reporting and notification period. He or she is under a continuous legal obligation to report and issue a public notice for every 5 per cent fluctuation of his or her shareholding.

10.053 A compulsory public offering is triggered when a shareholder, either through a public acquisition on the stock exchange or a private agreement, holds more than 30 per cent of shares in the target company. To purchase more than 30 per cent of shares requires the shareholder to submit an acquisition report to the CSRC and to make an acquisition offer to the general public.[66] The period of public offering is between 30 and 60 days.[67] The offer cannot be withdrawn. After the completion of the acquisition, the shareholder is prohibited from trading his or her shares within 12 months.[68]

10.054 The CSRC's Provisions on the Administration of the Acquisition of Listed Companies cover topics including the CSRC's role and enforcement powers, shareholder protection, directors, supervisors and senior managers' duty of loyalty and diligence, information disclosure, public offering and exemption procedures.

5. Consents and Approvals

10.055 A merger or acquisition in the PRC will require some form of approvals, registrations, permits, consents, recordals or filings in relation to the investor qualification, business name reservation or change, asset valuation, industry regulation, technology transfer or licensing, intellectual property transfer, environment protection, real estate acquisition and construction.

10.056 The FIE approval procedure is relevant to most M&As involving FIEs. For instance, approval from the approval authority of an FIE target is necessary for an equity or asset transfer, new capital contributions, an increase in registered capital, an increase in total amount of investment and amendments to the JV contract, as well as to the articles of association.

10.057 Industry-specific authorities such as the China Banking Regulatory Commission (the CBRC) and CSRC will become the primary approval authorities for foreign investment in banks and listing companies. The precise approval authority and its level for a given project, company or transaction are dependent on various factors, which have to be considered thoroughly in advance.

5.1 Approval Process for Direct Acquisitions

5.1.1 *Approval authority*

10.058 Under the current PRC law, similar to the formation of a new FIE, transactions involving the conversion of a domestic LLC such as an SOE into an FIE via a direct equity transfer or the transfer of the registered capital or the acquisition of the

[66] Securities Law, Art. 88.
[67] *Ibid*, Art. 90.
[68] *Ibid*, Art. 98.

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effective coordination mechanism among these authorities. A local government may also be involved in share issuance and trading if a listed company is transformed from an SOE. The very existence of multiple regulators does not necessarily improve the regulatory regime. Rather, it may increase the transactional costs and harm efficiency of the securities market as different authorities may have different policy concerns, regulatory focus, legislative agendas and monitoring tools.

2.2.1 *China Securities Regulatory Commission (CSRC)*

11.043 The Securities Law expressly confirms the CSRC's status of a centralised independent governing body for public companies. The functions of the CSRC include:

(1) formulating laws and regulations in relation to the securities industry and exercise of the approval powers under the laws and regulations;

(2) supervising and administering the issuance, trading, registration, custody and settlement of securities;

(3) supervising and administering participants in the industry including securities issuers, listed companies, securities exchanges, securities companies, securities registration and settlement institutions, securities investment funds management organisations, securities investment consultancy institutions, securities depository and clearing institutions, securities service institutions,[61] credit rating institutions, and professionals;

(4) formulating qualifications and codes of conduct for securities professionals;

(5) supervising the proper disclosure of information on securities issuance and transactions;

(6) supervising the conduct of the Securities Trade Association; and

(7) investigating any conduct that violates laws or administrative regulations.

11.044 It is clear that the CSRC has the dual power of overseeing and managing the securities market and of standardising existing law and regulations on a uniform and centralised basis. This centralisation movement suggests that local and municipal governments have been removed from the law-making or IPO approval and selection process. A shortcoming in this list is that the laws do not officially provide the CSRC with specific powers to regulate the internal control or governance of listed companies. Although the CSRC must enforce rules regarding disclosure and regulate the investment quality of public issuers, the CSRC has limited resources to enforce the law.

11.045 The 2005 Securities Law assigns the following regulatory functions to the CSRC:

- recognition and confirmation: allowing the definition of important information having a significant effect on securities prices outside Art. 75(iii) to be recognised and confirmed;

[61] Securities Law 2005, Arts. 122, 155, 169 and 179.

- formulation: formulating different norms or specific measures for instruction of audits or asset appraisal of securities companies;[62] or administrative measures for the examination and approval of securities industry service firms;[63]

- regulation, or stipulation of regulation: "issuers must conform to conditions for debt issuances stipulated in law",[64] "people engaged in administration of securities issuance, or trading",[65] and "conditions and procedures for review of securities firm establishments"; and[66]

- stipulation of law: e.g. "alluding to other situations regarding the handling of customer securities accounts".[67]

11.046 It has to be pointed out that, in terms of its rule-making power, the CSRC is explicitly charged with formulating norms subordinate to laws, legislative provisions, laws and administrative regulations, administrative measures, specific measures, public standards or qualifications "publicly" in accordance with the law.[68]

11.047 The CSRC is clearly required to "formulate departmental rules and its supervisory administration work system publicly".[69]

11.048 The CSRC often enacted *ex ante* bright-line rules, standards and prohibitions focusing voting mechanisms, transactional rights or disfavoured transactions. For example, the CSRC passed the Several Provisions on Protection of the Rights of Public Shareholders in 2004 and the Notice on Several Issues Concerning the Standardization of Funds Transfers Between Listed Companies and Their Affiliates and the Provision of Guarantees by Listed Companies in 2003, both of which regulated guarantees for affiliates and required disinterested "public" shareholder approval of related-party transactions.

11.049 The CSRC is granted broad investigatory powers and take the following actions:

(1) entering premises where illegal acts have been committed to investigate and to obtain evidence;

(2) questioning people and entities suspected of illegal acts and requiring them to make statements;

(3) checking and duplicating records of securities transactions, financial accounts and other relevant documents and sealing and retaining documents and materials that may be removed or concealed; and

(4) checking funds accounts and securities accounts of people suspected of illegal acts and applying to judicial institutions to freeze or to grant

[62] Securities Law 2005, Art. 149.
[63] *Ibid*, Art. 169.
[64] *Ibid*, Art. 57.
[65] *Ibid*, Art. 74.
[66] *Ibid*, Art. 128.
[67] *Ibid*, Art. 139.
[68] *Ibid*, Arts. 179(i), 179(iv) and 184.
[69] *Ibid*, Art. 184.

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