Yuanshi Bu (Ed.)
Chinese Business Law
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Edited by

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Preface and Acknowledgments

Thanks to its nature as an emerging major jurisdiction, Chinese law sparks great interest among foreign readers. For practitioners, it is important to keep track of new legal developments which may give rise to practical questions to comply with in the course of conducting business activities in China. For academics, it is intriguing to observe the maturing process of a hybrid legal regime which has been built by adopting models and experiences from other nations, inter alia the United States and European countries, in particular Germany.

At the same time, dealing with Chinese law is accompanied with difficulties caused by the peculiarities of the Chinese legal regime. First, the law in China is evolving dynamically, to certain extent even with volatility in areas such as outbound investment and securities. In this constantly changing legal environment it is difficult to capture the latest development even with best efforts, let alone to give reliable predictions. Second, Chinese lawmakers’ inclination to pragmatic approach and successive legal reform makes Chinese law less systemized and consistent. Its administrative and judicial practice often lacks the necessary transparency and predictability. Consequently, foreign readers frequently have to manoeuvre themselves through considerable ambiguities and uncertainty in the handling with Chinese law. Third, the economic and political context in which Chinese law is operating differs significantly from Western countries. To understand Chinese law, it is indispensable to be aware of the transitional nature of the Chinese economy and its various socialist legacies. Chinese business law is still characterized by a high density of government regulation, in particular where foreign investors are concerned, albeit market participants are increasingly gaining more economic autonomy. The reform of SOEs remains a prevailing concern of the Chinese government in regulating the economy, which partly determines the direction of enforcement of newly created legal tools such as the Bankruptcy Law and the Anti-monopoly Law. The Chinese securities regulator seems to treat the maintenance of index stability to be a major task of stock market regulation and acts according to this rationale. Last but not least, although foreign observers may often recall comparable provisions in their own legal system while studying Chinese law, it is a great linguistic challenge to translate Chinese legal terminology and doctrines that are often borrowed from other nations into a language accessible to readers of various jurisdictions, each of which share only a fraction of common features with the Chinese legal system.

Bearing this in mind, this book is designed to address aspects of Chinese law with a focus on business transactions from a comparative perspective. Most authors are trained both in China and other jurisdictions and advising foreign clients in their daily work. Being very well aware of these peculiarities, they are apt to illustrate Chinese law with a view to giving practical guidance to their readers.

Each chapter follows the same concept and consists of two sections. The first section gives an overview over the historical evolution or general assessment of a specific field of law, while the second one analyzes the main issues in depth and addresses questions raised in academic discussions or by practitioners, occasionally...
also touching upon cutting edge questions. In areas such as anti-monopoly and bankruptcy law where the legal framework is still in its infancy or where doctrine questions dominate the relevant discussion such as with secured transactions, the authors put more weight on scholarly analysis. In areas like M&A and outbound investment where academic reasoning only plays a limited role, the authors have chosen to approach controversial issues pragmatically by drawing on their own practical experience. As far as available, decisions of Chinese courts and the latest scholarly research findings are also considered. A brief summary of the respective field of law is included at the end of some chapters to highlight the major concerns again.

This book primarily aims to provide an updated, concise and detailed guidance of Chinese business law both to practitioners and academics. It begins with a chapter on China’s accession to WTO, which constitutes the driving force behind the changes of the Chinese legal landscape in recent years, and ends with two chapters on outbound investment and offshore investment vehicles to accommodate foreign readers’ interests in advising Chinese investors on their endeavours abroad. The major part covers a broad range of legal fields that are essential for doing business in China, including corporations, foreign investment, securities, M&A, anti-monopoly, secured transactions, bankruptcy, IP, and labor and labor dispute law. Although not each of them attracts the same amount of attention outside China, they all have experienced substantial changes recently, resulting in a direct impact on the overall environment for business operations in China.

This book does not contain full-text English translations of Chinese regulations as these are available either from public sources or from various commercial databases. A list of relevant PRC statutes, implementing rules and judicial interpretations are provided at the end of each chapter to enable a quick check. The original Chinese legal terminology is included in places where subtle differences exist as to their counterparts in English language.

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1997 Notice ................................. Supplementary Notice on Relevant Issues concerning the Pilot Implementation in Some Cities of the Merger and Bankruptcy of SOEs and the Reemployment of Workers
2001 Emergency Notice ........... Emergency Notice on Preventing Debtors from Debt Evasion in Bankruptcy Trials
2004 MOFCOM Rules ............. Provisions on the Approval of Investing in or Establishing Overseas Enterprises
2009 FX Provisions ................... Provisions on the Administration of Foreign Exchange for Outbound Direct Investment by Domestic Entities
ABS ............................................... Asset-Backed Securitization
Administration Measures of Foreign Securities .................................. Administrative Measures for the Provision of Foreign Securities by Domestic Institutions
ADR .............................................. American Depository Receipt
AIC ............................................... Administration of Industry and Commerce
AML .............................................. Anti-Monopoly Law
Appointment Rules ....................... Provisions on Appointing the Administrator in the Trial of Enterprise Bankruptcy Cases
ASG ............................................... WTO Agreement on Safeguards
Auto Policy ................................. Automotive Industry Development Policy
Bankruptcy Law ......................... Enterprise Bankruptcy Law
BTS ................................................ Block Trading System
CBRC ............................................ China Banking Regulatory Commission
CCP ............................................... Chinese Communist Party CCP or Central Counter Party
CEPA ............................................ Closer Economic Partnership Arrangement
CFFEX .......................................... China Financial Futures Exchange
CIC ................................................ China Investment Corporation
CIETAC ....................................... China International Economic and Trade Arbitration Commission
CIF ................................................ Cost, Insurance and Freight
CIRC ............................................. China Insurance Regulatory Commission
Circular 20 [2004] ..................... Decision on Reforming the Investment System
Circular 75 [2005] ..................... Circular of Relevant Issues on Fund Raising and Round-Trip Investment by Domestic Residents through Overseas SPVs
CJV ............................................... Contractual Joint Venture
CNNIC ......................................... China Internet Network Information Center
COA .............................................. Certificate of Approval
COFTEC ...................................... Commission of Foreign Trade and Economic Cooperation (local branch of MOFCOM and sometimes referred to as COFCOM)
Concentration Reporting Opinions ................................. Guiding Opinions on Reporting of Concentrations of Undertakings
Contract Law Interpretation .................................. Interpretation of the SPC on Certain Issues concerning the Application of the Contract Law of the PRC
CSDCC ........................................... China Securities Depository and Clearing Corporation Limited
CSRC ............................................ China Securities Regulatory Commission
Draft Concentration Reporting Measures .................................. Draft Interim Measures for Reporting of Concentrations of Undertakings
Draft Concentration Review Measures .................................. Draft Interim Measures for Review of Concentrations of Undertakings
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<tr>
<td>DTCC</td>
<td>Depository Trust and Clearing Corporation</td>
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<td>EC</td>
<td>European Community</td>
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<td>EIT</td>
<td>Enterprise Income Tax</td>
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<td>EJV</td>
<td>Equity Joint Venture</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>Foreign Funded Investment Company</td>
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<td>Foreign-invested Company Limited by Shares</td>
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<td>GAC</td>
<td>General Administration of Customs (China Customs)</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>GATT</td>
<td>European Union</td>
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<td>Growth Enterprise Market</td>
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<td>GI</td>
<td>Geographic Indication</td>
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<td>GPA</td>
<td>WTO Government Procurement Agreement</td>
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<td>General Principles of Civil Law</td>
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<td>HK</td>
<td>Hong Kong</td>
</tr>
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<td>HKIA</td>
<td>Hong Kong International Arbitration Center</td>
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<td>Central Huijin Investment Ltd.</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>Industry Catalogue</td>
<td>Industrial Catalogue for Foreign Investment</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commission</td>
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<td>IP</td>
<td>Intellectual Property</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<td>Intellectual Property Rights</td>
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<td>JSLC</td>
<td>Joint Stock Limited Company</td>
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<td>LAC</td>
<td>Legislative Affairs Committee (of the SCNPC)</td>
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<td>LAO</td>
<td>Legislative Affairs Office (of the State Council)</td>
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<td>L.c.</td>
<td>In the place cited</td>
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<td>LC</td>
<td>Listed Company</td>
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<td>LLC</td>
<td>Limited Liability Companies</td>
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<td>M&amp;A</td>
<td>Mergers and Acquisitions</td>
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<td>M&amp;A Regulations</td>
<td>Regulations on Acquisition of Domestic Enterprise by Foreign Investors</td>
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<tr>
<td>MFN</td>
<td>Most Favored Nation</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>Ministry of Commerce</td>
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<td>MOFTEC</td>
<td>Ministry of Foreign Trade and Economic Cooperation (currently merged into MOFCOM)</td>
</tr>
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<td>MOJ</td>
<td>Ministry of Justice</td>
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<td>MOLSS</td>
<td>Ministry of Labor and Social Security</td>
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### Abbreviations

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<td>Ministry of Science and Technology</td>
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<tr>
<td>MOU</td>
<td>Memorandums of Understanding</td>
</tr>
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<td>NCA</td>
<td>National Copyright Administration</td>
</tr>
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<td>NCSSSF</td>
<td>National Council for Social Security Fund</td>
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<td>NDRC</td>
<td>National Development and Reform Commission</td>
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<td>NDRC 2009 Circular</td>
<td>Circular on Relevant Issues in Improving Outbound Investment Project Administration</td>
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<td>NDRC Rules</td>
<td>Interim Administrative Measures on Approval of Outbound Investment Projects</td>
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<td>NET</td>
<td>National Electronic Trading System</td>
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<td>NPC</td>
<td>National People's Congress</td>
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<td>NPO</td>
<td>Non-Profit Organization</td>
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<td>NSSF</td>
<td>National Social Security Fund</td>
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<td>NSSF Outbound Investment Rules</td>
<td>Interim Rules on the Administration of Outbound Investment by the National Social Security Fund</td>
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<td>NSSF Rules</td>
<td>Interim Measures on the Administration of Investment of the National Social Security Fund</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OEM</td>
<td>Original Equipment Manufacturer</td>
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<td>Old Bankruptcy Law</td>
<td>Enterprise Bankruptcy Law (for Trial Implementation) of 1986</td>
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<td>Rules for Foreign Exchange Administration on Outbound Investment</td>
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<td>Old MOFCOM Rules</td>
<td>MOFCOM HK/Macao Rules and 2004 MOFCOM Rules</td>
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<td>OTC</td>
<td>Over-the-Counter</td>
</tr>
<tr>
<td>PBOC</td>
<td>People’s Bank of China</td>
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<tr>
<td>PF</td>
<td>Permanent Establishment</td>
</tr>
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<td>POWL</td>
<td>Public Offer without Listing</td>
</tr>
<tr>
<td>PRAB</td>
<td>Patent Review and Adjudication Board</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>Protocol</td>
<td>Protocol on the Accession of the People’s Republic of China to the WTO</td>
</tr>
<tr>
<td>QDII</td>
<td>Qualified Domestic Institutional Investor</td>
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<td>QFII</td>
<td>Qualified Foreign Institutional Investor</td>
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<td>QFII Investment Measures</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<td>Remuneration Rules</td>
<td>Provisions on Determining the Administrator’s Remuneration in the Trial of Enterprise Bankruptcy Cases</td>
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<td>Rep Office</td>
<td>Representative Office</td>
</tr>
<tr>
<td>RMB</td>
<td>Renminbi</td>
</tr>
<tr>
<td>SAC</td>
<td>Securities Association of China</td>
</tr>
<tr>
<td>SAFE</td>
<td>State Administration of Foreign Exchange</td>
</tr>
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<td>SAIC</td>
<td>State Administration of Industry and Commerce</td>
</tr>
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<td>SASAC</td>
<td>State Asset Supervision and Administration Commission</td>
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<td>SASAC Interim Measures</td>
<td>Interim Measures for the Supervision and Administration of Investment by Central Enterprises</td>
</tr>
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<td>SAT</td>
<td>State Administration of Taxation</td>
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<td>SCNPC</td>
<td>Standing Committee of the National People’s Congress</td>
</tr>
<tr>
<td>SCSC</td>
<td>State Council Securities Committee</td>
</tr>
<tr>
<td>SDRG</td>
<td>State Development and Reform Commission (formerly the State Development Planning Commission)</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
</tr>
<tr>
<td>SIPP</td>
<td>Securities Investor Protection Fund</td>
</tr>
<tr>
<td>SIPO</td>
<td>State Intellectual Property Office</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprise</td>
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<tr>
<td>SMEB</td>
<td>Small and Medium Enterprises Board</td>
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<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>SOE</td>
<td>State-owned Enterprise</td>
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<tr>
<td>SPC</td>
<td>Supreme People’s Court (of the PRC)</td>
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<td>SPC Draft Provisions of 2003</td>
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<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
<tr>
<td>SSE</td>
<td>Shanghai Stock Exchange</td>
</tr>
<tr>
<td>SSNIP</td>
<td>Small but Significant Non-transitory Increase in Price</td>
</tr>
<tr>
<td>ST</td>
<td>Special Treatment</td>
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<td>STAQ</td>
<td>Securities Trading Automatic Quoting System</td>
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<td>State Council Opinions</td>
<td>Opinions of the State Council on Promoting the Reform, Opening-up and Steady Growth of Capital Markets</td>
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<td>STS</td>
<td>Share Transfer System</td>
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<td>Shenzhen Stock Exchange</td>
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<td>Trademark Bureau</td>
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<td>TPSS</td>
<td>Transitional Product-Specific Safeguards</td>
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<td>Agreement on Trade-Related Investment Measures</td>
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<td>TRIPS</td>
<td>Agreement on Trade-Related Aspects of Intellectual Property Rights</td>
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<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
</tr>
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<td>U.S.</td>
<td>United States</td>
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<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>VAT</td>
<td>Value-added Tax</td>
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<tr>
<td>WFOE</td>
<td>Wholly Foreign-owned Enterprise</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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Chapter 1. China’s Accession to WTO

I. Overview

After 15 years of comprehensive negotiations, China formally became a member of the WTO on December 11, 2001. The Chinese government considered accession to the WTO a unique opportunity for the Chinese economy to be integrated into the world’s economy; it is, moreover, a lever to accelerate and deepen economic and legal reforms inside China. China’s accession to the WTO afforded almost all other WTO members the possibility to access to a huge market of more than 1.3 billion people, accounting for almost 20% of potential consumers worldwide. For the WTO itself, China’s accession brought about plenty of implications and risks, putting at stake its own capability to successfully cope with the accession of such a giant. Despite its success, the lengthy process of accession to the WTO was neither easy nor smooth. Negotiations were hindered by the very nature of China being both a developing and a developed country. Whereas the Chinese government continuously stressed China’s status as a developing country during negotiations, Western countries viewed China as an economic powerhouse and feared that its accession could severely harm their own economies. This led China finally to accept an unprecedented number of conditions and commitments in exchange for full admission to the WTO in 2001. The Protocol on the Accession of the People’s Republic of China to the WTO (hereinafter: Protocol) includes a large number of obligations for China concerning many aspects of its economy and trade to be reached over a transitional period of 5 years. All these commitments aimed to ensure that China acts as an actual free market economy, clearly aligning itself with the basic principles of the international trading system, and to provide the other WTO members with a transitory protection from any negative consequences arising out of China’s entrance to the WTO. There-

1 China was one of the 23 founding members of the General Agreement on Tariffs and Trade (GATT) and became a party to it on 21 May 1948. However, the Kuomintang Government withdrew membership in 1950. The validity of this action was challenged by the mainland Communist Government, yet this dispute was left unresolved. In 1982, the People’s Republic of China (PRC) was granted observer status in GATT, and in June 1986 the PRC’s government applied for resumption of its GATT membership. Nevertheless, different political and economic factors prolonged the process of accession. See Ma, 190–191; Halverson, 323–326.

2 Halverson, 333 et seq.

3 Crosby, 76.

4 Kerr/Hobbs, 3 et seq.

5 Halverson, 320 et seq.

6 These concessions are considered by some authors to be “sound policies that China would be wise to adopt even without WTO membership” (Clarke, 97).

7 These principles are: 1) Reduction of barriers to trade; 2) Non-discrimination between nations and between domestic and non-domestic producers of goods and providers of services; 3) The rule...
fore, parallel to its general obligation to comply with the WTO agreement as a whole, China particularly commits itself, inter alia:
1) To ensure a uniform administration of the legal and administrative regime, including the quest for transparency and judicial review.
2) To fully ensure to all enterprises in China the right to trade, that is, the right to import and export goods, and to levy taxes and charges on them in conformity with the General Agreement on Tariffs and Trade of 1994.
3) To liberalize those service sectors covered by the General Agreement on Trade in Services (hereinafter: GATS).
4) To stringently control or eliminate subsidies in accordance with the Agreement on Subsidies and Countervailing Measures.
5) To accept its treatment as a non-market economy in anti-dumping cases.
6) Notwithstanding the ruling of the WTO Safeguards Agreement, to accept the right of other WTO members to apply – until 2013 – Transitional Product-Specific Safeguards (TPSS) as regards Chinese goods in certain broadly defined cases.
7) To comply with several obligations included in the Protocol as to agricultural products, mainly in relation to the elimination of quotas and export subsidies. Besides that, the Protocol also embodies rules concerning State trading, prohibition of non-tariff measures, technical barriers to trade, import and export licensing, price controls, or sanitary and phytosanitary measures.

The large number of commitments embodied in the Protocol promptly created some concerns about China’s ability to comply with all of these. Now, after a transitional period and after China’s having shown its economic strength by turning into the world’s third largest economy, the question seems to be a rather different one. At present, it needs to be ascertained whether China is really willing to fully fulfil its WTO obligations or, whether, on the contrary, it is about to take an increasingly protective stance favoring “economic nationalism” by a selective adaptation of its WTO obligations and commitments. However, only 7 years have passed since China joined the WTO and its involvement in this institution is considered to be “still in its infancy.” This chapter will address some of the most relevant commitments accepted by China in the Protocol, analyzing their current degree of fulfillment and the difficulties existing so far to accomplish them. Thus it will focus on (1) the legal and institutional arrangements after WTO accession, with
regard to the establishment of the “rule of law” in China, (2) the acceptance of the right to trade, (3) the liberalization of the trade in services and (4) two additional issues not specifically governed by the Protocol: public procurement and environmental issues. It is worth noting that China’s accession to the WTO has lead to a number of formal complaints being brought against it. The WTO’s Dispute Settlement Body has examined, inter alia, China’s policies on imported automotive parts (supra Chapter 3 at 20), counterfeiting, and the import and distribution of foreign publications, films and music.

II. Main Issues

1. Legal System

The accession to the WTO includes a general obligation for China to render its legal system compatible with the WTO agreement. According to article XVI, para. 4 of the Agreement Establishing the World Trade Organization, China – like any other WTO member state – must “ensure the conformity of its laws, regulations and administrative procedures” with its WTO obligations. Although some controversies still exist as to the direct effect of international law obligations in China or, conversely, as to the necessity for these to be stated in a domestic statute to be fully effective in China, Chinese government made efforts to identify, reform or repeal all laws and regulations inconsistent with China’s WTO duties and to enact new regulations designed to fully implement China’s WTO obligations and commitments before its full accession to the WTO, thus bringing legal modernity to China.

Besides this general requirement, there are three specific demands made to China by the Protocol in relation to its legal system: first, the quest for transparency; second, the necessity of uniform, impartial and reasonable application of law and; third, the assurance of prompt judicial review. All three aim at implementing the rule of law in China, making its legal system more predictable and fair for foreign economic actors. Certainly, Western lawyers may consider these three obligations the very basis of any Western legal system and, therefore easily attainable in practice. Nevertheless, their accomplishment in China is far from easy. Besides the

21 A general overview of what “rule of law” means in Western countries and China, and a critical approach to the possibilities of implementing the “rule of law” in China may be found in Wang Jiangyu, 349 et seq.; Killion (2007–2008), 566 et seq.
26 Li, 104. Some controversies exist about the capability of Asian countries to truly implement the legal concepts and principles that underlie the whole WTO system. These principles – rule of law, transparency, uniform application of law – are deemed to be contrary to those countries’ historical background. See Biukovic, 809.
27 Clarke, 100–104; Cao, 379–381.
28 Clarke, 104–105.
29 Blazey/Govind, 49.
weight that Confucianism still carries in Chinese mentality, the effects of the Cultural Revolution during which schools of law were closed down and neither lawyers, nor judges, nor courts existed for several years are still felt in China’s legal arena. In fact, it was only in the late 1970s that this situation began to change and significant progress was made to construct a legal framework for China’s socialist market economy.

**a) Transparency**

Transparency is a key principle of the WTO system. The Protocol sets out certain clear obligations as to this issue:

First, China accepts to enforce only those “laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of foreign exchange that are published and readily available to other WTO Members, individuals and enterprises”. Besides that, China is obliged to make available to WTO Members upon request and translated into one or more of the official languages of the WTO, all laws, regulations and other measures pertaining to or affecting those matters already mentioned before such measures are implemented or enforced, in no event later than 90 days after their implementation or enforcement.

Second, China shall specify an official journal dedicated to the publication of all these laws, regulations and other measures providing, subject to certain exceptions, a reasonable period for comment to the appropriate authorities before such measures are implemented. China is compelled as well to establish an enquiry point where, “upon request of any individual, enterprise or WTO Member” all legal information relating to the measures required to be published under para. 2(C)1 of the Protocol may be easily and rapidly obtained “within 30 days after receipt of a request.”

Transparency is considered a basic tool to ensure the effective and fair functioning of the WTO system as to commercial relations with China. Although China has taken some impressive steps to improve transparency leading to achieve “an all time high” in this field, certain problems still exist. In fact, it is broadly accepted that “some aspects of China’s trade policy regime remain complex and opaque.” The Chinese legal regime is certainly very complex. Laws, regulations and measures related to WTO matters share a large number of potential sources, which makes them often unavailable to the public. Having all of these rules and regulations both translated and published into a single official journal is, therefore, absolutely

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31 Spence, 161.
32 To this respect, see Wang Jiafu, 297 et seq.
33 See as to its meaning, Biukovic, 806–807.
34 Agreement on Trade-Related Aspects of Intellectual Property Rights.
35 Art. 2 clause(C) no. 1.
37 Art. 2 clause(C) no. 1 in fine.
39 This journal must be published on a regular basis and made available to individuals and enterprises (Art. 2 clause(C) no. 2).
40 Art. 2 clause(C) no. 3.
41 Blazey/Govind, 51.
essential for those willing to trade with or invest in China.\textsuperscript{44} Today, difficulties still exist when it comes to the functioning of this system\textsuperscript{45} and some doubts remain as to whether all types of trade related measures and laws are being published.\textsuperscript{46} In addition, the provision of notice or reasonable opportunity for public comment foreseen in the Protocol was either not implemented in practice or the period for comment provided was too short.\textsuperscript{47}

\textbf{b) Uniform Application of Law}

9 China committed itself to apply and administer “in a uniform, impartial and reasonable manner all its laws, regulations and other measures” relating to the WTO.\textsuperscript{48} This obligation refers to all levels of government bodies: central, regional or local governments. China also agreed to establish a mechanism to bring forward cases of non-uniform application of the trade regime.\textsuperscript{49} This uniform application has been gravely affected by the highly complex legal and political reality of China, a country in which overlaps in competence of authorities are commonplace and in which central government in a number of areas and sectors still struggles to fully implement its decisions.\textsuperscript{50} Concerns as to this issue have already been raised by member states during the negotiation process\textsuperscript{51}, and although coordination between the central government and local authorities has improved in recent years, it is still unsatisfactory, hence affecting uniform application of laws across the country.\textsuperscript{52}

\textbf{c) Judicial Review}

10 China agreed to establish and maintain “tribunals, contact points and procedures”\textsuperscript{53} for the prompt, independent and impartial review of all administrative actions relating to trade law.\textsuperscript{54} China’s ability to comply with this WTO requirement has been affected – since the very moment of its accession – by several facts deeply embedded in China’s internal struggles, including lack of preparation of judges, widespread corruption or local protectionism, control of courts and prosecutors by the Chinese Communist Party – real separation of powers does not exist in China currently,\textsuperscript{55} or the existence of a social and economic culture based on relationship networks (guanxi).\textsuperscript{56} All these elements do not only impede attempts to

\textsuperscript{44} But this was only accomplished in 2006, 5 years after accession: “China Foreign Trade and Economic Cooperation Gazzette”, published on a regular basis by the Ministry of Commerce of the People’s Republic of China (MOFCOM), available at http://english.mofcom.gov.cn/static/column/policyrelease/gazette.html/1.
\textsuperscript{45} See for instance, Biukovic, 821–823.
\textsuperscript{46} See 2008 USTR Report, 95.
\textsuperscript{47} Hom, 21.
\textsuperscript{48} Art. 2 clause (A) no. 2 Protocol.
\textsuperscript{49} Art. 2 clause (A) no. 4 Protocol.
\textsuperscript{50} This fact has a direct influence on the level of compliance of WTO obligations by China. See Clarke, 116–117.
\textsuperscript{52} China’s Trade Policy Review, 29, marginal number 21.
\textsuperscript{53} Art. 1 clause (A) no. 4 Protocol.
\textsuperscript{54} Judicial review is also provided for in other WTO texts such as art. 13 GATT 1994. See Killion (2007–2008), 571–572.
\textsuperscript{55} Killion (2005), 72; Killion (2007–2008), 579 et seq.
\textsuperscript{56} Hom, 22–23 and 26; Blazey/Govind, 57; Hung, 91–107; Lee, 505 as regards banking services’ liberalization.
ensure uniform, impartial and independent application of laws across the country but, moreover, directly affect the access to courts in certain areas of practice. Consequently, many problems still remain as of today concerning the quest for uniform application of law in China, despite all efforts made by the Chinese government to solve them.

2. Trade in Goods

The double character ascribed to China as being both a developing and developed country is clearly ascertainable when analyzing obligations embodied in the Protocol as regards the right to trade. On the one hand, China committed itself to fully liberalize the trade in goods in three years after joining the WTO with the exception of those goods listed in Annex 2A to the Protocol. Therefore, by 2004, all enterprises and persons in China and abroad should be free to import and export goods from and to China. Consequently, China also accepted to liberalize distribution services within the country and allowed for their “internal sale, offering for sale, purchase, transportation, distribution or use, including their direct access to end-users”. China agreed as well to reform and modernize its trade regulatory system. At the same time, China accepted certain clauses and devices limiting the importation of Chinese products to other WTO member states, mainly by denying it full “market economy” status or by levying special safeguards against Chinese products.

a) Right to Trade and Anti-dumping Regulation

In general terms, China has broadly and timely met its obligation as to the right to trade. As a result, tariffs have decreased to an average of 8.8% for non-agricultural products. Nevertheless, several unjustifiable tariff and non-tariff barriers to trade in relation to industries and products of high relevance for western countries still exist in practice. These measures hamper exportations to China and create the feeling of incomplete implementation of WTO obligations.

As part of its commitment to fully implement the right to trade, in 2004 China amended the Foreign Trade Law (对外贸易法), which was first promulgated on May 12, 1994, and comprises eleven chapters and provides a general response to issues raised by foreign trade. It deals with foreign trade dealers, the import and

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57 Blazey/Govind, 48.
58 China’s Trade Policy Review, 26 marginal numbers 10–12.
59 Hung, 108 et seq.
60 Art. 5 para. 1 Protocol.
61 Art. 5 para. 1 Protocol.
62 Commission of the EU. Competition and Partnership, 8; 2008 USTR Report, 27.
63 The European Commission specifically refers to textiles and clothing, leather and fur, footwear, ceramics, steel and vehicles. See Commission of the EU, Competition and Partnership, 8.
64 The European Commission refers to product certifications, labelling standards, import approval requirements, custom clearance delays or sanitary and health requirements. See Commission of the EU, Competition and Partnership, 9.
65 In fact, three cases against China are pending before the WTO since 2006. These cases relate to imports of automobile parts: cases DS 339 (claimant: European Union), DS340 (claimant: USA) and DS 343 (claimant: Canada). Available at http://www.wto.org/english/thewto_e/countries_e/china_e.htm.
export of goods and technologies, international trade in services, protection of trade-related aspect of intellectual property, foreign trade orders, investigations, remedies and promotions, and legal liabilities. Chapter 8, which refers to foreign trade remedies, is especially relevant because it includes anti-dumping regulations.

Anti-dumping measures in China are governed by the aforementioned Chapter 8 of the Foreign Trade Law and by the Anti-dumping Regulations (反倾销规定) issued on November 26, 2001, and revised in March 2004.\textsuperscript{67} Both instruments include detailed rules on anti-dumping, specifically on the determination of dumping, calculation of margins, determination of injury, investigation procedures, anti-dumping duties, and notifications.\textsuperscript{68} According to these regulations, the Ministry of Commerce (MOFCOM) is responsible for investigating and determining the existence of dumping. Both pieces of legislation have been accompanied by MOFCOM’s issuance of “Provisions on the Antidumping Investigation of Industry Injury”\textsuperscript{69} and “Provisions on Responding to Antidumping Cases Relating to Export Products”\textsuperscript{70}, and by two documents issued by the Supreme People’s Court’s (SPC) with regard to anti-dumping procedures: “Provisions of the Supreme People’s Court on Several Issues concerning the Hearing of International Trade Administrative Cases”\textsuperscript{71} of August 2002, and “Provisions of the Supreme People’s Court on Certain Issues concerning the Applicability of Laws in the Hearing and Handling of Anti-dumping Administrative Cases”\textsuperscript{72} of September 2002, relating to the revision by the SPC of decisions adopted by the MOFCOM regarding anti-dumping cases.\textsuperscript{73}

Although the Chinese anti-dumping system is deemed to be largely consistent with WTO obligations, some problems still remain with regard to its implementation.\textsuperscript{74} These arise mainly from the interpretation of certain relevant WTO terms by Chinese authorities – \textit{i.e.} “domestic industry”, “a major proportion”, “discriminatory imposition”.\textsuperscript{75} Besides that, the application of the entire anti-dumping regime shares problems already mentioned in relation to the Chinese legal system as a whole, \textit{i.e.} lack of transparency and procedural fairness.\textsuperscript{76}

\textsuperscript{67} Available at http://ia.ita.doc.gov/trcs/downloads/documents/china/G_ADN_N_1_CHN_2_Suppl3.doc.

\textsuperscript{68} Choi/Gao, 665.


\textsuperscript{71} (最高人民法院关于审理国际贸易行政案件若干问题的规定), promulgated on August 27, 2002 and effective on October 1, 2002.

\textsuperscript{72} (最高人民法院关于审理反倾销行政案件应用法律若干问题的规定), promulgated on November 21, 2002 and effective on January 1, 2003.

\textsuperscript{73} These two Supreme People’s Court rules are basic for satisfying the obligation to provide for judicial review of anti-dumping measures in accordance with art. 2 para. (D) no. 1 Protocol and with art. VI GATT of 1994, that requires judicial review. See \textit{Killion} (2003–2004), 421–425 and 444 \textit{et seq.}

\textsuperscript{74} To date, Chinese authorities have resorted to anti-dumping legislation quite often. For instance, Chinese authorities initiated 39 anti-dumping investigations between January 1, 2005 and June 30, 2007: 27 out of 39 referred to chemicals. In 16 cases the investigation ended up with measures. See China’s Trade Policy Review, 61 marginal number 61.

\textsuperscript{75} Choi/Gao, 667 \textit{et seq.}

\textsuperscript{76} 2008 USTR Report, 32.
II. Main Issues

b) Safeguard Measures against Chinese Products

China agreed to be treated as a “non-market economy” for a period of 15 years from the date of its accession to the WTO. Nevertheless, prior to 2016, a WTO member state could inter partes establish – “under the national law of the importing WTO member state” – that this member state considers China a “market economy.”77 The “market economy” status is highly relevant with regard to the application of Article VI of the General Agreement on Tariffs and Trade of 1994 (GATT 1994), of the Agreement on Implementation of Article VI GATT 1994 – the so-called “Anti-Dumping Agreement” –, and of the Agreement on Subsidies and Countervailing Measures – the “SCM Agreement”. In practice, granting this status is a decisive element to verify the level of dumping in anti-dumping cases:

1) In determining price comparability for anti-dumping investigations, countries awarding China the status of a “market economy” may use Chinese prices or costs for the specific industry under investigation to verify the existence of dumping.

2) On the contrary, those countries that deny China the status of a “market economy” will refer to alternative methodologies in determining the normal value of a product. That means that for the imposition of anti-dumping duties, the price of a specific product produced in China will not be compared with other Chinese products, but with products originating from third countries of similar economic development. A “surrogate normal value” will be created using the costs and profit margins existing in the surrogate country and not in China to ascertain the existence of dumping.78

China is perfectly aware of the weaknesses this status creates for its exporters of goods.79 Therefore, it has undertaken bilateral negotiations to obtain the status of a full “market economy” prior to the end of the 15 years period. Today, almost 80 countries recognize China’s “market economy” status. Nevertheless, neither the U.S. nor the European Union80 consider that all conditions necessary to grant China the status of a full “market economy” have already been fulfilled.81 China considers this is a highly political decision in so far that other countries with a much less liberalized market have been awarded this status.82

Safeguards measures are disciplined by art. XIX GATT and the WTO Agreement on Safeguards (ASG). The ASG permits Member States to adopt temporary “safeguard actions”83 in order to protect certain domestic industries threatened by

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77 Art. 15 para. d Protocol.
78 In the USA, for instance, Singapore is used at many occasions as the country of comparison; in Singapore labour costs are as much as 20 times higher than labour costs in China. See Tracey, 84.
79 See to this respect, China’s market economy status: “Will article 15 cost us another 15 years?”, People’s Daily Online, available at http://english.people.com.cn/200406/28/print20040628_147731.html. In fact, China filed two cases against the U.S. in relation to anti-dumping measures: DS368 (2007) and DS379 (2008), available at http://www.wto.org/english/countries_e/china_e.html. In practice, granting this status is a decisive element to verify the level of dumping in anti-dumping cases:
80 In fact, the EU declared China to be an “economy in transition”. See Commission of the EU. Competition and Partnership 13. As to the USA, see Tracey, 87 et seq.
81 As regards necessary conditions to obtain the status of full market economy see Tracey, 87–88, for the U.S. and 89–90, for the EU.
82 See e.g. Russia’s status as a “market economy” although it is not even a WTO member state. For China’s market economy status see: “Will article 15 cost us another 15 years?”, People’s Daily Online, available at http://english.people.com.cn/200406/28/print20040628_147731.html.
83 See Schick, 157 et seq. as regards its requirements and practical application.
imports. These measures may not exceed a total period of eight years and they may only be used in extraordinary circumstances. Nevertheless, the implementation of the ASG has given rise to several problems in practice to a certain extent due to the existence of some ambiguities in the ASG favoring contentious interpretations. Besides this general regime, the Protocol grants WTO member states the right to impose transitional product-specific safeguards on Chinese products.

19 China has suffered from the imposition of special safeguards by other countries on certain strategic products. The trade in textiles is a vivid example of the somewhat exorbitant use of the Transitional Product-Specific safeguard mechanism by Western countries, which were seriously concerned about their national textile industries being affected by the termination of the 10-year transition period under the WTO Agreement on Textiles and Clothing. Accepting the existence, in practice, of certain unfair practices by China – like the control of the RMB’s exchange rate or a generalized resource to subsidies – cannot hide the fact that these kinds of measures heavily threaten the normal functioning of the entire WTO free trade regime.

3. Trade in Services

20 China accepted to fully liberalize the trade in services within a seven-year time frame starting from accession. Joining the GATS forced China to almost fully open its so far highly closed services market to foreign firms. In fact, obligations accepted by China in this field are said to be higher than those accepted by any other new WTO member states with regard to the free trade of services, leading “to one of the most dramatic episodes of liberalization” in recent history. In line with GATS provisions, almost no service is exempted from the quest for liberalization in China: professional services, computer and related services, telecommunications, construction and engineering services, distribution services, education services, financial services, insurance services or transport services are all referred to in the Protocol (infra Chapter 3 at 14).

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84 Art. 2 para. 1, available at http://www.wto.org/english/docs_e/legal_e/25-safeg.doc. According to this rule, importations must cause “serious injury to the domestic industry that produces like or directly competitive products”.
85 Art. 7 para. 3.
86 Schick, 187.
87 In relation to the US safeguard case before the WTO, see Schick, 169 et seq.
88 Art. 16, see Ma, 191–195. The U.S.-China bilateral agreement on WTO of November 15, 1999 also foresees specific safeguard provisions in relation to certain products. See Dardick, 472 et seq.
89 China filed a claim against the U.S. as to U.S. steel safeguards in 2002 (DS252). The dispute ended in 2003 when the U.S. President issued a proclamation terminating all of the safeguards measures subject to the dispute, available at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds252_e.htm.
90 See Luo, 81 et seq.
91 See as to this controversy, Lou, 457 et seq.
92 See Athanasakou, 288 et seq.
93 See Luo, 89.
95 See Mattoo, 301–304.
96 Mattoo, 299.
97 A general approach is found in Mattoo, 305–320.
II. Main Issues

The way Chinese authorities have implemented WTO obligations as regards the trade in services over the last few years has drawn increasing criticism by foreign firms and WTO member states; serious doubts arose as to the real will of China to fully comply with its obligations as regards this issue. This chapter will focus on the financial sector to evaluate whether China has fully implemented GATS commitments in this area, mainly regarding banking, credit card services and financial data flow.

a) Banking

China is an extremely attractive market for foreign banks. Its large population and its steady economic growth lead to the rapid expansion of China’s financial sector. Foreign banks are eager to gain access to and manage any of the already existing Chinese banks – these being usually rather inefficient despite recent legal reforms – and to freely supply banking services in China to both foreign and national clients starting from the end of the transitional period. In contrast, the Chinese government, intending to protect domestic banking activities, accepts only limited intervention of foreign banks in China. The Chinese government is interpreting in a very restrictive manner the terms “commercial presence” and “commercial presence” embodied in art. 1 GATS to support protective measures. Whereas foreign banks approach “commercial presence” in line with art. XXVIII para. (d) GATS, the Chinese Government affirms that China has only committed itself to allow certain foreign institutions to establish Chinese-foreign joint-venture banks, but not to acquire Chinese banks, and that foreign equity participation in China’s domestic banks is an issue of cross-border merger and acquisitions. This

98 2008 USTR Report, 6–9.
99 Main legislative texts regulating the activity of banks in China are the Law on the People’s Bank of China (中国人民银行法), the Law on Commercial Banks (商业银行法), and the Banking Supervision Law (银行业监督管理法), amended on October 31, 2006. Some guidelines have also been issued to improve banking activities: the Guidelines on the Corporate Governance of Joint Stock Commercial Banks (股份制商业银行公司治理指引) and the Guidelines on the Internal Control of Commercial Banks (商业银行内部控制指引) are relevant among others. As regards the operation of foreign banks in China note (i.e.) Regulations on Administration of Foreign-funded Banks (外资银行管理条) and the Detailed Rules for the Implementing the Regulations on the Administration of Foreign-funded Banks (外资银行管理条例实施细则), the latter being specifically devoted to foreign investment in Chinese financial institutions and the China Banking Regulatory Commission (CBRC), both of 2006, the Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions (境外金融机构投资入股中资金融机构管理办法). An analysis of these texts is available in Jirak, 333–335. See also, China’s Trade Policy Review, 141 marginal number 137 and note 125, and 145 marginal number 149.
100 Crosby, 76–77 and 83 et seq. as regards China GATS schedule and specific financial sector obligations.
101 Art. I, para. 2.
102 Art. I, para. 2, letter (c).
103 Art. XXVIII para. (d) GATS states: “(d) ‘commercial presence’ means any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service”. The WTO Understanding on Commitments in Financial Services also shares this approach in Art. 5, available at http://www.wto.org/english/docs_e/legal_e/54-ufins.doc.
104 See Crosby, 88–91, especially 90.
attitude has drawn deep concerns as to its compatibility with China’s WTO banking sector commitments.106

b) Foreign Credit Card Services

According to China’s GATS schedule, foreign financial institutions should be free to fully provide in China “payment and money transmission services, including credit, charge, and debit cards”107 by the end of 2006. Nevertheless, China currently restricts foreign credit card companies’ access to the Chinese market. Among other conditions, they must co-brand with Chinese operators and conduct payments through the Chinese monopoly payment network.108 Despite different arguments provided for by the Chinese government to justify this move,109 this behaviour is widely considered to impair China’s GATS commitments as to this sector.

c) Financial Data

GATS commitments oblige China to allow foreign financial institutions almost unlimited access to provide services in China, both to national and foreign residents. Nevertheless, shortly before the end of the transitional period in December 2006, the Chinese Government issued “Measures for Administering the Release of New and Information in China by Foreign News Agencies”,110 restricting the direct distribution of financial data to domestic Chinese customers – Chinese banks, brokers, newspapers – by foreign news agencies and only allowing these services to be provided by the State-owned agency Xinhua.111 The measure was widely considered to be in violation of China’s WTO obligations regarding the free trade of services.112 After joint consultations with the U.S., the EU and Canada113 China agreed to change this policy by June 30, 2009.114 However, as of today, the said services may still only be provided by Xinhua.

4. Others

China’s accession to the WTO included an enormous number of commitments by China. Nevertheless, some issues were either left aside or not directly considered. This was the case for public procurement and environmental issues.

a) Public Procurement

Although the Protocol is silent as to this issue, the Report of the Working Party directly addresses it.115 According to this report, China committed itself to conduct

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106 Crosby, 98.
109 Crosby, 101–104.
111 Owens, 389.
112 Owens, 396 et seq.
113 Note that different disputes against China were initiated in 2008 before the WTO as to this issue: DS372 (claimant: European Union), DS373 (claimant: USA) and DS378 (claimant: Canada). All of these ended with an agreement between China and the three claimants, available at http://www.wto.org/english/tratop_e/dispu_e/case_e/ds372_e.htm.
public procurement “in a transparent manner, and provide all foreign suppliers with equal opportunity to participate in procurement pursuant to the principle of Most Favored Nation (MFN) treatment”.116 Despite the promulgation of the Law on Government Procurement in 2002,117 several gray areas for foreign participation still exist, and deep reforms will be required in case China joins the WTO Government Procurement Agreement (hereinafter: GPA) in the near future.118 In fact, China committed itself to start negotiations “as soon as possible”119 after its WTO accession, but it was only at the end of 2007 that its government signed a written application for joining the GPA.120

b) Environmental Issues

Neither the Protocol nor the Report of the Working Party directly refer to environmental issues arising from China’s WTO membership. Nevertheless, those issues do exist121 and are twofold. On the one hand, freer trade implies more trade for China and that most probably will directly impact environmental preservation.122 On the other hand, great efforts are needed to prepare the Chinese industry to deal quickly and soundly with problems arising from “green barriers” – sanitary standards, eco-labelling, eco-packaging – currently existing in Western countries.123


118 Note Tong, 165–171.
121 See Mushkat, 256 et seq.
122 Zhao, 55 et seq.
123 Zhao, 81 et seq.
Chapter 2. Corporations and Partnerships


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Chapter 2. Corporations and Partnerships

I. Overview

The first Company Law of the PRC was not adopted until December 29, 1993. Although the preparatory works date back to 1983, it took a decade to overcome the ideological disagreements and theoretical disputes concerning the nature of state-owned enterprises’ (SOE) property rights. The 1993 Company Law particularly focused on the restructuring of SOEs into shareholding companies, which is why the law provided for rather high amounts of minimum registered capital and contained only few discretionary provisons. Following minor modifications in 1999 and 2004, the Company Law was fundamentally amended in 2005. The revised provisions on SOEs take into account that as of 2003, SOEs are generally subject to supervision by the State Asset Supervision and Administration Commission of the State Council or its local counterparts. In addition, the restriction of SOEs to certain branches and products provided for by the 1993 Company Law has been eliminated in the 2005 Company Law, which became effective on January 1, 2006.

“Companies” in the sense of the Company Law are limited liability companies (LLC) and joint stock limited companies (JSLC). Both types of companies are enterprises with legal personality whose liability is limited to their assets, their shareholders’ liability to the company being limited to the extent of the capital contribution (LLC) or shares (JSLC) for which they subscribed. Unless otherwise stipulated in laws on foreign investment, the Company Law also applies to foreign-invested enterprises (FIE), which are dealt with in Chapter 3 of this book.

While the term “company” is commonly understood as a generic term covering, inter alia, corporations and partnerships, “company” (公司) in the context of Chinese law exclusively refers to corporations, i.e. entities having a legal personality and existence distinct from that of its members (supra at 2), as opposed to partnerships which lack legal personality. This chapter addresses companies in the narrow sense of the word in Chinese law (part II, infra at 4–111) as well as partnerships (part III, infra at 112–148).

II. Main Issues Regarding Corporations

1. Sources of Law

The Company Law is complemented by the Supreme People’s Court’s “Provisions on Several Issues concerning the Application of the Company Law of the PRC (I) and (II)” (hereinafter: SPC Provisions I and II) which entered into force on

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1 Chen Jianfu, 491, 492. – For an extensive account of China’s legislation on companies since 1903, see Jiang/Li (2005b), 24–29.
2 Chen Jianfu, 492.
3 Fu/Yuan, 5.
4 Münzel (2006a), 289.
5 Unlike art. 64 of the 1993 Company Law, art. 65 of the 2005 Company Law no longer provides for such a restriction.
6 Art. 2 Company Law.
7 Art. 3 Company Law.
8 Art. 218 Company Law.
9 As to the applicability of the Company Law to FIEs, ibid. at 35–41.
10 Black’s Law Dictionary, 255.
May 9, 2006 and May 19, 2008 respectively. While the SPC Provisions I mainly consist of transitional provisions, the SPC Provisions II address the dissolution and liquidation of companies in much detail.

Moreover, the Supreme People’s Court issued “Provisions on Several Issues concerning the Handling of Company Disputes (I) (Draft for Comment)” (hereinafter: SPC Draft Provisions of 2003) on November 4, 2003. The adoption of these provisions was postponed due to the expected revision of the Company Law. After the revision of the Company Law in 2005, some of the issues addressed by the SPC Draft Provisions of 2003 became part of the Company Law itself (e.g., art. 74 para. 2 Company Law very much resembles art. 24 of the SPC Draft Provisions of 2003). The fact that some parts of the SPC Draft Provisions of 2003 have not been adopted by the Company Law of 2005 does not mean that these parts were thereby finally discarded. Where the issues concerned are not regulated by the Company Law, it is still helpful to consult the SPC Draft Provisions of 2003, bearing in mind that these provisions are not authoritative sources.

2. Theory of the Legal Person

As stated by art. 3 Company Law, companies are legal persons. Chinese civil law textbooks typically distinguish three main theories on legal personality: fiction theory (Savigny, Windscheid), denial theory (sub-variants by Jhering, Brinz, and Hölder) and actual existence theory (sub-variants by Gierke and Michoud). As art. 36 of the General Principles of Civil Law (hereinafter: GPCL) shows, Chinese civil law has adopted the organization entity sub-variation of the actual existence theory developed by Michoud, which is also being reflected by China’s company law jurisprudence. According to this theory, the personality of a legal person is based on an organization which differs from the members constituting the legal person.

3. The Ultra Vires Doctrine

The ultra vires doctrine has, at least as regards company law, been abolished in mainland China. However, this point of view is still being questioned by some authors, which makes it necessary to give a brief account of the concept of ultra vires and its development.

a) Function and History

An act which is conducted “ultra vires” (literally: “beyond powers”) is beyond the scope of the powers of a corporation as defined by law or by the corporation’s founding documents; and the classification of an act as “ultra vires” results in

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11 Bu, 169 n. 15.
12 Reportedly, parts of the SPC Draft Provisions of 2003 are being applied by the judiciary (Bu, 169 n. 15).
13 This shows not only in the title of the SPC Draft Provisions of 2003 and in the fact that they have not been formally adopted, but also in the text of the provisions: art. 44 no. 1 expressly gives a second opinion in brackets.
15 民法通则, promulgated on April 12, 1986 and effective from January 1, 1987; minor revision effective from August 27, 2009.
16 Jiang Ping, 135.
17 Chen Jianlin at n. 96.
18 The following is based on the more detailed and very instructive explanations by Wolff, 635–638.
II. Main Issues Regarding Corporations

invalidity of the respective act. The main objective of this rule is to protect the interests of shareholders and creditors by ensuring that a company’s capital be used within the limits of its known and declared business exclusively. The *ultra vires* doctrine was developed by courts in common law jurisdictions in the 19th century. As a reaction, companies tended to define their scope of business as broadly as possible, by this means undermining the functioning of the *ultra vires* doctrine and turning it into a mere pitfall for *bona fide* third parties dealing with the company. It was thereupon substituted by the establishment of the managers’ legal duty to protect shareholders’ interests and finally overridden in many common law countries.

b) The *Ultra Vires* Doctrine in Mainland China

Unlike in the common law jurisdictions, the introduction of the *ultra vires* doctrine in China primarily aimed to serve the needs of a planned economy, i.e. to safeguard state property and to obviate transactions contradictory to the plan. Hence, even though the motive for the recent abolishment was probably the same as in the common law countries, the underlying process making this step possible at all is China’s turn from a planned economy towards a market economy.

The rise and fall of the *ultra vires* doctrine took place as follows: The *ultra vires* doctrine was established in China by art. 42 GPCL, according to which an enterprise as legal person shall conduct operations within the scope of business approved and registered. Moreover, art. 11 para. 3 Company Law (1993) restricted the activities of a company to its registered scope of business.

The gradual downfall of the *ultra vires* doctrine started with art. 10 clause 1 of the 1999 Interpretation of the Supreme People’s Court on Certain Issues concerning the Application of the Contract Law of the PRC (Part 1) (hereinafter: Contract Law Interpretation): “Where a contract is entered into by the parties outside their scope of business operation, the people’s court shall not thereupon make it invalid.” This was understood as having abolished the *ultra vires* doctrine.

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19 The latter aspect also showed in art. 58 para. 1 no. 6 GPCL (no. 6 was abolished on August 27, 2009), according to which contracts violating the state’s mandatory plans were null and void. (The law used the term “economic contract”, which referred to the Economic Contract Law [经济合同法], promulgated on December 13, 1981, and effective from July 1, 1982, last revision effective from September 2, 1993). After this law had been replaced by the Contract Law in 1999 [infra n. 97], the term was simply to be read as “contract”, cf. Tang/Gao, 911.)

20 As soon as in May 1993, the final protocol of the National Symposium on the Dispensation of Justice in Economic Cases held by the Supreme People’s Court had stated in its art. 3 that *ultra vires* contracts should not generally be declared void (jiang/Li [2005b], 31).

21 (最高人民法院关于适用《中华人民共和国合同法》若干问题的解释 (一)), promulgated on December 19, 1999 and effective on December 29, 1999.

22 It should be noted that the Contract Law (infra n. 97) itself does not address the *ultra vires* problem at all. Art. 50 states that “where the legal representative or the person in charge of a legal person or other organization exceeds the limits of power in making a contract, the act of representation shall be effective unless the counterpart is aware or ought to be aware of the excess of the limit of power.” According to the understanding of Cai/Sun, 91, and Yin Tian, 193, this provision deals with *ultra vires* acts; a perception which could be supported by the translations by Shu, 288/289 and by CCH Asia Pacific, §5–650 (“Where a legal person or the legal representative or …”). However, the Chinese wording of art. 50 as well as its position within the law (arts. 48 et seqq.) clearly indicate that the provision only refers to the question of the validity of acts of representation (also cf. Ling, 138, and Lau, 636). Yet acts exceeding the power of representation do not necessarily involve action beyond the scope of business of the company.

23 Wolff, 643.
whether the Contract Law Interpretation could actually override art. 11 para. 3 Company Law (1993) as the latter is superior to the former within the hierarchy of norms. Besides, non-contractual *ultra vires* acts naturally remained completely unaffected by the Contract Law Interpretation.\(^{24}\)

Art. 12 of the 2005 Company Law (the successor of art. 11 para. 3 of the 1993 Company Law) no longer contains a limitation as to the company’s business activities. Writers opining that the *ultra vires* doctrine continues to apply argue that art. 12 of the 2005 Company Law still requires any change in the object clause to be registered at the State Administration for Industry and Commerce (SAIC).\(^{25}\) However, this may as well be seen as a mere means of ensuring due registration of business activities. Hence, the more convincing conclusion to be drawn from the above-mentioned change of the Company Law is that in mainland China the *ultra vires* doctrine does not apply for domestic companies anymore.\(^{26}\)

c) Remaining Relevance of the Object Clause

Activities exceeding the approved and registered scope of business still constitute an administrative offense. The competent authorities may issue a warning, impose a fine, confiscate illegal income, order the suspension of business operations until the matter is rectified or confiscate or revoke the business license.\(^{27}\) Thus, it is still important to carefully define the business scope in the articles of incorporation. Besides, civil acts in general (i.e. independent of the applicability of the *ultra vires* doctrine) are invalid if they violate mandatory provisions of the *law* (法律; *infra* Chapter 3 at 10–11).\(^{28}\) A violation of mandatory provisions even of *administrative regulations* (行政法规; *infra* Chapter 3 at 10–11) results in the invalidity of contracts.\(^{29}\) This is the reason why the above-mentioned art. 10 Contract Law Interpretation (*supra* at 11) adds an exception in clause 2 for contracts that involve the operation of a business which is restricted by the State or is subject to special permission of the State, or which is prohibited by laws or administrative regulations. Such restrictions exist, among others, in the area of foreign direct investment.\(^{30}\)

4. Compulsory Provisions and their Effect

A pivotal question is to what extent the rules of the Company Law are compulsory and in which way such compulsory provisions affect the validity of the articles of association and the business operation of the company.\(^{31}\)

\(^{24}\) Tang/Gao, 386, in 2003 still considered the *ultra vires* doctrine effective.

\(^{25}\) Lau, 636. (Fu/Yuan, 41, unconvincingly base their opinion on an unspecific reference to the GPCL.)

\(^{26}\) Cai/Sun, 90, and Bu, 83 at 25. – From the point of view of Liu Jingwei, 96, the *ultra vires* doctrine is still in effect for non-enterprise legal persons (questionable, cf. Werthwein, n. 829).

\(^{27}\) Art. 30 para. 1 no. 2 of the Administrative Regulations of the PRC Governing the Registration of Enterprise Legal Persons.

\(^{28}\) Art. 58 para. 1 no. 5 GPCL, Tang/Gao, 909.

\(^{29}\) Art. 52 no. 5 Contract Law.

\(^{30}\) For details, *infra* Chapter 3 at 48.

\(^{31}\) The following was inspired by the paper of Wang Baoshu. However, the systematization proposed here differs from the one devised by Wang Baoshu, 22–28.
a) How to Identify Compulsory Provisions

Several (but far from all) compulsory provisions reveal themselves by wordings such as “shall”, “shall not” etc. Additionally, there are three types of rules that may generally be classified as compulsory: (1) provisions on shareholders’ rights; (2) provisions concerning the duties and powers of the meeting of shareholders, the shareholders’ general meeting, the board of directors, the board of supervisors, or the liquidation group, (3) provisions dealing with the nonperformance of the duties of the chairman, the deputy chairman, or the chairman of the board of supervisors.32

b) Effect of Compulsory Provisions on the Articles of Association

The establishment of articles of association (章程) is a prerequisite for the incorporation of a company.33 In this context it is to note that unlike some common law jurisdictions, Chinese law does not distinguish the “memorandum of association” from the “articles of association”. Only one single document is required for the establishment of a company. In principle, the articles of association as a means of autonomous regulation prevail over laws and regulations.34 Under the 1994 Company Law, this point rarely became practically relevant for two reasons: the registration authorities provided for standard articles of association for all sorts of companies, and most articles of association simply replicated provisions of the Company Law.35 Under the 2005 Company Law, the articles of association generally have gained in relevance.

To a large extent, the articles of association can be customized according to the specific needs of each individual company. For example, under the 2005 Company Law, certain issues are completely left to stipulation in the articles of association,36 while others may be elaborated within certain limits given by the Company Law,37 or the articles may at least make additional arrangements.38 However, the articles of association may not violate compulsory provisions of law.39 Where articles of association conflict with such compulsory provisions, they are invalid. For example, the articles may not restrict the duties and powers of the meeting of shareholders as defined by the Company Law.40

c) Effects on the Business Operation of the Company

The violation of compulsory provisions may also lead to the invalidity of other acts. Generally, it can be differentiated between provisions stipulating duties to act, provisions stipulating duties of forbearance, and provisions directly determining the

32 Wang Baoshu, 23, 24. – A more ramified model (inter alia, differentiating between limited liability companies and companies limited by shares) is proposed by Luo, 78–84.
33 Arts. 23 no. 3, 77 no. 4 Company Law.
34 Wang Baoshu, 25.
35 Wang Baoshu, 25.
36 E. g. art. 51 para. 2 Company Law.
37 E. g. art. 13 Company Law.
38 E. g. arts. 49, 56 Company Law.
39 Wang Baoshu, 27; Luo, 79–83, proposes to differentiate the initial drafting of the articles of association and their subsequent amendment because the former is a true contract between all shareholders, whereas for the latter a two-thirds majority is sufficient (arts. 38 para. 1 no. 10, 44 para. 2 and arts. 100, 104 para. 2 clause 2 of the Company Law respectively). On this basis, he takes a less restrictive approach towards the initial drafting of the articles of association.
40 Wang Baoshu, 28.
invalidity of certain acts. The duties to act can be left aside in this context because the violation of such a duty (e.g. the shareholders’ duty to make their capital contributions, art. 28 para. 1 Company Law) just consists in not conducting the required act, so that there is no object of a potential invalidity. Hence, the following will focus on the two latter types of provisions.

19 The violation of a duty of forbearance does not lead to the invalidity of the prohibited act. For example, companies shall not engage in business operations which are not related to the liquidation during the liquidation period.\[41\] In case a company still does so, the company registration authorities will issue a warning and confiscate the illegal income.\[42\] The business operation itself (e.g. the conclusion of a contract on behalf of the company), however, will remain effective\[43\] so as to protect the *bona fide* third party.

20 The third type of provision (e.g. arts. 22 para. 1, 147 para. 2 Company Law) directly declares certain acts null and void. It is to note that this consequence is restricted to the respective act itself (e.g. the appointment of a heavily indebted person as a director, art. 147 para. 1 no. 5), whereas acts “based” on that void act (contracts concluded by this director on behalf of the company) remain valid as far as a *bona fide* third party’s interests are concerned.\[44\]

5. Limited Liability Companies

a) Establishment

21 In principle, the registration authorities have no discretionary power whether to register a company. As soon as the conditions set forth by the Company Law\[45\] are fulfilled, the company will be registered.\[46\] However, companies in certain industries (e.g. security, hygiene, and environment) still need approval as a prerequisite for the registration.\[47\]

22 (1) Shareholders. A (regular\[48\]) limited liability company may be established by 2 to 50 shareholders.\[49\] In practice, this limit is often exceeded in the case of a former SOE being transformed into an LLC because shares are assigned to the employees.\[50\] It is therefore being conjectured whether the limit is intended to apply to non-employee shareholders only.\[51\] Yet this is very unlikely because such a proposal had been vetoed by the lawmaker in the last amendment of the Company Law.\[52\] As a solution, one might argue that the number of the shareholders of an *already-established* LLC may be increased beyond 50 since the limitation prescribed by art. 24 Company Law only applies to the establishment of LLCs.\[53\]

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41 Art. 187 para. 3 Company Law.
42 Art. 206 Company Law.
45 Art. 23 Company Law.
46 Art. 6 para. 1 Company Law.
47 Art. 6 para. 2 Company Law; *Fu/Yuan*, 39.
48 For the special case of a one-person LLC, cf. *infra* at 47 et seqq.
49 Art. 24 Company Law.
50 *Bu*, 169 at 7.
51 *Fu/Yuan*, 50.
52 *Bu*, 169 at 7.
53 Differing opinion: *Jiang/Li* (2005b), 134.
Upon incorporation, a LLC bears the duty to establish a register of shareholders with every registered shareholder being entitled to exercise their shareholder rights in proportion with the registered capital contributions. However, this provision only stipulates a rebuttable presumption. This raises the question how to handle cases in which the register of shareholders deviates from the registration documents and/or the articles of association of the company. While details remain contended, the bottom line seems to be that a distinction has to be made between formal criteria (such as investment certificates, signatures to the articles of association, or the contents of the register of shareholders) and material criteria (e.g. the payment of the subscribed capital, or the actual assumption of shareholder rights and duties), and that the fulfillment of the material criteria should be sufficient for someone’s position as a shareholder to be acknowledged.

24 (2) Nominal Shareholders. Disputes may also arise between a de facto shareholder (a shareholder who makes his capital contribution to the company under the name of a nominal shareholder) and the nominal shareholder appointed by him in the case that the nominal shareholder does not carry out the de facto shareholder’s instructions on how to exercise the shareholder rights. According to the SPC Draft Provisions of 2003, the de facto shareholder may assert his shareholder rights by himself if (1) more than half of the other shareholders know that he is the de facto shareholder, (2) the company has already acknowledged the exertion of shareholder rights by him and (3) there is no breach of compulsory provisions of law. If the de facto shareholder only demands the nominal shareholder to pass on the dividend and other pecuniary benefits from the invested capital to him, it suffices that (1) they have agreed that the de facto shareholder bears the risks of the investment and (2) there is no breach of compulsory provisions of law.

25 (3) Registered Capital. The minimum registered capital was reduced by the revision of the Company Law from RMB 100,000 to RMB 30,000. However, authorities often demand significantly higher amounts to make sure that a new company possesses sufficient funds to carry on the intended business, and special provisions on foreign investment may require higher amounts of registered capital for certain industries. Payment may be made by installments, but the initial contribution of capital by all shareholders may neither be less than 20 % of the registered capital (the total of capital contributions subscribed for by all the shareholders as registered with the company registry) nor lower than the minimum statutory registered capital.

The shareholders’ capital contributions may be made in cash as well as in kind, i.e. non-cash property the monetary value of which can be appraised and that is transferrable in accordance with the law. However, capital contributions are not available in the form of services, credit, names of natural persons, goodwill,
franchise rights, or property encumbered by security rights.\textsuperscript{62} The law leaves the question unanswered whether shares can be contributed to a company’s registered capital,\textsuperscript{63} triggering extensive discussion on the issue.\textsuperscript{64} In any event, a minimum of 30\% of the registered capital must be contributed in cash.\textsuperscript{65}

\textbf{b) Organizational Structure}

\textbf{27} \textit{(1) Mandatory Organs.} The legally required organs of an LLC are the shareholders’ meeting and the board of supervisors. The ruling body of an LLC is the shareholders’ meeting. Its extensive responsibilities include such matters as decisions on the business policy and investment plans of the company, election and replacement of directors and supervisors, passing resolutions on the increase or reduction of the registered capital, amendment of the articles of association etc.\textsuperscript{66} As far as the articles of association do not stipulate otherwise, all shareholders are to be notified 15 days prior to the convening of a shareholders’ meeting (be it a regular meeting or an extraordinary meeting\textsuperscript{67}), and voting rights are exercised in proportion to the shareholders’ subscribed (not necessarily paid in) capital contribution.\textsuperscript{68}

\textbf{28} An LLC also has to establish a supervisory board consisting of at least three members including a chairman, which is composed of shareholders’ representatives and employees’ representatives; the employees’ representatives are to be democratically elected by the employees, and their ratio within the supervisory board may be no less than one third.\textsuperscript{69} Meetings of the supervisory board are to be held at least once a year, and the supervisors may propose additional \textit{ad hoc} meetings.\textsuperscript{70} LLCs with a relatively small number of shareholders or that are relatively small in scale may appoint one or two supervisors without establishing a board of supervisors.\textsuperscript{71} In this case, there is no employees’ participation requirement to be met.

\textbf{29} The board of supervisors, or, where a board of supervisors has not been established, the supervisors bear(s) the duty to inspect the company’s financial affairs, supervise the performance of duties by directors and senior officers\textsuperscript{72} and propose their dismissal, propose to convene \textit{ad hoc} shareholders’ meetings, submit motions to a shareholders’ meeting, and file lawsuits against a director or senior officer under art. 152 Company Law.\textsuperscript{73} Additionally, they are entitled to conduct investigation upon discovering irregularities (a term which has to be further defined by the judiciary yet) in the company’s operations and (on the expense of the company) consult an accounting firm etc. for assistance.\textsuperscript{74}

\begin{footnotes}
\item[62] Art. 14 para. 2 of the Administrative Regulations on Company Registration and art. 8 para. 3 of the Provisions for the Administration of Registration of the Registered Capital of Companies.
\item[63] Deschandol/Desmeules, 13.
\item[64] Bu, 168 at 4.
\item[65] Art. 27 para. 3 Company Law.
\item[66] Art. 38 Company Law.
\item[67] For this differentiation, cf. art. 40 Company Law.
\item[68] Arts. 42, 43 Company Law.
\item[69] Art. 52 paras. 1–3 Company Law.
\item[70] Art. 56 Company Law.
\item[71] Art. 52 para. 1 Company Law.
\item[72] This term is defined by art. 217 no. 1 Company Law, \textit{infra} at 108.
\item[73] Art. 54 Company Law.
\item[74] Art. 55 para. 2, art. 57 Company Law.
\end{footnotes}
Supervisors have the right to attend meetings of the board of directors (as non-voting attendees) and raise questions or make suggestions in respect of issues on which the board of directors decides. They may not concurrently serve as directors or senior officers of the same company. This incompatibility aims to avoid conflicts of interests. The appointment of an incompatible person as supervisor therefore is void as it constitutes a violation of a compulsory provision.

(2) Optional Organs. An LLC may choose to establish a board of directors consisting of 3 to 13 members, which has a chairman and may optionally have one or several vice chairman/-men. In case the LLC is relatively small in terms of scale or the number of shareholders, it may choose to have an executive director instead of a board of directors. The shareholders’ meetings are convened by the board of directors and presided over by its chairman; where a board of directors has not been established, these functions are fulfilled by the executive director.

Despite being only an option, it is common for a company to appoint a manager who is engaged and dismissed by the board of directors. In case there is an executive director instead of a board of directors, he may concurrently serve as manager. As far as not provided otherwise in the articles of association, the functions and powers of the manager comprise practically any matter concerning the company’s day-to-day business as well as some long-term issues, e.g. drafting the company’s basic management system or formulating the specific rules and regulations of the company. This shows that the term “manager” as used by the Company Law means an executive body of a company, i.e. it does not cover all the personnel colloquially referred to as “managers”. This is also reflected by the fact that the manager of a company ranks among its senior officers as defined by the Company Law.

(3) Controversial Issues. If the procedure for convening or the method of voting at a shareholders’ meeting violates the law, a shareholder is entitled to apply to rescind the resolution before a people’s court within 60 days from the date of the resolution being adopted. The merits of such a shareholder’s claim in the following situations are currently debated among the judiciary (without any definitive solution so far):

(1) A resolution is adopted upon a motion put forward during the shareholders’ meeting and which the shareholders have not been informed of by prior notification. – As the law, unlike for companies limited by shares, does not explicitly require this in the case of an LLC, such a procedure should not be seen as a violation of law.

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75 Art. 55 para. 1 Company Law.
76 Art. 52 para. 4 Company Law.
77 Jiang/Li (2005b), 175.
78 Jiang/Li (2005b), 175.
79 Art. 52 para. 4 Company Law explicitly states that incompatible persons “may not” serve as supervisors.
80 Arts. 41 para. 1, 45 paras. 1, 3 Company Law.
81 Art. 51 Company Law.
82 Art. 41 Company Law.
83 Art. 50 para. 1 Company Law.
84 Art. 51 para. 1 Company Law.
85 Art. 50 Company Law.
86 Art. 217 no. 1 Company Law; infra at 108.
87 Art. 22 para. 2 Company Law.
88 Jiangsu Province Higher People’s Court Second Civil Division, 8.
(2) A time limit of less than 15 days has been set by the articles of association or by agreement of all shareholders for notifying the shareholders of a proposed meeting, and the notification is made according to this reduced time limit. Can resolutions passed by this shareholders’ meeting be rescinded, i.e. does art. 42 Company Law provide for a minimum time limit? – There is no compelling basis for such an understanding of art. 42 Company Law. The wording of this provision not only allows to extend the time limit, but also to reduce it.

(3) A shareholder does not attend the shareholders’ meeting because it has been convened in a way which violates the law (i.e., the shareholder was not duly notified). Can a resolution adopted by this meeting be rescinded even if the shareholder could not have hindered the resolution by casting an opposing vote anyway? – Even in cases of this kind, the resolution should be subject to rescission as art. 22 para. 2 Company Law does not explicitly require a causal connection between the violation of law on the one hand and the resolution on the other hand. According to this understanding of art. 22 para. 2 Company Law, the provision is aimed at generally disciplining the board of directors in order to protect shareholders’ rights.

c) Transfer of Equity

(1) Transfer by Contract. While there are no specific constraints on the transfer of equity of an LLC among the shareholders themselves, the transfer to a non-shareholder is subject to the consent of the simple majority of the other shareholders (to be distinguished from a majority of their voting rights). Shareholders who fail to reply to the written request for consent within 30 days are deemed to consent to the transfer. In case there is no majority consenting to the transfer, the non-consenting shareholders shall purchase the equity to be transferred, otherwise they are deemed to consent the transfer.

Where a transfer of equity has obtained the required consent, the other shareholders have a pre-emptive right to purchase the respective equity on identical terms. If, in the case of conflicting pre-emptive rights of two or more shareholders, a negotiation on the acquisition ratio remains unsuccessful, the involved shareholders are entitled to exercise their pre-emptive rights in proportion to their respective capital contributions.

If the company’s articles of association stipulate otherwise concerning the transfer of equity, such stipulation prevails. However, the company’s autonomy in this respect is not completely unlimited: The articles of association cannot exclude the shareholders’ right to transfer their equity to non-shareholders. As Wang convincingly argues, in some situations such a transfer will be the only way

89 Unless otherwise provided for in the articles of association, a shareholder’s voting rights at shareholders’ meetings shall be commensurate with his capital contributions (art. 43 Company Law).

90 Art. 72 paras. 1, 2 Company Law; Gao, 159.

91 The Law (art. 72 para. 2 clause 3) imprecisely says: "Where more than half of the other shareholders do not consent". Strictly speaking, even if only 50% of the other shareholders withhold their consent, the prerequisite of more than half of the other shareholders consenting to the proposed transfer (art. 72 para. 2 clause 1) cannot be complied with. – For more flaws of this kind in the 2005 Company Law see Lau, 643, 646.

92 Art. 72 para. 3 Company Law.

93 Art. 72 para. 3 Company Law.
to withdraw from the company. Even though the 2005 Company Law sets up relatively strict requirements for the transfer of equity to non-shareholders, it always leaves this exit open, and this basic decision of the Company Law may not be foiled by the articles of association.\textsuperscript{94} In other words: As far as art. 72 Company Law enables a shareholder to withdraw from the company, it is shareholder-protective and therefore compulsory.

The transfer of equity comprises three steps: First, the transferor and the transferee enter into a contract of transfer. Second, the company amends the register of shareholders concerning the relevant shareholders and their capital contribution in accordance with the contract, thereby making the transfer of equity legally effective for the transferor, the transferee and the company. Third, the company carries out the procedures for the registration of the amendment with the company registry. Not until then the transfer of equity is effective against a third party.

Step 1: As the Company Law does not require that the contract be concluded in a particular form, it can be made by oral agreement as well as in written form.\textsuperscript{95} The validity of the contract of transfer does not depend on the amendment of the register of shareholders or the amendment of registration with the company registry (steps 2 and 3). The requirement to take steps 2 and 3 after the contract has been established\textsuperscript{96} is not a requirement of approval and registration within the meaning of art. 44 para. 2 Contract Law.\textsuperscript{97, 98}

Step 2: The contract itself does not directly change the equity situation of the company,\textsuperscript{99} but on the basis of the contract the parties are entitled to request the company to amend its register of shareholders (and its articles of association, which is of no additional legal significance and does not require a vote of the shareholders’ meeting) accordingly.\textsuperscript{100} The transfer of equity does not become effective for the transferor, the transferee and the company until the register of shareholders is amended.\textsuperscript{101} Besides, the company is obliged to issue an investment certificate to the new shareholder and cancel the original shareholder’s investment certificate.\textsuperscript{102}

Step 3: Finally, the company has to apply to the company registration authorities for registration of the amendment of the register of shareholders within 30 days from the date of equity transfer.\textsuperscript{103} As soon as the amendment is registered,\textsuperscript{104} the

\textsuperscript{94} Wang Baoshu, 28.
\textsuperscript{95} Art. 10 Contract Law; Zhou, 297 without explicit reference to the Contract Law.
\textsuperscript{96} Arts. 74, 33 para. 3 Company Law.
\textsuperscript{97} (合同法), promulgated on March 15, 1999 and effective on October 1, 1999.
\textsuperscript{98} Jiang/Li (2005a), 230/231. Art. 44 para. 2 of the Contract Law reads: “Where a contract may become effective only after the completion of approval and registration procedure according to the provisions of laws or administrative regulations, such provisions shall prevail.”
\textsuperscript{99} Jiang/Li (2005a), 232; Bu, 185 at 73.
\textsuperscript{100} Jiang/Li (2005a), 232; art. 74 Company Law.
\textsuperscript{101} Jiang/Li (2005a), 232; art. 33 para. 2 Company Law.
\textsuperscript{102} Art. 74 Company Law.
\textsuperscript{103} Art. 33 para. 3 Company Law and arts. 26, 35 of the Administrative Regulations on Company Registration. – Art. 18 para. 1 clause 2 of the SPC Draft Provisions of 2003 proposes the transferee be entitled to institute a lawsuit against the company requesting it to apply for registration in case the company fails to do so of its own accord.
\textsuperscript{104} In case the application documents are complete, comply with the statutory format and are delivered to the company registration authorities by hand, the decision to grant registration or not shall be made right on the spot (arts. 52 para. 1 no. 1, 54 para. 1 no. 1 of the Administrative
transfer of equity becomes effective against any third party. The registration is not a prerequisite for the validity of the transfer of equity but rather an instrument to protect a *bona fide* third party doing business with the company. This is why the company register is made available to the general public for inspection.

(2) Mandatory Equity Buyback. As a special kind of equity transfer, shareholders under certain conditions have the right to request the company to buy back their equity at a reasonable price (appraisal right). If the shareholders’ meeting passes a resolution despite the opposition of a shareholder, he can request equity buyback if (1) the company has not distributed profit to the shareholders despite it could lawfully have done so, (2) the company merges, divides, or transfers its main assets, or (3) a ground for dissolution as specified in the articles of association arises and the shareholders’ meeting decides to continue the operation of the company. This provision aims to protect minority shareholders under the principle of majority votes. As there is no general standard as to what a “reasonable price” is, this question will often have to be answered by the courts.

(3) Succession. As a form of “automatic” equity transfer, the lawful successor of a deceased natural person shareholder may succeed to his qualifications as a shareholder, unless otherwise stipulated in the articles of association. This explicit stipulation on the succession of the qualifications as a shareholder in the Company Law is necessary in that art. 3 of the Law of Succession only regulates the inheritability of property (in the case of a shareholder, the equity held by him) but not of other rights (such as the qualification as a shareholder). Therefore, the articles of association may only exclude the successor’s right to inherit the decedent’s qualifications as a shareholder but not the successor’s right to inherit the equity because only the former is subject to regulation by the Company Law, while the latter is being governed by the Law of Succession exclusively.

As the relationship among the shareholders is (at least to some extent) based on mutual trust, the shareholders may wish to provide for the exclusion of succession into the decedent’s qualifications as a shareholder in the articles of association. In practice, the articles of association therefore will (1) stipulate the obligation of the company or one or more of its shareholders to acquire the deceased’s equity from his successor, (2) fix a price or a method of price calculation, and (3) stipulate the successor’s obligation to transfer the equity to the company/the shareholder(s).

d) One-Person LLC

Following the international trend, the one-person LLC was legally recognized in the 2005 Company Law. Prior to that, single membership had only been an

### Regulations on Company Registration. However, these provisions do not fix a time limit within which the registration authorities have to implement a decision.

105 Art. 33 para. 3 Company Law.
106 Jiang/Li (2005a), 233.
107 Art. 57 of the Administrative Regulations on Company Registration.
108 Art. 75 Company Law.
109 Fu/Yuan, 68.
110 Art. 76 Company Law.
111 (继承法), promulgated on April 10, 1985, and effective on October 1, 1985.
112 Jiang/Li (2005a), 238.
113 Gao, 160.
114 Chen Jianlin at n. 5.
option for wholly state-owned enterprises\textsuperscript{115} and wholly foreign-owned enterprises\textsuperscript{116}. According to the Company Law, a one-person LLC is an LLC with one natural or legal person as a sole shareholder.\textsuperscript{117}

(1) Special Requirements. The recognition of one-person LLCs entails considerable risks for the creditors of such companies. The sole shareholder of a one-person LLC will often be the company’s sole director and thus be able to commingle his personal property with the company’s property and abuse this situation to infringe upon the interests of the company’s creditors.\textsuperscript{118} The main purpose of the special provisions on one-person LLCs (arts. 58–64 Company Law) is to minimize these risks.

First of all, the minimum registered capital of a one-person LLC is RMB 100,000, and the capital contribution specified in the articles of association in accordance with this minimum amount has to be paid up in one instalment.\textsuperscript{119} Moreover, a natural person may not be involved in more than one one-person LLC: a natural person is barred from establishing more than one one-person LLC, and a one-person LLC established by a natural person is prohibited from establishing another one-person LLC.\textsuperscript{120} Besides, a one-person LLC’s business license bears the remark whether the company is wholly-funded by a natural person or a legal person.\textsuperscript{121}

It may seem that the special requirement to prepare annual financial accounting reports for auditing\textsuperscript{122} does not at all differ from the audit requirement imposed on all companies\textsuperscript{123,124}. It therefore has been suggested to adopt stricter rules on this matter for one-person LLCs.\textsuperscript{125} However, despite the almost identical wording of the two provisions, art. 165 Company Law was not intended to introduce such a general requirement; in fact, regular LLCs are only required to prepare annual financial accounting reports for auditing if another provision expressly states so.\textsuperscript{126} As a consequence, the audit requirement imposed on one-person LLCs by art. 63 Company Law actually is a special requirement.

Much more importantly, the sole shareholder has to keep his personal property strictly separate from the property of the company: In case the shareholder is unable to prove that the company’s property is independent from the shareholder’s personal property, he is jointly and severally liable for the company’s debts, i.e. the company’s creditors may either sue the company or the sole shareholder.\textsuperscript{127} This rebuttable presumption of lacking separation of assets imposes the full burden of proof on the sole shareholder. An example of lacking separation of assets would be the sole shareholder operating the company’s business from his private house\textsuperscript{129} (which is not that unlikely for the owner of a small business).

\textsuperscript{115} Chen Jianlin n. 11.
\textsuperscript{116} Infra Chapter 3 at 31.
\textsuperscript{117} Art. 58 para. 2 Company Law.
\textsuperscript{118} Fu/Yuan, 62; Guo/Qin, 136.
\textsuperscript{119} Art. 59 para. 1 Company Law.
\textsuperscript{120} Art. 59 para. 2 Company Law.
\textsuperscript{121} Art. 60 Company Law.
\textsuperscript{122} Art. 63 Company Law.
\textsuperscript{123} Art. 165 Company Law.
\textsuperscript{124} Chen Jianlin, 442/443.
\textsuperscript{125} Hong/Li, 112.
\textsuperscript{126} Gui/An, 149.
\textsuperscript{127} Art. 64 Company Law.
\textsuperscript{128} Fu/Yuan, 64.
\textsuperscript{129} Example by Chen Jianlin n. 39.
(2) Alternatives. Aside from the one-person LLC, there are two more ways for an individual person to run a business with limited liability\(^{130}\) which are both based on a regular LLC: The first way is to establish a regular LLC and subsequently have all shareholders exit the company except one (which is called a “subsequent one-person LLC” hereinafter). The second way is to use a nominal shareholder (e.g. the de facto sole shareholder’s spouse/parent/child) who will hold only a negligibly small amount of equity, the result being a de facto one-person LLC.

As to the subsequent one-person LLC, the crucial question is whether the special provisions on one-person LLCs apply as soon as there is only one shareholder left.\(^{131}\) This is rather likely because such a subsequent one-person LLC perfectly complies with the definition of a one-person LLC given by art. 58 para. 2 Company Law.\(^{132}\) The courts might even directly (i.e., despite neither the conditions of art. 64 nor of art. 20 para. 3 Company Law are fulfilled) hold the sole shareholder personally liable for the company’s debts if he fails to apply for registration of the company as a one-person LLC within a certain period of time.\(^{133}\)

That being said, the better alternative to a regular one-person LLC is the establishment of a de facto one-person LLC. The de facto sole shareholder is able to avoid the special requirements regarding one-person LLCs as to minimum capital contribution as well as the restrictions on the establishment of multiple one-person LLCs and the burden of proving the separation of assets.\(^{134}\)\(^{135}\)

However, a de facto one-person LLC also implicates two disadvantages: Firstly, its management is not as streamlined as it is for the regular one-person LLC (where no shareholders’ meetings are required). Secondly, there is a risk that the nominal shareholder might make a nuisance of himself in case the relationship to the de facto sole shareholder turns hostile (e.g. in the case of divorce), especially by suing the de facto sole shareholder under art. 152 Company Law.\(^{136}\)

(3) Conversion to Regular LLC. Some hold the view that it is impossible to convert a one-person LLC to a regular LLC by the accession of new shareholders

\(^{130}\) If a limitation of personal liability is not desired, it may be taken into consideration to establish an individual proprietorship enterprise according to the Individual Proprietorship Enterprise Law. Advantages are: no minimum capital required; eased bookkeeping requirements; no corporate income tax to be paid (cf. Bu, 159 at 12). However, this form of organization is available for Chinese citizens exclusively (art. 47 Individual Proprietorship Enterprise Law). – Anyway, a significant proportion of the sole shareholders of one-person LLCs might have to practically give up limited liability by signing personal guarantees in order to obtain bank loans (cf. Chen Jianlin n. 2).

\(^{131}\) At least, art. 32 of the SPC Draft Provisions of 2003 proposes not to declare a contract of transfer void for the sole reason that the intended transfer of equity would leave the company with only one shareholder.

\(^{132}\) Gao, 158, obviously takes the applicability of the special provisions on one-person LLCs for granted.

\(^{133}\) Such tendency is reflected by art. 50 para. 3 of the SPC Draft Provisions of 2003. However, it has to be considered that the one-person LLC had not been legally recognized yet when the SPC Draft Provisions of 2003 were formulated.

\(^{134}\) It must be noted that the courts might be more likely to find an abuse of the company’s independent legal person status in de facto one-person LLCs than in normal LLCs. (Cf. Chen Jianlin, 430 and ibid. n. 38, with reference to art. 50 para. 1 of the SPC Draft Provisions of 2003; but again, one must keep in mind that the one-person LLC had not been legally recognized yet when the SPC Draft Provisions of 2003 were formulated.) In case of such abuse, the shareholder will be held personally liable for the company’s debts under art. 20 para. 3 Company Law.

\(^{135}\) Chen Jianlin, 433.

\(^{136}\) Chen Jianlin, 429.
on the grounds that the relevant provisions are not applicable to one-person LLCs. However, as far as can be seen there is no actual basis for such an opinion as the special provisions on one-person LLCs only cover the establishment and organizational structure, leaving all other aspects to be dealt with according to the provisions on regular LLCs.

6. Joint Stock Limited Companies

a) Establishment

The establishment of a JSLC requires a minimum registered capital of RMB 5 million and can be achieved either by means of promotion or by means of share offer. For both methods, the number of promoters must be between 2 and 200, at least half of which are required to have their domiciles in China. However, if the number of shareholders subsequently drops to one, the company is not mandatorily required to be liquidated.

Under the promotion method, the promoters subscribe for all the shares to be issued by the company, whereas under the share offer method the promoters only subscribe for a part (at least 35%) of the shares to be issued and offer the remaining shares either to the public or to a specific target group of subscribers. A public offer is especially relevant for the conversion of an LLC into a JSLC, while the offer to a specific target group (rendering private placement possible) is the usual form of establishment of a JSLC under the share offer method. Compared to the share offer method, the promotion method is the less complicated way to form a JSLC.

b) Organizational Structure

(1) Shareholders’ General Meeting. Similar to the situation in an LLC, the ruling body in a JSLC is the shareholders’ general meeting. Its responsibilities are the same as for the shareholders’ meeting of an LLC. A shareholders’ general meeting...
has to be convened once a year (annual meeting), and extraordinary shareholders’
general meetings are to be held in certain situations as specified by the Company
Law.\textsuperscript{149} The shareholders shall be notified of the date and venue and of the agenda
20 days in advance of a shareholders’ general meeting (15 days in case of an
extraordinary shareholders’ general meeting); additionally, it is required that this
information be publicly announced 30 days in advance where a JSLC has issued
bearer shares.\textsuperscript{150}

60 Exactly as in the case of an LLC, it is debatable whether a shareholder who was
not duly notified can apply for rescission of a resolution adopted by the share-
holders’ general meeting although he could not have hindered the resolution by
casting an opposing vote (\textit{supra} at 36).

61 Shareholders who attend the shareholders’ general meeting have one voting right
for one share held, except for the shares of the company held by the company itself,
which are barred from voting.\textsuperscript{151} The board of directors, independent directors or
qualified shareholders of a listed company are allowed to solicit for the share-
holders’ right to vote in a shareholders’ general meeting (proxy soliciting) under the
condition that the shareholders are not paid for such solicitation and adequate
information is provided to the persons whose voting rights are being solicited.\textsuperscript{152}

62 (2) Board of Directors. A JSLC is required to establish a board of directors of 5 to
19 members, among them the chairman of the board (by whom the shareholders’
general meetings are convened and presided over\textsuperscript{153}) and (optionally) one or several
vice chairman/-men.\textsuperscript{154} There is no mandatory requirement on employees repre-
sentation.\textsuperscript{155} The board of directors has to convene at least twice a year and all of
the directors and supervisors are to be notified 10 days in advance.\textsuperscript{156} A meeting of
the board of directors can only be validly convened if more than half of the
directors attend.\textsuperscript{157} Resolutions of the board require the affirmative vote of more
than half of all the (i.e. not only of the attending) directors, each director (including
the chairman) having one vote.\textsuperscript{158} A director who is unable to attend the meeting of
the board of directors in person may commission another director in writing with
attending the board meeting on his behalf.\textsuperscript{159}

63 (3) Manager(s). The board of directors appoints and dismisses the manager(s) of
the JSLC (unlike in the case of an LLC, there has to be at least one manager), the
functions and powers of the manager(s) being the same as in the case of an LLC
(\textit{supra} at 32).\textsuperscript{160} Directors may concurrently serve as managers.\textsuperscript{161} As already stated
(\textit{supra} at 32), the term “manager” in the sense of the Company Law does not cover
all the personnel colloquially referred to as managers.

\begin{footnotesize}
\begin{itemize}
\item[149] Art. 101 Company Law.
\item[150] Art. 103 para. 1 Company Law.
\item[151] Art. 104 para. 1 Company Law.
\item[152] Art. 10 of the Code of Corporate Governance for Listed Companies (\textit{cf. infra} n. 191).
\item[153] Art. 102 para. 1 Company Law.
\item[154] Arts. 109 para. 1, 110 para. 1 Company Law.
\item[155] Art. 109 para. 2 Company Law.
\item[156] Art. 111 para. 1 Company Law.
\item[157] Art. 112 Company Law.
\item[158] Art. 112 Company Law.
\item[159] Art. 113 para. 1 Company Law.
\item[160] Art. 114 Company Law.
\item[161] Art. 115 Company Law.
\end{itemize}
\end{footnotesize}
(4) Supervisory Board. A JSLC also has to establish a supervisory board. As regards its composition, including the principle of incompatibility, and its functions and powers, it does not differ from its counterpart in an LLC (supra at 28–30). Differences to be mentioned are that a vice chairman/vice chairman of the supervisory board may be appointed and meetings have to be held at least once each six months (instead of only once a year).

(5) Independent Directors (Listed Companies). If the shares issued by the JSLC are listed and traded on a stock exchange, the company is required to have independent directors. Originally, the 1993 Company Law adopted the German-type two-tier board system with two separate organs for management (board of directors) and supervision (supervisory board) respectively. However, the institution of supervisors failed to satisfactorily fulfill the supervisory function due to supervisors’ lacking professional qualification, their close relations with the management and the absence of effective mechanisms of exercising supervisory power.

In this situation, the institution of independent directors (also called non-executive directors or outside directors) was grafted onto the existing two-tier system although it had been developed under the Anglo-American one-tier system (under which management and supervision functions are combined in one organ). The China Securities Regulatory Commission (CSRC) Guidelines for the Establishment of the System of Independent Directors in Listed Companies define the concept of independent directors, their functions and powers, and the method of appointing them. Usually, the shareholders’ general meeting elects the independent directors on nomination by the board of directors or of a major shareholder.

As an explanation for the coexistence of two supervisory instances it is usually stated that there is a division of tasks between the supervisory board and the independent director(s): While the latter checks the course of business for expediency beforehand, the former monitors its lawfulness ex post. However, the blending of the Anglo-American model and the German model is being blamed for diluting the effectiveness of both the board of directors and the supervisory board and for duplicating the company’s administrative costs.

c) Issue and Transfer of Shares

Shares of the same class carry the same rights and the same benefits. Shares are legally required to have par value and may be issued at the par value or at a premium but shall not be issued below par value. The Company Law only allows issuing registered shares or bearer shares, other classes of shares such as preference shares, 

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162 Arts. 118, 119 Company Law.
163 Arts. 118 para. 2, 120 para. 1 Company Law.
164 Arts. 123, 121 Company Law.
165 Fu/Yuan, 84.
166 Fu/Yuan, 84, 85; Bu, 178 at 42.
168 Bu, 178 at 42.
169 Bu, 178 at 43.
170 Cheung, 28.
171 Art. 127 para. 1 Company Law.
172 Art. 128 Company Law.
173 Art. 130 para. 1 Company Law.
ordinary shares and non-voting shares are to be regulated by the State Council.\textsuperscript{174} The terms and price are to be the same for shares of the same class and same issue.\textsuperscript{175} A company may only issue registered shares to its promoters and to legal persons.\textsuperscript{176} When new shares are issued to the public (share placement\textsuperscript{177}), the company is required to announce a prospectus for the new shares and financial accounting reports, and prepare subscription forms.\textsuperscript{178}

69 In order to prevent promoters from selling their shares\textsuperscript{179} immediately after the beginning of the public issuing so as to make profits from the gap between the original share price and the issuing price, the law provides for a lock-up period of one year, i.e. promoters may not transfer their shares within one year from the date of establishment of the company.\textsuperscript{180} A lock-up period also applies to shares held by directors, supervisors and senior officers\textsuperscript{181} (which include the managers) of a company, who are barred from transferring their shares of the company within one year from the date on which the company’s shares are listed for trading. Moreover, they may not transfer more than 25\% of their shares of the company per year. Upon leaving the company, they are not allowed to transfer any of their shares of the company for a period of six months.\textsuperscript{182} It is not clarified whether the transferability of shares may, beyond the scope of art. 142 Company Law, be generally restricted.\textsuperscript{183}

70 The Company Law does not allow companies to hold treasury shares. It imposes restrictions on the acquisition of a company’s shares by the company itself so as to ensure the maintenance of share capital and to protect the company’s creditors and shareholders.\textsuperscript{184} A JSLC may only purchase its own shares if (1) it is reducing its registered capital, (2) it is merging with another company which holds shares of the company, (3) it will grant the shares to its employees as an incentive and the amount of purchased shares does not exceed 5\% of its total issued shares, or (4) a shareholder who opposes a resolution of a shareholders’ general meeting on the merger or division of the company requests that the company buy back his shares; additionally, certain procedural requirements must be met.\textsuperscript{185}

7. The Legal Representative

71 “Legal representative” (法 定 代 表 人) is a peculiar term of Chinese Company Law. Although the legal representative may entrust another person, e.g. a deputy manager, with the power to act as his agent (i.e. not as a direct agent of the company),\textsuperscript{186} each company in China is only allowed to have one legal representa-
tive.\textsuperscript{187} Therefore, in the company registry only one person is registered as having the authority to represent the company, e.g. to conclude contracts or institute legal proceedings in the name of the company.\textsuperscript{188} The chairman of the board of directors, the executive director, or the manager of the company can be appointed as its legal representative in the company’s articles of association.\textsuperscript{189} Detailed stipulations concerning the eligibility as a legal representative, the registration procedures etc. are made by the Administrative Provisions on the Registration of Legal Representatives of Enterprise Legal Persons.\textsuperscript{190}

8. Corporate Governance

The first major step towards a sound corporate governance system in China was taken by the Code of Corporate Governance for Listed Companies.\textsuperscript{191} While these provisions were restricted to listed companies, the 2005 revision of the Company Law introduced an improved corporate governance system for all sorts of companies. Some of its features are highlighted in the following, whereas liability issues are to be addressed in more detail later (infra at 95 et seqq.).

a) Fiduciary Duties

The 2005 Company Law for the first time expressly imposes fiduciary duties (i.e. duties of loyalty and care) towards the company on directors, supervisors and senior officers.\textsuperscript{192} Even though the law does not explicitly stipulate the same for controlling shareholders\textsuperscript{193,194} it still features, to some extent, fiduciary duties of controlling shareholders as well. While duties of loyalty predominantly are duties of forbearance, duties of care mainly are duties to act.\textsuperscript{195}

(1) Directors’ and Senior Officers’ Duty of Loyalty. The concrete meaning of the duty of loyalty is substantiated by art. 148 para. 2 and art. 149 Company Law. According to art. 148 para. 2, directors and senior officers may neither use their positions to accept bribes or illegal income of any other kind, nor seize property of the company. Art. 149 para. 1 lists several types of prohibited behaviors (such as the misappropriation of corporate funds or unauthorized disclosure of the company’s secrets) and ends with a catch-all provision according to which directors and senior officers are to refrain from “other acts that breach their duty of loyalty”\textsuperscript{196}. Self-dealings, i.e. concluding contracts or carrying out transactions with the company in breach of the company’s articles of association or without the consent of the shareholders’ (general) meeting, are prohibited.\textsuperscript{196} The scope of this provision is too narrow in that it does not cover dealings carried out not by directors or senior officers themselves but by persons who are personally or economically related to

\textsuperscript{187} Jiang/Li (2005a), 82; Tang/Gao, 436.
\textsuperscript{188} Bu, 179 at 44; art. 38 GPCL.
\textsuperscript{189} Art. 13 Company Law.
\textsuperscript{190} (企业法人法定代表人登记管理规定), promulgated by the SAIC on April 7, 1998, and re-promulgated on June 23, 1999.
\textsuperscript{191} (上市公司治理准则), issued by the CSRC and effective on January 7, 2002.
\textsuperscript{192} Art. 148 Company Law.
\textsuperscript{193} The term “controlling shareholder” is defined by art. 217 no. 4 Company Law; infra at 106.
\textsuperscript{194} Anderson/Guo (part 1), 19, suppose the reason for this omission might be that the state is still the controlling shareholder in most Chinese companies.
\textsuperscript{195} Zhou, 389.
\textsuperscript{196} Art. 149 para. 1 no. 4 Company Law.
them. Moreover, dealings with the company’s subsidiaries instead of the company itself are not expressly covered. In addition, the provision is too restrictive because it fails to stipulate an exception for contracts which do not harm the company (e.g. a director granting an unsecured and interest-free loan to the company). Directors and senior officers owe a duty to, without the consent of the shareholders’ (general) meeting, not take advantage of their position to acquire for themselves or a third party business opportunities which belong to the company, or to engage in business identical to the company’s business for themselves or for the benefit of another. The law does not give a definition of “corporate opportunity.” Problems arise in case a company does not have sufficient resources to take the available business opportunities. From this perspective, directors and senior officers should be allowed to use those opportunities waived by the company and those which the company, as a matter of fact, is unable to pursue. On the other hand, the law fails to address the question whether (and if so, for how long) the non-compete provisions concerning directors and senior officers remain applicable after such persons having left the company. Moreover, art. 149 Company Law lacks a provision concerning the burden of proof. As regards self-dealings, it is being suggested to impose the burden of proof on the relevant director/senior officer in case he has not informed the shareholders’ meeting on the prospective transaction in advance.

In light of the numerous open questions it is advisable to establish individualized rules on these issues in articles of association and for this purpose it may be helpful to consult the Guidelines for the Articles of Association of Listed Companies (infra at 79).

As a special provision concerning directors (not senior officers) of listed companies, art. 125 Company Law prohibits a director from voting in case that director and the enterprise involved constitute related parties. “Related parties” are controlling shareholders, de facto controllers, directors, and senior officers of a company on the one hand, and the enterprise directly or indirectly controlled by these persons on the other hand. Generally, the use of such a relationship to the detriment of the company is prohibited by art. 21, which (unlike art. 148) also addresses controlling shareholders and de facto controllers.

(2) Directors’ and Senior Officers’ Duty of Care. Unlike the duty of loyalty, the duty of care is not being specified in more detail by the Company Law at all. For listed companies, a further explanation of this concept can be gathered from the Guidelines for the Articles of Association of Listed Companies, which in art. 98

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197 Li, 126, 127; Liu Yuechuan, 68.
198 Yuan, 171.
199 Liu Yuechuan, 68, 67.
200 Art. 149 para. 1 no. 5 Company Law.
201 Zhou, 405 mentions the criterion whether the opportunity is closely related to the company’s present and/or future business activities.
202 Yuan, 171.
203 Zhou, 405; Yuan, 171.
204 Yuan, 171.
205 Liu Yuechuan, 68; Li, 127.
206 Art. 217 no. 4 Company Law.
and art. 125 para. 2 address directors’ and senior officers’ duties of care (for their duties of loyalty, see art. 97). Even though the Guidelines nominally only apply to listed companies, they can as well provide valuable guidance in defining duties of care in all other types of companies.208

(3) Supervisors’ Fiduciary Duties. The fiduciary duties as outlined above (supra at 74–79) for directors and senior officers basically also apply to supervisors. However, art. 149 Company Law does not apply to supervisors as the addressed conducts are beyond the scope of a supervisor’s function.209

(4) Controlling Shareholders’ Fiduciary Duties. As stated above, the Company Law does not explicitly stipulate controlling shareholders’210 fiduciary duties in art. 148. However, art. 20 para. 1 and art. 21 Company Law may be understood as providing a certain basis for at least a minimum of such fiduciary duties:211 According to these provisions, a shareholder may not abuse his shareholder rights or his position as a related party to harm the company.

b) Minority Shareholder Protection

One of the important minority shareholder protections is introduced by the above-mentioned art. 21 Company Law as this provision helps to put a curb on controlling shareholders’ self-dealings.212 Additionally, minority shareholders are entitled to compensation for losses caused by other shareholders abusing their shareholder rights and by third parties (including controlling shareholders) infringing upon the lawful rights and interests of the company.213

Secondly, the hurdles for participation in the company’s decision-making have been substantially lowered. For instance, the threshold for shareholders of an LLC to request the convening of an extraordinary shareholders’ meeting has been reduced from 25 % to 10 % by the 2005 revision of the Company Law.214 Furthermore, a JSLC may now adopt cumulative voting in elections of directors or supervisors,215 which strengthens the minority shareholders’ position by enabling them to amplify all their votes for the director or supervisor candidate favored by them.216

Minority shareholders’ participation in the process of corporate decision-making is also facilitated by improving their access to information.217 In recent years, the number of lawsuits concerning the access to information increased to approximately 15 % of the total of company law disputes.218 A very important innovation in this respect is the right of the shareholders of an LLC to examine the company’s accounting books for legitimate reasons.219 However, this will often involve the risk of disclosing trade secrets to the plaintiff. For this reason, in the relevant discussion the judiciary partly favors the approach to appoint an accountant reviewing the

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208 Zhou, 392 (referring to the original version of the Guidelines).
209 Li, 126.
210 The term “controlling shareholder” is defined by art. 217 no. 4 Company Law; infra at 106.
211 Shi Tiantao, 383; Wang Yucheng, 254; Liu Jing, 102, 103.
212 Anderson/Guo (part 1), 21.
213 Arts. 20 para. 2, 152 para. 3 Company Law; cf. Anderson/Guo (part 1), 21, 22.
214 Art. 40 para. 2 Company Law; cf. Anderson/Guo (part 1), 22.
215 Art. 106 Company Law.
216 Fu/Yuan, 80.
217 Arts. 34, 98, 117, 151 Company Law; cf. Anderson/Guo (part 1), 22.
218 Jiangsu Province Higher People’s Court Second Civil Division, 7.
219 Art. 34 para. 2 Company Law; cf. Anderson/Guo (part 1), 22.
company’s accounting books on behalf of the plaintiff and passing only the result of the review to the plaintiff.220

Finally, shareholders of an LLC are (on certain conditions) granted the option to exit the company by requesting the company to purchase back their equity (supra at 44).

c) Shareholder Lawsuits

A novelty to Chinese statutory221 law is the shareholder derivative lawsuit under art. 152 of the 2005 Company Law. According to this provision, certain shareholders may directly initiate legal proceedings before the people’s courts in their own name for the benefit of the company.222 The derivative suit mainly aims at enabling shareholders to enforce claims of the company against its managing officers and directors. Such claims are unlikely to be prosecuted by the company itself as the company is controlled by its officers and directors who will be reluctant to authorize the company to bring suit against themselves. The opposed form of shareholder lawsuits is the direct lawsuit under art. 153 Company Law, which is brought by a shareholder on his own behalf. The direct suit serves to enforce claims based on the shareholder’s ownership of shares (such as the shareholder’s right to receive dividends and to examine the company’s books and records).

The preconditions for these two types of shareholder lawsuits differ in respect of the person/entity that has suffered a loss: Where the company itself was caused to incur a loss, the lawsuit of choice is the shareholder derivative lawsuit, whereas a direct lawsuit fits if the shareholder himself/herself has suffered a loss. However, it will often be hard to determine whether the harm is suffered by the shareholders or the company as harm of the company will (indirectly) result in the diminution of the value of the shareholders’ shares.223 Due to this ambiguity it seems possible that in many cases the shareholders have the option to choose freely which type of lawsuit to file. Taking into account the onerous procedural restrictions of the derivative lawsuit as well as the fact that only a direct lawsuit results in payment of recovery directly to the shareholders,224 they are rather likely to opt for a direct lawsuit.225

Therefore it is necessary to clearly delineate the causes of action which proceed as direct suits from the ones that are only actionable as derivative suits. A clue provided by the Company Law in this respect is that gains made by directors or senior officers in violation of their duty of loyalty to the company (supra at 74 et seqq.) “belong to the company”,226 indicating that claims based on the breach of fiduciary duties should proceed as derivative suits.227 Additionally, it might be

220 Jiangsu Province Higher People’s Court Second Civil Division, 7.
221 The Higher People’s Courts of Jiangsu Province and of Shanghai released interpretations establishing rules for derivative lawsuits in their respective jurisdictions in 2003 (cf. Anderson/Guo (part 2), n. 13.
222 A very detailed account of the procedures for derivative lawsuits is given by Anderson/Guo (part 2), 17–20.
223 Liu Junhai, 252; Anderson/Guo (part 2), 17.
224 Liu Junhai, 253.
225 Anderson/Guo (part 2), 17.
226 Art. 149 para. 2 Company Law.
227 Anderson/Guo (part 2), 17.
useful for China’s judiciary to refer to the distinction criteria developed in US law.\textsuperscript{228} However, even these will sometimes be ambiguous.\textsuperscript{229}

d) Restrictions on the Provision of Security

As the provision of security can put a company’s property at substantial risk, \textsuperscript{89} art. 16 Company Law contains restrictions in this respect: The provision of security for a third party requires a resolution either of the shareholders’ (general) meeting or the board of directors, depending on which of these organs has been authorized in the articles of association, while granting security for a shareholder or the \textit{de facto} controller of the company can only be approved by resolution of the shareholders’ (general) meeting. In the latter case, the relevant shareholder or the shareholder controlled by the \textit{de facto} controller of the company is barred from casting his vote, and the resolution requires a simple majority of the voting rights held by the other shareholders attending the meeting. Additionally, the articles of association may define a limit for the total amount of such security or the amount of any single security. If in a \textit{listed} company the amount of security provided within one year is to exceed 30% of the company’s entire assets, a resolution of the shareholders’ general meeting is required which has to be passed by at least two thirds of the voting rights held by the shareholders attending the meeting.\textsuperscript{230}

9. Capital Increase and Capital Reduction

A company that proposes to reduce its registered capital is required to prepare a balance sheet and a list of assets. For the purpose of the protection of creditors’ rights, the company shall notify its creditors and announce the proposed reduction in newspapers. The creditors may, within certain time limits, demand full repayment or provision of a commensurate security. The capital reduction may not result in a registered capital lower than the statutory minimum.\textsuperscript{231} Both increase and reduction of a company’s capital are to be registered with the company registry.\textsuperscript{232}

In case an LLC increases its registered capital, the contribution to the additional capital by the shareholders has to comply with the provisions of the Company Law on capital contributions in connection with the establishment of an LLC (\textit{supra} at 26).\textsuperscript{233} A JSLC may increase its registered capital by issuing new shares, in which case shareholders’ subscriptions for the new shares are bound by the provisions of the Company Law on the payment of subscription monies in connection with the establishment of a JSLC.\textsuperscript{234} As the Company Law does not incorporate the concept of authorized capital (i.e. the option to stipulate in the articles of association that the board of directors may increase the capital up to a certain amount by issuing new shares), a capital increase always requires a resolution of the shareholders’ general meeting.

\textsuperscript{229} Liu Junhai, 254.
\textsuperscript{230} Art. 122 Company Law.
\textsuperscript{231} Art. 178 Company Law.
\textsuperscript{232} Art. 180 para. 2 Company Law.
\textsuperscript{233} Art. 179 para. 1 Company Law.
\textsuperscript{234} Art. 179 para. 2 Company Law.
10. Dissolution and Liquidation

The dissolution and liquidation of a company is addressed by part ten of the Company Law (arts. 181 et seqq.). In addition, enhanced protection for minority shareholders and creditors in the process of dissolution and liquidation of a company is provided by the SPC Provisions II. The liquidation upon dissolution is to be distinguished from the liquidation in case of bankruptcy (for details on bankruptcy, infra Chapter 8).

A company may be dissolved either by a resolution of the shareholders’ (general) meeting, or by administrative or court decision, whereas the courts will only decide to dissolve a company upon a petition of a shareholder or several shareholders holding alone or in aggregation at least 10% of all shareholder voting rights. This latter procedure is designed as an ultima ratio in case of deadlock situations as further defined by art. 1 para. 1 SPC Provisions II.

When a company is to be dissolved for other reasons than merger or division, it has to establish a liquidation committee which is, in the case of an LLC, composed of the shareholders or, in the case of a JSLC, of the directors or other persons appointed by the shareholders’ general meeting, within a specified time limit. If the company fails to do so, its creditors or a shareholder may apply to a people’s court to form a liquidation committee. The liquidation committee’s functions and powers include, inter alia, to examine the company’s property and to prepare a list of assets, to notify creditors of the liquidation, to dispose of and liquidate relevant unfinished business of the company, and to participate in civil litigation activities on behalf of the company.

11. Liability

The Company Law features numerous provisions on liability, many of which have been introduced by the 2005 revision of the law. The following discussion focuses on the civil liabilities imposed on the company and the relevant actors.

a) The Company

The company bears civil liability for the operational activities of its legal representative and other personnel. There are three different understandings of the somewhat vague term “other personnel”, according to which it respectively covers (1) all members of the company’s organs except the head (probably the legal representative) of the company or (2) persons beside the company’s legal representative upon whom certain functions and powers are conferred by the articles of association, especially managerial personnel, but not ordinary workers; or (3) all employees of the company except its legal representative. The third opinion is

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235 In-depth survey by Pissler/Hippel (in German).
236 Zhu/Mendel, 24.
237 Art. 191 Company Law.
238 Art. 181 nos. 1–3 Company Law.
239 Arts. 181 nos. 4, 5, 183 Company Law, art. 1 para. 1 SPC Provisions II.
240 Fu/Yuan, 104.
241 Art. 184 Company Law.
242 Art. 184 Company Law; art. 7 para. 3 SPC Provisions II.
243 Art. 43 GPCL.
244 Tang/Gao, 645.
As the scope of the company’s liability is basically restricted to the operational activities of its legal representative and other personnel, the question arises as to who bears liability for acts related to the establishment of the company but conducted before the company actually being established. During such a preparatory period, the company does not exist yet, nor is there a legal representative or other personnel who could cause any kind of liability for the company.

As the Company Law itself is silent on this matter, it is helpful to consult the SPC Draft Provisions of 2003 (supra at 5). In these provisions, the establishment stage is referred to as “actions of establishment of the company”. This stage begins with the signing of an agreement of establishment or the articles of association by the entirety of investors or the promoters respectively, and ends with the issuance of a company’s business license or a decision not to establish the company at all.

If the company finally is established, it bears all necessary expenses made during the establishment stage and is liable for all debts incurred during this period of time. Particularly, it bears the obligations from contracts made by the investors or promoters in the name of the company to be established. This transfer of liability from the investors or promoters towards the company takes place by operation of law ("law" in this context referring to the SPC Draft Provisions of 2003 which, as already mentioned, technically are a mere indication). An alternative way to eliminate the investors’ or promoters’ personal liability would be novation, i.e. the substitution of an original pre-incorporation contract with a new contract between the company and the third party on similar terms. However, the concept of novation is practically alien to Chinese law.

b) Investors and Promoters

(1) Investors of an LLC. Before an LLC is established or when its establishment has failed, the entirety of investors bears joint and several liability for all debts incurred during the establishment stage. If the establishment has failed, the necessary expenses made during this period of time are to be borne by the investors according to the ratio of agreed capital contribution, except where the agreement of establishment or the articles of association stipulate otherwise. Where the establishment has failed due to an investor’s failure to fully pay up his investment or due to his fault in any other respect, he is liable to the other investors for the (actual, not only the necessary) establishment expenses made until then.
101 If an investor concludes a contract for his personal benefit but in the name of the company to be established, and the other party to the contract is or should be aware of this fact, the investor himself bears the contractual obligations. It goes without saying that obligations resulting from contracts entered into by the investors in their own name have to be fulfilled by the concerned investor/promoter himself as well.

102 (2) Promoters of a JSLC. The promoters of a JSLC are liable for damages incurred in the course of establishment due to the promoters’ fault, and, if the JSLC cannot be established, they bear joint and several liability for the debts and expenses incurred by the establishment activities as well as for refunding the subscription monies already paid by subscribers plus bank deposit interest calculated for the same period. Promoters who fail to duly make their capital contribution are liable for breach of contract in accordance with the promoters’ agreement.

c) Shareholders

103 (1) Liability to the Company’s Creditors. A very important innovation by the 2005 revision is the implementation of the doctrine of “piercing the corporate veil” (i.e. a shareholder’s joint and several liability for the company’s debts if he abuses the limitation of his liability) in art. 20 para. 3 and art. 64 Company Law. While art. 20 para. 3 applies for regular LLCs and for JSLCs, art. 64 is specially designed for one-person LLCs. The motive for this differentiation is that it is much easier to abuse the limitation of liability for the sole shareholder of a one-person LLC than for a shareholder of a regular LLC or a JSLC.

104 Under art. 20 para. 3, the preconditions for “piercing the corporate veil” are rather strict: The shareholder (the defendant) must have abused the company’s independent legal person status or his limited liability as a shareholder to evade and repudiate debts, and this must have caused “serious” harm to the interests of the company’s creditors, both of which the company’s creditor (the plaintiff) has to prove. Art. 64 differs from art. 20 para. 3 in the following aspects: (1) it suffices to assume a liability under art. 64 if the company’s assets are not independent of the shareholder’s personal assets, neither an “abuse” nor a “serious harm” is required; and (2) the burden of proof of the independency of assets is imposed upon the shareholder. This makes it much easier to pierce the corporate veil of a one-person LLC than of a regular LLC or a JSLC.

105 Shareholders of an LLC serving as members of a liquidation committee who willfully or by gross negligence cause the company or its creditors losses are liable to the company or its creditors respectively.

106 (2) Liability to Other Shareholders and/or the Company. A shareholder is liable for losses caused for the company or other shareholders by abuse of his shareholder

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255 Art. 95 Company Law.
256 Art. 84 para. 2 Company Law.
257 Before 2005, this doctrine was only addressed by arts. 48 et seqq. of the SPC Draft Provisions of 2003, which apply to a company’s controlling shareholders exclusively.
258 Supra at 48.
259 Art. 184 para. 1 clause 2 Company Law.
260 Art. 190 para. 3 Company Law.
rights.261 A controlling shareholder who uses his position as a related party (supra at 78) to the detriment of the company is also liable for damages.262 A controlling shareholder is a shareholder whose capital contribution to an LLC accounts for at least 50 % of the company’s total capital or whose shareholding accounts for at least 50 % of the total share capital of a JSLC, or a shareholder whose capital contribution or shareholding, although not accounting for 50 %, is nonetheless, through the voting rights attaching to his capital contribution or his shareholding, able to materially influence the resolutions of the shareholders’ meeting or shareholders’ general meeting.263

d) De Facto Controllers

A company’s de facto controller bears liability to the company equally to a controlling shareholder (supra at 106),264 “de facto controller” meaning a person who, although not being a shareholder of the company, is nonetheless able to direct the acts of the company by virtue of an investment relationship, agreement or other arrangement.265

e) Senior Officers

Senior officers, which include a company’s manager, deputy manager, financial officer, the secretary to the board of directors of a listed company266 and other persons specified in the company’s articles of association,267 are liable to the company in the same way as a controlling shareholder (supra at 106).268 In case a senior officer violates laws, administrative regulations or the company’s articles of association, thereby causing harm to a shareholder’s interests, the shareholder is entitled to file a direct lawsuit against him.269 However, senior officers are not directly liable to harmed third parties such as creditors of the company etc.270

f) Directors and Supervisors

A company’s directors and supervisors are liable to the company and its shareholders equally to senior officers (supra at 108). As regards the directors of a JSLC, there are two additional liability provisions: Firstly, they are liable to the company or its creditors for compensation if they, while serving as members of a liquidation committee,271 willfully or by gross negligence cause the company or its creditors respectively to suffer loss.272 Secondly, a director is liable to the company for damages if he took part in a resolution of the board of directors which violates laws, administrative regulations, the company’s articles of association or the resolutions of the shareholders’ general meeting and which causes the company to incur

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261 Art. 20 para. 2 Company Law.
262 Art. 21 para. 2 Company Law.
263 Art. 217 no. 2 Company Law.
264 Art. 21 para. 2 Company Law.
265 Art. 217 no. 3 Company Law.
266 Cf. arts. 121, 124 Company Law.
267 Art. 217 no. 1 Company Law.
268 Art. 21 para. 2 Company Law.
269 Art. 153 Company Law.
270 Wang/Jia, 368, who propose to change this situation (369).
271 Art. 184 para. 1 clause 2 Company Law.
272 Art. 190 para. 3 Company Law.
serious losses, unless the director has expressed his opposition to the resolution when it was put to the vote.273

g) Inapplicability of the Business Judgment Rule

Under the Chinese Company Law, the liability of directors and senior officers is not limited by a “business judgment rule” (elimination of liability for erroneous acts or omissions involving a question of business judgment as far as there is no fraud, conflict of interest or bad faith; no second-guessing by courts, with the benefit of hindsight, of decisions which yield less than optimal results) as originated in US law.274 However, the question of to what extent such a limitation imposed on judicial review of managerial decisions should be introduced to China, be it by law or by judicial interpretation,275 is regarded as an important issue.276 At the same time, it is emphasized that due to substantial differences between the legal systems of the US and China it is impossible simply to replicate the US model.277

h) Indemnification for Management’s Civil Liabilities

In order to strengthen the management’s readiness to take entrepreneurial risks, it may be necessary to indemnify directors and senior officers. It is highly doubtful whether a general reduction or even exclusion of liabilities (e.g. by the articles of association278) is within reach under the 2005 Company Law as its provisions on management’s liabilities have to be classified as compulsory (supra at 15 et seqq.).279 The very few exceptions expressly stipulated by the Company Law280 obviously are designed for dispensations in individual cases, and they cannot be extended at will. It is also generally impossible to exempt liability for losses caused by intention or gross negligence by contract.281 Consequently, director & officer liability insurance (D&O Insurance) is highly recommended282 and, even though this kind of insurance has not yet been explicitly regulated in China,283 seems to be the only practicable solution.

273 Art. 113 para. 3 Company Law.
274 Cf. Anderson/Guo (part 1), 21; Wang Zhenyu, 131; Rong, 56. – As Rong points out, the 2006 revision at least punctually shows a certain tendency to leave decisions to the company itself instead of the courts (which is at the bottom of the business judgment rule): Unlike under the old art. 189, according to art. 184 of the new Company Law the liquidation committee is, in the first instance, to be established by the company itself (Rong, 56). – Yin Dafei, 336, puts forward a completely different (and very interesting) approach: Unlike a majority of authors who equate the Chinese expression “勤勉义务” in the Company Law with the term “duty of care” (and translate the latter as “duty of care”) (e.g. Liu Jianhui, 404), Yin argues that the use of the Chinese expression “勤勉义务” actually is intended to impose less strict liabilities on the relevant personnel than implied by the above-mentioned equation of expressions, thus deeming it unnecessary to apply the business judgment rule in China. However, this approach has remained unechoed so far.
275 The latter being proposed by Chang, 60.
276 Shi Hui, 287.
277 Chang, 60; Shi Hui, 287.
278 As suggested by Anderson/Guo (part 1), 21.
279 Wei Xiaowen, 30.
280 Art. 149 para. 1 nos. 3, 4 Company Law (cf. Wei Xiaowen, n. 4).
281 Art. 53 no. 2 Contract Law.
282 Anderson/Guo (part 1), 21.
283 Wei Xiaowen, 31.
III. Main Issues Regarding Partnership Enterprises

Originally, partnership was only regulated by the scarce provisions of the GPCL on individual partnership.\(^{284}\) In addition, some local legislators issued their own regulations on partnership.\(^{285}\) On February 23, 1997, the Partnership Enterprise Law was promulgated after three years of consultation.\(^{286}\) It took effect on August 1, 1997. However, this initial version of the law was incomplete under several aspects as it lacked provisions on limited partnerships, foreign partners in partnerships, etc.\(^{287}\) As a consequence, a comprehensive revision of the law was adopted on August 27, 2006 and came into effect on June 1, 2007. The Partnership Enterprise Law is accompanied by the Administrative Measures of the PRC on the Registration of Partnership Enterprises promulgated on November 19, 1997, and revised on May 9, 2007 (revision effective from June 1, 2007).

1. Forms of Partnership Enterprises

The Partnership Enterprise Law provides for three forms of partnership enterprises: general partnership enterprise, limited partnership enterprise, and special general partnership enterprise. The name of a partnership enterprise shall directly indicate the respective type of partnership enterprise; otherwise a fine may be imposed.\(^{288}\)

Partnership enterprises under the Partnership Enterprise Law are to be distinguished from individual partnership under the GPCL because only the former are given the additional attribute “enterprise” by the law.\(^{289}\) Theoretically, as “partnership” is the generic term, the GPCL provisions on individual partnerships are applicable not only to non-enterprise individual partnerships, but (subsidiary) also to partnership enterprises which are formed by individuals (as opposed to legal persons and other organizations) exclusively. Practically, however, the legal framework for partnership enterprises established by the Partnership Enterprise Law as the special statute leaves no gaps that could be filled by the GPCL provisions on partnerships (which themselves are rather sketchy anyway).\(^{290}\)

a) General Partnership Enterprise

A general partnership enterprise is formed by general partners exclusively; every partner bears unlimited joint and several liability for the debts of the partnership enterprise with his personal property.\(^{291}\) Where the law provides specifically for how liability should be borne by general partners, such provision prevails.\(^{292}\)

\(^{284}\) Arts. 30–35 GPCL.
\(^{285}\) E. g., the Shenzhen Partnership Regulations (1994) (cf. Chen Jianfu, 484 n. 106).
\(^{286}\) Chen Jianfu, 485.
\(^{287}\) Chen Jianfu, 485.
\(^{288}\) Arts. 15, 56, 62, 94 Partnership Enterprise Law.
\(^{289}\) However, the Partnership Enterprise Law fails to give a definition of the term “enterprise”.
\(^{290}\) One might at most raise the converse question whether the Partnership Enterprise Law analogously applies to non-enterprise individual partnerships. Cf. Bu, 161 at 3.
\(^{291}\) Art. 2 para. 2 Partnership Enterprise Law.
\(^{292}\) Art. 2 para. 2 clause 2 Partnership Enterprise Law. This provision refers to art. 57 Partnership Enterprise Law, which will be discussed later (infra at 120).
b) Limited Partnership Enterprise

A limited partnership enterprise is formed by general partners and limited partners; the general partners are jointly and severally liable without limit for the debts of the partnership enterprise and limited partners are liable for the debts of the partnership enterprise up to their subscribed capital contribution. The number of partners is capped at 50, at least one has to be a general partner. The limitation to a maximum of 50 partners is intended to prevent the use of limited partnership enterprises as an illegal means for public fundraising.

The introduction of the limited partnership enterprise by the 2006 revision allows for, and is primarily aimed at, greater structuring flexibility by permitting the combination of institutions/individuals who have management experience or R&D capabilities and those with capital, i.e. venture capital financings.

c) Special General Partnership Enterprise

Professional service organizations that provide fee-based professional and skilled services for clients may be established as a special general partnership enterprise. Special general partnership enterprises are special in two aspects, namely forms of liability and insurance requirements; otherwise, the provisions on general partnerships remain applicable.

The introduction of the special general partnership enterprise is considered one of the most notable changes brought about by the 2006 revision of the Partnership Enterprise Law. The range of the said professional service organizations is under debate as it is somewhat unclear which organizations are “enterprises” and which are not. Some opine that enterprise organizations include law firms, accountancy firms, medical clinics, and architecture firms, etc. Others hold that law firms and probably also accountancy firms and medical clinics are non-enterprises. However, even in the case of non-enterprise type professional service organizations, the liability of the partners may be guided by the provisions of the Partnership Enterprise Law on the liability of partners in general partnership enterprises.

If in a special general partnership enterprise a partner incurs liability either by acting willfully or negligently in the course of providing professional services, only

293 Art. 2 para. 3 Partnership Enterprise Law.
294 Art. 61 Partnership Enterprise Law.
295 Chen Jianfu, 489.
296 No. 1 and no. 3 of the Explanations regarding the “Partnership Enterprise Law of the PRC (Revised Draft)” (关于《中华人民共和国合伙企业法(修订草案)》的说明), promulgated by the Law Committee of the National People’s Congress (Law Committee of the NPC) on April 25, 2006. Reproduced in Cao/Zhang, 24 et seqq. (25, 27).
297 Art. 55 para. 1 Partnership Enterprise Law.
298 Chen Jianfu, 489.
299 McKenzie/Mendel, 32.
300 These were explicitly mentioned in art. 70 of the revised draft of the Partnership Enterprise Law, cf. Cao/Zhang, 26.
301 Chen Jianfu, 487. Bu, 164 at 16 only gives accountancy firms as an example.
302 The Law Committee of the NPC proposed to expressly address law firms as non-enterprise professional service organizations, see no. 5 of the Report on the Circumstances of the Revision of the “Partnership Enterprise Law of the PRC (Revised Draft)” (关于《中华人民共和国合伙企业法(修订草案)》修改情况的汇报), promulgated by the Law Committee of the NPC on June 24, 2006.
303 Münzel (2006b), n. 12.
304 Art. 107 Partnership Enterprise Law.
that partner may be held unlimitedly liable; and the other partners are only liable up to their respective share to property in the partnership enterprise.\textsuperscript{305} All partners bear joint and several unlimited liability for debts incurred in the course of providing professional services by acts of partners without intention or gross negligence, and for all other debts of the partnership enterprise.\textsuperscript{306}

Special general partnership enterprises are required to establish a practice risk fund and purchase professional liability insurance\textsuperscript{307} so as to protect their creditors' interests from being harmed by the limitation of liability.

2. Basic Differences to LLCs

The (very obvious) disadvantage of a partnership enterprise compared to an LLC is the unlimited liability of at least one partner.\textsuperscript{308} On the other hand, there are several advantages more or less directly related to this disadvantage:\textsuperscript{309} (1) Capitalization: Unlike companies, partnership enterprises do not require a minimum registered capital. More importantly, there is no restriction regarding the means of capital contribution (as far as general partners are concerned): it may take the form of \textit{any} kind of property right as well as the form of labor services.\textsuperscript{310} (2) Taxation: The former double taxation of partnership enterprises (i.e. the partnership enterprise itself was taxed as an enterprise and the partners were taxed on their income) has been legally\textsuperscript{311} abolished by art. 6 of the 2006 revised Partnership Enterprise Law.\textsuperscript{312} This creates a significant taxation advantage over an LLC. (3) Organizational structure: A partnership enterprise has a more streamlined organizational structure than an LLC in that it is not required to establish a board of directors or a supervisory board or to appoint an executive director and a supervisor/supervisors.

3. Partners

The establishment of a partnership enterprise requires a minimum of two partners.\textsuperscript{313} Partners may be natural persons (who, if they serve as general partners, have to be fully capable of civil conduct), legal persons or other organizations.\textsuperscript{314} However, wholly state-owned and wholly state-funded companies, state-owned enterprises, listed companies and charitable institutions and social organizations are prohibited from acting as general partners.\textsuperscript{315}

The eligibility of legal persons to partnership enterprises is an amendment introduced by the 2006 revision of the Partnership Enterprise Law.\textsuperscript{316} It might

\textsuperscript{305} Arts. 55 para. 2, 57 para. 1 Partnership Enterprise Law.
\textsuperscript{306} Arts. 55 para. 2, 57 para. 2 Partnership Enterprise Law.
\textsuperscript{307} Art. 59 para. 1 Partnership Enterprise Law.
\textsuperscript{308} Cf. art. 61 para. 2 Partnership Enterprise Law.
\textsuperscript{309} The following is based on Du, 70.
\textsuperscript{310} Art. 16 para. 1 Partnership Enterprise Law. As to the means of capital contribution by limited partners, cf. art. 64 Partnership Enterprise Law.
\textsuperscript{311} In fact, the double taxation had already been abolished by a circular of the State Council in 2000 (Chen Jianfu, 490).
\textsuperscript{312} And, subsequently, by art. 1 para. 2 of the Enterprise Income Tax Law (企业所得税法, promulgated on March 16, 2007, effective on January 1, 2008).
\textsuperscript{313} Arts. 14 no. 1, 61 para. 1 Partnership Enterprise Law.
\textsuperscript{314} Arts. 2 para. 1, 14 no. 1 Partnership Enterprise Law.
\textsuperscript{315} Art. 3 Partnership Enterprise Law.
\textsuperscript{316} Zhu, 77; McKenzie/Mendel, 32.
seem doubtful at first glance whether companies may act as general partners\textsuperscript{317} in
that art. 15 Company Law stipulates that a company may invest in other companies,
but, unless otherwise provided by law, may not become an investor that bears joint
and several liability for the debts of the enterprise in which it has invested. In light
of this provision one could assume that art. 2 para. 1 Partnership Enterprise Law
only allows companies to be limited partners. However, the argumentum e contrario
derived from art. 3 (supra at n. 315) shows that, unlike SOEs etc., other types of
companies are allowed to act as general partners in a partnership enterprise.

125 It is argued that, in addition to unlimited liability for the partnership enterprise’s
debs, the investment as a general partner exposes the investing company to the risk
that the other general partners may, referring to the relationship of mutual trust and
supervision among the general partners, require the company to reveal internal
information on its business operation, and might even claim a right to participate in
the making of the company’s strategic decisions.\textsuperscript{318} Therefore it is held advisable to
integrate restrictions on investment as general partner into a company’s articles of
association.\textsuperscript{319} However, this point of view is questionable as the partners to a
partnership enterprise do not have such a right to interfere in another general
partner’s individual affairs, be the general partner a natural or a legal person.

126 As to whether foreigners and foreign enterprises are capable of establishing a
partnership enterprise in China, art. 108 Partnership Enterprises Law leaves it to the
State Council to formulate administrative measures on the establishment of partner-
ship enterprises in China by foreign enterprises or individuals. This means that, as a
matter of fact, foreigners are unable to establish partnership enterprises before the
State Council issues such administrative measures.\textsuperscript{320} As early as in January 2007, a
draft version of the Administrative Measures on Foreign-Invested Partnership En-
terprises was elaborated,\textsuperscript{321} which has to deal with the following difficulties:\textsuperscript{322}

127 (1) Uncertainties concerning the organizational structure of foreign-invested
partnership enterprises. The revised art. 68 para. 1 Partnership Enterprise Law
contradicts art. 53 para. 1 of the Implementation Regulations for the Law of the
PRC on Sino-foreign Cooperative Joint Venture Enterprises (issued 1995), which
requires cooperative enterprises without legal person status to establish a joint
management body consisting of representatives appointed by both parties to the
cooperative enterprise. On the contrary, art. 68 para. 1 Partnership Enterprise Law
states that limited partners have to refrain from conducting partnership affairs and
representing the limited partnership enterprise in external dealings.

128 (2) Potential inconsistency with the revised Partnership Enterprise Law. According
to art. 16 para. 1 Partnership Enterprise Law, capital contributions may be made in
the form of labor services. Taking into account China’s restrictive approach towards
foreign labor, the draft excludes foreign partners from this form of capital contribu-

\textsuperscript{317} The eligibility as general partner is (without further explanation) assumed by Zhu, 83.
\textsuperscript{318} Zhu, 82.
\textsuperscript{319} Zhu, 83.
\textsuperscript{320} Chen Jianfu, 491, assuming that previous foreign investment laws which allow contractual
arrangements for limited partnership, e.g. the Provisions for the Administration of the Establish-
ment of Foreign Investment Venture Capital Enterprises (2003), will continue to apply before the
State Council promulgates its new administrative measures (ibid., n. 145).
\textsuperscript{321} Fu, 74.
\textsuperscript{322} Fu, 74.
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tion. However, it is questionable whether administrative measures can actually restrict the scope of application of a law. In any event, the relevant regulations on employing foreigners are to be considered.

(3) Internal conflict of objective. Although the draft aims to treat domestic and foreign capital equally and to remove obstacles impeding foreign investment, an equal treatment is hardly conceivable as long as foreign investment is subject to special supervision and control in China.

As a result of this difficult situation, the draft has not been put into force as of July 2009.

4. Organizational Structure, Operation

The law does not contain any detailed compulsory stipulations on the organizational structure and operation of partnership enterprises. It only requires the written partnership agreement to contain statements on key issues such as the distribution of profits and losses, the conduct of partnership affairs, etc.⁴²³

Absent a different agreement, all general partners have equal rights in the conduct of partnership affairs,⁴²⁴ decisions on certain important matters (e.g. a change in the name of the partnership enterprise) are subject to the unanimous approval of all of the partners, and resolutions on all other matters require a simple majority of the partners, each partner having one vote.⁴²⁵

5. Admission, Withdrawal and Removal of Partners

The admission of a new partner is subject to the unanimous resolution of all partners, unless the partnership agreement stipulates otherwise.⁴²⁶

A partner has a statutory right to withdraw from the partnership at any time against the payment of compensation for the losses caused to the partnership enterprise by the withdrawal.⁴²⁷ There are two exceptions: If the partnership agreement does not specify a duration for the existence of the partnership, a partner is allowed to withdraw from the partnership provided that the withdrawal does not adversely affect the partnership enterprise’s conduct of affairs, and all the other partners have been notified of the withdrawal 30 days in advance.⁴²⁸ If a duration is specified, a partner may withdraw under certain circumstances defined by the law, e.g. in the event of a major violation of an obligation stipulated in the partnership agreement by another partner.⁴²⁹

The law provides for automatic withdrawal of a partner upon occurrence of certain circumstances such as the death of a natural person partner or the order to close down a legal person partner.⁴³⁰ If a general partner is deemed to have no capacity or limited capacity for civil conduct, the partner may be converted to a limited partner upon the unanimous resolution of the other partners (as a consequence, a general partnership enterprise will be transformed into a limited partner-

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³²³ Arts. 14 no. 2, 18, 63 Partnership Enterprise Law.
³²⁴ Arts. 26, 67, 68 Partnership Enterprise Law.
³²⁵ Arts. 31, 30 Partnership Enterprise Law.
³²⁶ Art. 43 Partnership Enterprise Law.
³²⁷ Art. 47 Partnership Enterprise Law.
³²⁸ Art. 46 Partnership Enterprise Law.
³²⁹ Art. 45 Partnership Enterprise Law.
³³⁰ Arts. 48 para. 1, 78 Partnership Enterprise Law.
ship enterprise); where such an unanimous resolution cannot be achieved, the partner with no capacity or limited capacity for civil conduct shall be withdrawn from the partnership.\textsuperscript{331}

If a general partner dies, his successor, pursuant to provisions in the partnership agreement or upon unanimous resolution of all partners, succeeds as a partner to the partnership enterprise; if the successor does not enter the partnership enterprise, the deceased partner’s share of property is to be returned to the successor.\textsuperscript{332}

Removing a partner is subject to an unanimous resolution of all other partners if one of the circumstances defined by the law occurs with a partner, e.g. in case a partner has intentionally or negligently caused loss to the partnership enterprise. The removed partner is to be notified of the resolution for removal and may file for legal proceedings with the People’s Court within 30 days.\textsuperscript{333}

6. Transfer of Shares in Property

Unless stipulated otherwise in the partnership agreement, the transfer of a partner’s share in property of the partnership enterprise, whether in full or in part, to an external party (i.e. a party other than another partner) is subject to unanimous resolution of all the other partners, and they have a pre-emptive right of purchasing the respective shares in property on identical terms.\textsuperscript{334} A limited partner may, pursuant to the provisions of the partnership agreement, transfer his share in property in the limited partnership enterprise to an external party, provided that the other partners have been notified 30 days in advance.\textsuperscript{335}

7. Capital Increase and Capital Reduction

As there are no specific requirements as to a minimum registered capital etc., the decision on the reduction as well as on the increase of capital is left to the partners: They may, in accordance with the provisions of the partnership agreement or upon the decision of all the partners, increase or reduce the capital contribution to the partnership enterprise.\textsuperscript{336}

8. Dissolution and Liquidation

A partnership enterprise is to be dissolved if one of several circumstances enumerated in art. 85 Partnership Enterprise Law occurs, e.g. the partnership has consisted of only one partner for a period of thirty days,\textsuperscript{337} or the business license of the partnership enterprise has been revoked. In addition, art. 75 stipulates for

\textsuperscript{331} Arts. 48 para. 2, 79 Partnership Enterprise Law. – In a limited partnership enterprise, the conversion of a general partner to a limited partner or vice versa requires the unanimous resolution of all the partners if the partnership agreement does not stipulate otherwise; where only limited partners remain, the limited partnership enterprise shall be dissolved; where only general partners remain, the enterprise shall be converted to a general partnership enterprise (arts. 75, 82 Partnership Enterprise Law).

\textsuperscript{332} Art. 50 Partnership Enterprise Law. The succession into a limited partner’s status is possible without any prerequisites, cf. art. 80 Partnership Enterprise Law.

\textsuperscript{333} Art. 49 Partnership Enterprise Law.

\textsuperscript{334} Arts. 22 para. 1, 23 Partnership Enterprise Law.

\textsuperscript{335} Art. 73 Partnership Enterprise Law.

\textsuperscript{336} Arts. 34, 60 Partnership Enterprise Law.

\textsuperscript{337} Arts. 85 no. 4, 14 no. 1, 61 Partnership Enterprise Law.
dissolution where only limited partners remain in a limited partnership enterprise. Upon dissolution, the partnership enterprise will be liquidated. The partners may either in their entirety act as the liquidator or by a simple majority appoint one or more partners or an entrusted third party to act as the liquidator within 15 days from the event which triggered the dissolution of the partnership enterprise.339

A liquidator will, inter alia, liquidate the partnership enterprise assets, settle all outstanding affairs of the partnership enterprise which are related to liquidation, represent the partnership enterprise in litigation or arbitration proceedings, notify the creditors of the partnership enterprise of the dissolution, and finally prepare a liquidation report and apply for de-registration of the partnership enterprise.340 Like in the case of companies, the liquidation upon dissolution is to be distinguished from the liquidation in case of bankruptcy341 (for details on bankruptcy, infra Chapter 8).

9. Liability

A focal point of the Partnership Enterprise Law is how liabilities are borne by partners, which is why some aspects of liability have already been discussed above, especially within the outlines of the different forms of partnership enterprises (supra at 113 et seqq.). The following will concentrate on the civil liabilities stipulated by the Partnership Enterprise Law.

a) The Partnership Enterprise

A partnership enterprise itself shall first use its entire property, which consists of all capital contribution by the partners, profits and any other property that is lawfully obtained in the name of the partnership enterprise, to clear its debts. Restrictions to a partner’s right to represent the partnership enterprise in external dealings shall not be used as a defense against a bona fide third party.344

b) General Partners

If a partnership enterprise is unable to repay its due debts, all general partners bear unlimited joint and several liability, even if the debts were incurred prior to a general partner’s admission or after the admission of a partner as limited partner but prior to this partner’s conversion into a general partner. However, a partner whose total payment exceeds the ratio of loss distribution as stipulated by art. 33 of the law may seek recourse from other partners. A partner who has already withdrawn from the partnership bears unlimited liability jointly and severally for any debts of the partnership enterprise incurred prior to the withdrawal as well.346

338 Art. 61 of the Partnership Enterprise Law requires limited partnership enterprises to have at least one general partner.
339 Art. 86 Partnership Enterprise Law.
340 Arts. 87, 88 para. 1, 90 Partnership Enterprise Law.
341 Art. 92 Partnership Enterprise Law.
342 Chen Jianfu, 489.
343 Arts. 38, 20 Partnership Enterprise Law.
344 Art. 37 Partnership Enterprise Law.
345 Arts. 39, 40, 44 para. 2, 83 Partnership Enterprise Law.
346 Art. 53 Partnership Enterprise Law.
The general partners’ unlimited joint and several liability for debts incurred by the partnership enterprise during its period of existence remains even after the partnership enterprise has been de-registered.\textsuperscript{347}

Apart from being liable to the partnership enterprise’s creditors, partners are, in certain cases, also liable to the partnership enterprise itself and to the other partners: A partner who conducts partnership affairs without the required unanimous resolution of all partners (such requirement may exist according to art. 32 para. 2 of the law or the partnership agreement) is liable to compensate for any loss thereby caused to the partnership enterprise or the other partners.\textsuperscript{348} The same applies to partners who conduct partnership affairs despite not being authorized to do so,\textsuperscript{349} and to partners who engage in businesses that compete with the partnership enterprise.\textsuperscript{350}

Further liability to the partnership enterprise and the other partners is imposed on partners who, abusing their authorization to conduct partnership affairs,\textsuperscript{351} take possession of partnership enterprise interest or property, thereby causing losses to the partnership enterprise or its other partners.\textsuperscript{352} If partners who are responsible for the conduct of partnership affairs fail to complete change registration formalities regarding changes of registered matters in time\textsuperscript{353}, they bear an obligation to compensate for any loss suffered by the partnership enterprise, other partners, or \textit{bona fide} third parties.

c) Limited Partners

The limited liability assumed by a limited partner for a limited partnership enterprise’s debts extends to the debts incurred by the limited partnership enterprise prior to the limited partner’s admission.\textsuperscript{354} Where a general partner is converted into a limited partner, that partner bears unlimited liability jointly and severally for debts incurred by the partnership enterprise while the partner was a general partner.\textsuperscript{355} A limited partner who has withdrawn from the limited partnership enterprise is liable for debts incurred by the limited partnership enterprise prior to the withdrawal up to the amount of property received from the limited partnership enterprise upon his withdrawal.\textsuperscript{356} If a limited partner enters into transactions with third parties in the name of the limited partnership enterprise without authority and thereby causes the limited partnership enterprise or other partners to suffer loss, he is liable for compensation.\textsuperscript{357}

A limited partner is \textit{unlimitedly} liable for debts incurred in a particular transaction if the third party involved has sufficient reason to believe that the limited partner is a general partner in the transaction.\textsuperscript{358} In order to enable limited partners

\textsuperscript{347} Art. 91 Partnership Enterprise Law.
\textsuperscript{348} Art. 97 Partnership Enterprise Law.
\textsuperscript{349} Art. 98 Partnership Enterprise Law.
\textsuperscript{350} Arts. 99, 32 para. 1 Partnership Enterprise Law.
\textsuperscript{351} As to such authorization, \textit{cf.} arts. 26, 67, 68 Partnership Enterprise Law.
\textsuperscript{352} Art. 96 Partnership Enterprise Law.
\textsuperscript{353} \textit{Cf.} art. 13 Partnership Enterprise Law.
\textsuperscript{354} Art. 77 Partnership Enterprise Law.
\textsuperscript{355} Art. 84 Partnership Enterprise Law.
\textsuperscript{356} Art. 81 Partnership Enterprise Law.
\textsuperscript{357} Art. 76 para. 2 Partnership Enterprise Law.
\textsuperscript{358} Art. 76 para. 1 Partnership Enterprise Law.
to participate in the key decision making of the enterprise without running the risk of bearing unlimited liability, the Partnership Enterprise Law provides for a safe harbor mechanism. Safe harbor activities include, *inter alia*, participation in a decision to admit or remove a general partner and in the selection of an accounting firm to audit the limited partnership enterprise, or making a proposal concerning the business management of the enterprise.359

d) Liquidators

Finally, the law provides for liabilities of liquidators in order to protect the interests of both the partnership enterprise and its partners on the one hand and the creditors of the partnership enterprise on the other hand: First, if a liquidator fails to submit a liquidation report to the enterprise registration authority or conceals or omits important facts in the liquidation report, any expense or loss arising therefrom is to be borne and compensated by him.360 Second, where a liquidator makes illegal profits from, or takes possession of partnership enterprise property in the course of liquidation, he bears an obligation to return the illegal profit and property to the partnership enterprise and is liable to compensate for any loss suffered therefrom by the partnership enterprise or other partners according to the law.361 Where a liquidator violates provisions of the Partnership Enterprise Law and thereby harms the interests of the creditors by hiding or transferring partnership enterprise property, making fraudulent records in the balance sheet or the list of assets, or distributing property before settlement of debts, he bears liability for compensation pursuant to the law.362

IV. Relevant Laws & Regulations

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359 Art. 68 para. 2 Partnership Enterprise Law, which includes a complete list of safe harbor activities.

360 Art. 100 Partnership Enterprise Law.

361 Art. 101 Partnership Enterprise Law.

362 Art. 102 Partnership Enterprise Law.
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Chapter 3. Foreign Investment Law


I. Overview

1. Concept of Foreign Direct Investment

Foreign direct investment (FDI), based upon the OECD Benchmark Definition of Foreign Direct Investment,\(^1\) “is a category of cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise.”\(^2\) The concept encompasses the FDI by type such as purchase/sale of existing equity in the form of mergers & acquisitions (M&A), greenfield investment and extension of capitals.\(^3\) Greenfield investments refer to freshly additional investments (ex nihilo investments). Extension of capital relates to increased investments as an expansion of an established business. It is in general conceived that greenfield investment and extension of capital have the potential of exerting a deeper impact on the receiving economy in term of employment, business performance and growth, although this could not be always the case.

\(^{1}\) OECD, OECD Benchmark Definition of Foreign Direct Investment, 4th Ed., 2008.
\(^{2}\) Para. 11, ibid.
\(^{3}\) Para. 272, ibid.
The discussion in this Chapter regarding Chinese legal regime on FDI follows such OECD definition. However, it only addresses those regulations dealing with green-field investment and extension of capital. M&A type of FDI is covered in Chapter 5.

2. Brief Recount of Foreign Direct Investment

China’s unprecedented economy growth has come hand in hand with the inroad of FDI in gradually opened-up regions and industry sectors. Inspired by the success stories of the neighbouring countries, China’s policy-maker enlisted the open-door policy as the key strategy to initiate the economic reform process in the early 1980’s. The original purpose of the policy is to introduce dearly needed capital, managerial expertise and modern technology in a couple of encircled special economic zones (SEZ) along the southern coastal line, where capitalism, to certain extent, was experimented and tolerated. The cautious trial-and-error style of FDI policy was in line with the duel-track approach at the initiative stage of China’s economic reform, in that the market mechanism was introduced in parallel to the soviet central planning and was allowed to gradually outperform the command economy. As such, FDI was at the beginning limited to specific geographic areas and selected industrial sectors. The initial success of SEZs provided the reformists within the Chinese Communist Party (CCP) the necessary leverage and legitimacy to move forward and to emulate the SEZ’s model of development to other regions, first in selectively marked development zones and industrial parks along the coastal area and later to the rest of the country. The industrial sectors accessible to FDI were also gradually enlarged.

Through the 1980s the inflow of FDI grew steadily which concentrated in the Guangdong and Fujian provinces, where the SEZs are located. There was an influx of FDI in 1992–1993 ensuing the reinforcement by the country’s top leader regarding China’s continuous reform policy. Such political stunt eased the concern about China’s future after the Tiananmen incidence in 1989 and unleashed a new round of rapid inflow of FDI and institutional updates. Since 1996, the annual inflows of FDI have been over USD 40 billion. China has claimed about one-third of total developing country FDI inflows in recent years. China is the third largest recipient of FDI in the world after the United States and United Kingdom and the single largest developing country recipient of FDI.

3. Evolution of FDI Legal Regime

a) Landmark Law on Equity Joint Venture

What FDI initially faced was a bleak economy and legal vacuum in the havoc wreaked by the Great Cultural Revolution. The mounting task was for China’s

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4 The first four SEZ were respectively established in Shenzhen, Zhuhai, Shantou and Xiamen in 1979. In 1984, fourteen port cities were announced to open up to FDI. In 1985, the opened-up region was extended to the Yangzi River Delta, Pearl River Delta, Minnan Delta and Hainan Island. In early 1990s, Shanghai set up the Pudong New Area. Furthermore, China central and local government have declared numerous economic and technological development zones (ETDZ), high- and new technology development zones, bonded zones that all accommodate FDI incentives and policies. "By 2003 there were well over 100 investment zones recognized by central government. There are six SEZs (the four original, Hainan and Pudong), 54 national-level ETDZs, 53 nationally recognized high-tech industrial zones and 15 Bonded Zones.", Naughton, 410.

5 Naughton, 402 et seq.

6 Greene/Tsai, 35.
legislators and administrators to lay down a legal framework that would adequately protect the interests of foreign investors. The legislative improvisation started from the landmark law for Sino-foreign joint venture enterprise in 1979\(^7\) and its implementation rules in 1983\(^8\). The loosely phrased skeletal law sets forth a package of rudimentary rules for foreign investors in establishing equity joint ventures (EJV) with Chinese partners. The significance of the law was however more on its symbolic stance toward China’s commitment of encouraging FDI and recognizing the legal status of the associated interests. This becomes prominent as several pieces of groundwork legislation fundamental to the transitional market economy at the time, such as the Law on Domestic Economic Contracts\(^9\), Law on Foreign Economic Contracts\(^{10}\), and the General Principles of Civil Law\(^{11}\), were yet to be promulgated.

b) Proliferation of FDI Regulations

FDI-related law-making picks up speed with the proliferation of FDI activities throughout 1980s and 1990s, which brought with them about novel situations and problems. Thus, the 1982 Constitution includes a clause in dedication for recognizing the interests and status of FDI under the governance and protection of Chinese law.\(^{12}\) To accommodate the need for alternative legal forms to structure investment, law on wholly foreign-owned enterprises (WFOE) was enacted in 1986\(^{13}\) and law on Sino-foreign cooperative joint ventures (CJV) was enacted in 1988\(^{14}\). The legal vehicles available to FDI were extended further in 1990s to include foreign investment joint stock limited company\(^{15}\) and foreign investment holding company\(^{16}\). All these legal vehicles for FDI are generically referred to in Chinese law as foreign investment enterprises (FIE). EJV, CJV, WFOE, joint stock limited company and holding company are the prescribed legal forms that foreign investors could pigeonhole their investment.\(^{17}\)

\(^7\) (中外合资经营企业法), promulgated by the NPC on July 8, 1979, and revised respectively on April 4, 1990 and March 15, 2001 and effective on the same date.


\(^9\) (经济合同法), promulgated on December 13, 1981 and repealed by the Contract Law promulgated on March 15, 1999.

\(^10\) (涉外经济合同法), promulgated on March 21, 1985 and repealed by the Contract Law promulgated on March 15, 1999.


\(^13\) (外资企业法), promulgated on April 12, 1986 and revised on October 31, 2000 and effective on the same date.

\(^14\) (中外合作经营企业法), promulgated on April 13, 1988 and revised on October 31, 2000 and effective on the same date.

\(^15\) By the Interim Provisions on Several Issues regarding the Establishment of Foreign Investment Joint Stock Company (关于设立外商投资股份有限公司若干问题的暂行规定), promulgated by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) on January 10, 1995.


\(^17\) For detailed discussion about the legal features of these alternative FIE vehicles, please refer to infra at 27–34.
FDI has been closely administered ever since its first entry in China. The incorporation of FIE must obtain ex ante verification and approval from various in-charge authorities. Besides those corporate straightjackets as established by the FIE laws and implementation rules, there are a myriad of regulations and administrative measures that would cover the complete life circle of a FIE, which may relate to, inter alia, the following aspects:

- Foreign investment sector guidance;
- Sector specific FIE regulations in relation to engaged industries;
- Technology transfer;
- Import, export and distribution;
- Labour and social securities;
- Foreign exchange compliance;
- Custom duty, revenue tax and VAT;
- Income tax;
- Merger, acquisition, liquidation and dissolution; etc.

China’s gradualist and pragmatic approach of economic reform has a far-reaching ramification on FDI legislation. FIE are governed with a separate set of rules which are different from those applicable to the domestic enterprises. The policy concern behind this approach is two-folded. On the one hand, at the starting phase of open-door policy, FDI was not immediately embraced with open heart. There was still considerable concern on its potential political and economic significance on China’s socialism cause and national interests. To encircle them within designated fences and marks would be beneficial to keep them at bay and simply roll back if things do not turn out as expected. On the other hand, to make it attractive for FDI, incentives and concessions would be offered, in exchange for what China really needs such as foreign capital, technologies and managerial expertises. This requires a set of rules for identifying the qualified investors and gate-keeping the threshold.

Most regulations are put into place to reflect the constantly changing perception of the need and usefulness of FDI. As thus, “FDI regulation has been tentative, general, and flexible and has depended on the broad discretion of various agencies regulating foreign investment enterprises … for its practical application.” These regulations involve manifold central governmental agencies such as the State Council, various ministries, commissions and committees under its auspice as well as their local counterparts. Among others, the key bodies that FDI would interact most with include the National Development and Reform Commission (NDRC) (responsible for FDI project verification), Ministry of Commerce (MOFCOM) (responsible for the approval of FIE establishment) and State Administration for Industry and Commerce (SAIC) (responsible for FIE registration) and their respective local delegations. Besides, local governments also draft FDI-related rules that are applicable to the FIEs located in their jurisdictions. China’s numerous SEZs, development zones and industrial parks competed to relentlessly churn out batches of incentive policies to draw FDI in favor of their localities. Obviously, multifarious agencies aspire to multifarious interests and agenda, which were translated in the FDI legislation as a spaghetti-like intertwined body of rules with overlaps and

18 Chen, 625.
19 Lubman, 193.
20 For details please refer to infra at 22–25.
conflicts. Vast discretion accorded to the agencies provides leeway to interpret and implement the rules in pursuit of the then-prevailing policy preference.

c) Recent Streamlining and Consolidation Reform

By all accounts, it goes without saying that in creating a vast body of FDI regulations from scratch and making them also work in practices, in particular under the context of Chinese economy in a constant state of flux, Chinese law-makers and administrators have achieved a grand accomplishment. In recent years, there are significant legislative efforts to straighten a clear hierarchical order among the numerous FDI-related laws and regulations, and to consolidate the recurring rules under a single code that could be cross-applied to all forms of FIEs. The 1999 Legislation Law\(^21\) was the first official attempt to hierarchize levels of regulations and remark their prevailibility. Thus, the Constitution is of the supremacy. All the other statutes must not contradict the Constitution’s provisions. On the second level are the laws of the National People’s Congress (NPC) or its Standing Committee. Then come the administrative regulations of the State Council (行政法规), which deal with the executive or administrative matters pertaining to the respective subjects of the NPC laws. The diverse ministries, commissions and bureaus subordinated under the State Council, issue administrative rules (部门规章) within their functionalities. Finally, local people’s congress and local people’s governments produce local regulations and local rules (地方性法规) applicable only to the local matters.

Among all the levels of FDI legislations, the prevailability is subject to the generally accepted principles, i.e. the higher rules prevail over the lower rules, the new rules prevail over the old rules and the special rules prevail over the general rules. Correspondingly, the Constitution, laws, administrative regulations, administrative rules, local regulations and local rules have a descending level of superiority in order. When laws, regulations or rules from a particular government body carry contradictory provisions, the general principle applies so that special rules prevail over general rules, and new rules prevail over old rules. Also, when a discrepancy arises between local regulations and administrative rules, the State Council or the Standing Committee of the NPC shall be called upon to resolve the instant matter.

In practices, confusion about legal applicability persists despite these clearly defined rules. The State Council and its auxiliary ministries continue to exercise their delegated law-making power with little constraints. As the intervals of NPC sessions last for a period of one year and the NPC delegates are rather honorary positions which seldom require legal expertise, the NPC hardly exert any monitoring on the law-making activities of administrative bodies. In order to have any meaningful influence, NPC’s laws by and large depend on the implementation measures from the State Council and its various ministries, who are normally more knowledgeable and experienced in dealing with practical issues within respective businesses. In many cases, voices from the civil society challenging the propriety of certain administrative rules are simply too feeble or lack of the channel to get through to the NPC or its Standing Committee. This leads to the situation where the State Council and/or various miniseries are simultaneously the maker, the interpreter and the executor of the governing rules, with little restraint on their discretions.

China FDI’s legal regime went head to head against two fundamental principles of the World Trade Organization (WTO). One is the transparency of law and policy. The ad hoc departmental and regional secondary FDI legislation arouses conflicts of rules, regional forum shopping and turf wars between agencies, which makes it hard to discern a reliable source of applicable rules and practices that could provide a firm standard code of conducts. The other is WTO’s requirement on trade-related investment measures (hereinafter: TRIMs) that were abundant in China’s pre-WTO legal regime, such as strict foreign exchange control, requirement of product export and local contents, and requirements for technology inputs. The bilateral and multilateral negotiation regarding China’s entry into WTO thus put forward substantial debates on how China should amend its FDI legal regime to address the transparency and TRIMs issues. Specific commitments China made upon its entry into WTO\textsuperscript{22} were implemented rather expediently in that substantial non-conforming regulations and practices were abolished within a short period after (and indeed even before) the signature of the Protocol. The EJV, CJV and WFOE law were all revised in 2000 in the call for removing non-conforming TRIMs so that FIEs are allowed to procure in both domestic and international markets, to engage more freely in distributing activities, and the former foreign exchange self-balance, technology inputs and product export requirements were abolished.\textsuperscript{23}

Under the General Agreement on Trade in Services (hereinafter: GATS), China is in general obligated to accord to service providers from other WTO member states national and most favored national treatment but is allowed and has opted to prescribe reservations in certain service sectors as explicitly set forth in the Most Favored Nation (MFN) Exemptions annexed to the Protocol. Such reservations aim to cushion the blow that might bring about by WTO entry on those domestic service providers still in the nascent stage of development. The bargains and deals in pursuit of a final package of compromises regarding China’s commitments in the sectors such as finance, telecommunication, distribution and media etc. have captured a significant part of the game in the WTO negotiation. Such sector-specific commitments were by and large transposed into administrative rules governing FIEs engaging in respective areas of services.

WTO accession has given China a strong impetus to streamline the commercial laws and regulations in accordance with the WTO framework. It has also contributed to the momentum of making the FDI regime more transparent and consolidated (\textit{supra} Chapter 1 at 9). In practice, for some recent new or revised laws or regulations,\textsuperscript{24} Chinese authorities started circulating the draft version among the selected circle of interested parties or to the general public for comments and suggestions before they are formally adopted. This makes the legislation process


\textsuperscript{23} Chen, 642–643.

more accessible and responsive to the market and society at large that are to be affected by legal application.

WTO accession has greatly enlarged the market access for FDI and the general liberalization of China’s economy. This means lowered entry and operation hurdles for FDI and much levelled playing field for both foreign and domestic players. The former trade-off between entry control and tax concessions for FDI has lost much of its relevance. As thus, in the recent years there is a strong consolidation tendency in the Chinese legislations which are set to govern both Chinese and foreign business under a common set of rules. The most representative move in this trend is the lately adopted uniform law on enterprise income tax (EIT)\(^{25}\) which abrogates the then-prevailing tax preferential treatments for FDI and applies a universal income tax rate across China-domiciled companies, no matter the origin of their investment. With little reservations, most market-based laws in recent years do not make distinction between domestic and foreign invested enterprises.\(^{26}\) Many provisions that are contained in FDI-related industry specific regulations are rather similar with those general law and regulation that are applicable to Chinese enterprises, except for those provisions set aside to reflect China’s specific commitment under WTO accession.\(^{27}\)

Despite these recent legislation overhaul and consolidation, China FDI legal regime retains two distinctive features in the legacy of pre-WTO era. Firstly, a bifurcated legal system remains intact where foreign and domestic investments are subject to separate sets of regulations. Even if there is a distinctive signal of converging between the rules for the foreign and the domestic, the bifurcated framework remains unchanged. Secondly, FDI-related regulations are essentially a bundle of corporate organizational instruments tailored respectively to relevant industry or service sectors. They are in fact industry-specific company laws for foreign investment enterprises, while a unified statute that defines across the board for foreign investment is in the lack. As a result, China’s FDI regulation continues being piecemeal, departmental and sector-specific. This leads to inconsistency and repetitiveness among the provisions in the FDI regulations. As some commentators have proposed\(^{28}\), future FDI legislation should aim for a unified foreign investment code that could streamline the redundant or uneven provisions in the existing regulation. The legal forms and corporate organizations of FDI shall converge under the single umbrella of the Company Law. However, so long as these stay within academic discussion, FDI will continue facing a myriad of sectoral and multileveled regulations, with respect to investment access, legal form, business administration and other regulatory control to be described in the ensuing sections.

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\(^{27}\) For example, the Administrative Regulation on Foreign Capital Financial Institutions (外资金融机构管理条例), promulgated by the State Council on December 20, 2001 and effective on February 1, 2002; the Administrative Regulation on Foreign Capital Insurance Institutions (外资保险公司管理条例), promulgated by the State Council on December 5, 2001 and effective on February 1, 2002.

\(^{28}\) Shan, 48–50.
II. Main Issues

1. Investment Access

China’s legal regime differentiates FDI in a variety of industries and services categories and employs different treatments in terms of level of approval, required Chinese national stake, limited legal vehicles and tax concessions. This is in line with the initial strategy of open-door policy to attract FDI into the sectors in the priority of national economy development. For a long time before the 1990s, however, the guiding principles of FDI direction were kept as internal rules or guarded secrets, which facilitated agency discretion and manipulation and made up the major source of investors’ dissatisfaction. In 1995, China promulgated a FDI Direction Guideline and Industry Catalogue that delineated for the first time China’s sector priority regarding FDI and the corresponding restrictions and incentives. Together with other regulations and policies, China has erected an entry threshold for FDI regarding the engaged industries and the corresponding verification and approval procedures.

a) Industry Direction and Catalogue

The FDI Direction Guideline classifies the FDI projects into four categories, namely encouraged project, permitted project, restricted project and forbidden project. While a project that falls in forbidden category is barred outright for foreign investment, an encouraged project would enjoy preferential treatments, including lower level of approval procedures in local jurisdictions and respective tax concessions. For those industries that fall under the restricted category, the approving authorities shall be at least at the level of provincial government. As the encouragement for export performance, the foreign investment projects under the Restricted Category will be treated as permitted projects in case 70% of the products are exported.

The Industry Catalogue itemizes the sorts of industries that are included in each category. For certain sectors and industries that are deemed as sensitive to the national interests, it requires that the legal vehicles available to FDI are limited to EJVs or CJVs, or Chinese nationals should have majority or relative majority.

29 Provisional Regulation on Guiding Foreign Investment Direction and Industrial Catalogue for Foreign Investment, jointly promulgated by the State Planning Commission, the State Economic and Trade Commission and the Ministry of Commerce (MOFCOM) on June 20, 1995. Such Guideline and Catalogue have been regularly updated to reflect the changing situation and prevailing industry policy. The latest revision of the Guideline was on February 11, 2002 and effective on April 1, 2002 and the latest revision of the Catalogue was on October 31, 2007 and effective on December 1, 2007.

30 Art. 4, FDI Direction Guideline.

31 Art. 10, ibid.

32 Art. 12, ibid.

33 Art. 10, ibid.

34 For example, Chinese herbal medicine plantation, natural resource exploration, civil aviation vehicle and engine design and production, train line network and various service sectors such as telecommunication, retail, insurance, securities, medicine clinic etc.

35 Chinese Majority means that the consummate investment from Chinese partners is above (including) 51% of the foreign investment projects. Art. 8, ibid.

36 Chinese Relative Majority means that the consummate investment from Chinese partners is more than the investment of any foreign investor. Art. 8, ibid.
stake. There are also a Sub-Catalogue for FDI in Dominant Industry in the Central and Western Region of China\(^37\) and a Sub-Catalogue for Encouraging FDI in High-tech Industry\(^38\) that tip over for less developed regions and China’s most needed technologies. China’s policy in automotive sector presents an illustrative case study on the holistic approach that China has taken to bolster the local sourcing and technology, curtail the foreign competition and nurture the home brands. Consistently, in 1999, 2002, 2005 and 2007 version of Industry Catalogue, FDI stake in whole auto assembly projects is limited to 50 %, while FDI in auto part sector is allowed to take the legal form of WFOE. Upon WTO entry, China committed to cut down the tariff for imported whole auto from 51.9 % and 61.7 % down to 25 % by 2006 and the imported auto parts down to 10 % by 2006. On May 21, 2004, the State Development and Reform Commission released the Automotive Industry Development Policy (汽车产业发展政策), effective as of June 1, 2004 (“\textbf{2004 Auto Policy}”). 2004 Auto policy is mainly for bringing China’s outdated auto policy in line with WTO obligations and setting forth a roadmap for development of automotive industry in the timeframe till 2010. The 50 % ceiling for foreign stake in assembly business is maintained. Each brand-name foreign automaker is limited to establish only two joint ventures in China for each vehicle category. In other words, assembly business are welcomed but well guarded so that local partners could keep a major stake and domestic producers are left with necessary growth space. 2004 Auto Policy, on the other hand, strives to develop a robust domestic components industry, where activities in domestic auto parts R&D and capacity building are incentivised. In a concerted move, two measures were churned out in 2005\(^39\) essentially making the imported auto parts subject to a tariff rate imposed on imported whole autos if the imported parts would comprise more than 60 % of the value of the finished cars, namely a tariff uplifting from 10 % to 25 % for the concerned auto parts. With no double, the measures intend to protect local components industry from the competition from foreign auto parts producers, which was expected to be intensified in the face of substantial tariff cut mandated by WTO obligation. The contestable measures eventually lead EU, US and Canada bring formal complaints to the WTO Dispute Settlement Body. China defended its position till the proceedings ran their full course to the WTO Appellate Body, which ruled on December 15, 2008 against China that said measures have violated the most favored nation and national treatment principle under GATT.\(^40\) Nevertheless,

\(^{37}\) (中西部地区外商投资优势产业目录), Jointly promulgated by the State Planning Commission, the State Economic and Trade Commission and the MOFCOM on November 29, 2001 and latest revised on December 23, 2008 and effective on January 1, 2009.

\(^{38}\) (鼓励外商投资高新技术产品目录), Jointly promulgated by the MOFCOM and Ministry of Science and Technology June 2, 2003 and latest revised on December 31, 2006 and effective on January 1, 2007.

\(^{39}\) Measures for the Administration of Importation of Automotive Parts and Components for Complete Vehicles (构成整车特征的汽车零部件进口管理办法) (Decree No. 125), which entered into force on April 1, 2005; Rules for Determining Whether Imported Automotive Parts and Components Constitute Complete Vehicles (进口汽车零部件构成整车特征核定规则) (General Administration of Customs Public Announcement No. 4), which entered into force on April 1, 2005.

the lengthy proceedings have provided well-needed grace period for domestic auto
parts producers.\footnote{Zhang Xiaowen, China’s experience in the WTO Dispute Settlement System as Defendant – A Close Examination of the Auto Parts Case, available at http://www.allacademic.com/meta/p313993_index.html.}

21 The FDI Direction Guideline and Industry Catalogue are the entry points for foreign investors in the interaction with China’s FDI verification and approval procedure. They provide the investors with a benchmark to make an informed evaluation about their approach and strategy of investment in China. From this perspective, the FDI Direction Guideline and Industry Catalogue have prescribed the underlying rules of the game and greatly enhanced the level of legal transparency and certainty. Nevertheless, China employs a mandatory verification and approval process for all FDI projects. Even if the concerned industry belongs to those encouraged or permitted sectors, foreign investor still need to undergo a formal verification and approval procedure with in-charging agencies before they can establish commercial presence in China to conduct businesses.

b) Verification and Approval Procedures and Authorities

22 The approving process for a FDI project consists of, in sequence, the project verification, contract or articles of association review and commercial registration. Project verification is handled by the NDRC or its local counterparts. Authority sharing between the central and local government is linked to the scale and category of investment. As such, a FDI project with a total investment of USD 100 million or above in the encouraged or permitted category or of USD 50 million or above in the restricted category must be verified by the NDRC in Beijing. Other FDI projects below these thresholds could be verified by provincial or lower level NDRC delegations, although projects in the restricted category can only be verified at provincial level.\footnote{Art. 12, State Council Decision on the Reform of Investment System, promulgated on July 16, 2004; Arts. 3 and 4, Interim Measure on Verification of Foreign Investment Project, promulgated by the NDRC on October 9, 2004 and effective on the same date.}

23 The project proposal submitted to the NDRC would need to describe the details of the contemplated project including the particulars of the investors, operation and business plan, utilities demand, environment impact and project finance etc.\footnote{Art. 5, Interim Measure on Verification of Foreign Investment Project.} Opinions from sponsoring bank and respective environment, site-selection, land and state-owned assets in-charging authority shall be attached.\footnote{Art. 6, ibid.} NDRC’s verification is based upon its perception on the candidate project regarding its conformity with a variety of checkpoints and standards, such as the Industry Catalogue, medium-to-long term national economy and societal development plan, industry development plan and restructuring policy, public interests, competition law, requirements of land use, city zoning and environment protection, technical and processing standard, and capital account and foreign-debt control etc.\footnote{Art. 12, ibid.} NDRC’s self-justified rules testify the general observation about Chinese legislation that is intentionally written in broad and indeterminate languages which leave plenty of discretion in interpreting their true meaning. There are abundant general principles, vagueness and ambiguity, undefined terms, broadly worded discretion, omissions...
and general catchall phrases. One advantage of such fuzziness is surely for NDRC to accommodate changing situations and priorities. The problem is certainly NDRC’s and its local counterparts’ broad discretion in applying their own interpretation of the rules in verifying (or not) the candidate FDI projects. There is barely legal remedy available if any applicant is not satisfied with the decision of NDRC or its local counterparts, as the administrative discretion is generally not subject to judicial review according to Chinese administrative law doctrine. This leads to a FDI verification process in many occasions becoming more a political lobby and bargaining exercise than a law-implementation procedure.

The second step down the process is the MOFCOM’s (or its local counterpart) approval for the incorporation of FIEs that embody the FDI projects. While NDRC’s verification is on the substance of the project, MOFCOM’s review is on the form and structure aspect. This involves the examination of required documentation such as application letter, feasibility study report, joint venture contract, articles of association, and name list of the board members etc. There are mandatory provisions required for the joint venture contract and the articles. In the event that the concerned business involves those that are subject to the regulation by industrial ministries, a pre-approval from such presiding ministry is mandatory which shall constitute the condition precedent for MOFCOM’s approval. In most cases, these sector-specific regulations would specify investors’ qualification and investment requirements which foreign investors shall comply with and testify by written proof. Also when the State-owned assets are involved, the endorsement in writing from the responsible state-owned assets administrator regarding the disposal and pricing of such assets is required. The MOFCOM’s approval would clear up the way for the incorporation of FIEs that will carry out the contemplated operations and businesses.

The legal establishment of a FIE takes effect upon the commercial registration with the SAIC or its local counterparts and the issuance of the business licence. The business license records the basic information of a FIE such as its name, address, legal representative, business scope and duration. Before a FIE is incorporated, it should conduct a company name pre-verification with the SAIC to preclude any confliction with existing firm names. Having obtained the verification from the NDRC and the approval from the MOFCOM, FIE’s commercial registration with the SAIC is rather a formal procedure. Mandatory documentation for the registration normally include the articles of association, identity evidence of the shareholders, in-kind capital transfer/injection agreement, capital verification report from public certified accountants, name list of board members and appointment letters, right proof for using the premise, and the pre-verification of the company name etc. There are various post-

46 Lubman, 147.
47 Art. 7, supra at n. 8.
48 Arts. 11 and 13, ibid.
49 For example, FDI in banking, securities and insurance industry would need pass the entry approval respectively from the China Banking Regulatory Committee, China Securities Regulatory Committee and China Insurance Regulatory Committee. FDI in telecommunication, transport, logistic, commercial distribution, media, construction, engineering, legal and accounting service etc. are subject to respective ministries’ regulation and approval.
50 Art. 20, Administrative Regulation on Company Registration (公司登记管理条例), promulgated by the State Council on December 18, 2005 and effective on January 1, 2006.
registration procedures with respect to foreign exchange, custom, labour, finance and tax authorities in order that the FIE may officially commence its operation.

It should be noted that provincial governments delegates approving authorities to lower levels of the agencies. The unfettered agency discretion in project verification and approval pose additional transaction cost for FDI. While in relatively more developed regions or at higher-level authorities it is likely to have a more consistent and transparent style of rule implementation, the dealing in remote regions or at lower level is more likely to run into unexpected complications. In many occasions, the trade-off between the local support and flexibility and the potential undue influence from governmental agencies makes the selection of the location to place the project a very hard decision. This is the area where rental seeking flourishes, as good relations with the authorities would be so crucial that a local partner or agent becomes indispensible to smooth the course of negotiation.

2. Alternative Legal Vehicles for FDI

a) Common Forms

Any FDI project has to establish a commercial presence in China in order to conduct businesses. The most commonly chosen legal forms are EJVs51, CJVs52 and WFOEs53. An EJV is an independent legal person with limited liability, with Chinese and foreign parties sharing the profits and losses based upon their respective capital contributions to the registered capital. Contribution could be in the form of cash, tangible goods, technical know-how, intellectual property right, building and land use rights etc.54 The value of non-cash contribution could be attained through negotiation among the joint venture parties, but the evaluation of the land use right will have to engage an asset valuer to make a formal appraisal.55 The board of directors is the highest authority of an EJV, the composition of which shall be kept in proportion to the shareholders’ equity ratio. There are mandatory protective provisions to the interests of minority shareholders, under which certain important decisions such as articles of association amendment, termination or dissolution, division or merger or capital increase requires unanimous resolutions of presenting directors.56 The quorum of board meeting is at least 2/3 of the directors. In practice the minority shareholder may wish and manage to insert a clause in the articles that would accord to it a veto right regarding prescribed matters, namely any resolution for such matters must be approved by the director (s) appointed by the minority party. Alternatively, the quorum of board meeting may request the presence of at least one director appointed by the minority shareholders. It is also to the discretion of contractual arrangement that board

51 Supra at n. 7.
52 Supra at n. 14.
53 Supra at n. 13.
54 Art. 5, EJV Law; arts. 22–29, Implementation Rules of the EJV Law.
55 Art. 10, para. 2, Executive Opinions on Several Issues on Applying Laws regarding the Examination, Approval and Registration of Foreign Investment Enterprises, jointly promulgated by SAIC, MOFCOM, General Administration of Customs (GAC), and State Administration of Foreign Exchange (SAFE) on April 24, 2006. Such exemption of the appraisal requirement is only extended to the EJV. For non-cash contribution in other forms of FDIs such as CJVs or WFOEs, the involvement of asset valuer is mandatory.
56 Art. 33, Implementation Rules of the EJV Law.
resolutions for itemised issues would require a higher percentage of directors’ endorsement than a simple majority in that the significance each joint venture party places on relating matters are more closely represented. From the perspective of majority shareholders, however, it is very important to set up the necessary mechanism in the articles in that the resolution process would not be simply blocked by one party’s refusal to present at the summoned meeting. A commonly used solution is that after two calls for a board meeting, the meeting quorum would be deemed as being met if one party shuns the meeting without proper reasons. Chairman of the board is the legal representative of the EJV and the daily operation is under the leadership of the general manager.57

An EJV’s board thus concurrently function also as a shareholders’ meeting for a common limited liability company under the Company Law. It is both a decision-making and execution body. Board members are directly appointed by respective shareholders and act according to the directions from the appointing shareholders. The board does not aspire to the ultimate interest of the EJV. Instead, it is dominated by the investors’ negotiated interests and bargains so that the independent corporate interests of an EJV do not really exist. Under such circumstance, it is hardly to hold any board member accountable for his activities for breach of fiduciary duties. The newly inserted clauses in the Company Law regarding directors’ loyalty and fiduciary duty58 and the rights of shareholders’ to lodge derivative suits against the board members on behalf of the company59 do apply to the EJVs. This creates an awkward new situation for directors of EJV to walk on the thin line balancing between the interests of the company and those of the shareholders. The obscure separation of power structure in the corporate governance of an EJV is the innate feature for the unstable fate of many failed EJV projects in the past and future.

A recent prominent example is the legal feud between Danone and Wahaha, the partners of five EJVs engaging in soft drink business and competing head-to-head with the international brand-name such as Coca Cola in local market. The major disputes are concerned with numerous non-joint venture operations that the Chinese partner keeps running in parallel to those EJVs with Danone. At the initial stage of the joint venture, the significance of such non-joint venture operations were marginal so that the parallel operations were tolerated by Danone and tacitly incorporated into the supply chain of the EJVs. However, in time, these non-joint venture operations grew at substantial paces with lucrative proceeds. As a counterbalancing strategy, Danone acquired other local brands (including Robust) and teamed with other partners to establish joint ventures so as to contain the proliferation of Chinese partner’s non-joint venture operations, but to no avail. After failing to persuade the Chinese partner to vest to it certain stakes in the non-joint venture operations, Danone launched a series of law suits in China and overseas against the non-joint venture operations, Chinese partner and his family members on the basis of violation of joint venture contract, non-competition clause and trade-mark infringement. Among others, there are also legal suits against the executives of the EJVs for their upholding parallel posts in the non-joint venture operations has violated the fiduciary duties owed to the EJVs. On the same token,

57 Arts. 34–35, ibid.
58 Art. 148, Company Law.
59 Art. 164, ibid.
Wahaha brought similar suits against those directors that appointed by Danone to the EJVs on the grounds that they were serving in the board of those other joint ventures that Danone established with other partners. So far all the court/tribunal decisions, Chinese or foreign alike, are in favor of Wahaha.\textsuperscript{60} The courts’ holdings clearly confirm the applicability of fiduciary duty to directors of EJVs.

Compared with EJV, a CJV is a more flexible vehicle in that the joint venture partners have more latitude in defining their mutual rights and obligations in the cooperative contract. In general, CJVs differ from EJVs in that: (1) while the EJV partners have to share the profits, losses and control of the joint venture in accordance with the equity ratio, the parties of a CJV may freely decide how they would allocate the profits and losses;\textsuperscript{61} (2) a CJV has the option to take up the legal person status.\textsuperscript{62} The CJV Law provides that those CJVs that meet the relevant legal requirements may obtain the legal person status. For those CJVs that are not legal persons, the joint venture parties should jointly and severally bear unlimited liability for the debts of the CJV; (3) it is not necessary to set up a board structure in a CJV, as it is the case with an EJV. The investors of a CJV may choose to have either a board of directors or a joint management committee.\textsuperscript{63} Normally, a legal person CJV is likely to have a board of directors since it will adopt a management system similar to that of an EJV. A CJV without legal person status, however, is required to establish a joint management committee; (4) the registered capital is normally not allowed to decrease in the duration of an EJV with very few exceptions. On the contrary, the foreign investor is able to recoup its investment in a CJV ahead of the term expiration, by way of expedient depreciation or disproportional profit distributions etc.\textsuperscript{64} As such, the CJV provides more flexibility in the investment and management of the joint venture. But, CJV structure would also require the joint venture parties elaborate in much detail in the underlying cooperative contract of their respective rights and obligations.

A WFOE is an enterprise with capital completely provided by foreign investors. Normally a WFOE is held by only one investor. In the event two or above foreign parties intend to jointly invest in China, they may directly establish a WFOE in China. However, the purpose may be better suited by setting up at home or at an offshore location an intermediary corporation and using such to establish a WFOE in China. For long time, the availability of WFOE vehicle used to be limited to those high-tech or exportation oriented business. The revision of the WFOE Law in 2000 struck out these statutory performance criteria under the China’s commitments upon the entry into WTO to keep in consistency with TRIMs. In recent years, there is a striking increase of the popularity for WFOE at the expense of the EJV. The advantage in WFOE’s closed corporate/intellectual property control, with no need to share decision with Chinese partners, is the main reason of its preference over the EJV or CJV. However, external factors such as the advancing market liberalization and the increasing confidence of both Chinese authorities and the foreign investors, 

\textsuperscript{61} Art. 21, CJV Law.
\textsuperscript{62} Art. 2, \textit{ibid}; art. 4, Implementation Rules of the CJV Law.
\textsuperscript{63} Art. 12, CJV Law.
\textsuperscript{64} Art. 21, para. 2, CJV Law.
have contributed to this momentum. Through capital increase or buying-out the Chinese partner(s), an existing EJV could also be legally converted into a WFOE.

b) Alternative Forms

The legal form of joint stock limited company (JSLC) was formally recognized in the 1993 Company Law. However it was until 1995 when the question about if and how FDI could take up the form of JSLC was clarified. Under the FI-JSLC Provisions, to set up a FI-JSLC, at least five promoters are required, with more than half of these having domiciles in China. The FI-JSLC should have a minimal registered capital of RMB 30 million (in comparison to the then-prevailing capital requirement in the Company Law of RMB 10 million). A FI-JSLC could be incorporated by promotion or by share offering (supra Chapter 2 at 57, 58). It may also be established by conversion from an existing EJV, CJV or WFOE. In comparison with the EJV or WFOE, a FI-JSLC has incorporated the more flexible share dealing and resolution mechanism as provided under the Company Law. Majority shareholders are not constrained by the compulsory unanimous consent requirements for specified matters. The conditions for equity restructure and share transfer are more lenient which provide better capital liquidity. Furthermore, a JSLC is the prerequisite legal form in order for initial public offering at the Chinese domestic stock exchanges.

The FI-JSLC is less a popular legal vehicle for FDI than the EJV. The driving force for FDI entering into China was and is continuing to be the Chinese market and inexpensive labour. This leaves the capital-raising feature of the FI-JSLC less valued. Even though the transfer of shares in a JSLC is exempted from the unanimous agreement among the shareholder, as in the case of an EJV, the transfer is still subject to the prerequisite approval of the in-charging authority in order that it could come into force, which makes the seemingly easy divest process of a FI-JSLC in essence not that easy. These compromises to the key features of a FI-JSLC make it hard to justify the tedious approval bureaucracy and burdensome conditions associated with the establishment of FI-JSLC. As such, most cases where the legal form of FI-JSLC is indeed used are the outcome of transactions such as M&A or capital increase, rather than green field investment, in that an existing state-owned enterprise or FIE is converted to a FI-JSLC following specified approval procedures.

Governing rules on the foreign-invested holding company (Holding Co.) were inaugurated in 1995 and have been adjusted for several times in the call for providing more relaxation and wider business opportunities. For foreign investors with extensive investment in China, a Holding Co. is a useful tool to place scattered group affiliates under a single umbrella and to provide integrated inter-group

65 Schaub, 38–40.
66 The Company Law was promulgated on December 29, 1993, and revised respectively on December 25, 1999, August 28, 2004 and October 27, 2005 and effective on January 1, 2006.
67 Interim Provisions on Several Questions concerning the Establishment of Foreign Invested Joint Stock Limited Companies (FI-JSLC Provisions), promulgated by the MOFCOM on January 10, 1995 and effective on the same date.
68 Nägeli, 165.
69 Establishment of Companies of an Investment Nature by Foreign Investors Tentative Provisions, promulgated by the MOFCOM on April 4, 1995 and effective on the same date.

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services. Nevertheless, a Holding Co. remains a very expensive vehicle.\textsuperscript{71} Foreign founders cannot simply convert existing paid-in equity capital in the existing EJV, CJV or WFOE into the registered capital of a Holding Co. At least USD 30 million in the registered capital of a Holding Co. must be additional fresh capital injection or commitment in the China-domiciled investee companies. The permitted business scope of Holding Co. has been expanded piecemeal along with the pace of business sophistication and paralleled legal development, which may cover investment, distribution, finance and treasury and share services. It is an attractive legal vehicle for streamlining business operation, consolidating corporate governance, and integrating administrative functions. However, recent market liberalization enables foreign investors to take up these activities through alternative vehicles other than a Holding Co. For example, for shared service centre purpose, a service and consulting WFOE would be a valuable alternative. For distribution business, a Foreign Invested Commercial Enterprise (FICE) in the form of an EJV or WOFE might provide a wider permitted business scope. Regional headquarters as promoted in local jurisdictions such as in Shanghai\textsuperscript{72} or other cities are less expensive tools while providing most of the functionalities of a Holding Co.

c) Application of Company Law

35 The most recent revision on the Company law was on October 27, 2005 and came into effect on January 1, 2006. It has conducted a major overhaul of its previous version in the call for lessening the capital injection burden, lowering the threshold for JSLC incorporation and initial public offering, facilitating the share transfer and transaction, improving the corporate governance and protection of minority shareholders. Art. 218 of 2005 Company Law states: “This Law shall apply to limited liability companies and joint stock limited companies with foreign investment. Where laws concerning foreign investment provide otherwise, such provisions shall prevail”. As such, FI-JSLC is governed by the Company Law from then on, which renders the validity of FI-JSLC Provisions in question. As the FI-JSLC Provisions are “administrative rule” (规章) from the MOFCOM, it should not have prevailing effects over 2005 Company Law which only recognizes the prevailability of FDI-specified “laws” (法律).\textsuperscript{73} Therefore, provisions in the FI-JSLC Provisions that are in contradiction to the 2005 Company Law should be regarded as obsolete upon 2005 Company Law coming into force.

36 On the same token, EJV, CJV and WFOE in the form of limited liability company, shall continue applying the respective FIE laws, the provisions of which do prevail over 2005 Company Law if they are otherwise stated. It is less clear whether the implementation rules of these FIE laws prevail over 2005 Company Law.

\textsuperscript{71} Having been trimmed down for several times, the thresholds for a Holding Co. retain largely three parameters, i.e. (1) the total assets of the foreign founder shall be no less than USD 400 million, and at least one FIE has been established with the paid-in capital above USD 10 million; or (2) More than 10 FIEs have been established with the paid-in capital above USD 30 million; and (3) The minimum registered capital of a Holding Co. shall be no less than USD 30 million.

\textsuperscript{72} Rules for Encouraging Multinational Companies to Set-up Regional Headquarters, promulgated by the People’s Government of Shanghai Municipality on July 7, 2008, under which the registered capital of the regional headquarter in the form of a management company is set at no less than USD 2 million.

\textsuperscript{73} Supra at 10–11.
II. Main Issues

Law, as they are only at the rank of “administrative regulations” (行政法规) that are produced by the State Council. Given the facts that they are enacted to implement FDI-specified laws, one logical interpretation could be that art. 218 of 2005 Company Law do regard them as having prevailing validity.

The Opinions for Applying the Company Law on FIEs\textsuperscript{74} confirm the above analysis regarding the rule of conflicts between the Company Law and the FIEs-specific laws. The company organization of the EJVs and CJVs would continue applying the EJV and CJV laws and are basically not affected by the 2005 Company Law. The board of directors is the authoritative body. The mechanism of unanimous resolution on key issues is retained. There is no legal basis for the power and function of the shareholders’ meeting.

The corporate organization of WFOE\textsuperscript{75} and FI-JSLC are explicitly set subject to the 2005 Company Law. As such, the shareholders’ meeting will be the highest governing body for a WFOE, which decides the key matters of the company business. Shareholders’ meeting could adopt resolutions by qualified majority vote defined by the articles of associations. Those very important issues (such as merger, division and change of capital or articles etc.) require 2/3 majority voting right (for EJV, a unanimous board resolution is necessary). Accordingly, the board of directors and supervisors are mandatory bodies for a WFOE with pre-defined duties and functionalities according to the 2005 Company Law\textsuperscript{76}.

The organization of a FI-JSLC should conform to the JSLC-related stipulations in the 2005 Company Law. Provisions regarding the establishment prerequisites, compositions, procedures, functions and duties of the respective shareholders’ meeting, board of directors and board of supervisors as contained in the 2005 Company law shall therefore replace those corresponding regulations in the FI-JSLC Provisions, except that the approval of MOFCOM shall still be indispensable.

The new features in the 2005 Company Law not referred to in any of the FIE Laws would nonetheless apply to FIEs, including:\textsuperscript{77}
- Lowered minimal capital (For EJV or CJV, RMB 30,000; for WFOE RMB 100,000);
- Up to 70 % non-cash capital contribution;
- Non-capped investment in other companies;
- Exit right of shareholders; and
- Derivative suit against directors, supervisors or executives.

The uneven application of the Company Law on FIEs has created an extremely complicated corporate legal regime for FDI in China. While WFOEs and FI-JSLCs are largely integrated under the uniform rule of governance according to the Company Law, EJVs and CJVs remain self-contented under their specific corporate structures. The situation is unsatisfying in the face of deepened market opening and

\textsuperscript{74} Executive Opinions on Several Issues on Applying Laws regarding the Examination, Approval and Registration of Foreign Investment Enterprises, jointly promulgated by the SAIC, MOFCOM, GAC, SAFE on April 24, 2006.

\textsuperscript{75} Unlike the EJV and CJV laws, the WFOE Law does not provide any detailed regulations about the corporate bodies and structure for a WFOE in the form of a limited liability company. That is the reason that 2005 Company Law would govern WFOE.

\textsuperscript{76} For the WFOEs and FI-JSLCs that are established before January 1, 2006, they are not required to amend the articles of association but may voluntarily adjust their organizational settings in line with the stipulations of the Company Law.

\textsuperscript{77} Arts. 18, 26, 27, 59, 81, 165, Company Law.
liberalization. In the author’s view, it hardly makes any more sense to keep the FDI corporate legal regime splitting between the FIE Laws and the Company Law. If being stripped of those contents in relation to FDI verification and approval, the remaining provisions in the current FIE Laws are nothing but corporate-related regulations. A more sensible solution would be to consolidate the provisions regarding the legal forms for FDI under the umbrella of the Company Law and to set aside a special FDI law to accommodate the concerns about FDI’s general market access, investment protection and business operations.

3. Business Regulation and Other Administrative Control

a) Permitted Scope of Business

The business scope of a FIE, a key registration item in the articles of association and the business license, defines the realm of its permitted activities. An unlimited or non-exhaustive business scope is not available for FIEs (though it is possible for Chinese domestic enterprises). A FIE is therefore confined within the prescription of the business scope as registered in its incorporation documents. Any business expansion will require a unanimous board resolution (for the purpose of amendment of articles of association) and corresponding approval from the original approving authorities. The limited business scope for FDI is the logical outcome of China’s FDI verification and approval system. As any FDI project is verified and approved in accordance with the Industry Catalogue, it is coherent to keep the incorporated FIE adhere to such approved field of businesses. In particular, as the former FIE income tax law grants tax concession to those FIEs engaging in industrial production, a vital interest is thus to ensure that any business activities beyond the approved scope should not be valid and eligible for such concession.

The business scope limitation poses great challenge for the foreign investors that have a variety of business operations in need of integrated inter-group services such as distribution, sale and after-sale services. A FIE with a prescribed business scope is supposed to be self-contented so that it should only take care of its own operations and products. Any activities for importing, distributing and servicing products that are not directly linked to a FIE’s operation is not allowed. A FIE therefore has to retain its own procurement and maintenance network. A centralized service centre is not conceived under such regulatory framework. For a long time, the Holding Co. was the viable tool in response to such needs, although the high threshold for Holding Co. makes it a luxury that only multinationals could afford. Other distribution vehicles available to foreign investors include the bonded-zone trading companies, representative offices (“Rep Office”), or sales offices of local subsidiaries, but these structures proved insufficient to cater for the comprehensive trading and distribution needs of foreign investors.

In compliance with China’s commitments upon the entry in WTO, from December 11, 2004 onwards, FICEs are eligible to distribute imported and locally-manufactured products throughout China by way of commission agency, wholesale, retail or franchise and to carry out a host of related ancillary services, such as assembly, sorting and grading of bulk lots, storage and warehousing and garage

78 Cf. supra Chapter 2 at 13.
services, marketing, advertising and after-sale services etc. This new full-fledged distribution vehicle made it feasible to review and rationalize the distribution strategy currently applied by foreign investors. As thus, the distribution function insofar being carried out by the bonded-zone trading companies, Rep Office and Holding Co. could be taken over by a FICE. Separate distribution networks under the local subsidiaries could also be consolidated under a single FICE vehicle. An existing manufacturing FIE may also apply to expand its current business scope to cover distribution service.

Many recent private equity foreign investments are often leveraging on a so-called “contractual control” mechanism to evade sector-specific restriction, such as in Internet portal, telecommunication or education business. Under a widely used round-trip investment structure, an offshore special purpose vehicle is set up in which the Chinese individual founders and private equity funds hold respectively stakes. Such offshore vehicle then applies for the establishment of a WFOE in China. While the technology or service business is placed in such WFOE, real business operations are carried out in the name of a pure Chinese company. Operational proceeds from the business operation will be repatriated to the WFOE or an offshore vehicle through pre-defined transactions including intellectual property licensing, technical support, consulting service or leasing or marketing cooperation. Such structure essentially enables FDI engaging into the business sectors that are still highly restricted for foreign investment. The potential risks under such structure is the vulnerability of those contracts under Chinese contract law which may hold that these contracts are invalid due to illegal purpose of evasion of mandatory legal provisions. Nevertheless, many FDI, including the nascent private equity investment that are active in China, are packaged in such structure and have listed the shares of the offshore special purpose vehicle at overseas stock exchanges.

b) Capital Requirement

China imposes a statutory equity/debt ratio on foreign investment projects. With a total investment of less than USD 3 million, foreign investors are required to bring in more than 70% own capital. With larger amount of total investment, the allowed amount in debt finance is proportionately increased. Capital payment for a FIE in the legal form of liability company should be made according to statutory schedules. In the event of one-off payment, the registered capital should be paid off within 6 months after the establishment of a FIE. In the event of instalment payment, the

79 Administrative Measures for Foreign Investment in the Commercial Sector, promulgated by the MOFCOM on April 16, 2004 and effective on June 1, 2004.
80 Li, 94–99.
81 Such as Internal news portal Sina.com, education group New Oriental, computer game producer Shenda etc.
82 As such, for a FDI project with the total investment of more than USD 3 million but less than USD 10 million, a minimal 50% (or no less than USD 2.1 million) own capital is required; for the total investment of more than USD 10 million but less than USD 30 million, a minimal 40% or no less than USD 5 million is required; for the total investment of more than USD 30 million, a minimal one third (or no less than USD 12 million) of own capital is required. Art. 3, Interim Provisions on the Ratio between the Registered Capital and Total Investment of Sino-foreign Equity Joint Venture Enterprises, promulgated by the SAIC on February 17, 1987 and effective on the same date.
first instalment must be no less than 15% of the subscribed amount and be paid off within 3 months.\textsuperscript{83} The rest is, according to the Company Law, to be paid off within 2 years of the incorporation. Capital payment of a FI-JSLC is set to following the schedule mandated by the Company Law, namely at least 20% upon the incorporation and the rest within 2 years. Nevertheless, a FI-JSLC incorporated by means of publicly offering shares requires fully paid-off capital upon the incorporation. At least 20% of increased capital of FIEs in the form of a limited liability company or FI-JSLCs should be paid upon changing the registration and the rest be paid off within 2 years after the registration change.

47 In-kind contribution is normally required to be appraised by a certified assets valuer. However, for EJVs, the value of non-cash contribution such as tangible goods (including equipments) and industrial property etc., excluding the land use right, could be attained through negotiation among the joint venture parties and does not need assets appraisal.\textsuperscript{84} In the event that the Chinese partner brings in non-cash contribution to a joint venture project, it is to the interest of foreign investors to keep an eye on the valuation of such non-cash contribution. In some cases, Chinese partners tend to increase the value of the contribution so as to lower their cash-injection or to increase the deal price. To engage a neutral third-party valuer who follows accredited appraisal rules and methodologies will help to arrive at a fair transaction price in most cases. Even if State-owned assets are concerned, where statutory appraisal must be conducted by designated valuers and the result must be verified by governmental agencies, foreign investors should ensure that their own representatives be involved and play a double-check role throughout the whole valuation process.

c) Industry-Specific Regulations

48 FIEs shall abide by industry-specific laws and regulations that are governing its scope of businesses. In general these laws and regulations are promulgated for specific industries that aim to regulate all the operating entities in the concerned industry in China, irrespective of their foreign or domestic nature. For example, any EJV or WFOE banks in China are subject to the Commercial Bank Law and various prudential regulations promulgated or administered by the China Banking Regulatory Committee with respect to capital adequacy, risk control and corporate governance requirements etc.\textsuperscript{85} These are universally applicable across the industry participants. However, national laws for specific industries would also delegate legislation power for respective ministries to set forth special rules applicable for FDI in the given industry. This is often the case in service sectors, where China has made, upon WTO entry, substantial commitments as well as reservations regarding FDI’s market access and operations. In the case of banking industry, for example, certain phased-out restriction on EJV and WFOE banks in terms of geographic coverage or client coverage, fund sourcing and employing, introduction of new line of business etc.\textsuperscript{86} are in place.

\textsuperscript{83} Several Stipulations on the Schedule of Payment by the Parties of the Sino-foreign Equity Joint Venture Enterprises, promulgated by the MOFCOM on January 1, 1988 and effective on March 1, 1988.
\textsuperscript{84} Art. 10, Opinions for Applying the Company Law on FIEs.
\textsuperscript{85} Wei, 225.
\textsuperscript{86} Ibid, 232–242.
d) Taxation on Income

Prior to the adoption of the unified Enterprise Income Tax Law, China had employed an income tax regime that differentiates between the domestic enterprises and FIEs. Preferential tax treatment for FIEs in the form of reduced tax rates or tax holidays are accorded to certain qualified enterprises. FIEs engaged in production having a period of operation of not less than 10 years are eligible for income tax exemption for the first 2 profit-making years and a 50% reduction for the next 3 years. Furthermore, FIEs established in SEZs or other special economic zones pay income tax at a reduced rate of 15% or 24%. In comparison, domestic Chinese enterprises were subject to a higher income tax rate of 33%.

The tax incentive program premising on the origin of capital was aligned with China’s initial open-door policy of attracting and encouraging FDI. However, the discrimination had placed domestic enterprises at an inferior status while competing with FIEs. It proposed the so-called “round-trip” practices where Chinese investors channelled their domestic capital through an offshore vehicle so as to disguise itself as FDI for the associated tax benefits. It encouraged the short-termed activities that aim to exploit the tax holiday concession in that the project were to be shut down as soon as the tax exemption went expired. China’s successful accession into WTO, together with the consequence of an enlarged market openness and liberalization, called into question on the merit of keeping a bifurcated tax regime and eventually led to the enact of the unified Enterprise Income Tax Law (EIT Law).

The EIT Law applies to all enterprises established in China, domestic or foreign-owned alike. A flat 25% income tax rate is imposed on a resident enterprise for its global incomes or a non-resident enterprise for its China-sourced incomes. The EIT Law abandons the origin-based tax incentives. Instead, it employs a non-discriminatory regional and sectoral tax preferential treatment for investment (domestic or foreign) to be made in western and central part of the country or high-tech sectors so that the priority of national development interest continues being entertained. For sure, the EIT Law removes the incentive for round-tripping practices from the tax optimising perspective, as investment, merely because of coming from abroad, is not longer the decisive factor for enjoying the preferential tax treatments. Placing the FIEs and domestic enterprises under a common tax code enhances the transparency and consistency in the tax legal regime. It also encourages the investors to take a long-term approach when considering investing in China, which is beneficial for a more stable FDI environment.

Under the EIT Law and its implementation rules, any dividends payable to foreign investors by FIEs will be subject to a Chinese withholding tax at the rate of

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87 (企业所得税法), promulgated by the National People’s Congress on March 16, 2007 and effective on January 1, 2008.
88 Provided that, however, in the event the project terminates before the expiry of the full 10-year period, tax concession it has enjoyed will need to be paid back. Nevertheless, the trick can be played in that the operation could be kept losing money until the fifth year so as to keep the practice in consistency with the condition for the tax concession.
89 Li, 160–161.
10 %, which, until the effectiveness of the EIT Law, had never been charged. The inception of a new layer of dividend tax makes it advisable for foreign investors to leverage the existing tax treaties that China has entered into with other countries or regions. For example, under the treaty of avoidance of double taxation between China and Hong Kong, tax rate for such dividend is reduced to 5 % (provided that the equity interests held by such Hong Kong investor in the FIE is above 25 %), making an intermediary Hong Kong company as the equity holder of a China-based FIEs tax efficient.

e) Foreign Exchange Administration and Capital Transfer

China removed exchange restrictions on current account in December 1996 when the revision of foreign exchange regulation incorporated the obligation of Article VIII of the IMF’s Articles of Agreement. Renminbi (“RMB”), the legal currency of China, had since then been fully convertible on current accounts. As thus, payment under current accounts, such as the importation and exportation price, advance, profit repatriation, dividends, salary and other legal incomes of foreign entities or individuals could be effected directly upon presentation of valid documents with exchanges that domestic entities (including FIEs) purchase from designated banks or have debit previously in their bank accounts.

Foreign exchanges flow over the border under capital account (for example FDI or foreign loan) is still subject to the approval and registration with the SAFE. Advanced reporting and approval from the SAFE is mandatory for the legal validity of the transaction and deriving interests or profits. Therefore, after a FIE’s incorporation, it is essential that a foreign exchange registration with the SAFE should be conducted so that the foreign capital could be remitted and converted into RMB. Dividend distribution by FIEs to foreign investors under the current account, as freely as described above, premise on the full compliance with such SAFE capital account registration requirement. China’s foreign exchange regime applies equally to domestic Chinese enterprise and FIEs. One different feature is however that the FIE could incur foreign debts without an advanced approval and registration with the SAFE, provided that the loan amount is within the difference between the total investment and registered capital as verified and approved in the course of FIE incorporation.

Before distributing after-tax profits, FIEs are required to make up any losses carried forward from previous years. Also, a portion of profits has to be allocated to mandatory funds, including a reserve fund, an expansion fund and a separate fund for staff bonus and welfare. For EJV or CJV, there is no minimal or maximal limit on

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91 Art. 27 (5), EIT Law; Art. 91, Implementation Rules of the EIT Law.
92 Art. 10(2), Arrangement Between the Mainland China and Hong Kong Special Administrative Region Government regarding Avoidance of Double Taxation and Tax Evasion, executed on August 21, 2006 and entered into force on January 1, 2007.
94 Arts. 12–15, ibid; Arts. 21–25, Administration Regulation on Foreign Exchange Settlement, Sales and Payment, promulgated by the People’s Bank of China on June 20, 1996 and effective on July 1, 1997.
the amount allocated to these funds. The board of directors can decide the allocation ratio at their own initiative.\textsuperscript{96} For a WFOE, the expansion fund is not required. But a WFOE must set aside a minimum 10 \% of after-tax profits into the reserve fund until the accumulated reserve fund reaches 50 \% of the registered capital.\textsuperscript{97} The remaining part is distributable profits from which the board of directors may declare dividends to the investors in proportion to their contribution to the registered capital. For foreign exchange dividends, FIEs could remit directly from their bank accounts or purchase convertible foreign exchanges with banks by presenting a valid board resolution on profit distribution. At present, China imposes a 10 \% withholding tax on the dividends distributed to the foreign investors.\textsuperscript{98}

Foreign investor may opt to incur fees, interests or royalties by associated transactions with FIEs so that profit repatriation would be realized before income tax. While the foreign investors must pay withholding tax and/or business tax on their incomes arising from such associated transactions, the taxable income base of the FIEs could be reduced. These transactions could take the form of technology licence, service agreement, loan from mother company or R&D cost sharing arrangements etc.

Manufactory royalties used to be capped at 5 \% by the MOFCOM under its obsolete regime of approving technology transfer. The maximal royalty-charging term was limited to 10 years. Since 2001, a file-for-record system has been adopted for most of the cross-border technology transfer, which replaces the pre-approval process.\textsuperscript{99} As a result, the commercial terms and conditions for technology transfer such as the royalty level and payment term are no longer subject to the screening by the authority.

Nevertheless, foreign technology owners are required to present supporting documents, before royalties could be remitted out of China, as part of the formalities for foreign exchange administration purpose. These include the inter-company agreements that set out the terms of technology transfer, the registration certificates issued by the MOFCOM and the tax clearance certificates issued by in-charge tax bureaus. Royalties are subject to both a 10 \% withholding tax and a 5 \% business tax. Since January 2009, business tax is not longer deductible for withholding tax purpose,\textsuperscript{100} so that the effective tax rate on royalties is 15 \%. Nevertheless, such tax charge is still much lower than 25 \% enterprise income tax, presenting a valuable case for tax optimization.

Foreign investors could provide services and thus get paid under service agreements with their FIEs in China. It is not requested to register or file service agreements with authorities. To remit service fee is therefore subject to less paper work requirement under foreign exchange control in comparison with royalties’ remittance. Fees paid by FIEs to their parents for services provided are subject to a 5 \% business tax, which usually shall be paid by the FIEs on behalf of their parents. In addition, where the servicing period is long enough (more than 6 months in any

\textsuperscript{96} Art. 76, Implementation Rules of the EJV Law.
\textsuperscript{97} Art. 167, Company Law.
\textsuperscript{98} Supra at n. 91.
\textsuperscript{99} Administrative Regulation on Technology Importation and Exportation, promulgated by the State Council on December 19, 2001 and effective on January 1, 2002.
\textsuperscript{100} Art. 8, Interim Methods on Withholding Tax of Non-resident Enterprises, promulgated by the State Administration of Tax on January 9, 2009 and effective on January 1, 2009.
12-month period) to constitute a Permanent Establishment ("PE") in China, a 25% enterprise income tax will be charged on the deemed profits of the foreign service provider, which vary from 10% to 40% of the income arising from onshore service. If PE could not be established, enterprise income tax is theoretically not applicable. In practice, tax authority sometime would nonetheless treat the fees as loyalties and levy a 10% withholding tax. Service fees at arm’s length are normally deductible for FIE’s enterprise income tax purposes. However, “management fees” charged by parents on the basis of inter-group cost sharing program is not deductible.

Loan interests paid by FIEs to their parents are subject to a 10% withholding tax and 5% business tax payable by FIEs on behalf of their parents. Such interests paid are deductible for FIEs’ enterprise income tax purpose. However, as mentioned above, under the foreign exchange regime China imposes mandatory equity/debt ratio on FIEs. With a given amount of the registered capital, foreign debts that a FIE is permitted to raise are capped. Loans granted by foreign parents above the cap will need to go through the foreign-debt registration procedure with the SAFE and the remittance of interests is subject to the approval of the SAFE.

It should be noted that in recent years, Chinese tax authority become more proactive in regulating transfer-pricing activities. The revision of the Enterprise Income Tax Law has places special emphasis on anti-avoidance measures. Following suits after the OECD Transfer Pricing Guidelines, Chinese law adheres to the arm’s length principle in administering transfer pricing, which requests that a transfer price should be the same as if the transacting parties were indeed two independents, not part of the same corporate structure. Foreign investors’ transactions with FIEs in China as discussed above for profit repatriation purpose should thus comply fully with the requirements such as transfer pricing related documentation, reporting and advance arrangement etc. with Chinese tax authority.

III. Concluding Remarks

China’s FDI-related law, though still under a bifurcated framework separated from that of Chinese enterprises, has lost much of its uniqueness in the recent year. In essence, FIEs and domestic enterprises are increasingly governed by the same legal standards with general applicability. Laws on contract, corporate, property, tax and competitions have erected a levelled institutional ground-field for both Chinese and foreign players. WTO-enhanced market openness and liberalization greatly induce the flattenedness of the legal provisions. The convergence of FDI regulations with the commonly applicable national laws prophesies a consolidated Company Law that could pull the scattered provisions existing in a variety of FIE-related regulations under a single piece of legal instrument, while leaving the FDI-specific rules to other legal codes.

China’s FDI verification and approval process remains strict. The seemingly clear entry conditions and procedures could become blurred if confronted with the

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101 Arts. 41–48, Enterprise Income Tax Law.
103 Interim Implementation Method for Special Tax Treatment, promulgated by the State Administration of Tax on January 8, 2009 and effective on January 1, 2008.
implementing opaqueness and unfettered agency discrepancy. A myriad of authorities and interests could intertwine with one another that may risk a FDI project being caught in between a political stalemate. The future improvement on China’s FDI legal regime is therefore not only dependent on the promulgation of consistent and clearly defined rules and regulations, but also on the transparent implementation of such and eventually on the furtherance of rule of law across the country’s political and societal arena.

### IV. Relevant Laws & Regulations

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Chapter 4. Securities

Chapter 4. Securities


I. Overview

1. Introduction to Securities Regulation in China

a) Growth of the Chinese Capital Market

1 Since the introduction of the reform and opening-up policy, China witnessed the emergence and development of domestic capital markets. The increasing sophistication of the Chinese economy (from centrally-planned to market-oriented) and the transformation of former State-owned Enterprises (SOEs) both call for more dynamic and accommodating financial institutions. In retrospect, three phases highlight the evolution of this development:

2 Phase 1 (1978–1992): China initiated a full scale economic reform. Capital markets began to emerge in response to the incorporation process of Chinese enterprises. The Shanghai Stock Exchange (SSE) was founded on November 26, 1990 and in operation on December 19. Roughly at the same time, the Shenzhen Stock Exchange (SZSE) was established in one of the Special Economic Zones at Shenzhen.

3 Phase 2 (1993–1998): As elaborated hereinafter, the China Securities Regulatory Commission (CSRC, 证监会) was set up and has gradually consolidated and streamlined the supervision of capital markets. Regional pilot programs were therefore integrated and expanded nationwide.

4 Phase 3 (1999–current): With the promulgation and subsequent revisions (2004, 2005) of the Securities Law of the People’s Republic of China (Securities Law) marking a milestone, the legal status of China’s securities markets has been formalized and strengthened, and a series of major reforms have been implemented or are ongoing.

5 The Chinese securities market is currently ranked the third largest capital market in the world, trading around 6 percent of the world’s securities. As of the end of 2008, China’s capital market consisted of 1,625 listed companies, 104.5 million effective investor accounts and a market value of RMB 12.14 trillion. The growing importance of the Chinese capital market is also indicated by the increasing value of

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2 Before the establishment of the People’s Republic of China in 1949, there had been securities markets and trading. The Beijing Stock Exchange opened in June 1918 and was the first stock exchange established by the Chinese. During the 1920s and 1930s, Shanghai became a leading financial centre in the Far East. See CSRC Report, 155.

3 The official abbreviation for the Shenzhen Stock Exchange is SSE, too. To avoid unnecessary confusion, this chapter refers to it as the SZSE instead.

4 CSRC Report, 153.

5 Available at http://hubei.csrc.gov.cn/n575458/n4239016/n7828263/n11147943/n11311291/11311394.html.
listed Chinese companies. For example, the A share Initial Public Offering (IPO) in November 2007 of PetroChina (中国石油), a state-controlled oil giant under the auspices of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), managed to raise RMB 66.8 billion. Immediately after its IPO, PetroChina at that time became the world’s largest company in term of market capitalization accruing a value of USD 930 billion, and almost doubled Exxon Mobile’s market capitalization of USD 486 billion.6 Similarly, against the tumultuous meltdown of many global financial giants, three commercial banks of China topped the list of worldwide banks in terms of market capitalization as of the end of June, 2009 – Industrial and Commercial Bank of China (ICBC, 中国工商银行, USD 257 billion), China Construction Bank (CCB, 中国建设银行), and Bank of China (BOC, 中国银行).7

b) Creation of the Securities Regulation Framework

Centralized securities regulation was introduced in October 1992 when China’s State Council established the Securities Committee (SCSC, 证券委), being composed of the heads of ministries and commissions such as the Ministry of Finance (MOF), the People’s Bank of China (PBOC), the Supreme People’s Court (SPC), and its operative organ – the CSRC. During the National Financial Sector Work Conference in November 1997, the supervision of securities firms which had previously been overseen by the PBOC shifted to the CSRC. In April 1998, the SCSC also merged with the CSRC marking a pivotal point in China’s securities regulation.

The Securities Law passed in 1998 and effective from July 1, 1999 was the first national law by the National People’s Congress (NPC) to regulate the issuance and trading of securities in China. After a minor amendment in 2004 and a much more substantial revision in 2005, the current version of the Securities Law has been effective since January 1, 2006.8 Issues not fully covered by that law are governed by the provisions of the Company Law (the latest version being effective as of January 1, 2006) as well as other laws (e.g., the Securities Investment Fund Law) and administrative regulations.9

*Inter alia*, the Securities Law 2005 Revision:
– Echoed the similar change to other related laws, relaxed restrictions on the range of financial services to be provided by securities, banking, trust, and insurance industries while adhering to the principle of segregated management and supervision;
– Clarified rules on securities issuance, trade, registration and settlement and left room for building a multi-layered market system;
– Refined the listed company supervision system, raised legal obligations for controlling shareholders or de facto controllers, as well as for directors, supervisors, and senior managers;

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6 Available at http://www.bloomberg.com/apps/news?pid=20601087&sid=afq.WPd_zCO4. However, since its startling debut at SSE with almost RMB 44 for its closing price per share, the price of Petrochina A share has been falling while following the volatile ups and downs of the overall market; its closing price as of June 30, 2009 was RMB 14.48.
8 The provisions cited in this chapter are those of the revised Securities Law unless otherwise specified.
9 Art. 2 Securities Law.
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- Enhanced the transparency of the IPO approval process, and established a sponsorship system for IPOs;
- Tightened the supervision of securities firms to mitigate securities market risks by enhancing internal control requirements, senior management and main shareholder qualifications, and surveillance and corrective measures;
- Strengthened the protection of the rights and interests of investors, particularly minority public investors, with the setup of a national protection fund and the improvement of the civil liability compensation regime;
- Increased law enforcement measures and imposed heavier punishments for violating securities laws, including more civil liabilities and the CSRC sanctioned denial of re-entry into the capital market.10

In line with this revision, the NPC subsequently enacted Amendments VI and VII to the Criminal Law to clarify penal liabilities of listed companies, securities firms and other entities related when violating the law, and imposed severer punishments for market manipulation and other forms of securities fraud. Furthermore, the State Council and its ministries and commissions took efforts to review and amend relevant administrative regulations and department rules. The CSRC in particular promulgated or revised numerous implementing rules to put the new Securities Law in effect. Meanwhile, the SPC is enacting or deliberating judiciary interpretations to address such issues from the perspective of the judiciary.

It is noteworthy that the aforementioned and continuing trends of securities regulations are often indicated by state policies. Most importantly, the State Council released Opinions of the State Council on Promoting the Reform, Opening-up and Steady Growth of Capital Markets (hereinafter: State Council Opinions, 国九条) on January 31, 2004. The State Council Opinions declare that developing the capital market is of strategic importance, it thus set out the principles, goals, guidelines and policies for stabilizing and developing capital markets, and emphasize the following aims: establishing multi-layered markets and introducing new products, improving the quality of listed companies, supervising securities intermediaries, enhancing supervisory capacity, preventing and reducing market risks, opening-up the market gradually.11 Considering the fact that the State Council is the final decision maker for many important legal matters12, observers might well bear those statements in mind with a view to the future development of securities laws or their application in China.

2. Defining Securities

a) Scope of Application of the Securities Law

Article 2 of the Securities Law sets out the scope of its application: “The provisions of this Law shall be applied to the issuance and trading of stocks, corporate bonds as well as any other securities as lawfully recognized by the State Council within the territory of the People’s Republic of China.”13, and further: “Any

10 CSRC Report, 231.
11 201–02, ibid.
12 For instance, the Securities Law Revisions and Non-tradable Share Reform, infra at 26–32, were both approved and largely initiated by the State Council.
13 Art. 2 para. 1 Securities Law. Up to now, no other kinds of securities have yet been recognized by the State Council.
listed trading of government bonds and units of securities investment funds shall be governed by this Law. Where there is any special provision in any other law or administrative regulation, the special provision shall prevail (emphasis added)."\textsuperscript{14} For government bonds and securities investment fund units, the application of the Securities Law is restricted to listed trading (not issuance) and would be further trumped if other laws (e.g., the Securities Investment Fund Law) or administrative regulations were to stipulate other rules.

The Revision of the Securities Law in 2005 expanded its scope to incorporate the issuance and trading of securities derivatives: "The measures for the administration of issuance and trading of securities derivatives shall be prescribed by the State Council according to the principles of this Law."\textsuperscript{15} With little surprise, securities derivatives are not defined explicitly. With regard to one of the most common categories of derivative – futures –, the State Council in 2007 enacted a Regulation on the Administration of Futures Trading.\textsuperscript{16}

In practice, commodity futures have been traded at three futures exchanges located in Dalian, Zhengzhou and Shanghai, respectively. For financial futures China Financial Futures Exchange (CFFEX) was founded on September 8, 2006 in Shanghai, as a joint project by Shanghai Futures Exchange, Zhengzhou Commodity Exchange, Dalian Commodity Exchange, Shanghai Stock Exchange, and Shenzhen Stock Exchange. The trading of CSI 300 index futures became CFFEX’s first task and has been on trial but not yet officially launched. Other financial derivatives such as additional index futures, index options, government bonds futures and currency futures are planned to be run by the CFFEX at a later stage.

Securitization contributed greatly to the global financial crisis. But in China, asset-backed securitization (ABS) is still at a very early stage of its development. Some pilot projects, implemented, for example, by China Construction Bank were driven by a strong sense of trial encouraged by the regulator; others were believed to be primarily motivated by the desire to exploit a new way to eliminate non-performing loans.\textsuperscript{17} ABS products are traded thinly on the inter-bank market for institutional investors and are not traded on stock exchanges. Some foreign commentators advised China to open up its securitization market, adding that ABS in China could be jump-started by first focusing on cross-border securitization and by establishing a dependable group of regional investors.\textsuperscript{18}

Bond financing has been less developed, too. In 2008, bonds worth RMB 6.9 trillion were issued, of which almost RMB 5 trillion were governmental bonds or central bank notes, and 1.2 trillion were financial institution bonds. Bonds issued by various business enterprises accounted for the remaining RMB 250 billion, which is subject to a controversial regulatory and market segregation: With regard to issuance, Corporate Bonds (公司债, as referred to in art. 2) are under the supervisory authority of the CSRC and available only for listed (stock) companies, while Enterprise Bonds (企业债, most of them issued by SOEs) are subject to the approval of the National Development and Reform Commission (NDRC). In addition, to avail Short/Medium Term Financing Notes (短期/中期融资券) for

\textsuperscript{14} Art. 2 para. 2 Securities Law.
\textsuperscript{15} Art. 2 para. 3 Securities Law.
\textsuperscript{16} (期货交易管理条例), promulgated on March 6, 2007 and effective on April 15, 2007.
\textsuperscript{17} Wei, 226.
\textsuperscript{18} Faleris, 202.
qualified issuers, a filing has to be made with the PBOC. As to trading, the bond market comprises the inter-bank market, exchange market, and bank over-the-counter (OTC) market, and is again complicated by regulatory turf wrestles. This segregation of the markets, coupled with the absence of an effective arbitrage mechanism, undermines market efficiency. The State Council Opinions called for liberalizing and speeding up the development of bond markets, therefore more regulatory coordination is needed to further the integration or interlinkage among bond markets.

In general, the definition of “securities” in the Securities Law seems rather narrow, targeting mostly stocks and corporate bonds. By comparison, § 2 (a) of the U.S. Securities Act of 1933 defines securities to be “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

Furthermore, a particularly important feature of the US Securities Act of 1933 definition is the concept of an investment contract. It turned out to be the catch-all provision to capture securities not covered by the list of instruments identified by § 2 (a). The test for an investment contract was set out in Howey: To constitute an investment contract, there must be an (1) investment of money, (2) in a common enterprise, (3) with expectation of profit by the investor, (4) solely from the efforts of another. The fourth element, however, has been interpreted widely to be an undeniably significant or essential effort from another.

Illegal stock public issuance and the various forms of collective investment schemes (Ponzi or others) have victimized many people in China, and often result in social unrest. For instance, after two years’ investigation and indictment, Ms. Wu Ying (吴英) was tried in April 2009 for defrauding investors of almost RMB 390 million by promising a three to ten percent monthly return. That money was purported to be invested in the enterprises she set up, but was in fact used to repay other investors, to purchase real estate and vehicles, and for other personal uses. Not surprisingly, Ms. Wu denied all allegations and attributed the loss to business failure being exacerbated by her prosecution.

The majority of these cases have been dealt with charges of “unlawful deposit-taking from the public” or monetary fraud, thus leaving a lot of legal inconsistency and doubts unresolved. Most regulators, judges and scholars are more familiar and

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19 CSRC Report, 259.
22 Which will be discussed infra at 43–46.
therefore more comfortable with handling those cases in a creditor-debtor framework and with regard to unlicensed financial businesses. Thus they inherently tend to rely heavier on banking laws and regulations. This approach arguably better fits into China’s tradition, which like Germany’s and Japan’s, emphasizes indirect financing with commercial banks allocating capital and assuming risks. This stands in contrast to later investor-issuer models. Nevertheless, the Securities Law regime could suggest a promising alternative to cope with these widespread problems. By introducing the Howey test, the definition of “securities” in China could be broadened substantially, and the scope of the Securities Law’s application could be expanded to cover more investment disputes.

b) Categories of Listed Stocks

Within the current Securities Law and Company Law regime, stock is usually referred to as common stock of a Joint Stock Limited Company (JSLC), although the State Council did receive the legislative authorization to enact separate regulations for the issuance of other classes of stocks by JSLCs. With regard to common stocks listed in China (including Hong Kong) and abroad, A shares make up the largest bulk and will be elaborated further hereinafter. These are RMB-denominated shares mainly for domestic investors (individual or entity) and available to foreign investors only through limited channels.

Also listed domestically, B shares are denominated in RMB but subscribed to and traded in US dollars (for those listed in SSE) or Hong Kong dollars (for those listed in SZSE). B shares had emerged against the shortage of foreign currency and tight foreign exchange control in the early 1990s and were originally available only to overseas investors. In November 1991, Shanghai Vacuum Electronic Devices Company Limited (上海真空电子) was the first Chinese company to issue B shares. Starting from February 2001, China permitted domestic residents to open B shares accounts with legally-obtained foreign currency and trade in B shares. With other forms of stocks flourishing, the importance of B shares declined, and trading volume and market capitalization shrank. As for B shares, the Securities Law stipulates that the specific measures on the subscription or trading of shares of domestic companies in foreign currencies shall be separately formulated by the State Council.

Meanwhile, more and more Chinese domestically-incorporated companies are listed in Hong Kong or foreign stock exchanges. In June 1993, Tsingtao Brewery Company Limited (青岛啤酒) was listed in Hong Kong as the first Chinese company to issue H shares (H representing Hong Kong listed). In August 1994, the Special Regulations for PRC Joint Stock Limited Companies Issuing Shares and Listing Outside of the PRC was implemented to address this tendency. In October 2006, Industrial and Commercial Bank of China (ICBC, 中国工商银行) succeeded

24 Art. 132 Company Law. Up to now, no such regulation has been enacted by the State Council. Note that all shares of listed companies are name shares.
25 For example, China launched the Qualified Foreign Institutional Investor (QFII) program in December 2002 to allow foreign institutional investors with prior approval to trade A Shares.
26 CSRC Report, 170.
27 Art. 239 Securities Law.
28 CSRC Report, 171.
in simultaneous IPOs and listings on the Shanghai and Hong Kong markets for the first time, making it the world’s largest IPO at the time.

23 In August 1994, Shandong Hua-Neng Power Development Company Limited (山东华能电力) was listed on the New York Stock Exchange (NYSE) through the form of American Depository Receipt (ADR, 美国存托凭证) and was the first company to issue N shares (likewise, N represents New York). In March 1997, Beijing Da-Tang Power Generation Company Limited (北京大唐发电) became the first Chinese company to go public on the London Stock Exchange (LSE) and thus issued L shares. In May 1997, Tianjin Zhongxin Pharmaceutical Group (天津中新药业) went public on the Singapore Stock Exchange as the first S shares company.29

24 As an alternative, some explorative Chinese individuals and entities began to incorporate special purpose vehicle (SPV) overseas that went public in Hong Kong or New York since 1999, raising at peak times a total of about RMB 314 billion in 2006.30 The shares of those listed SPVs are commonly referred to as Red-chips (红筹股) (infra Chapter 12 at 1). H Shares and Red-chips companies have now become an important component of Hong Kong capital markets.31

25 The Securities Law requires that direct or indirect offers of securities overseas by a domestic enterprise or overseas listing of its securities for trading must be approved by the State Council’s securities regulatory authority according to the provisions of the State Council.32 The issuances of H (or N, L, S) shares have long been under a close approval review by the CSRC. With an increasing wariness towards the surge of private enterprises becoming listed overseas as Red chips, the CSRC together with other ministries issued in 2006 Regulations on Acquisition of Domestic Enterprise by Foreign Investors (infra Chapter 5 at 1).33 This new rule put trans-border equity or asset deals aiming at Red chips overseas listings under a tightened multi-agency scrutiny. The obscurity of the review process, however, has led almost all such endeavours to end in a stall. Additionally, the CSRC has signed nearly 50 bilateral Memorandums of Understanding (MOUs) with securities and futures regulatory authorities in more than 40 countries and regions34 in an effort to enhance international regulatory cooperation.

3. Structure of Securities Markets

a) Non-Tradable Share Reform

26 In Chinese domestically-listed companies, the ownership structures are often highly concentrated, with the state or state-controlled entities being the controlling shareholder or de facto controller. For instance, between 1999 and 2003, the total holdings of all large shareholders (defined as shareholders who hold more than 5% shares of the company) in listed companies amounted to 54.26%. On average, the largest shareholder in a Chinese listed company held 45.64% of the company’s

29 CSRC Report, 170.
30 There are often discrepancies between prices of A shares and H shares of the same company. For example, PetroChina’s first A shares listing day in October 2007 closed with a price of RMB 43.96 per share for A shares and only HK$ 18 (about RMB 17) per H share.
31 CSRC Report, 186.
32 Art. 238 Securities Law.
33 Promulgated on August 8, 2008 and effective on September 8, 2006.
34 Including Hong Kong, Singapore, Australia, Japan, France, Germany, Italy, Holland, Canada, India, Brazil, and the UK and US etc.
stock. Of the 1,104 Chinese companies listed in 2001, the state was the largest shareholder in 84.1% of these companies (930 companies, holding an average of 46.5% of shares), while the largest shareholder of the remaining 15.9% of these companies were private owners (174 companies, holding an average of 34.8%). A study of listed companies between 2001 and 2003 showed that until 2003, 21% of listed companies in China had a non-governmental owner in ultimate control, while 23% were controlled by the central government and 56% by various levels of local governments.

This government-dominated concentration was made even more complicated by the segregation of A shares, i.e. the so-called share-split (股分置). A shares have been further divided into tradable shares (流通股) and non-tradable shares (非流通股) based upon whether they could be listed and traded on stock exchanges. Tradable shares are those purchased by public investors in Initial Public Offerings (IPOs) and listed on exchanges. Non-tradable shares are those held by the shareholders before the companies went public and may only be transferred through negotiation among designated parties under certain restrictions. This dichotomy derived from an early experiment of the shareholding reform, in which the transfer of state-owned shares was deemed unnecessary. For more than a decade, a listed company would state in a prospectus or public listing statement that all shares held by shareholders before the public offering would not be listed and traded publicly in accordance with laws, regulations and CSRC rules for an indefinite period of time, while all shares publicly offered could be listed and were tradable on a stock exchange.

With mindsets changing with regard to the management of state-owned assets, this became more problematic and resulted in an increased surplus of non-tradable shares. Early attempts to reduce the amount of state-owned shares through sales on the open market (国有股减持) often gave rise to sharp market plunges and soon ended in suspension. By the end of 2004, the total shares of listed Chinese companies were 714.9 billion, of which 454.3 billion shares (or 64% of all shares) were non-tradable. 74% of non-tradable shares were state-owned.

The share-split led to unequal rights and to different pricings for shareholders of tradable and non-trade shares, increased the divergence of interests between company controller and average investors, and impeded takeover mechanisms from functioning effectively to discipline the market. On April 29, 2005, under the leadership of the CPC and the State Council, the CSRC launched the Non-tradable Share Reform/Split Share Structure Reform (股分置改革), following the principle of “centralized organizing (by the CSRC and stock exchanges) and decentralized decision-making (by the shareholders of each involved listed company)”. No explicit government intervention or standardized pricing was imposed. After a

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35 See chart extracted from Xu/Xin/Chen, 92.
36 See chart extracted from Liu/Sun/Liu, 53.
37 See chart extracted from Xia/Fang, 44.
38 Non-tradable shares included state-owned shares, legal person shares (法人股) and a small portion of natural person shares for some companies. Shares derived from a rights issue or bonus issue based on non-tradable shares were classified to be non-tradable shares too.
39 CSRC Report, 177.
40 CSRC Report, 204.
41 But the CSRC did implement rules guiding this reform, the most important of which being the CSRC Administrative Measures on the Split Share Structure Reform of Listed Companies, promulgated and effective on September 4, 2005.
piloting and policy coordination phase, the existing non-tradable shares have been diminished gradually. New IPOs no longer create non-tradable shares.

The reform process was designed and implemented to allow market participants to negotiate and resolve issues between themselves. In its core, holders of non-tradable shares were to reach agreement with holders of tradable shares in order to change (or clarify) the status of shares and settle on appropriate compensation. In practice, this was generally achieved by holders of non-tradable shares giving out a portion of shares to holders of tradable shares at mutually agreed prices. The process typically started with a proposal to float non-tradable shares put forward by the holders of non-tradable shares, which would then be revised by all shareholders. Votes ensued on this proposal by all shareholders and by tradable shareholders, respectively. With the help of stock exchanges and the stock settlement and clearance system, listed companies were required to provide the necessary IT systems to facilitate voting online. The proposal could only be passed by at least two thirds of all the shareholders having voted and at least two thirds of holders of tradable shares having voted. Listed companies planning to float formerly non-tradable shares could take measures to stabilize share prices when necessary.

By the end of 2007, 1,298 companies listed on SSE and SZSE had either initiated or completed this reform, accounting for 98% of the total listed companies subject to this reform. Only 33 listed companies had not yet initiated the reform. At the end of 2008, 99.41% of all shares on SSE became tradable (31.99% without any limit, 67.42% still subject to certain sale limits). At SZSE, 98.77% of all shares became tradable (59.13% without limits, 39.65% subject to limits). In the long run, this significant non-tradable share reform leveled out equity rights and pricing, and realigned shareholders’ interests, therefore enabling the secondary market to better reflect the value of listed companies. However, with the promised lock-up periods ending, the former non-tradable shares, especially those from non-controlling large holders, have kept pouring into the market, which contributed greatly to the stock market’s nosedive. It later accumulated with problems originally due to the global financial crisis and economic recession.

On June 19, 2009, the State Council of China launched another major move by announcing that all companies with state-owned shares which had been initially publicly offered and has been listed on domestic stock exchanges since the 2005 Non-tradable Share Reform have to transfer shares equivalent to 10% of IPO amounts for free from their former state entity holders to the State Pension Fund (全国社保基金). Meanwhile, the no-sale lockup period of those shares transferred has been extended for another 3 years. The long term goal of this shift between

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42 205, ibid.
43 For a narrative comment, see Kister, 312.
44 This compensation was bizarrely named “consideration” (对价), a term used in contract law.
45 As shares or warrants. On average, three additional shares were given out for every ten shares held by shareholders of tradable shares.
46 Including, inter alia, purchase by controlling shareholders, buy-back by listed companies, preset conditions for sales of previously non-tradable shares, lock-up period, preset repurchase prices, and issuance of warrants.
47 As of April 2009, only 21 listed companies remained, most of which were financially distressed.
49 CSRC Report, 205–06.
different state assets holders was said to fortify China’s social security system, helping it to deal with an aging population. However, its immediate effect might have been to ease the market panic following the resumption of IPOs after a 9 months suspension since September 2008. Though generally accepted by the market, this move created technical problems for some companies concerning the particular amount of transfer and in rare cases led to a change of control over the company. Also, for state entity holders with private minority shareholders or significant debts, the transfer may give rise to concerns or disputes between shareholders or between debtors and creditors.

b) Emerging Multi-Layered Markets

The State Council Opinions called for the creation of a fully multi-layered stock market. The SSE and SZSE have been playing a pivotal role in this endeavor, yet have developed different focuses on it. The SSE has become the pre-eminent stock market in Mainland China in terms of the number of listed companies, the number of shares listed, total market value, tradable market value, securities turnover in value, stock turnover in value and Treasury bond turnover in value. December 2008 ended with over 864 companies being listed. In an effort to develop the blue chip market, the total market capitalization at SSE reached RMB 9.73 trillion, and capital raised from SSE market surpassed RMB 223 billion. A large number of companies from key industries, infrastructure and high-tech sectors have not only raised capital, but also improved their operations by listing on the SSE market. In terms of market capitalization, SSE ranks fourth globally after NYSE, NASDAQ, and the Tokyo stock exchange.

At the end of 2008, the SZSE hosted 740 listed companies and accounted for a total market capitalization of RMB 2.41 trillion. With an emphasis on the emerging corporate China, the SZSE not only fosters its main board (主板) to grow, but takes on a very pro-active approach on launching new markets. In addition to optimizing the stock transfer system to become an effective trading platform for non-listed public companies and de-listed companies, the SZSE is famous for two feature markets: the Small and Medium Enterprises Board (SMEB, 中小企业板) and the Growth Enterprise Market (GEM, 创业板).

Set up in May 2005, the SMEB was designed to be a market segment for small or medium caps with pronounced core businesses, high growth potential and intensive technological contents; it is exploring innovative and customized solutions for small and medium-sized enterprises with regard to trading, disclosure and stock watch. As of mid 2009, the SMEB included 273 listed companies, and has raised capital totalling RMB 120 billion.

The SMEB tailor-made initiatives included an open call auction during the pre-opening session to ward off market manipulation by allowing greater transparency. Furthermore, closing prices are determined by last-three-minute call auctions, and deviations in volatility, turnover and closing prices are brought into stock watch to curb market abuse. Regular audits on raised fund usage in comparison to publicized investment targets, open corporate results, annual public meetings on corporate

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53 Other efforts such as the Share Transfer System will be discussed infra at 80.
54 Editorial, Securities Market Herald (证券市场报), vol. 6, 2009.
financial health and business development, and an intermediary credit supervision system are obligatory.\footnote{Special Rules Governing Listings on the SME Board and Special Rules Governing Trading on the SME Board were enacted to reinforce compliance on corporate disclosure and trading activities.}

However, the listing threshold of the SMEB is as high as the main board’s, rendering it unavailable for most capital thirsty start-up companies. Therefore, the introduction of a Growth Enterprise Market (GEM) in China has been long advocated with reference to the NASDAQ. A healthy GEM is conducive to meet the direct financing needs of emerging enterprises, especially high-tech companies, as well as for providing exit channels for venture capital.

On March 31, 2009, the CSRC promulgated Provisional Administrative Measures for IPOs and listing on the Growth Enterprise Market, which greatly accelerated the unveiling of China’s GEM. Although still high when compared with NASDAQ’s standards, the GEM listing thresholds are substantially lower than those for the main board.\footnote{For further discussion, see infra at 63.} Other prominent features of the GEM include the introduction of an investor entry or suitability system which corresponds to investors’ capacities to bear risks and requires an adequate notice of risk to investors. In addition the supervision of company controlling shareholders and de facto controllers has been strengthened. CSRC and SZSE have also drafted various implementing rules on issues such as listing applications, prospectus preparation, GEM-tailored sponsorship system, and the review process. Other preparations include intermediaries’ training and risk education for investors. The Provisional Measures came into force on May 1, 2009, and the GEM debuted eventually on October 30 with 28 companies constituting the first group to list there.

Generally speaking, the SMEB and GEM are still at an early stage of development with limited scale and industry coverage. While progress being made, the stringent listing requirements on size, profitability and industry focus still exclude many start-up companies which lack a profit history from being listed, cut short their financing options and reduce the range of risk-return profiles available to investors. Also, only a very limited range of products such as stocks, corporate bonds and certain warrants, are currently traded on stock exchanges. To build a full multi-layered stock market is, therefore, still an ongoing challenge for China.

About 123.6 million investor accounts (121.2 million for A shares and 2.4 million for B shares) have been opened as of the end of 2008, of which 104.5 million were effective, while only 47% of A share accounts engaged in a transaction with the past one year period.\footnote{China Securities Depository and Clearing Corporation Limited, 2008 Annual Statistics Report, 5. Some of this was related to the sagging market of that year, others may be linked to so-called “ghost accounts”.} The general picture shows that there is a high proportion of retail investors with frequent trading behavior, a small number of institutional investors, and only limited participation of insurance companies and social security investment funds. A growing but still inadequate number of securities investment funds provide limited products, yet show only a weak capacity for innovation. Collective investment schemes are poorly coordinated, underdeveloped and include a problematic privately-placed fund management.\footnote{CSRC Report, 268–76.}
Consequently, to achieve a more balanced and less volatile market will demand continuing efforts to foster institutional investors and investor education. Insurance companies and mutual funds should be encouraged to involve themselves more actively in the securities market. Restrictions on foreign shareholding in securities entities and their business scope should be gradually lifted. Education programs, particularly those targeted towards small and medium sized investors should be stressed, focusing on risk awareness and rational investment. Investors should be better equipped to protect their legitimate interests through civil litigation and other means (infra at 130).

II. Main Issues

1. Securities Issuance

a) Definition of Public Issuance

Under the current Securities Law regime, an issuance is deemed to be a public issuance if one the following requirements is being fulfilled: (1) securities are issued to non-specific targets, (2) securities are issued to accumulatively more than 200 specific targets (several rounds of issuance of a JSLC will be aggregated in calculating the 200 target limit), or (3) issuance covered by other acts as stipulated by any law or administrative regulation.59 As a general authorization, this last alternative allows to introduce new scenarios of public issuance by other laws and administrative regulations.

It is important to determine whether an issuance is public or not. A public issuance must satisfy the requirements of the relevant laws and administrative regulations and shall be reported to the State Council securities regulatory authority or a department upon authorization by the State Council for review and approval according to law.60 Furthermore, for any securities that are not issued publicly, advertising, public inducement or public issuance in any disguised form is prohibited.61

What constitutes a specific or non-specific target is still largely discussed in China without being precisely illustrated. In the United States, case law offers the following definition:

"In its broadest meaning the term 'public' distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-haired men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less 'public', in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering, though not open to everyone who may choose to apply, is none the less 'public' in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made... . To determine the distinction between 'public' and 'private' in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction."62

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59 Art. 10 para. 2 Securities Law.
60 Art. 10 para. 1 Securities Law.
61 Art. 10 para. 1 Securities Law.
In essence, the targets of private placements should be those entities or individuals capable to “fend for themselves” even without federal protection.\textsuperscript{63} Such basic tenets might well be embraced in China.\textsuperscript{64} For example, an interpretative book edited by the authors of the Securities Law, narrows the scope of “specific targets” to include institutional or individual investors capable of assessing and bearing investment risk, or to persons close to and familiar with the issuer such as executives or employees.\textsuperscript{65}

As discussed above, CSRC’s permission is required for public issuances. It is also required for any listed company making a non-public issuance. Art. 13 of the Securities Law states that a listed company that makes any non-public offer of stocks shall satisfy the requirements as prescribed by the State Council securities regulatory authority and shall be report to the securities regulatory authority for review and approval.\textsuperscript{66}

b) The Initial Public Offering Process

(1) Roadmap and Key Steps. In Hong Kong, the H share IPO has been fairly standardized and normally takes 4 months to 1 year time. It requires the following steps: first, a resolution is passed by the company and approvals received from the CSRC and other related Mainland agencies. Various intermediaries are selected to carry out due diligence and draft the prospectus, file the draft prospectus with the regulatory body (the Hong Kong Stock Exchange and Securities and Futures Commission in Hong Kong and the Securities and Exchange Commission in the United States if needed) and then respond to comments and revise the prospectus. Afterwards, a preliminary offering memorandum (“red herring”) is printed and road shows hosted, which will be followed by pricing, executing underwriting agreements and price determination letter, and printing the final prospectus. The process ends with a closing, and second closing might be needed if a green shoe option is granted and exercised\textsuperscript{67}).

The A share IPO process has been gradually streamlined and is comparable to international practice as well as to the above mentioned H share IPO. Starting from March 2001, a new ex-ante review and approval system has been implemented by the CSRC, requiring mandatory information disclosures prior to issuance and including a post-issuance monitoring and sanctioning. Market-driven pricing mechanisms start to replace government-driven pricing mechanisms. Echoing the latest Securities Law revision, a series of CSRC regulations and rules have been released to enhance the market mechanism since 2006, such as CSRC Administrative Measures on the Initial Public Offering and Listing of Stocks or that on

\textsuperscript{64} Guo (2004a), 78.
\textsuperscript{65} Zhou/Li/Gui, 35.
\textsuperscript{66} These requirements will be discussed in detail infra at 77, 78.
\textsuperscript{67} The Green Shoe option, or over-allotment option, is an option granted to the leading underwriter by the issuer, through which the leading underwriter can over-allot up to 15% of the total underwriting amount at issuing price. Within 30 days of the listing, the leading underwriter has the right to purchase stocks of the issuer, or demand the issuer to issue more shares to investors up to the over-allotment amount. The Green shoe is a mechanism to stabilize after-IPO prices by changing the supply and demand of stocks. The IPO of Industrial and Commercial Bank of China (ICBC) in October, 2006 was the first to introduce the Green shoe option for domestic A shares issuance.
Issuance of Securities by Listed Companies. An IPO of stocks in Mainland China will, without exception, be followed by a listing on one stock exchange. The offered stocks are all new shares.

The IPO process generally takes place following these steps: the JSLC adopts the issuance resolution by its shareholders’ meeting and engages a securities company as the sponsoring institution. The sponsor assists the issuer to obtain the CSRC’s review and permit, prepare the prospectus, and handle the underwriting (承销) and disclosure.

The key players in the IPO process include the issuer, issuer’s counsel, sponsors/underwriters (securities companies or investment banks), underwriter’s counsel, accountants and other professionals, public relations companies, and the regulators. In terms of legal work, there is usually a division of labor and responsibility. The issuer’s counsel is responsible for conducting the primary due diligence, drafting the prospectus, advising the company on various legal issues, representing the company in negotiating the underwriting agreement and for issuing an opinion to the underwriters. The underwriter’s counsel is responsible for conducting due diligence, a verification in case of a Hong Kong IPO, for reviewing and commenting the prospectus, drafting and negotiating underwriting agreements on behalf of the underwriters, negotiating comfort letters with the accountants on behalf of the underwriters, handling closing and issuing an opinion to the underwriters.

Due diligence is central to the entire IPO process. It is being exercised by the sponsor, underwriting securities companies, and various securities service organizations. Due diligence is the comprehensive investigation of the issuer’s business, financial position, prospects, and major risks. Although not an explicit defence in itself as in the US, due diligence is vital for intermediaries and professionals in China to avoid possible liabilities: Art. 69 and art. 173 of the Securities Law impose on these key players joint and several liabilities (with the issuer) for false disclosure, misleading statements or major omissions, “unless they are able to prove they are not at fault” by having properly paid due diligence. Therefore, the sponsor, underwriter and securities service organizations bear the burden of proof as to due diligence so to exclude themselves from liabilities.

(2) Sponsorship and Book Building. The sponsorship system and book building process are two important measures for China’s market-oriented public issuance reform and have been under continuing improvements since their first introduction. Originated in HK and the UK, the sponsorship system for stock issuance was first utilized in December 2003 in the Mainland market for IPOs by JSLCs, and for

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68 See the discussion infra at 61 et seqq. and the list of relevant laws and regulations at the end of this chapter.

69 Although sometimes observed in foreign capital markets (e.g. Japan or the UK), a company can choose not to list even after a public offer (POWL – Public Offer Without Listing). This author believes that in accordance with art. 10, para. 2 Securities Law, a company could trigger public issuance requirements by issuing to accumulatively more than 200 specific targets, without intent to going public and being listed; thus, an explicit exception should be set to accommodate this.

70 Proposals have been raised as to the sale of outstanding shares held by existing shareholders throughout the IPO process.

71 In accordance with art. 169 Securities Law, securities service organizations include investment consultancy institutions, financial consultancy institutions, credit rating institutions, asset valuation institutions and accounting firms.

72 For further discussion, see infra at 128, 129.
listed companies to issue new shares and convertible bonds. The CSRC set requirements for sponsoring institutions (most of them are securities companies) and representatives of sponsoring institutions (i.e. individuals). The Securities Law 2005 Revision formally recognized the sponsorship system and required that "the sponsor shall comply with the professional rules and industry standards, act in good faith and with due diligence, prudently verify the (issuance) application documents and information disclosure materials of the issuer, and procure and guide the issuer to operate in a standardized manner".74

53 The sponsoring institution is in most cases the leading underwriter in a late IPO stage. In addition to preparing and verifying issuance documents, the sponsor is to supervise the issuer to abide by disclosure and other requirements during certain periods after listing. As mentioned above, the sponsor shall bear joint and several liabilities with the issuer for false disclosure, misleading statements or major omissions, unless he is able to prove not to be at fault.75

54 In May 2006, the CSRC issued a Guidance on Due Diligence Performed by Sponsoring Representatives, which defined in greater detail the methodology and coverage of due diligence. It pointed to the necessity of independent opinions by sponsors and to the need to investigate related-party transactions. Generally, CSRC’s Guidance set out key criteria for assessing the integrity and performance of sponsors.76

55 There are two common forms of underwriting: firm commitment underwriting (包销) and best efforts underwriting (代销). Firm commitment underwriting requires the underwriter(s) to purchase all of the issuer’s securities and then resell them to the public buyers, or the underwriter to buy at the end of the underwriting period any remaining unsold securities. Best efforts underwriting requires the underwriter only to act as an agent on behalf of the issuer. Aimed to protect average investors, the Securities Law 2005 revision introduced a new concept of issuance failure (发行失败) applied to best efforts underwriting only. According to this new concept, underwriting is deemed to have failed, if the underwriting period expires and if the quantity of stocks sold fails to reach 70 % of the planned quantity. In this case, the relevant issuer shall return to the subscribers of stocks the issuing price plus interests as calculated at the bank deposit rate for the same period of time.77

56 Securities underwriting in China drew inspirations from related international organizations such as the International Capital Market Association (ICMA), and especially from experiences gained at the Hong Kong securities market. In past years, several important new features have been implemented to emphasize market functioning and to reduce governmental intervention. This includes regulations concerning book building and road shows, green shoe options, share allotment among designated strategic investors, equity warrants, as well as the coordinated simultaneous issuance and listing in domestic and overseas markets. In particular, book building may be considered a big step towards international practice.

73 The CSRC Provisional Measures for Sponsorship of Securities Issuance and Listing, which was replaced by the CSRC Administrative Measures for Sponsorship of Securities Issuance and Listing, promulgated on August 14, 2008, came into force as of December 1, 2008, was revised on May 13, 2009 and was effective on June 14, 2009.
74 Art. 11 para. 2 Securities Law.
75 Art. 69 Securities Law.
76 CSRC Report, 221.
77 Art. 35 Securities Law.
With a view to increasing institutional investors’ capacities for pricing, CSRC in 2004 first released a Circular on Several Issues concerning the Book-building Procedure for IPOs, removing formally the former government approval for the share issuance price and replacing it with a book building process. The issuance price is to be decided in two rounds of price quotes provided by CSRC accredited institutional investors, such as qualified securities investment fund management companies, securities companies, trust investment companies, finance companies, insurance institutional investors, and qualified foreign institutional investors (QFIIs).

In September 2006, the CSRC issued Administrative Measures for Securities Issuance and Underwriting, further improving the book building process, pricing and share allotment during an IPO, and increasing the supervision of issuers, securities companies, other intermediaries and investors during the issuance process. Nevertheless, criticisms remain against the lack of equity and transparency, against suspicious collusions between quote and price bidders, the unfair distribution of new shares (low lot-winning rate for individual investors), and price volatility after trading began on secondary markets. For example, on June 29, 2007, the first day of Topband Electronics & Technology Co. Ltd.’s listing on the SZSE, its stock started trading with RMB 39 per share and at once reached RMB 71, forcing the SZSE to temporarily suspend trading twice on the same day. By comparison, the company’s issuance price had only been RMB 10.48. During the following four trading days, its price turned around suddenly and nosedived by 10 percent each day. A truly accurate pricing mechanism has, thus, not yet been introduced.

Partly due to the harsh economic meltdown, China witnessed a 9 month IPO freeze starting from September 2008, creating an opportunity for the CSRC to revise its IPO rules and to address the subscription process considered to having been abused by financial intermediaries. Accompanying the resumption of IPOs on June 10, 2009, the CSRC released its new rules on IPOs in an effort to improve market fairness and to better protect small investors. These changes allowed single investors to own only one stock subscription account, while previous regulations permitted investors with over 5 million RMB in capital to own more than one account which, for them, lead to better opportunities to purchase new shares in an IPO. In addition, investors may now choose to subscribe either online or offline, which effectively prevents institutional investors – who usually subscribe via offline channels – from competing with small investors in an online subscription. The long term goals the CSRC pledged to pursue includes trimming the amount of locked-up shares in an IPO and increasing the tradable shares on the market, giving brokers more freedom to terminate the issuance and to allocate the subscription quota among investors. Further reforms on the issuance process are expected to lead towards a more flexible and market-oriented IPO mechanism.

(3) Review and Approval by CSRC. The Securities Law requires that the CSRC shall be responsible for the review and approval of applications to issue stocks in accordance with the statutory issuance conditions, and that such procedures shall be

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78 CSRC Administrative Measures for Securities Issuance and Underwriting, promulgated on September 17, 2006, which came into force as of September 19, 2006.
79 CSRC Report, 223.
80 CSRC Guiding Opinions on Further Reforming and Improving the New Shares Issuance Mechanism, which came into force as of June 10, 2009.
made public, and subject to supervision according to law. Art. 13 Securities Law sets out that an IPO of stocks of a company is subject to this company having a complete and well-operated organization, the capability of making profits successively, a sound financial status, no false record in its financial statements over the latest 3 years, that is must not have violated the law and that it meets any other requirements as prescribed by the securities regulatory authority approved by the State Council.

Pursuant to art. 13 (4) Securities Law, the CSRC promulgated in May 2006 Administrative Measures on the Initial Public Offering and Listing of Stocks prescribing further requirements. In terms of financial and accounting conditions, the company must have a positive net profit of over 30 million RMB accumulatively within the latest 3 accounting years, which are computed in the light of comparative low net profits upon deduction of non-regular profits/losses, a net cash flow of over 50 million RMB accumulatively, or a business income of over 0.3 billion RMB accumulatively within the latest 3 accounting years, as well as no uncovered deficit in the latest period. The minimum total amount of stock capital shall be 30 million RMB before issuance. The proportion of its intangible assets (upon deduction of its land use right, right to aquatic breeding and right to mining) in its net assets at the end of the latest period shall be not higher than 20%.

Note that, since in practice the IPO is always followed by a listing, stock exchange rules for listing requirements as discussed infra at 83 et seq., are also to be considered and complied with.

For GEM listings, the CSRC Provisional Administrative Measures for IPOs and listing on the Growth Enterprise Market effective as of May 1, 2009, set forth the threshold for companies’ applications with the CSRC. Companies seeking to be listed on the GEM must have been in continuous operation for at least 3 years and satisfy the following conditions: (1) profitable for the last 2 years with net profits of at least 10 million RMB and sustained profit growth, or (2) profitable for the latest year with net profits of at least 5 million, revenues of at least 50 million RMB and sales growth over the last 2 years of at least 30% (net profit to be calculated on the basis of the amount before or after deducting non-recurring profit and loss, whichever is lower), net assets of at least 20 million RMB, no uncovered loss at the end of the latest accounting period, and post-IPO share capital of at least 30 million RMB.

On the whole, the Securities Law tried to reduce the impression of compulsory and arbitrary approvals by using softer language, i.e., the wording of art. 10 literally changed from the old-fashioned phrase “examination and approval” (审批), a widely used term during the era of the planned economy and usually entertaining some antipathy, to a more neutral and rule-based “review and approval” (核准), hinting at a more relaxed sense of approval. The Securities Law also declares that after shares have been issued according to law, the issuer shall himself be responsible for any change in operation or earnings, and that the investors shall them-

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81 Art. 23 para. 1 Securities Law.
82 Promulgated and effective on May 18, 2006.
83 Art. 33 Administrative Measures on the Initial Public Offering and Listing of Stocks. Other requirements concern the independence of operation and management, standardized operation, utilization of raised funds.
84 Supra at 33.
85 Art. 10 Securities Law.
86 Peng, 84–86.
selves be responsible for any investment risks caused by such change. In other words, any endorsement and possible liabilities associated with the approval is being denied by the CSRC. Although the long run goal is said to be a disclosure-based and registration-only issuance system, the current practice is still not free of merit regulation. It smells strongly of an IPO quality and even quantity control, and exercises wide discretion when issuing approvals.

The time frame set by the Securities Law for the CSRC to carry out its review and approval is three months from the acceptance of the application documents, which must include the application form, business license and articles of association of the company, the resolution of shareholders’ meeting, a prospectus, financial accounting report, name and address of the receiving bank, name of the underwriter and the relevant agreement, and the sponsor’s letter. However, the period of time assumed by the issuer to submit supplementary materials or to correct its application documents as instructed shall not be counted into the three-month time limit. Unsuccessful applicants shall be informed of the reasons for non-approval. If the CSRC later discovers that the application does not satisfy the statutory requirements or procedures, the approval granted shall be revoked to halt the issuance. Where the securities have been issued but not listed, the issuer shall, upon revocation of the approval, refund to securities holders the issue price plus interests based on the bank interest rate for the same period.

Although the approval or disapproval is granted by and in the name of the CSRC, a committee established by the CSRC plays a key role – the Public Offering Review Committee (发审委). This committee is mandated by the Securities Law to review applications for share issuance. Its specific formulation measures, the tenure of members as well as the working procedures of the issuance examination committee are formulated by the CSRC. The current size of the committee is 25 members, of which 17 are full time members sent by the CSRC, accounting firms, asset appraisals companies and law firms, while the others are part-time members sent by the CSRC and other governmental agencies such as the National Development and Reform Commission (NDRC), academia, stock exchanges and financial intermediaries. Many efforts have been made to improve the committee’s professionalism and to augment public supervision, yet concerns remain about its adequacy, integrity and transparency. On April 14, 2009, the CSRC rule on the issuance review committee has been revised. A separate committee (创业板发审委) is now required to be set up for reviewing GEM applications which is comprised of 35 members (5 of which are sent by the CSRC). Also, another separate committee has been set up to review applications for takeover and reorganization (并购重组委).

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87 Art. 27 Securities Law.
89 Art. 14 Securities Law.
90 Art. 24 Securities Law.
91 The sponsor shall bear joint and several liabilities with the issuer; unless it can prove that it is not at fault; where the controlling shareholders and the actual controller are at fault, they shall bear joint and several liabilities with the issuer, art. 26 Securities Law.
92 Art. 22 Securities Law.
93 CSRC Report, 219.
(4) Disclosure. Information disclosure upon which investors can build their judgment is the cornerstone of modern securities regulation. The Securities Law laid great emphasis on disclosure during different stages. Firstly, issuers proposing to undertake an IPO are required to disclose all relevant application documents upon submitting them to the CSRC. This intends to allow the public an opportunity to review the application pending, thus, any suspect violation or irregularity may be made known to the CSRC.

Once an application for issuance is approved, the issuer shall publish the public offering documents in accordance with the provisions of the laws and administrative regulations prior to the public offering and place such documents at a designated venue for inspection by the public. The company shall not issue securities prior to the publication of these documents. Among those documents published, the share prospectus (招股说明书, or the method of offer for corporate bonds) is the most important. In addition, financial and accounting reports are required to be published.

After the listing, the listed company is subject to continuing disclosure requirements: interim reports (half-year report, to be published within two months from the end of the first half-year of each accounting year), an annual report (to be published within four months from the end of each accounting year), and ad hoc reports (to be published immediately when a major event occurs that may have a major impact on the price at which a listed company’s shares are traded and of which the investors have no knowledge) are required.

“Major events” are defined to include: a significant change in business policies or the scope of business, a decision concerning a major investment or a major asset purchase, the conclusion of an important contract which may have significant influence on the assets, liabilities, rights and interests and business outcome of the company, major debts and default on major debts, serious losses or damages, a change of directors or managers or one-third or more of the number of supervisors, significant changes to the shareholding of shareholders who hold 5% or more of the shares or to the controlling stake of the actual controller, decisions on the reduction in capital, merger, division, dissolution and application for bankruptcy, a major lawsuit or a resolution of a shareholders’ meeting or the board of directors being rescinded or declared null and void, allegations of crimes committed towards the company or its directors, supervisors or senior management. The Securities Law also authorizes the CSRC to stipulate other situations to be included into the company’s ad hoc report.

To secure the listed company’s disclosure, directors and senior managers of a listed company are required to include their opinions for recognition in the periodic report by written form. Also, the board of supervisors shall carry out an examination on the periodic report of its company as formulated by the board of directors and produce the relevant examination opinions in writing. The directors, supervisors and senior managers of a listed company shall then ensure the authenticity,
II. Main Issues

accuracy and integrity of the information as disclosed by their listed company.\textsuperscript{101} As for the method of disclosure, the information as prescribed by law to be disclosed shall be publicized by the media as designated by the CSRC and shall, at the same time, be made available for public reference at the company’s domicile and a stock exchange.\textsuperscript{102} There has been some research on the general role played by the media in China, including to promote corporate information disclosure, which shows how media commercialization has resulted in incentives for the media to expand the scope of critical reporting and to influence public opinions and court decision-making.\textsuperscript{103} By means of these mandatory disclosure requirements, the issuance of stocks is expected to be carried out with transparency, equity and fairness (公开公平公正) – the three cardinal principles of China’s Securities Law.\textsuperscript{105}

c) Secondary Issuances by a Listed Company

Listed companies also need to raise capital through secondary issuance. On May 7, 2006, the CSRC released Administrative Measures on the Issuance of Securities by Listed Companies\textsuperscript{106}, art. 3 of which stipulates that listed companies may issue securities by way of public offering to non-specific targets or private offering to specific targets. The general requirements for the public offering of listed companies oblige listed companies to have a proper organization structure and sound operations, to bear no false records in financial accounting documents during the past 36 months, to have been profitable for consecutive periods and sound in financial status and to have scheduled a proper use of the issuance proceeds.\textsuperscript{107}

Furthermore, specified criteria need to be met for public offerings. These include: the listed company must not have provided guarantees for others during the past 12 months which violated any law or regulation, and must have been profitable consecutively in the past three accounting years (comparing net profits after deduction of extraordinary gains or losses and net profits before deduction, the lower amount shall be the basis of calculation). The senior management and core technical personnel are stable and there has not been any significant adverse change during the past 12 months. If the listed company has made a public offering of securities during the past 24 months, the operating profits in the year of this offering has not dropped by 50\% or more as compared to the year before. Cumulative profits distributed in the form of cash during the past three years shall be not be less than 30\% of the annual average distributable profits realized in the past three years. The company must not have been subject to administrative sanction by the CSRC or criminal punishment for violation of securities law, administrative rules or regulations during the past 36 months. It must not have been subject to open reprimand by a stock exchange during the past 12 months, and the listed company and its controlling shareholder or actual controllers must

\textsuperscript{101} Art. 68 Securities Law.
\textsuperscript{102} Art. 70 Securities Law.
\textsuperscript{103} Liebman, 1–2
\textsuperscript{104} For liabilities to arise from this violation of disclosure, see infra at 125–129.
\textsuperscript{105} Art. 3 Securities Law.
\textsuperscript{106} Promulgated and effective on May 8, 2006.
\textsuperscript{107} Art. 6–10 Administrative Measures.
There are two kinds of public offerings by listed companies – the placement of new shares only to existing shareholders (share rationing, 配股) and the public offer of new shares to non-specific targets or the general public (additional issuance, 增发).

For share rationing, in addition to the abovementioned general requirements and criteria, further conditions include that (1) the size of the proposed placement shall not exceed 30% of the total share capital before the placement of shares, (2) the controlling shareholders shall, prior to the shareholders’ meeting, publicly commit themselves to the quantity of placement shares they propose to subscribe and (3) the issuance shall be carried out by way of best efforts stipulated in the Securities Law.

For additional issuance, in addition to the general requirements and criteria, different conditions need to be complied with: (1) the weighted average return on net assets in the past three accounting years shall not fall below 6% on average (comparing net profits after deduction of extraordinary gains or losses and net profits before deduction, the lower amount shall be the basis of calculation); (2) except for financial enterprises, it must not have been holding large amounts of financial assets for trading and financial assets for sale, or been lending such amounts to others, or been entrusting others with wealth management at the end of the latest accounting period; (3) the issuing price shall be no lower than the average price of the company’s shares in the 20 trading days before the public announcement of the letter of intent for issuance, or the average price of the preceding trading day.

The Securities Law also mandates that, when listed companies issue convertible corporate bonds, they shall comply with both the issuing requirements for corporate bonds and those for stocks, and shall obtain the approval of the CSRC. The Administrative Measures set out the detailed requirements and procedures for listed companies to publicly offer convertible corporate bonds and warrants.

When listed companies plan to conduct a private offering to specific targets using non-public methods (上市公公司非公开发行股票), the Securities Law requires that they shall satisfy the requirements as prescribed by the CSRC that have been approved by the State Council, and shall be reported to the CSRC for review and approval. Therefore, for listed companies, all issuances, i.e. even a private offering, shall be subject to the CSRC’s scrutiny. Chapter 3 of the Administrative Measures lines out the following requirements, inter alia: (1) the specific targets shall satisfy the criteria stipulated in the resolution of the company’s shareholder’s meeting; (2) the number of specific targets shall not exceed ten; (3) the issuing price shall not be lower than 90% of the average price of the company’s shares in the 20 trading days before the pricing benchmark date; (4) the shares issued shall not be transferred within 12 months from issuance; (5) shares subscribed by the controlling share-

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108 Art. 6–11 Administrative Measures.
109 Art. 12 Administrative Measures.
110 Art. 13 Administrative Measures.
111 Art. 16 para. 3 Securities Law.
112 Art. 14–35 Administrative Measures.
113 Art. 13 para. 2 Securities Law.
114 Art. 37 Administrative Measures. Where the specific targets are overseas strategic investors, approval of the relevant State Council departments shall be obtained.
holders, actual controllers or other enterprises controlled by the controlling share-
holder or actual controllers shall not be transferred within 36 months.\footnote{115}

However, a lawful private offering will be prevented if there are any false records, 78 misleading statements or major omissions in the application documents of the said issuance, if the rights and interests of the listed company have been severely infringed by the controlling shareholders or actual controllers, and such damage has not been cured, if the listed company and its subsidiary have provided guarantees for others in violation of regulations, and such guarantees have yet to be discharged, if incumbent board members, senior management have been subject to administrative sanctions of the CSRC within the latest 36 months, or openly reprimanded by a stock exchange within the latest 12 months, if the listed company, or its incumbent board directors or senior management are under investigation by the judicial authorities for suspected criminal offences or under investigation by the CSRC for suspected violations of laws or regulations, if certified public accountants have issued a qualified opinion, an adverse opinion or a disclaimer of opinion in their auditing reports within the last year and on the latest financial statement, except when the major impacts of the issues involved in this opinion have been removed, or if the said issuance involves major reorganization.\footnote{116}

2. Securities Trade and Takeover

a) Stock Trade and Transfer

(1) Securities Trading Places. The Securities Law requires that stocks, corporate bonds and other securities issued to the public according to law be listed and traded (上市交易) on stock exchanges (证券交易所)\footnote{117}, or transferred (转让) on other securities trading places (其他证券交易场所) approved by the State Council.\footnote{118} A corresponding provision of the Company Law requires that shareholders are to transfer their shares at lawfully established securities trading places or by other means as specified by the State Council.\footnote{119} Therefore, “transfer” in its broader sense includes both listed trading as well as (in a narrower sense) the transfer on other securities trading places. The latter will be discussed hereinafter.

As mentioned above, the two stock exchanges in Mainland China consist of three entities: (1) SSE and the main board of SZSE; (2) the Small and Medium-sized Enterprises Board (SEMB) on SZSE; and (3) the Growth Enterprises Market (GEM) on SZSE. “Other securities trading places” is a vague concept subject to rapid evolution. One example is the Share Transfer System (STS, 代办股份转让系统). The STS was launched by the Securities Association of China (SAC, 中国证券业协会)\footnote{120}
in 2001 to ease the transfer of tradable shares for companies originally listed on STAQ and NET systems. The STAQ and NET systems represent an unsuccessful Chinese experiment to open a NASDAQ-like virtual trading market; both were closed by the government in 1999. The STS later also hosted transfers of shares from delisted companies formerly listed on SSE and SZSE.

In January 2006, the STS was further expanded to include the share transfer of unlisted JSLCs in Beijing Zhongguancun Science Park (北京中关村高科技园区) – a pilot project to boost high-tech startup companies and venture capital. The requirements for such unlisted JSLCs required the respective company to have received permission from the government of Beijing, to have a main business and the capability of making profits successively, to show sound corporate governance, and to satisfy other SAC requirements. In addition, transfers and capital raise must expand beyond Zhongguancun and the number of shares in each deal must be more than 30 thousands.

Responding to the call for a multi-layered market system and a diversified product structure, a few equities exchanges (2022.01) in China are managed by local governments (e.g. in Tianjin and Chongqing); they undertook some efforts to obtain recognition from the State Council as "other securities trading places".

(2) Listed Trading on Stock Exchanges. In China, the IPO of a JSLC is always immediately followed by a stock exchange listing, therefore, in practice, aside from the IPO requirements, the issuer needs to satisfy listing requirements simultaneously. Art. 50 of the Securities Law sets out the followings: The stock shall have been legally publicly issued, the total amount of the company capital shall be no less than RMB 30 million, the shares as publicly issued shall reach more than 25 % of the total amount of corporate shares, where the total amount of capital stock of a company exceeds RMB 0.4 billion, the shares as publicly issued shall be no less than 10 % thereof, the company must not have violated the law over the last 3 years, and there must not have been any misrepresentation in its financial statements. Note that a stock exchange may prescribe requirements for listing that are stricter than those prescribed. These shall be reported to the securities regulatory authority under the State Council for approval. An application for the listing of any securities shall be filed with a stock exchange and shall be subject to the review and approval of the stock exchange according to law and, if passed, a listing agreement shall be reached by both parties. With regard to exchange regulation, a stock exchange shall, pursuant to laws and administrative regulations of securities, formulate the rules of listing, trading and membership administration as well as any other relevant rules, and shall report them to the CSRC for approval.

From their beginnings, SSE and SZSE have gradually moved to a paperless securities system and are utilizing an automatic trading system matching large

122 NET refers to the National Electronic Trading System developed in April 1993.
124 Applicable for the listing on SSE and SZSE (including SEMB, but not GEM).
125 Although labelled to be a self regulated entity in art. 102 Securities Law, stock exchanges in China have still been under strong influence of the government, and many of their rules need CSRC’s approval to become effective.
126 Art. 48 Securities Law.
127 Art. 118 Securities Law.
amounts of buy and sell orders in a centralized order process, prioritized on the basis of price and time. The exchanges’ depository and clearing companies use highly-automated electronic depository systems. Aiming to reduce price volatility, daily price change floor and ceiling limits have been introduced and set at a range of 10% in either direction for most companies since December 1996.128 The largest bulk of trades in stock exchanges is being carried out by a centralized automatic matching system. The remaining amount of trades are facilitated by negotiation and certified by stock exchanges daily, subject to certain quantity, price and procedural limits – a system referred to as the Block Trading System (BTS, 大大宗交易系统). Recently, stock exchanges have increased the use of the BTS to help float formerly non-tradable shares released after the Non-tradable Share Reform129, and have improved BTS information disclosure.130

The stock exchange shall suspend the listing of a company where the total amount of capital stocks or share distribution of the company changes and thus, fails to meet the requirements of listing, where the company fails to publicize its financial situation according to the relevant provisions, or has any misrepresentation in its financial statements, which may mislead the investors, where the company has violated the law, where the company has been operating at a loss for the latest 3 consecutive years, or under any other circumstance as prescribed in the listing rules of the stock exchange.131

The stock exchange shall decide to terminate the listing of the stocks of a company, i.e. delist these stocks, where the total amount of capital stocks or share distribution of the company changes and thus, fails to meet the requirements of listing, where the company fails to meet the standards of listing within the period prescribed by the stock exchange, where the company fails to publicize its financial situation according to the relevant provisions or has any false record in its financial statements and refuses to make any correction, where the company has been operating at a loss for the last three consecutive years and fails to gain profits in the year thereafter, where the company is dissolved or has announced bankruptcy, or under any other circumstance as prescribed by the listing rules of the stock exchange.132

Therefore, a company recording losses of three consecutive years is suspended from trading, and will be delisted if it fails to reverse losses in the year following its suspension. In April 2001, Shuixian (水仙) became the first company to be delisted from the A shares market. Shares of delisted companies from stock exchanges can now be transferred to the Share Transfer System mentioned before.

To provide an early warning system to the public prior to delisting, SSE and SZSE in April 1998 created a “Special Treatment” (ST, 特别处理) category to distinguish shares of those companies with serious financial or other problems. Later, the ST category has been further divided into the “Star ST (\*ST)” and “other STs” categories.

128 CSRC Report, 168.
131 Art. 55 Securities Law.
132 Art. 56 Securities Law.
The “ST sub-category is known as a delisting risk warning (退市风险警示), the typical triggering situation of which being a company that records two consecutive years of losses. Unlike it is the case with ordinary stocks (10 %), the daily price change floor and ceiling limits for ST stocks is restricted to 5 %.

If a stock exchange decides to suspend or terminate the listing of any securities, it shall announce the decision in a timely manner and report it to the CSRC for the record. Any company dissatisfied with a decision of a stock exchange on disapproving, suspending or terminating its listing, may file an application for review with the review organ established by the stock exchange. The status of this sort of review is ambiguous, and this author believes that it should be subject to an ultimate judicial check, following the principle that no one should judge himself.

It is worthy to note the legal status of stock exchanges. For the purposes of the Securities Law, the term “stock exchange” refers to a legal person that provides the relevant place and facilities for concentrated securities trading, organizes and supervises the securities trading, and applies a self-regulating administration. The establishment and dissolution of a stock exchange shall be subject to the decision of the State Council.

Income generated from various commissions that is at the discretion of a stock exchange shall first be used to guarantee the normal operation of the stock exchange as well as the gradual improvement thereof. The gains as accumulated by a stock exchange that adopts a membership system shall belong to its members. The rights and interests of a stock exchange shall be jointly shared by its members. No accumulated gains of a stock exchange may be distributed to any member within the existing term. In response to the worldwide trend towards exchange demutualization, proposals have been discussed to create an incorporated stock exchange as a supplement or competitor to the current membership stock exchanges. Yet until now, SSE and SZSE are still membership stock exchanges and as such under the strong influence of the CSRC. For instance, the Securities Law requires the general manager of the stock exchange to be appointed and dismissed by the CSRC.

Commentators argue that China’s stock exchanges should be given more autonomy to practice effective self-regulation and to promote market competition, and that direct government control over the securities market and exchanges should be reduced to a level of general supervision only. Another research paper found that reputational sanctions imposed by stock exchanges in China proved to be a useful mechanism for punishment and deterrence within the capital market. Its empirical evidence and interview results strongly suggest that the market finds a stock

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133 CSRC Report, 179.
134 Due to the extreme difficulties for being listed in China, there have only been a few cases of voluntary delisting. Recently, two listed companies of the SSE – Xinhui Zhongbao Co. Ltd. (新湖中宝) and Xinhui Venture Investment Co. Ltd. (新湖创业) – announced a plan for merger through stock swap, in order to avoid competition. After the merger, the latter would be liquidated and, therefore, delisted.
135 Art. 72 Securities Law.
136 Art. 62 Securities Law.
137 Art. 102 Securities Law.
138 Art. 105 Securities Law.
139 Art. 107 Securities Law.
140 Shi, 213.
exchange’s prompt disclosure of information significant, and considers the fact that a company has been criticized constitutes a new and significant piece of information itself. Those findings imply that Chinese stock exchanges have carved out a meaningful, if limited, self-regulatory role for themselves despite severe institutional constraints on their independence.\textsuperscript{141}

(3) Prohibitions from Trading. The Securities Law prohibits certain people from trading. Practitioners in stock exchanges, securities companies, securities depository and clearing institutions, the functionaries of securities regulatory bodies as well as any other personnel who have been prohibited by laws and administrative regulations from engaging in any stock transaction shall, within their tenures or the relevant statutory term, not hold or purchase or sell any stock directly or in any assumed name or in a name of any other person, nor may they accept any stocks from any other person as a present. Anyone in such a situation shall transfer the stocks he has held according to law.\textsuperscript{142}

Under art. 45 Securities Law, securities trading service institutions and the relevant personnel that produce auditing reports, asset appraisal reports or legal opinions for stock issuance may not purchase or sell any stock attributed with their reports within the underwriting term of stocks or within 6 months as of the expiration of the underwriting term of stocks. Likewise, securities trading service institutions and the relevant personnel that produce auditing reports, asset appraisal reports or legal opinions for listed companies may not purchase or sell stocks within the period from the day when an entrustment of a listed company is accepted, to the fifth day after the aforesaid documents are publicized.

Similar to § 16 of the US Securities Exchange Act, the Securities Law in China imposes regulations on short swing profits. Art. 47 Securities Law stipulates that where any director, supervisor and senior manager of a listed company\textsuperscript{143} or any shareholder who holds more than 5\% of the shares of a listed company, sells the stocks of the company held within 6 months after purchase, or purchases any stock sold within 6 months thereafter, the proceeds generated thereof shall be incorporated into the profits of the relevant company. The board of directors of the company shall assist the company to receive these proceeds.

Where the board of directors of a listed company fails to implement the provisions as prescribed in the preceding paragraph, the shareholders concerned have the right to require the board of directors to implement them within 30 days. Where the board of directors of a company fails to implement them within the aforesaid term, the shareholders have the right to directly file for litigation with the People’s Court in their own names for the interests of the company. If the board of directors of a company fails to implement the provisions as prescribed, the directors

\textsuperscript{141} Liebman/Milhaupt, 983.
\textsuperscript{142} Art. 43 Securities Law.
\textsuperscript{143} Art. 142, para. 2 Company Law requires that “the directors, supervisors and senior managers of a company shall report to the company the shares of the company that they hold and changes in their shareholding. While in the service of a company, a director, supervisor or senior manager may not transfer more than 25\% of his total holding of the company’s shares per year, nor may he transfer the shares of the company he holds for a period of one year from the date on which the company’s shares are listed for trading. When any of the aforementioned persons leaves the company, for a period of six months, he may not transfer the shares of the company that he holds. Other restrictions on the transfer of the company’s shares by directors, supervisors and senior managers of the company may be specified in the company’s articles of association.”
in charge shall bear joint and several liabilities. Art. 47 Securities Law eased the way for a company to recover benefits from insiders, without having to bear the troublesome proof of scienter or other requirements for insider trading.\footnote{But this author suggests that certain defenses or exceptions like those of US SEC Rule 16b–3 and 16b–7 might be considered to be added in order to complete the rule. Simply put, the SEC has adopted several exemptions to its Section 16(b) short-swing profit regulation, including Rule 16b–3 – “Transactions between an Issuer and Its Officers or Directors,” and Rule 16b–7 – “Mergers, Reclassifications and Consolidations.” Transactions that satisfy the conditions of either of these exemptive rules are not subject to Section 16(b) short-swing profit recovery.}

(4) Brokerage Regulations. The Securities Law mandates that only a member of a stock exchange may enter into a stock exchange to engage in the centralized trading of securities.\footnote{Art. 110 Securities Law.} As a result, an investor must conclude an entrustment agreement with a securities company on securities trading, open an account of securities trading in a securities company and entrust the securities company to purchase or sell securities on his behalf in writing, by telephone or any other means.\footnote{Art. 111 Securities Law.}

Concerning the services provided by the securities company, the Securities Law imposes several prohibitions to strengthen investor protection, for example:

(1) Prohibition on the mixing of funds. Art. 139 requires that the trading settlement funds of the clients of a securities company shall be deposited in a commercial bank and be managed through separately opened accounts in the name of each client. The specific measures and implementation procedures shall be formulated by the State Council. A securities company may not commingle any trading settlement funds or securities of its clients into its own assets. Any entity or individual is prohibited from misusing any trading settlement funds or securities of its/his clients in any form. Where a securities company goes bankrupt or through liquidation, the trading settlement funds or securities of its client may not be defined as its insolvency assets or liquidation assets. Under any other circumstance as irrelevant to the liabilities of its clients or under any other circumstance as prescribed by law, the trading settlement funds or securities of its clients may not be seized, frozen, deducted or enforced compulsorily.

(2) Prohibition on discreitional accounts. A securities company that engages in brokerage operations may not decide on any purchase or sale of securities, class selection of securities, trading volume or trading price on the sole basis of its client’s full and discreitional entrustment.\footnote{Art. 143 Securities Law.}

(3) Prohibition on profit promises. A securities company may not make a promise to its clients on the proceeds as generated from securities transactions or on compensating the loss as incurred from securities transactions by any means.\footnote{Art. 144 Securities Law.}

For a long time, although such prohibitions have been complied with and enforced, many securities companies engaged in voluminous illegal high-risk activities such as the misappropriation of clients’ deposits, bonds or discretionary funds, and illegal off-balance-sheet operations while the assets of securities companies had been misappropriated by their controlling shareholders or other related parties. By early 2004, the whole industry was on the brink of bankruptcy. Thus, the CSRC had to implement a comprehensive restructuring program for securities
companies (证券公司综合治理) implementing the liquidation and restructuring of failed securities companies, stricter supervision, and long-term industry capacity building. Securities companies were categorized according to their risk exposure level and became subject to different policies and supervisory measure. Only companies with solid financial conditions and sound corporate governance were granted a permission to carry out innovative and efficiency-enhanced business, such collective investment schemes, private equity and stock loans. By the end of August 2007, CSRC announced that it had completed its comprehensive restructuring program and had achieved its desired goals.149

To further protect investors, especially those invested in troubled securities companies, the Securities Investor Protection Fund (SIPF, 证券投资者保护基金) has been established. The SIPF will be composed of capital paid by securities companies and any other lawfully raised capital. The specific measures with regard to the financing, administration and use of this fund will be formulated by the State Council.150

b) Foreign Investors

(1) Gradual Openness. On November 14, 1986, Deng Xiaoping met a delegation from the New York Stock Exchange (NYSE) headed by its then Chairman John Phelan. When Mr. Phelan presented as gifts a NYSE badge and a sample share certificate, Mr. Deng presented in return a share of Shanghai Feile Audio Equipment Company (上海飞乐音响). Having received the “first share of contemporary China”, Mr. Phelan went in person to the Jing’an District Branch of the ICBC’s Shanghai Trust & Investment Company, to register the transfer of the share. This share certificate has been kept at NYSE ever since.151

Since then, the door of China’s securities market has been opened to overseas investors in a non-linear manner. As mentioned above, B shares underwent a wave of ups and downs in the 1990s. In August 1995, Isuzu Motors Ltd. and Itochu Corp. of Japan became the first foreign companies to be the largest shareholders of a Mainland listed company – Beijing Beilu (北京北旅) – by contractually acquiring its non-tradable shares. This was the first time that foreigners became the largest shareholder of a China-listed company by purchasing legal person shares (法人股, one type of non-tradable shares). Also, a number of Sino-foreign equity joint ventures went public in China.152

After China’s entry into the WTO, former case-by-case privileges have been replaced by a rule-based approach. In November 2001, China passed a formal rule for eligible foreign investment enterprises to apply for listing on domestic exchanges.153 In November 2002, foreign companies were given the official “green light” to purchase state-owned shares and legal person shares of listed companies.154 In February 2006, special foreign investors were allowed to make strategic investments in the A shares of listed companies having completed the Non-tradable Share Reform.155

149 CSRC Report, 214–16.
150 Art. 134 Securities Law.
151 CSRC Report, 156.
152 171, ibid.
153 Certain Opinions Relevant to Foreign Investment in Listed Companies.
154 Notice on the Transfer of State-owned Shares and Legal Person Shares of Listed Companies.
155 Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors, See CSRC Report, 187.
(2) Qualified Foreign Institutional Investors. For ordinary foreign investors, the current channel to invest in A shares is by pooling funds through Qualified Foreign Institutional Investors (QFII). In December 2002, China launched the QFII program\textsuperscript{156} to allow licensed foreign institutional investors to trade A shares on the secondary market. QFIIs include foreign fund management institutions, insurance companies, securities companies and other asset management institutions that have been approved by the CSRC and granted an investment quota by the State Administration of Foreign Exchange (SAFE).\textsuperscript{157} Commercial banks including foreign banks have been gradually permitted to provide QFII custodian services.

To become a QFII, applicants shall satisfy the following condition, respectively: Fund management institutions need to have 5 or more years experience in asset management business; the securities assets managed in the latest accounting year shall not be less than USD 5 billion. For insurance companies, 5 or more years shall have lapsed since their establishment; the securities assets held in the latest accounting year shall not be less than USD 5 billion. For securities companies, 30 or more years experience in securities business are necessary, the paid-in capital shall be no less than USD 1 billion, and the securities assets managed in the last accounting year shall not be less than USD 10 billion. For commercial banks, total assets shall rank top 100 worldwide during the last accounting year, and the securities assets managed shall not be less than USD 10 billion. As for other institutional investors such as pension funds, charity foundations, endowment funds, trust companies, government investment management companies, 5 or more years shall have lapsed since their establishment, the securities assets managed or held in the latest accounting year shall not be less than USD 5 billion.\textsuperscript{158}

Within the approved investment quota, QFIIs may invest in RMB-denominated financial instruments such as stocks, bonds and warrants listed and traded in stock exchanges as well as securities investment funds. In addition, a QFII may subscribe to the offers of IPO shares, convertible corporate bonds, and secondary issuance by listed companies.\textsuperscript{159} QFIIs’ Investment in A shares are subject to certain limits: (1) for single foreign investors that hold the stock of one listed company through one or more QFIIs, the proportion of shares held shall not exceed 10 % of the total amount of shares of the company; and (2) the sum total of the proportions of A shares held by all foreign investors in a single listed company shall not exceed 20 % of the total amount of shares of the company.\textsuperscript{160}

c) Stock Settlement and Clearance

In March 2001, China Securities Depository and Clearing Corporation Limited (CSDCC) has been incorporated with a registered capital of USD 72.5 million by restructuring and merging the previously separate depository and clearing systems.

\textsuperscript{156} 185, ibid.
\textsuperscript{157} There are still restrictions concerning the convertibility of capital accounts in China.
\textsuperscript{158} Art. 1 CSRC Notice on Issues relating to the Implementation of the Administrative Measures on Investments in Domestic Securities by Qualified Foreign Institutional Investors, promulgated on August 24, 2006, effective on September 1, 2006.
\textsuperscript{159} Art. 9, ibid.
\textsuperscript{160} Art. 10, ibid.
of SSE and SZSE. The CSDCC is a non-profit legal person that provides centralized registration, custody and settlement services for securities transactions. The establishment of this institution is subject to the approval of the CSRC.

Shareholders shall put their shares under the custody of the CSDCC when trading them in an exchange. An investor who entrusts a securities company to undertake any securities trading shall apply for the opening of a securities account. The CSDCC shall, according to the relevant provisions, open a securities account for an investor in his own name. Therefore, China now is taking a path towards a direct securities holding system. Securities are bookkeeping data credited on the account at the CSDCC, and shareholders’ names are directly registered on the list of shareholders. The CSDCC can both custody the securities of investors and provide the name list of shareholders for issuers. In contrast, the US employs an indirect multilevel intermediary system, in which the Depository Trust and Clearing Corporation (DTCC) handles the clearance and settlement and in which its nominee “Cede & Co” acts as a nominal holder for listed companies.

The CSDCC shall, when providing netting services for a stock exchange, require the relevant clearing participant to deliver securities and funds in full amount and provide the guaranty of delivery according to the principles of delivery versus payment. Before a delivery is concluded, no one may use the securities, funds or collaterals involved in the delivery. Where a clearing participant fails to perform the duty of delivery according to schedule, the securities registration and clearing institution has the right to dispose the properties as prescribed above according to its operational rules.

The procedure for settlement and clearance may be summarized by the following steps: clients first deposit money and give order to a securities company, then this securities company reports the client order to a stock exchange. When orders have been matched, the CSDCC settles, delivers the money and securities with the securities companies as Central Counterparty (CCP). Finally, the securities company settles and delivers the money and securities to their client.

The current Securities Law and the CSRC Administrative Measures for Securities Registration and Clearing collectively define the principles for securities’ registration, clearing and settlement. Nevertheless, these relationships involving assets, contracts and trading are so complex that they often stretch beyond the boundaries of securities laws. This becomes particularly urgent during the liquidation of a failed financial institution, when creditors are desperate to receive the most valuable assets. Also, the time gap (T+1 for capital clearance, T+0 for stock settlement) resulting from two-tier settlements leaves room for misappropriation and dispute, and the risk management system centering on delivery versus payment has not yet been fully implemented in practice.

161 As for the bond market, custody and registration of bonds are carried out by both the CSDCC and the China Government Securities Depository Trust and Clearing Co. Ltd. separately. Although bonds can be transferred between the two, the segmented depository and clearing systems somewhat impede transaction efficiency. See CSRC Report, 259.
162 Art. 155 Securities Law.
163 Art. 159 Securities Law.
164 Art. 166 Securities Law.
165 US UCC Chapter 8 “Securities Entitlement” addresses rights of the ultimate shareholders.
166 Art. 167 Securities Law.
167 CSRC Report, 259.
d) Takeover: Disclosure and Tender Offer

There are two models regulating takeovers. The United Kingdom uses a mandatory tender offer model under which a buyer of stocks must offer to buy all the remaining stock by public tender if he purchases more than a certain percentage (usually 30%) of shares of a listed company. The second model is the United States model commonly referred to as the voluntary tender offer model. Within this model, there is no mandatory requirement for a tender offer, but there are disclosure requirements and proceeding requirements, if the purchaser chooses to make a tender offer to gain control of a listed company. China’s current takeover regulation takes a middle road, and may be referred to as a modified or moderate mandatory tender offer model. The purchaser may choose to offer and buy all stocks or a certain percentage of stocks of the listed company.

In practice, there are several means to purchase shares or gain control of a listed company in China. Investors can (1) buy shares in a stock exchange; (2) publicly buy inside and outside of a stock exchange by tender offer; (3) privately negotiate to buy by agreement; (4) buy the shares of a controlling shareholder of a listed company (indirect takeover); (5) buy at the same time and together with another party or act concerted (concerted action); or (6) acquire through legal action such as inheritance or judicial enforcement.

(1) Disclosure of Interests. Pursuant to art. 86 Securities Law, there are disclosure requirements once a shareholding threshold has been reached. Where an investor by securities trading at a stock exchange comes to hold by himself or with any other person by means of agreement or any other arrangement, 5% of the shares as issued by a listed company, the investor shall, within three days, submit a written report to the CSRC and the stock exchange, notify the relevant listed company and announce this fact to the general public. Within the aforesaid period, the investor may not purchase or sell any more shares of the listed company.

Where an investor holds by himself or with any other person 5% of the shares as issued by a listed company by means of agreement or any other arrangement, he shall, pursuant to the provisions of the preceding paragraph, report and publish each 5% increase or decrease of the issued shares of the said company he holds by securities trading at a stock exchange. Within the reporting period as well as 2 days after the relevant report and announcement have been made, the investor may not purchase or sell any more shares of the listed company.

(2) Tender Offer. Where an investor holds by himself or with any other person 30% of the stocks of a listed company by means of agreement or any other arrangement by securities trading at a stock exchange, and if the purchase is being continued, he shall issue a tender offer to all the shareholders of the said listed company to purchase all or part of the shares of the listed company. The offeror shall indicate the amount or percentage of shares he intends to purchase in his application with the CSRC and public disclosure documents. It shall be stipulated in a tender offer as issued to a listed company that, where the share amount as promised to be sold by the shareholders of the target company exceeds the

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168 The CSRC Administrative Measures on Takeovers of Listed Companies (promulgated on July 31, 2006, revised on August 27, 2008) applied these disclosure requirements for the shareholding by means of transfer agreement, Art. 14. The same is applicable for tender offer requirements.
scheduled amount of stocks for purchase, the purchaser shall carry out the acquisition in a pro-ratio way of acceptance.\textsuperscript{169}

According to art. 92 Securities Law, all the terms of acquisition as stipulated in a tender offer shall apply to all the shareholders of a target company. Furthermore, art. 93 prescribes that in the event of an acquisition by tender offer, a purchaser shall, within the term for acquisition, not sell any share of the target company, nor shall he buy any share of the target company by any other means that has not been stipulated by provisions of its tender offer or that overrules the terms as stipulated in its tender offer.

In the case of takeover by privately-negotiated agreement\textsuperscript{170}, the purchaser may render effective the equity transfer by entering into an agreement with the shareholders of the company targeted. When a listed company is to be taken over by agreement, the purchaser shall, within three days after the agreement has been reached, submit a written report on the takeover agreement to the CSRC and the stock exchange and make this agreement known to the general public. The takeover agreement may not be performed until the announcement has been made.\textsuperscript{171} If the purchaser has purchased, held or held with any other person 30\% of the shares of a listed company by privately-negotiated takeover agreement or any other arrangement and if the acquisition is being continued, the purchaser shall launch a tender offer to all of the shareholders of the target, i.e. the listed company, for the purchase of all or part of the company’s shares, unless a tender offer has been exempted by the CSRC.\textsuperscript{172} The conditions and procedures for this exemption are stipulated in the CSRC Administrative Measures on Takeovers of Listed Companies, art. VI.

Upon the expiration of a term for takeover, where the share distribution of a target company fails to fulfill the requirements of listing, the listing of stocks of the said listed company shall be terminated by the stock exchange according to law. The shareholders that still hold the shares of the target company have the right to sell their shares pursuant to equal terms as stipulated in the relevant tender offer. The purchaser shall make the purchase.\textsuperscript{173} The stocks of the target company as acquired by a purchaser in the takeover may not be transferred within 12 months after the acquisition has been concluded.\textsuperscript{174}

In recent years, measures have been taken by the CSRC to enhance the transparency and efficiency of takeover approval procedures. First, the original CSRC Administrative Measures formulated in 2002 were revised in 2006 and information disclosure standards were then issued. Secondly, a new pilot program encouraged controlling shareholders to transfer high quality assets into listed companies, which also triggered more M&A transactions. Thirdly, a special M&A review committee has been set up by the CSRC. These measures have been implemented with an aim to turn the capital market into the main vehicle for the corporate restructuring and industrial consolidation of Chinese companies.\textsuperscript{175}

\textsuperscript{169} Art. 88 Securities Law.
\textsuperscript{170} That has been common for non-tradable shares.
\textsuperscript{171} Art. 94 Securities Law.
\textsuperscript{172} Art. 96 Securities Law.
\textsuperscript{173} Art. 97 Securities Law.
\textsuperscript{174} Art. 98 Securities Law.
\textsuperscript{175} CSRC Report, 213.
3. Securities Fraud Enforcement

a) Fraudulent Disclosure

123 (1) Securities Law Provisions. The definition and liabilities of securities fraudulent disclosure (or misstatement) may be found in art. 63, 69 and 193 Securities Law. Art. 63 states, in principle, that the information as disclosed by issuers and listed companies according to law shall be authentic (真实), accurate (准确) and complete (完整), and may not include any false record, misleading statement or major omission. Civil compensatory liability and executive/administrative liability for misstatements are then imposed by art. 69, and 193 respectively.176 Meanwhile, criminal laws are intended to punish and deter more severe violations.177

124 Executive/administrative liability refers to the government-enforced liability against illegal acts, executed mostly by the CSRC. The penalties most often imposed as executive liability is the order to correct; other instruments include admonishment, fines, confiscation of illegal proceeds, revocation of registration, or the cancellation of the business license. The Securities Law 2005 Revision added one new category of executive liability – the denial of securities market entry (证券市场禁入) to art. 233. If the relevant laws and administrative regulations or the relevant provisions of the CSRC are violated, and if the circumstances are serious, the CSRC may take measures to prohibit the relevant individuals from entering into the securities market. For the purpose of art. 233, the term “prohibition from entering into the securities market” refers to a system, whereby a person may not undertake any securities practice or hold any post of director, supervisor or senior manager of a listed company within a prescribed term or for life. Since its introduction in June 30, 2009, the CSRC has imposed denial to securities market entry on 205 persons, 55 of which were for life.178

125 Executive/administrative liability for misstatements applies, where an issuer, a listed company or any other entity or individual obliged to disclose information (“obligor of information disclosure”) fails to disclose information according to the relevant provisions, or where there is any false record, misleading or major omission in the information as disclosed. In these cases the securities regulatory body shall order the obligor to correct, give a warning and impose a fine from RMB 300,000 RMB 600,000. The person-in-charge and any other person directly involved (such as the chairperson, director, senior manager) shall be given a warning and be imposed a fine from RMB 30,000 to RMB 300,000.179

126 According to art. 193, any controlling shareholder or actual controller of an issuer, a listed company or any other obligor of information disclosure who instigates (指使) any illegal act as prescribed above shall be subject to the same punishments. Art. 217 Company Law defines the meaning of “controlling shareholder” and “actual controller”. “Controlling shareholder” refers to a shareholder whose capital contribution occupies 50 % or more of the total capital of a LLC, or a shareholder whose stock occupies more than 50 % of the total equity stocks of a

176 Conceivably, criminal laws referred to in Art. 231 Securities Law cover liabilities for all severe securities frauds. To implement this, the CSRC and the Ministry of Public Security and Procuratorate cooperate.

177 Liu, 3.

178 Available at http://www.csrc.gov.cn/n575458/n575667/n818795/11282486.html.

179 Art. 193 Securities Law.
II. Main Issues

JSLC, or a shareholder whose capital contribution or proportion of stocks is less than 50%, yet where voting rights according to its capital contribution or the stock it holds are sufficient to impose a material impact upon resolutions of the shareholders’ meeting (足以对决议产生重大影响). “Actual controller” refers to anyone who is not a shareholder, but is able to hold actual control of the acts of the company by means of investment relations, agreements or any other arrangements (能够实际支配公司行为).

As discussed above (supra at 67), the directors and senior managers of a listed company shall sign a written opinion for recognition in their company’s periodic reports. The board of supervisors of a listed company shall carry out an examination on the periodic report of its company as formulated by the board of directors and produce the relevant examination opinions in writing. The directors, supervisors and senior managers of a listed company therefore guarantee for the authenticity, accuracy and completeness of the information as disclosed by their listed company.\(^\text{180}\)

Additionally, article 69 created a civil liabilities regime to remedy investors harmed by securities misstatements. Where the prospectus, corporate bond issuance materials, financial statement, listing report, annual report, midterm report, temporary report or any information as disclosed that has been published by an issuer or a listed company contains any false record, misleading statement or major omission, and thus causes losses to investors in the process of securities trading, the issuer or the listed company shall be subject to liabilities for compensation. Any director, supervisor, senior manager or any other person directly responsible of the issuer or the listed company, and the sponsor and underwriter shall be subject to joint and several liabilities for compensation, except for anyone able to prove his exemption of any fault. Where an issuer’s or a listed company’s controlling shareholder or actual controller is at any fault, he shall, together with the relevant issuer or listed company, be subject to joint and several liabilities for compensation.

In summary, there is: (1) strict liability for the issuer or the listed company with or without fault, which means that investors do not need to prove intent or negligence\(^\text{181}\); (2) putative fault liability for directors, supervisors, senior managers or any other person directly responsible of the issuer or the listed company, or the sponsor, or underwriter, i.e. these individuals or entities may not be held liable if they themselves prove their not being at fault, e.g. by using the due diligence defense; and (3) fault liability for the controlling shareholder or actual controller of issuer or the listed company; in this case, the burden of proof is on the plaintiff instead.\(^\text{182}\)

(2) Judicial Interpretation on Misstatements. In January 2003, the Supreme People’s Court issued a Judicial Interpretation on Cases of Civil Compensation Arising from Misstatements in Securities Market (“Judicial Interpretation on Misstatements”)\(^\text{183}\), further explaining legal rules and allowing civil action to compensate investors

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\(^{180}\) Art. 68 Securities Law.

\(^{181}\) Zhou/Li/Gui, 172.

\(^{182}\) Scholars provide comments and suggestions on this regime, including suggestions to differentiate contractual liabilities and torts liabilities in primary and secondary markets, and to further divide the liabilities imposed on different parties. See for example, Tang, 223.

\(^{183}\) Some Provisions of the Supreme People’s Court on Trying Cases of Civil Compensation Arising from Misstatement in Securities Market, promulgated on January 9 and effective on February 1, 2003.
harmed by misstatements. Art. 7 Judicial Interpretation on Misstatements clarifies that defendants in cases dealing with civil compensation arising from misstatements in the securities market may include: (1) actual controllers as initiators and controlling shareholders; (2) issuers or listed companies; (3) securities underwriters; (4) sponsors; (5) professional intermediation service organizations, such as accounting firms, law firms, asset appraisal organizations; (6) directors, supervisors and senior managers of (2), (3) or (4) and directly responsible individuals of (5).

The Judicial Interpretation on Misstatements has defined four kinds of illegal acts subject to civil liabilities: (1) false records (虚假记载), i.e. there are non-existent facts recorded in the disclosure documents; (2) misleading statement (误导性陈述), i.e. a statement made in the disclosure documents or in the media renders investors to develop a wrong estimation of their investments and causes serious consequences; (3) major omissions (重大遗漏), i.e. whoever is obliged to disclose fails to wholly or partially record in the disclosure documents those particulars that should be recorded; and (4) inappropriate disclosure (不当披露), i.e. whoever is obliged to disclose fails to disclose information that is to be disclosed within the appropriate time period or fails to publicly disclose information by legal means.\(^{184}\)

One controversial feature of the Judicial Interpretation on Misstatements is a requirement it added for investors to initiate civil lawsuits successfully. Where a lawsuit for civil compensation is brought forward by an investor against a securities misstatement, the People’s Court shall accept the civil lawsuit if it follows a decision on an administrative penalty by a relevant governmental organ or in accordance with a criminal order or judgment by the People’s Court.\(^{185}\) However, without an administrative penalty decision or criminal order preceding the case, the lawsuit will not be admitted by the court. On the one hand, this requirement saves investors the trouble to prove the existence of a misstatement. On the other hand, it reduces private lawsuits to be applied as a check for securities fraud and as a supplement or competitor to public enforcement.

Another often debated issue is the absence of a class action mechanism. This has been affirmed by the 2003 Judicial Interpretation on Misstatements. Art. 12 Judicial Interpretation on Misstatements states that the plaintiffs in civil compensation cases involving securities may only bring separate lawsuits (单独诉讼) or joint lawsuits (共同诉讼). Art. 14 Judicial Interpretation on Misstatements further stipulates that the number of plaintiffs in a joint lawsuit shall be determined before the opening session of the lawsuit. If the number of plaintiffs is too large, the lawsuit will be divided into several separate cases. Two to five litigation representatives may be selected for each case, and every litigation representative may entrust one or two agents ad litem. A litigation representative shall be especially authorized by the plaintiffs he represents to participate in the hearing, to modify or waive claims, and to reach settlement agreements with the defendants.\(^{186}\)

To file a claim, the plaintiff must prove that the investors bought the shares of the company which misstated information and that this information was material. Another hurdle that the plaintiff faces is causality. Pursuant to article 18 Judicial Interpretation on Misstatements, the People’s Court shall ascertain that there is

\(^{184}\) Art. 17 Judicial Interpretation on Misstatements.
\(^{185}\) Art. 6 Judicial Interpretation on Misstatements.
\(^{186}\) Art. 15 Judicial Interpretation on Misstatements.
closality between the false statement and the damage caused. This is the case (1) where the investments made by the investor are securities directly related to the false statement, (2) where the investor bought the securities on or after the date when the false statement was made, and held the securities until the date the false statement was revealed or corrected, and (3) where the investor suffered a loss on or after the date the false statement was revealed or corrected, which must have been due to his sale or continuing holding of the securities.

However, where the defendant pursuant to article 19 Judicial Interpretation on Misstatements then produces evidence to prove that the plaintiff fulfills any of the following circumstances, the People’s Court will ascertain that there is no closality between the false statement and the consequent damage: (1) the plaintiff has sold the securities before the date the false statement has been revealed or corrected; (2) the plaintiff invested on or after the date has been revealed or corrected; (3) the plaintiff invested although he clearly knew about the existence of the false statement; (4) the losses or part of the losses are caused by other factors such as systematic risks in securities market; or (5) the plaintiff invested maliciously or to manipulate the securities’ price.

Art. 20 Judicial Interpretation on Misstatements specifies that the date of revelation of the false statement refers to the date on which the false statement is first revealed publicly on the media, i.e. in newspapers or by radio or television stations that are issued or broadcasted in the entire country. The date of correction of the false statement refers to the date on which whoever made the false statement voluntarily announces to correct the false statement by the media designated by the CSRC to disclose securities market information, and submits to the listing suspension formalities in accordance with the relevant provisions.

As to reliance on the misstatement, note that in secondary markets, the “fraud on the market theory” applies. In an efficient market, misstatements will be reflected by the price of stock quickly, so an investors’ reliance on the price proves his reliance on the misstatement. The adoption of this theory in the Judicial Interpretation on Misstatements reduces the burden of proof for plaintiffs and renders it easier to establish closality.

When calculating a loss, the scope of liability for civil compensation due to the securities transaction shall be limited to the losses actually incurred with investors due to the false statement. The actual losses of the investors shall include: (a) loss in investment margin and (b) commission and stamp duty (tax) for the loss in investment margin.\(^\text{187}\)

Where an investor sells securities on or before the base day, his loss in investment margin shall be calculated by the margin between the average price for buying the securities and that for selling them, multiplied by the quantity of securities which the investor holds.\(^\text{188}\) Where an investor sells or still holds securities after the base day, his loss in investment margin shall be calculated by the margin between the average price for buying the securities and that of the closing price on the transaction day from the date the false statement has been revealed or corrected to the base day, multiplied by the quantity of securities which the investor holds.\(^\text{189}\)

\(^\text{187}\) Art. 30 Judicial Interpretation on Misstatements.
\(^\text{188}\) Art. 31 Judicial Interpretation on Misstatements.
\(^\text{189}\) Art. 32 Judicial Interpretation on Misstatements.
The “base day” for calculating the loss in investment margin is defined in Art. 33 Judicial Interpretation on Misstatements. It refers to the expiry date stipulated after the false statement is revealed or corrected, and is used to determine a reasonable period for calculating the loss and to limit the compensation to be received for the losses caused by the false statement. The first way to determine the base day is to determine the day when the accumulative transaction amount of the securities impacted by the false statement reaches 100% of tradable shares; transaction amounts of securities transferred under a block trading system shall not be calculated.

If the base day cannot be determined before the court trial starts in accordance with the preceding paragraph, the 30th trading day following the date of revelation or correction of the false statement shall be regarded to be the base day. If the accused listed company has been delisted from the securities exchange, the last trading day before delisting shall be regarded to be the base day. If the trading of the securities involved has been suspended, the last trading day before the suspension day is to be considered the base day; if trading has been restored, the base day may be determined in accordance with the preceding paragraph.

The case of Chen Lihua (陈丽华), et al. vs. Daqing Lianyi Petro-Chemical Co. Ltd. (Daqing Ltd., 大庆联谊) was the first securities fraud civil case tried in China. Largely in accordance with the Judicial Interpretation on Misstatements, this case was decided in the first instance by the Intermediate People’s Court of Harbin Municipality, Heilongjiang Province, on August 19, 2004, and when appealed, the final decision was issued by the Higher People’s Court of Heilongjiang Province on December 21, 2004.

Daqing Ltd. was established in 1997, during the process of its listing, its Prospectus had been prepared. Shenyin Securities (申银万国) was hired to act as a securities firm, it recommended and underwrote the issuance of the shares of Daqing Ltd. The Listing Announcement was issued on April 26, 1997. Sometime in 1999, the CSRC began investigations into possible misrepresentations of Daqing Ltd. On April 21, 1999, Daqing Ltd. announced in the China Securities Journal the investigation undertaken by the CSRC on alleged frauds in its Prospectus, Listing Announcement, and 1997 Annual Report. Thereafter, the CSRC found Daqing Ltd. and Shenyin Securities liable for misrepresentation, and published the finding on April 27, 2000. On March 31, 2001, CSRC issued an administrative sanction decision, finding Daqing Ltd. and Shenyin Securities liable for misrepresentation, and published the finding on April 27, 2000. On March 31, 2001, CSRC issued an administrative sanction decision, finding Daqing Ltd. and Shenyin Securities liable for disrepresentations.

Based on the Judicial Interpretation on Misstatements, Chen Lihua and 22 other investors as plaintiffs filed a lawsuit before the trial court, and alleged that the misrepresentations made by Daqing Ltd. and Shenyin Securities caused losses to them, and that Daqing Ltd. should be ordered to compensate them for losses. They also sought to hold Shenyin Securities jointly and severally liable for their losses. The trial found Daqing Ltd. liable for the plaintiffs’ losses and further ordered that Shenyin Securities should be liable for its portion of these losses since misrepresentations had been made in the fraudulent listing. Daqing Ltd. and Shenyin Securities appealed before the Appellate Court, which then affirmed this decision. A scholar of the Chinese University of Hong Kong argues that the two courts’ pro-investor rulings sent out a strong message against ruthless market abusers who face the risk
of being punished, adding that these rulings might help to restore market integrity and investors’ confidence.\textsuperscript{190}

Obviously, the Judicial Interpretation on Misstatements drew insights from overseas legislation and practice, yet has been subject to controversy since its debut, criticizing the prerequisite of administrative sanction or criminal judgment, and the lack of a class action mechanism. Nevertheless, by means of the Judicial Interpretation on Misstatements, misstatements virtually became the only securities fraud area in China against which defrauded investors could bring civil lawsuits to cover their losses. On the contrary, the victims of insider trading or market manipulation until now have been unable to resort to private lawsuit remedies in practice, even though the Securities Law itself makes these remedies available in theory.\textsuperscript{191} This is mainly due to the fact that in China trial courts will not accept a complaint filed by a plaintiff on securities fraud without a clear “green light” from the Supreme People’s Court (SPC) such as the Judicial Interpretation on Misstatements. Therefore, in these two areas, the only legal means against fraudulent acts are investigations and sanctions by the CSRC, and criminal prosecution for severe cases by the government.

Some commentators opined that China’s current legal and political environment contains various obstacles precluding private enforcement from playing a significant role in securities market regulation, adding that it might be a more viable strategy to strengthen public enforcement.\textsuperscript{192} Scholars from Taiwan discussed the Taiwanese practice of using a government sanctioned Non-Profit Organization (NPO) to supplement public and private enforcement. They argued that, due to Mainland China’s limited legal infrastructure and to political and social considerations, the Taiwanese model is particularly recommendable.\textsuperscript{193} An NPO offers advantages, such as its independence and expertise, and can help safeguard the interest of investors against being offset or diverted by competing government interests, such as the boosting of SOEs or “maintaining social stability”. Taking this approach into consideration, this author argues for the further collaboration between public and private enforcement, while improving the civil litigation mechanism in China. Neither public nor private enforcement can completely replace the other.\textsuperscript{194}

\textbf{b) Insider Trading}

Art. 76 Securities Law requires that any insider who has access to insider information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information, or advise any other person to purchase or sell such securities. Where any insider trading incurs any loss to investors, the insider shall be liable to these investors and shall compensate them according to law.

Art. 74 lists persons and entities that may be held liable for insider trading. Insiders who have access to insider information concerning securities trading include: directors, supervisors, and senior managers of the issuer; shareholders holding 5% or more of the company shares as well as their directors, supervisors, and senior managers; the actual controller of the company as well as its directors,

\begin{itemize}
  \item Xi, 492–496.
  \item Arts. 76 and 77 Securities Law, respectively.
  \item Layton, 83.
  \item Wang/Chen, 159.
  \item Guo (2009), 445–446.
\end{itemize}
Insider information thus becomes a key term to define. According to art. 75, the term “insider information” refers to information that concerns the business or finance of a company or may have a major effect on the market price of the securities thereof and that has not been publicized in securities trading. The following information falls under the scope of insider information: major events as prescribed in paragraph 2 of art. 67; plans of a company concerning any distribution of dividends or increase of capital; any major change in the company’s equity structure; any major change in guaranty of the company’s obligation; where the mortgaged, sold or discarded value of a major asset as involved in the business operation of the company exceeds 30% of the said asset; where any act as conducted by any director, supervisor or senior manager may be lead to liabilities for major damage and compensation; the relevant plan of a listed company regarding acquisition; or any other important information that has been recognized by the CSRC as having a marked effect on the trading prices of securities.

Without dispute, these provisions were developed under strong influence of the theory and legislation in the US, which themselves have been shaped by many renowned cases. For instance, the SEC case Cady & Roberts Co. (1961), established the fiduciary duty theory under which an insider fiduciary must disclose information or abstain from trading. Dirks vs. SEC established the tippee liability theory under which a tippee may assume a fiduciary duty to the issuer, its shareholders or the trading counterparty, if the tippee knows or should have known about the insider tipper’s breach, and the insider tipper personally benefits, directly or indirectly, from the tipping. Likewise, United States vs. O’Hagan eventually adopted the misappropriation theory first contemplated in Chiarella vs. United States, under which a person who owes a duty to the source of information and conducts a trade without disclosure is liable for insider trading.

Chinese securities regulation has been trying to accommodate some essences of these theories and to adapt these to fit its civil law statutory tradition and Chinese current realities. From the definition of insiders and insider information to the proof of insider trading, the aforesaid Securities Law provisions absorbed the US experiences, case laws, and statutes. On the other hand, since no civil lawsuit

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195 Guo (2005), 94–96.
196 Supra at 69 et seqq.
200 Yang, 86–124.
201 Concerning these efforts, see, for example, Zheng, 218–220.
concerning insider trading has been successfully filed to this date, enforcement against insider trading in China is exercised by the CSRC and criminal prosecutors. For example, in November 2008, the CSRC fined Mr. QU Xiang (瞿湘) RMB 30,000, considering him an individual who took advantage of his position in a company to obtain insider information, and who engaged in insider trading with A Shares of Tellus Holding Co. Ltd. (特力A). In a high profile case of 2007 – Hang Xiao Steel Structure Co. Ltd. (杭萧钢构) – several corporate officers and an outside tippee received one to three years’ prison sentences, a profit disgorgement and criminal fines.

c) Market Manipulation

Under art. 77, manipulation of the securities market by the following means is prohibited: where anyone, independently or in collusion with others, manipulates the trading price of securities or trading volume of securities by utilizing an advantage in respect of funds, shareholding advantage or information advantage to trade jointly or continuously; where anyone collaborates with others to trade securities at an agreed time, price and method, thereby affecting the price or volume of the securities traded (Often referred to as matched sales, 对倒); where anyone trades securities between accounts under self-control, thereby affecting the price or volume of the securities traded (Often referred to as wash sales, 洗售); or where anyone manipulates the securities market by any other means.

In recent years, the CSRC has imposed tighter checks on market manipulation, particularly making use of the last category of undefined “other means”. In December 2007, the CSRC imposed a fine of almost RMB 1.8 million on Mr. ZHOU Jianming (周建明) and confiscated his illegal earnings of the same amount. Mr. ZHOU’s trick was to place many large buying bids on certain stocks in order to create the appearance of active trading, and subsequently withdraw these bids covertly, so as to induce other investors to follow suit and thus reap the profits.

In another case of 2008, WANG Jianzhong (汪建中), legal representative of Beijing Shoufang (北京首放) Investment Consulting, was fined more than RMB 125 million the same amount he earned by price rigging from January 2007 to May 2008; his illegal earnings were being confiscated, too. Mr. WANG bought certain shares in advance before trying to push stock prices up by recommending these stocks to investors. Misusing his fame and the trust of his followers, he could then sell the stocks and profit from the price margin.

Where anyone causes any loss to investors by manipulating the securities market, the actor shall be subject to liabilities for compensation according to law. However, as mentioned above, the Supreme People’s Court is still drafting a comprehensive judiciary interpretation to enable private lawsuits arising from market manipulation and insider trading in practice. As to the current market manipulation rules themselves, this author opines that clear exceptions should be considered to

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202 Available at http://www.csrc.gov.cn/n575458/n776436/n3376288/n3376382/n3418730/n9800198/11022750.html.
203 Available at http://www.csrc.gov.cn/n575458/n776436/n3376288/n3376382/n3418730/n3418870/8926362.html.
204 Available at http://www.csrc.gov.cn/n575458/n776436/n3376288/n3376382/n3418730/n9800198/11032342.html.
accommodate productive market practices such as price stabilization measures, e.g. green shoe options. Also, finer lines might be drawn between takeover attempts and market manipulation.\footnote{Guo (2005), 96–97.}

**III. Concluding Remarks**

156 In China, the securities market is a vital means to support the development of a market economy, to optimize resource allocation, to funnel surplus capital into long term investment, to facilitate the restructuring of SOEs, to accelerate private sector growth, to improve the structure and efficiency of the financial markets, and thus to help maintain financial security. Within less than two decades, China’s securities markets have undergone fundamental changes which have taken other, more mature markets much longer to achieve. Accordingly, a securities law and regulation framework has been established and adapted gradually.

157 However, the development of Chinese securities market still faces many legal and systematic challenges. Measured by standards of financially matured countries, some commentators consider China to be still slow at building a legal framework and to have a weak law enforcement record for stock markets.\footnote{Pistor/Xu, 185.} Lasting efforts have to be made to build multi-layered markets, with rules and markets for bonds and emerging companies expanding in particular. Core competencies and autonomy need to be further enhanced, and transaction costs reduced. The reform of the issuance process is still unfinished, yet will move towards a more market-oriented liberalization. For listed companies, corporate governance and external discipline should be further strengthened, and the control of controlling shareholders should be made one priority. Market-driven merger and acquisitions should be improved. Fostering institutional investors will change an unbalanced investor base. The remedies made available by civil litigation should be expanded to cover a greater number of securities frauds, and private actions need to become aligned with governmental enforcement. The CSRC should evolve to produce more effective regulation.

158 At the same time, China has increasingly become integrated into the world and has unavoidably been influenced from the outside. For example, in July 1995, the CSRC became an official member of the International Organization of Securities Commission (IOSCO) at its 21\textsuperscript{st} annual meeting. In the future, more and more generally-accepted international practices should be absorbed into Chinese laws and examined by reality. After all, a dynamic economy calls for a healthy capital market and a sound legal environment.
## IV. Relevant Laws & Regulations

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Chapter 5. Mergers and Acquisitions


I. Overview

1. Evolution History

The legal regime governing mergers and acquisitions (M&A) in China may be characterized as having undergone three stages of evolution: a preliminary stage, a developmental phase, and a maturation period. Two major milestones of this evolutionary process were the PRC’s 2001 accession to the WTO and the enactment of the Regulations on Acquisition of Domestic Enterprise by Foreign Investors in 2006 (hereinafter: 2006 M&A Regulations).¹

During the preliminary stage, the laws governing M&A in China were embryonic derivations of the PRC’s principle laws and regulations found in the General Principles of Civil Law², Company Law³, Contract Law⁴, and the laws and regula-

¹ (关于外国投资者并购境内企业的规定), jointly promulgated by the Ministry of Commerce (MOFCOM), the State-Owned Assets Supervision and Administration Commission (SASAC), the China Securities Regulatory Commission (CSRC), the State Administration of Taxation (SAT), the State Administration for Industry and Commerce (SAIC) and the State Administration of Foreign Exchange (SAFE) on August 8, 2006, revised by the MOFCOM on June 22, 2009, and the revision became effective on June 22, 2009. This regulation repealed the Tentative Measures on Acquisition of Domestic Enterprise by Foreign Investors (外国投资者并购境内企业暂行规定) which was jointly promulgated by the Ministry of Foreign Trade and Economic Co-Operation (MOFTEC, the predecessor of MOFCOM), SAT, SAIC and SAFE on March 7, 2003 and entered into force on April 12, 2003.

² (民法通则), promulgated by the National People’s Congress (NPC) on April 12, 1986 and entered into force on January 1, 1987, last revised by the NPC on August 27, 2009.

³ (公司法), promulgated by the Standing Committee of the National People’s Congress (SCNPC) on December 29, 1993 and then revised by the SCNPC on December 25, 1999, August 28, 2004 and October 27, 2005, respectively. The latest revision of the Company Law entered into force on January 1, 2006.

⁴ (合同法), promulgated by the NPC on March 15, 1999 and entered into force on October 1, 1999.
Chapter 5. Mergers and Acquisitions

As a result of China’s accession to the WTO, the country’s M&A legal framework was forced to evolve very quickly. In order to honor its commitment to further open its markets, the PRC government began to allow foreign investments in many formerly restricted domestic industries such as finance, pharmaceuticals, telecommunication, civil aviation and construction. During this period of economic liberalization, a number of new regulations were issued by the Chinese government, particularly in the area of mergers and acquisitions involving state-owned enterprises (SOE).

The enactment of the 2006 M&A Regulations represented a significant maturation of the Chinese M&A legal framework, and from that point on, this framework has become increasingly sophisticated. During this period, the State Council and its different ministries issued additional administrative regulations governing foreign investments in SOEs, especially in listed SOEs.

On June 22, 2009, the 2006 M&A Regulations was amended by the Ministry of Commerce (MOFCOM) in order to, amongst other things, resolve inconsistencies between the 2006 M&A Regulations and the Anti-monopoly Law (AML). Basically, by such amendments, the entire chapter in the 2006 M&A Regulations pertaining to anti-monopoly review was deleted in the 2009 version of the regulation (M&A Regulations)(infra Chapter 6 at 39).

The M&A Regulations contains a comprehensive set of rules that regulate mergers and acquisitions conducted by foreign investors in the PRC. These rules cover an extensive range of topics and issues regarding foreign-related M&A including round-trip investment, use of special purpose vehicles (SPV) and red-chip listing that are discussed in Chapter 12 of this book. This chapter will focus on

5 These laws and regulations primarily include: Law on Foreign-Funded Enterprises (外资企业法), promulgated by the SCNPC on April 12, 1986, revised on October 31, 2000, and the revision became effective on October 31, 2000; Law on Sino-Foreign Equity Joint Ventures (中外合资经营企业法) promulgated by the NPC on July 8, 1979, revised on April 4, 1990 and March 15, 2001, respectively, and the last revision became effective on March 15, 2001; and Law on Sino-Foreign Contractual Joint Ventures (中外合作经营企业法) promulgated by the SCNPC on April 13, 1988, revised on October 31, 2000, and the revision became effective on October 31, 2000; together with their respective implementing rules.

6 Several Provisions on the Change of Equity Interests Held by Investors in Foreign Invested Enterprises (外资投资者股权变更的若干规定), jointly promulgated by the MOFTEC and SAIC on May 28, 1997 and entered into force on the same day.

7 Provisions on Mergers and Divisions of Foreign Invested Enterprises (外商投资企业合并与分立的规定), jointly promulgated by the MOFTEC and SAIC on September 23, 1999, revised on November 22, 2001, and the revision became effective on November 22, 2001.

8 Tentative Measures on Re-Investment of Foreign Invested Enterprises within China (关于外商投资企业境内投资的暂行规定), jointly promulgated by the MOFTEC and SAIC on July 25, 2000 and entered into force on September 1, 2000.

9 (反垄断法), promulgated by the SCNPC on August 30, 2007 and entered into force on August 1, 2008.

10 Art. 1 MOFCOM Decree No. 6 [2009] (商务部令2009年第6号), issued by the MOFCOM on June 22, 2009 and entered into force on the same day.

11 To-date PRC law (including M&A law) still treats M&A involving investors or investments originating in Hong Kong, Macao, and/or Taiwan as foreign-related M&A. Consequently, this kind of M&A is subject to laws and regulations other than those governing M&A between local enterprises.
other key issues concerning foreign-related M&A, including applicability of the M&A Regulations, national economic security review, asset/equity appraisal requirements, acquisition price payment requirements, and acquisition of Chinese listed companies (LC).

2. Fundamental Principles

Under the M&A Regulations, there are four fundamental principles that govern foreign-related M&A transactions in the PRC: The market entry requirements for foreign investment, the safeguarding of national economic security, the protection of state-owned assets and the anti-monopoly review requirements.

a) Compliance with Market Entry Requirements

As discussed previously in this book (supra Chapter 3 at 1 et seq.), foreign direct investment (FDI) in China is subject to certain market entry requirements which are specifically identified in the Industry Catalogue. The Industry Catalogue classifies industry sectors into three categories: “encouraged”, “restricted” and “prohibited.” Those industries not specifically identified in the Industry Catalogue are deemed as “permitted.” The Industry Catalogue is used by the Chinese government as a benchmark for analyzing and determining whether an FDI project is compatible with the country’s overall economic planning and foreign investment policies.

According to the M&A Regulations, these market entry requirements are also applicable to a foreign-related M&A transaction. Specifically, the M&A Regulations states that:

- Foreign investors shall not own, as a result of the acquisition, all of the equity interests of a Chinese enterprise in an industry where sole foreign investment is prohibited;
- The M&A transaction shall not deprive Chinese investors of their controlling interest or comparatively controlling interest in a Chinese enterprise in an industry where such controlling interest or comparatively controlling interest is required to be held by Chinese investors; and
- Foreign investors shall not acquire a Chinese enterprise in any industry where foreign investment is prohibited.12

It is also required by the M&A Regulations that the business scope of any enterprise acquired in a foreign-related M&A transaction shall meet the relevant industrial policies on foreign investment. In the event the business scope is non-compliant, the business scope must be adjusted accordingly.13

b) Safe-Guarding of National Economic Security

A national economic security review is triggered by a foreign-related M&A transaction in the event: (i) a foreign investor obtains, through acquisition, actual control over a domestic enterprise; and (ii) such acquisition involves a key industry or has or may have an impact on the national economic security, or the domestic enterprise owns well-known trademarks or Chinese traditional brands. In any of these circumstances, MOFCOM approval is required in order for the transaction to proceed.14

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12 Art. 4 para. 2 M&A Regulations.
13 Art. 4 para. 3 M&A Regulations.
14 Art. 12 para. 1 M&A Regulations.
Chapter 5. Mergers and Acquisitions

The M&A Regulations also stipulates that if MOFCOM approval is not sought as required and the M&A transaction causes or may cause significant impact on national economic security, the MOFCOM has the authority to block the transaction, force the re-transfer of relevant equity interests or assets to unwind a completed transaction, or adopt other measures deemed effective to eliminate any negative impact on national economic security.\(^{15}\)

The issue of national economic security was not an issue of public debate until the nation-wide attention over the attempted acquisition of a nationally prominent manufacturer by an American investment group in 2005. On October 25, 2005, the American company Carlyle Group (Carlyle) concluded a strategic investment agreement with China’s largest construction machinery manufacturer Xugong Group Construction Machinery Co. (XGCM). Carlyle initially intended to acquire 85% equity of XGCM at the price of USD 375 million. However, due to the public’s increasing dissatisfaction with foreign investors’ acquisition of China’s heavy machine manufacturers and outcry for protecting the national economic security, Carlyle was forced to lower its equity acquisition ratio first to 50% and then to 45%, allowing the majority ownership to remain with the original Chinese equity holders of XGCM. As the public opposition continued, the two parties declared their agreement to discontinue the proposed transaction on July 23, 2008. It is believed that one of the major factors behind the failure of this transaction was the concern over national economic security.\(^{16}\) Following the Carlyle/XGCM transaction, the principle of safe-guarding national economic security was integrated in the M&A Regulations\(^{17}\) and then reflected in the AML.\(^{18}\) In addition, this principle was subsequently emphasized in the 11th Five-Year Plan.\(^{19}\)

Although the principle of national economic security review has been codified in law, a couple of issues remain to be resolved. The first issue concerns the absence of a framework to differentiate between a national economic security review and an anti-monopoly review in the M&A transaction review procedure.\(^{20}\) This issue was highlighted in the Coca-Cola/Hui Yuan transaction which is discussed in depth in Chapter 6 of this book.\(^{21}\) This lack of a clear delineation between the two reviews is due, in part, to the fact that the concept of national security is not clearly defined in any of the relevant laws.

For instance, neither the M&A Regulations nor any other laws or regulations has provided a definition of the term “key industry” which is one of the major factors that triggers an economic security review. It has been suggested that the Chinese government should identify the key industries that are important for the country’s

\(^{15}\) Art. 12 para. 2 M&A Regulations.
\(^{17}\) Art. 12 M&A Regulations.
\(^{18}\) It is required by art. 31 of the AML that, where the acquisition of a domestic enterprise by foreign investors results in a business concentration and this acquisition concerns state security, a state security review shall be conducted in addition to a business concentration review.
\(^{19}\) The Plan on Use of Foreign Investment in the 11th Five-Year Period (利用外资“十一五”规划), promulgated by the National Development and Reform Commission (NDRC) on November 9, 2006.
\(^{20}\) Shang, 327–328.
\(^{21}\) *Infra* Chapter 6 at 65–71.
national economic security, and formulate special guidelines to regulate foreign investment into such industries.

The second issue is that there are no detailed operational procedures for a national economic security review. The M&A Regulations fails to clarify or provide guidelines on the following points: (i) whether it is the foreign investor or the target Chinese enterprise that bears the obligation to report to the MOFCOM; (ii) documentation required to be submitted to the MOFCOM for such a review; (iii) the timeframe for such a review; and (iv) procedures for the MOFCOM investigation of the transaction.

It has become apparent that the Industry Catalogue alone is not reliable to determine the likelihood of the Chinese government’s approval of a transaction, and no one can predict when and under what conditions the Chinese government may invoke national economic security concerns and scuttle a transaction.22

c) Protection of State-Owned Assets

According to the M&A Regulations, all M&A transactions must abide by the regulations concerning the management of state-owned assets and no M&A transaction shall lead to a transfer of state-owned assets in which those assets are undervalued.23

Despite the legal regime protecting state-owned assets, this principle remains difficult to enforce in practice. The difficulty primarily lies in identifying state-owned assets in a portfolio of different assets in an M&A transaction and determining what assets are state-owned assets.24 On its face, this does not seem to be a real issue, as it is common sense that the assets owned by the state are state-owned assets. However, the term “owned by the state” itself is not clearly defined under Chinese law. Strictly speaking, the term does not always mean “owned by the state as a sovereign body,” but sometimes may also refer to ownership by local governments, state-sponsored public affairs agencies (事业单位) or industrial regulatory departments. In practice, this ambiguity has caused a lot of misunderstanding, confusion and uneven practice in the identification and disposal of state-owned assets. The main reason for these problems is the inherent inconsistency in China’s existing legal regime governing state-owned assets.25

d) Anti-Monopoly Issues

The PRC anti-monopoly regime is codified by the M&A Regulations, the AML and other relevant laws and regulations. It is stipulated by the M&A Regulations that where an acquisition of a domestic enterprise by a foreign investor meets the filing thresholds set forth in the Provisions of the State Council on Thresholds for Reporting of Concentrations of Undertakings (hereinafter: Thresholds Provi-

22 Wolff, ¶6-300.
23 Arts. 3 and 5 and art. 14 para. 2 M&A Regulations.
24 Liao/Zhou/Li, 95–97.
25 A typical regulation of this kind is the Tentative Measures on the Identification of State-Owned Assets and the Management of Relevant Disputes on Asset Titles (国有资产产权界定和产权纠纷处理暂行办法), promulgated by the State-Owned Assets Administration Bureau (the predecessor of SASAC) and entered into force on December 21, 1993. This regulation seems to provide two different interpretations of “owned by the state” in an attempt to define the nature of the equity held by a state-sponsored public affairs agency in an enterprise.
the foreign investor shall report the transaction to the MOFCOM for approval, and the transaction shall not proceed without clearance from the MOFCOM. This application and approval process is all governed by the AML. Besides the AML and the Thresholds Provisions, the MOFCOM has issued a series of guidelines pertaining to these filing and review procedures. These laws and regulations have created a basic legal framework for the administration and regulation of anti-monopoly reviews of foreign-related M&A transactions.

3. Approval Authorities

The scrutiny of a foreign-related M&A transaction may involve various government agencies such as the MOFCOM, the State Asset Supervision and Administration Commission (SASAC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE), depending on the specific facts underlying the transaction. Among these various agencies, the MOFCOM acts as the ultimate authority that has and holds the final right to approve such transactions. That being said, the MOFCOM delegates this approval power to its branches at the provincial level.

Generally, an approval from a provincial branch of the MOFCOM is sufficient under the following circumstances:

- If the purchase price of a foreign-related transaction amounts to USD 100 million or less and the FIE, as the result of the transaction, belongs to an industry that is in the “encouraged” or “permitted” category according to the Industry Catalogue; or
- If the purchase price of a foreign-related transaction amounts to USD 50 million or less and the resulting FIE belongs to an industry in the “restricted” category of the Industry Catalogue.

However, it is stipulated by the M&A Regulations that, in any of the following circumstances, a foreign-related M&A transaction requires MOFCOM approval at the central government level, regardless of the size of the transaction:

- The FIE established as a result of the transaction is of a specific type or belongs to a specific industry that is subject to MOFCOM approval according to law;
- An offshore company established or controlled by Chinese enterprises or Chinese individuals acquires the affiliated Chinese companies of such Chinese enterprises or Chinese individuals;

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26 (国务院关于经营者集中申报标准的规定), promulgated by the State Council on August 3, 2008 and entered into force on the same day.
27 Art. 51 M&A Regulations.
28 Infra Chapter 6 at 39.
29 The MOFCOM shall not delegate power to a local branch below a provincial level branch. This is different from the FDI scenario where the establishment of an FIE may be subject to the approval of MOFCOM or its branch at either central, provincial or local level depending on the amount of total investment and by reference to the presence location.
30 Art. 5 MOFCOM Circular on Further Improving the Work of Examination and Approval of Foreign Investment (商务部关于进一步改进外商投资审批工作的通知), promulgated by the MOFCOM on March 5, 2009 and entered into force on the same day.
31 Art. 10 para. 2 M&A Regulations.
32 Art. 11 para. 1 M&A Regulations.
II. Major Issues

1. Applicability of M&A Regulations

The applicability of the M&A Regulations is of great importance to foreign investors engaged in inbound M&A transactions in the PRC. This is because in the event the M&A Regulations is applicable, a transaction shall be subject to certain requirements such as MOFCOM approval, mandatory equity/asset appraisal, required schedule for payment of acquisition price, national economic security review, notification to creditors of the target and public announcement of the transaction.40

The issue of applicability also needs careful analysis because the M&A Regulations contains certain ambiguous provisions concerning its scope. The ambiguity of the scope of the M&A Regulations may lead to an incorrect interpretation of the scope and applicability of the M&A Regulations, which could ultimately give rise to additional legal risks. If such a transaction is found to be non-compliant at a later date, such a finding could potentially lead to the unwinding of a completed transaction.

33 Art. 12 para. 1 M&A Regulations.
34 Art. 32 para. 1 M&A Regulations.
35 Art. 21 AML.
36 Art. 5 MOFCOM Circular on Further Improving the Work of Examination and Approval of Foreign Investment (supra at n. 30).
37 Ibid.
38 Art. 17 M&A Regulations.
39 Art. 26 M&A Regulations.
40 Art. 13 para. 3 M&A Regulations. As per this provision, a domestic enterprise that sells its assets to foreign investors shall dispatch a notice to its creditors and publish an announcement in a newspaper of provincial or higher level distributed nationally fifteen days before the investor files an application to the approval authority.
Chapter 5. Mergers and Acquisitions

a) Applicable Scenarios

The following four basic M&A scenarios are subject to approval pursuant to the M&A Regulations:

– A foreign investor purchases the equity interests of a shareholder in a domestic enterprise other than an FIE (Non-FIE), thereby converting the Non-FIE into an FIE;

– A foreign investor subscribes to an increase in registered capital of a Non-FIE, thereby converting the Non-FIE into an FIE;

– A foreign investor establishes an FIE for the purpose of making domestic acquisition and then purchases, through this FIE, the assets of a domestic enterprise and operates such assets; and

– A foreign investor purchases the assets of a domestic enterprise and uses such assets as registered capital to establish an FIE and operate such assets.41

The first two scenarios represent equity acquisition transactions, whereas the remaining two scenarios are assets acquisitions.

Furthermore, it is stipulated by the M&A Regulations that the acquisition of a domestic enterprise by a foreign-funded investment company (“FFIC”) is governed by the M&A Regulations.42 An FFIC is a special type of FIE used by foreign investors to establish a holding structure in China to make multiple investments in China.43 In many aspects, an FFIC enjoys the same or similar preferential treatments granted by law to an FIE.

b) Non-Applicable Scenarios

Set forth below are scenarios where a foreign-related M&A transaction is not subject to the governance of the M&A Regulations:

– A foreign investor purchases an equity interest in or subscribes to an increase in registered capital of an FIE;44

– A foreign investor purchases an equity interest or subscribes to an increase in registered capital of a domestic enterprise through an FIE that has already been established by such foreign investor for purposes other than the acquisition in question;45 or

41 Art. 2 M&A Regulations.
42 Art. 55 para. 1 M&A Regulations.
43 The major piece of legislation governing FFICs is the Regulation on the Establishment of Foreign-Funded Investment Companies (关于外商投资举办投资性公司的规定), promulgated by the MOFCOM on June 10, 2003, revised on February 13, 2004 and November 17, 2004, respectively, and the last revision became effective on December 17, 2004. According to art. 19 of this Regulation, the establishment of a company using investments from an FFIC shall follow the examination and approval procedures for the establishment of an FIE.
44 Art. 56 M&A Regulations. M&A transactions in this category are subject to the laws and regulations regarding transfer of equity interests in FIEs, primarily, Several Provisions on the Change of Equity Interests Held by Investors in Foreign Invested Enterprises (supra at n. 6).
45 Such M&A transactions are governed by the laws and regulations regarding investments of FIEs in China, primarily, Provisions on Mergers and Divisions of Foreign Invested Enterprises (supra at n. 7) and Tentative Measures on Re-Investment of Foreign Invested Enterprises within China (supra at n. 8).
A foreign investor purchases the assets of a domestic enterprise through an FIE that has already been established by such foreign investor for purposes other than the acquisition in question.\textsuperscript{46} M&A transactions in such non-applicable scenarios are regulated by other laws and regulations, and any matters not covered by such other laws and regulations may be governed by the M&A Regulations.\textsuperscript{47}

c) Border Line Scenarios

In some situations, there is no real clear answer as to the applicability of the M&A Regulations. Some of these border line scenarios include:

- A foreign investor acquires an equity interest in or subscribes to an increase in registered capital of a Chinese financial institution, or acquires the assets of a Chinese financial institution. It is arguable whether the M&A Regulations is applicable to an M&A transaction involving Chinese financial institutions such as commercial banks, securities companies and insurance companies. Basically, these financial institutions are supervised by the China Banking Regulatory Commission (CBRC), the CSRC and the China Insurance Regulatory Commission, respectively, but it remains unclear whether a foreign-related M&A transaction involving such a financial institution is outside of the authority of the MOFCOM; or
- A foreign investor acquires the assets of an LC. It is commonly acknowledged that foreign acquisition through purchase of A-shares is subject to the M&A Regulations, whereas an assets acquisition is not. In addition, special rules are applicable to a foreign-related M&A transaction involving an LC.\textsuperscript{48}

d) Summary

Presented below is a summary of the various scenarios discussed above in terms of applicability of the M&A Regulations:

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Target Company</th>
<th>Subject of Acquisition</th>
<th>Applicability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Acquisition</td>
<td>Foreign investor</td>
<td>Non-FIE</td>
<td>Equity interest or capital increase</td>
</tr>
<tr>
<td></td>
<td>Foreign investor</td>
<td>FIE</td>
<td>Equity interest or capital increase</td>
</tr>
<tr>
<td></td>
<td>Foreign investor</td>
<td>LC</td>
<td>Shares</td>
</tr>
<tr>
<td></td>
<td>Foreign investor</td>
<td>Domestic financial institutions</td>
<td>Equity interest or capital increase</td>
</tr>
</tbody>
</table>

\textsuperscript{46} In practice, it is difficult to differentiate this scenario from the 3\textsuperscript{rd} basic applicable scenario discussed above where a foreign investor establishes an FIE for the purpose of making domestic acquisitions and then purchases, through this FIE, the assets of a domestic enterprise and operates such assets. For details, \textit{infra} case study at 35–39.

\textsuperscript{47} Art. 56 M&A Regulations.

\textsuperscript{48} For details, \textit{infra} at 71 \textit{et seq}.

\textbf{Lawrence Shu/Liang Zhao}
### e) Case Study

A foreign company contemplated the acquisition of the assets of a domestic Chinese company. They were planning to establish a Wholly Foreign-Owned Enterprise (WFOE) which was then to purchase the assets of the domestic company. During the process of the asset acquisition, one of the major issues was whether an appraisal of the target assets was necessary for the proposed transaction to be approved by the Chinese government.

The asset appraisal issue became an issue of applicability of the M&A Regulations. This is because if the proposed transaction was subject to the M&A Regulations, the asset appraisal requirement contained therein would be applicable. As required by the M&A Regulations, the parties to an acquisition shall determine the transaction price based upon the appraised value of the assets. Such an appraisal is to be done by an appraisal institution lawfully set up in China.  

The key point was how the Chinese government would characterize the WFOE in this transaction. The WFOE may have been deemed as an FIE newly established specifically to purchase the assets of the domestic company, and thus the transaction would fall within the scope of the M&A Regulations. On the other hand, the WFOE could also be considered an existing, on-going FIE that had been established to perform activities above and beyond the acquisition in question. If it was determined that the WFOE was a pre-existing WFOE established for purposes other than the acquisition, then the M&A Regulations would not apply to the proposed asset acquisition and no asset appraisal would be required.

Since there was no clear guideline to differentiate between these two scenarios, relevant government agencies were consulted on this point. However, even the various government offices consulted voiced different opinions about the applicability of the M&A Regulations in this transaction.

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49 Art. 14 para. 1 M&A Regulations.
Despite the disagreements between the various government offices, a few internal guidelines seemed to emerge from the various discussions. The first internal guideline the government appears to follow is to examine the time gap between the establishment of the acquiring FIE and the closing of the acquisition transaction. If the time gap is long enough, the FIE is recognized as an existing FIE; otherwise, it is deemed a new FIE established specifically for the purpose of making the acquisition in question. The second internal guideline employed by the PRC government is the percentage of the amount of registered capital of the FIE used to pay the acquisition price. The lower the percentage, the bigger the possibility that an FIE will be categorized as an existing FIE with on-going concerns other than the consummation of the acquisition in question. Nevertheless, there are no particular standards on how long an FIE must be in existence or what base percentage of registered capital is the trigger for M&A Regulations applicability. The vague nature of these tests gives the government discretion in determining the applicability of the M&A Regulations. In the case at hand, the time gap was roughly two months and the purchase price represented more than 70% of the total registered capital of the WFOE. In this case, it was the government’s determination that the M&A Regulations was applicable and that, accordingly, an asset appraisal was required.

II. Major Issues

2. Transaction Price

a) Legal Framework

The M&A Regulations provides principles, rules and requirements on the appraisal of equity and/or assets to be sold or transferred in a foreign-related M&A transaction, and the forms of and required schedules for payment of the relevant transaction price. In addition to the M&A Regulations, the laws and regulations governing SOEs and public companies provide certain ad hoc rules and requirements that are also applicable to foreign-related M&A transactions involving SOEs, state-owned assets and public companies.\(^{50}\) Although these laws and regulations are not properly cross-referenced to each other with regards to the issue of acquisition price, in practice, the construction and enforcement of the

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\(^{50}\) These laws and regulations primarily include: (i) Administrative Measures on the Appraisal of State-Owned Assets (国有资产评估管理办法), promulgated by the SASAC on November 16, 1991 and entered into force on the same day; its implementing rules, promulgated by the SASAC on July 18, 1992 and entered into force on the same day; (ii) Circular on Reforming the Mode of Administration of Appraisal of State-Owned Assets and Strengthening the Supervision and Administration of Appraisal of State-Owned Assets (关于改革国有资产评估行政管理方式加强资产评估监督管理工作的通知), promulgated by the Ministry of Finance on December 31, 2001 and entered into force on the same day; its implementing rules, promulgated by the SASAC on July 18, 1992 and entered into force on the same day; (iii) Provisions on Several Issues regarding the Administration of Appraisal of State-Owned Assets (国有资产评估若干问题的规定), promulgated by the Ministry of Finance on December 31, 2001 and entered into force on the same day; (iv) Administrative Measures on Verification and Approval of State-Owned Assets Appraisal (国有资产评估项目核准管理办法), promulgated by the Ministry of Finance on December 31, 2001 and entered into force on the same day; (v) Administrative Measures on Strategic Investments of Foreign Investors in Listed Companies (外国投资者对上市公司战略投资管理办法), jointly promulgated by the MOFCOM, CSRC, SAT, SAIC and SAFE on December 31, 2005 and entered into force on January 31, 2006; (vi) Administrative Measures on Material Assets Reorganization of Listed Companies (上市公司重大资产重组管理办法), promulgated by the CSRC on April 16, 2008 and entered into force on May 18, 2008; and (vii) Administrative Measures on the Takeover of Listed Companies (上市公司收购管理办法), promulgated by the CSRC on July 31, 2006, revised on August 27, 2008, and the revision became effective on August 27, 2008.
relevant provisions have been treated as interrelated, and collectively they constitute a systematic legal regime governing M&A transaction price.

41 The laws and regulations mentioned above are enforced by various government agencies competent for the administration and regulation of foreign investment, SOEs/state-owned assets or LCs respectively. Depending on the facts pertaining to a particular M&A transaction, the MOFCOM takes a leading role in coordinating with the SASAC and/or the CSRC (if necessary) to exercise their supervisory and/or approval power over the price to be paid in a foreign related M&A transaction.

b) Equity/Asset Appraisal Requirement

42 Pursuant to the M&A Regulations, the transaction price of a foreign-related M&A transaction shall be determined based on the value of the equity to be transferred or the value of the assets to be sold as appraised by an equity/asset appraisal institution.51 The parties may jointly select any asset appraisal institution lawfully established in China for this purpose.52 This equity or asset appraisal requirement is a mandatory legal requirement for all foreign-related M&A transactions subject to the M&A Regulations. There are also similar appraisal requirements included in the group of administrative regulations governing SOEs, state-owned assets and LCs.53

43 The main purpose of this appraisal requirement is to ensure that foreign related M&A transactions are not structured in such a way as to evade the Chinese government’s administration of tax, control of foreign exchange or supervision of the flows of capital and assets associated with these types of deals. Particularly, the transaction parties are prohibited from using a price markedly lower than the appraised value to transfer equity, sell assets or to transfer capital overseas in a disguised manner.54 In addition, this regime is in place to make sure that the state-owned assets are not undervalued and the rights and interests of the investors of public companies are not infringed by under-the-table dealings.55

44 However, the parties to a foreign-related M&A transaction are permitted to negotiate an acquisition price in light of their particular business concerns and the actual conditions of the transaction. Basically, the appraisal value serves as a reference price for the transaction.

45 Nevertheless, in practice, the appraisal price may be dramatically different from the negotiated price. In this case, the issue is how to determine whether the difference is reasonable and thus acceptable to the government authority. Since there are no guidelines or rules available on this issue, the government authority exercises discretion to make such a determination. In the process of reviewing the transaction price, the government authority may ask transaction parties to provide a reasonable explanation as to why there exists such a large difference, particularly if the actual purchase price is much lower than the appraisal value. Due to the uncertainties in this regard, it is advisable that the transaction parties consult with the government authority as early as possible.56

51 Art. 14 para. 1 M&A Regulations.
52 Ibid.
53 Supra at n. 50.
54 Art. 14 M&A Regulations.
55 Sun, 150.
56 Wolff, ¶6-500.
It is further required by the M&A Regulations that appraisals shall be conducted in accordance with commonly used international appraisal methods. Apart from these general requirements, the M&A Regulations does not define “commonly used international appraisal methods” or provide detailed rules or requirements on methods of appraisal as identified by other laws or regulations governing SOEs or LCs. In practice, disputes may arise due to the very different understandings between the foreign investor and the Chinese target company on what kind of appraisal methods shall be qualified as the “commonly used international appraisal methods” for the purposes of asset/equity appraisal under the M&A Regulations.

c) Payment of Transaction Price

According to the M&A Regulations, the payment of a transaction price may be in the form of cash, in kind, industrial property, equity or a combination of any of these. The concept of “payment in kind” is broad and could include almost anything. The M&A Regulations does not provide a definition of “payment in kind” and it seems that a practice guideline on this issue does not exist. Therefore, it is important for the transaction parties to consult with the government authority on whether a specific type of assets in kind can be used to pay transaction price.

The M&A Regulations also provides detailed requirements on the schedule for payment of a transaction price. These schedules are dependent on the category of a particular foreign-related M&A transaction and the form of payment. As discussed above, there are four basic scenarios in which the M&A Regulations is applicable to a foreign-related M&A transaction. Different rules apply to some of these scenarios in terms of the schedule for payment of the transaction price.

Where a foreign investor purchases an equity interest in a domestic Chinese company or purchases the assets of a domestic Chinese company and uses those assets to establish an FIE, the following rules are applicable:

The foreign investor shall make full payment of the transaction price within three months of issuance of the business license of the FIE converted from the Chinese target company (Converted FIE). However, there are two exceptions to this general schedule requirement.

The first exception is that this three-month schedule may be extended in special circumstances if government approval is granted. If an extension is obtained, 60% of the transaction price shall be paid within six months of issuance of the business license of the Converted FIE, and the remainder shall be paid within one year of issuance of the business license of the Converted FIE. However, the M&A Regulations fails to define the term “special circumstance”, so it is up to the approval authorities to determine whether a transaction is qualified for such an exception.
exception to general rules. It remains unclear whether an application of this kind shall be filed with the MOFCOM at the central level or its branches at the provincial level. In practice, it is quite hard to obtain such approval.

Under the second exception, the three-month schedule may be extended to six months in the following circumstance: (a) the capital contribution made by the foreign investor into the Converted FIE accounts for less than 25% of the Converted FIE’s registered capital; and (b) the payment is made in kind, in industrial property, or in other non-cash forms. The exception will not apply to any circumstance where the transaction price is made in the form of cash.

Where a foreign investor subscribes to the increased registered capital of a non-FIE (thereby converting it to an FIE), the following rules are applicable:

If the Chinese target enterprise is a limited liability company or a joint stock limited company established by means of sponsorship, the foreign investor who subscribes to the increased registered capital of the target enterprise shall make payment of at least 20% of such subscribed registered capital on the date when the application is submitted for the business license of the Converted FIE, and the remaining portion of such subscribed registered capital shall be paid within two years of issuance of the business license of the Converted FIE (within five years, in the event the target enterprise is an investment company).

If the Chinese target enterprise is a joint stock limited company which issues new stocks for the purposes of increasing its registered capital, the foreign investor who subscribes to such new stock shall make payment within ninety days of MOFCOM approval of the foreign investment in the joint stock limited company.

Where a foreign investor establishes an FIE for the purpose of making domestic acquisition and then purchases, through this FIE, the assets of a domestic enterprise and operates such assets, the following rules are applicable:

Regarding the portion of the registered capital contributed by the foreign investor to the newly established FIE which is equivalent to the purchase price of the acquired assets, the foreign investor shall make full payment of this portion of registered capital within three months of issuance of the business license of the new FIE. This three-month payment requirement may be extended in special circumstances and such extensions are subject to government approval. If approval of the extension is obtained, 60% of this portion of registered capital shall be paid within six months of issuance of the business license of the new FIE, and the remainder shall be paid within one year of issuance of the business license of the new FIE.

Regarding the other portions of registered capital contributed by the foreign investor, (a) if the portions are paid in a lump sum, the payment shall be made

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64 Art. 16 para. 4 M&A Regulations.
65 Ibid.
66 Art. 16 para. 2 M&A Regulations; art. 26 Company Law; arts. 20 and 31 Regulation on the Administration of Company Registration (公司登记管理条例), promulgated by the State Council on June 24, 1994, revised on December 8, 2005, and the revision became effective on January 1, 2006.
67 Art. 16 para. 2 M&A Regulations; art. 81 Company Law; art. 31 Regulation on the Administration of Company Registration ( supra at n. 66); art. 13 Provisional Regulations on Certain Issues concerning the Establishment of Foreign Invested Joint Stock Limited Companies (关于设立外商投资股份有限公司若干问题的暂行规定), promulgated by the MOFTEC on January 10, 1995 and entered into force on the same day.
68 Art. 16 para. 3 M&A Regulations.
within six months of issuance of the business license of the new FIE; (b) if the portions are paid by installments, the amount of the initial payment shall not be less than 15% of the amount of the portions and shall be paid within three months of issuance of the business license of the new FIE, and the remainder shall be paid within two years of issuance of the business license of the new FIE.\(^6^9\)

Where the payment is made in the form of equity in an equity swap transaction, the schedule is six months after the issuance of business license of the Converted FIE (\textit{infra} at \(7^0\)).\(^7^0\) This means that the parties involved in an equity swap transaction will have three months more to complete their payment obligation compared to the first and third types of transactions described above, however there are no exceptions or extensions to this particular schedule requirement.

### 3. Equity Swap

As discussed above, under the M&A Regulations, equity may be used to pay the purchase price in an equity swap transaction.\(^7^1\) The M&A Regulations contains a whole chapter governing the rules of equity swaps as a means of payment in acquisitions.\(^7^2\) This chapter comprises generic equity swap rules and sets forth special rules regarding equity swaps between domestic companies and SPVs established for the purpose of red-chip listing.\(^7^3\)

#### a) Qualification and Requirements

To use an equity swap to acquire a domestic company, the overseas investor must be a listed company, unless it is an SPV defined by the M&A Regulations.\(^7^4\) In addition, the overseas investor shall meet the following requirements: i) it shall be in compliance with all the requirements on its lawful establishment; ii) the place where it is registered must have a well-developed corporate legal system; iii) no punishment has ever been imposed by the relevant supervisory authority upon such investor and its management personnel for the recent three years; iv) the place where it is listed shall have established a complete and mature system of securities exchange.\(^7^5\)

\(^6^9\) Art. 16 para. 3 M&A Regulations; art. 9 Executive Opinions on Certain Issues regarding the Application of the Law Governing Examination, Approval and Registration of Foreign Invested Companies (关于外商投资的公司审批登记管理法律适用若干问题的执行意见), jointly promulgated by the SAIC, MOFCOM, General Administration of Customs and SAFE on April 24, 2006 and entered into force on the same day; art. 26 Company Law; Art. 30 Rules for the Implementation of the Law on Foreign-Funded Enterprises (外资企业法实施细则), promulgated by the State Council on December 12, 1990, revised on April 12, 2001, and the revision became effective on April 12, 2001 Art. 4 Several Provisions on Capital Contribution of the Parties to Sino-Foreign Equity Joint Ventures (中外合资经营企业合营各方出资的若干规定), jointly promulgated by the MOFTEC and SAIC on January 1, 1988 and entered into force on March 1, 1988.

\(^7^0\) Arts. 17 and 36 M&A Regulations.

\(^7^1\) Arts. 17 and 27 M&A Regulations.

\(^7^2\) Chapter 4 M&A Regulations.

\(^7^3\) Arts. 39 and 44 M&A Regulations. For details of "red-chip listing", \textit{infra} Chapter 12 at \textit{et seq.}

\(^7^4\) Art. 28 M&A Regulations. It should be noted that the M&A Regulations does not provide rules governing equity swap between a domestic company and a non-listed overseas investor (excluding the SPV which is established for the purpose of red-chip listing). In this case, the reasonable inference is that equity swap is not yet an operable payment method for a non-listed overseas investor in an inbound acquisition.

\(^7^5\) \textit{Ibid.}
Besides the above-mentioned requirements for overseas investor, the M&A Regulations also stipulates requirements for the shares to be swapped. Specifically, the shares shall be lawfully owned and transferable by the shareholders of the overseas investors; not subject to any title disputes, pledge or any other encumbrance; listed and traded in a legally and openly operated overseas stock exchange (excluding over-the-counter transactions) and the trading price of the shares must have been stable for the past one year.

In an equity swap, the domestic target company and its shareholders are required to engage a PRC registered consultant who will be responsible for conducting due diligence on the truthfulness of the M&A application documents submitted to the MOFCOM, financial status of the overseas investor, verification of fulfillment of all the requirements and conditions listed above and completion of required evaluation of the equity of the domestic target company to be acquired. This consultant will also produce a report to the MOFCOM as part of MOFCOM approval process. Regarding the qualification of the PRC registered consultant, the M&A Regulations only sets forth very general requirements such as a good reputation, related working experience, no record of serious legal violations, and the ability to analyze the legal system of the jurisdiction where the overseas investor is incorporated and the overseas investor’s financial status. The M&A Regulations does not specify any detailed requirement for the PRC registered consultant such as (i) the profession of the consultant (e.g., accounting firm, law firm), (ii) the special license to be obtained for the qualification of such consultant, or (iii) the regulatory authority to which the consultant shall report.

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76 Art. 29 M&A Regulations.
77 Ibid.
78 Art. 30 M&A Regulations.
79 Art. 14 and arts. 28–31 M&A Regulations.
80 Art. 31 M&A Regulations.
b) Equity Swap Procedures

Presented below is a flow chart which reflects the general process for an equity swap as required by the M&A Regulations:

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**Flowchart of Equity Swap Procedures**

1. Step 1: Remarked MOFCOM approval on foreign investment
2. Step 2: Remarked FIE registration with SAIC and SAFE
3. Step 3: MOFCOM approval and SAFE registration of overseas investment by domestic company
4. Step 4: Non-remarked MOFCOM approval on foreign investment
5. Step 5: Non-remarked FIE registration with SAIC and SAFE
   (In case equity swap fails)
6. Step 6: Restoration of target company’s equity structure

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**Step 1: Remarked MOFCOM approval on foreign investment**

The use of equity swaps in an M&A transaction is subject to the approval of the MOFCOM. If all the requirements for the equity swap are met, a certificate of approval for investment by foreign investors will be issued by the MOFCOM, which shall be specifically remarked with a note indicating that the domestic company is the target of an M&A transaction involving equity swap, and that the certificate will be valid within six months from the date on which the Remarked FIE Business License of the domestic company is issued (Remarked Foreign Investment Certificate of Approval or Remarked Foreign Investment COA).  

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**Step 2: Remarked FIE registration with the SAIC and the SAFE**

Within thirty days upon its receipt of the Remarked Foreign Investment COA, the domestic company shall file for registration of the change of its equity structure and company category with the SAIC and the SAFE or their authorized local branches. These authorities will issue an FIE business license and an FIE foreign exchange certificate to the domestic target company, both of which shall be remarked with a note indicating that the certificate shall remain valid for eight months from the date of issuance of the business license (Remarked FIE Business License and Remarked Foreign Exchange Certificate, respectively).  

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81 Arts. 32 and 33 M&A Regulations.  
82 Art. 34 M&A Regulations.
Step 3: MOFCOM approval and SAFE registration of overseas investment by domestic company

Within six months from the issuance date of the Remarked FIE Business License, the domestic company or its shareholders shall apply to the MOFCOM and the SAFE for approval and registration of their overseas investment. If it is verified that the domestic company or its shareholders hold shares in the overseas investor, the MOFCOM will issue a certificate of approval for overseas investment by a Chinese enterprise (Overseas Investment COA).83

Step 4: Non-remarked MOFCOM approval on foreign investment

After the Overseas Investment COA is obtained, an equity swap may be conducted between the domestic company or its shareholders and the overseas investor. If it is verified that the domestic company or its shareholders hold shares in the overseas investor, the MOFCOM will issue a non-remarked certificate of approval for investment by foreign investors (Non-Remarked Foreign Investment COA), which shall replace the Remarked Foreign Investment COA.84

Step 5: Non-remarked registration with the SAIC and the SAFE

Within thirty days after its receipt of the Non-Remarked Foreign Investment COA, the domestic company must apply to the SAIC and the SAFE or their authorized local branches for issuance of a non-remarked FIE Business License and a non-remarked FIE Foreign Exchange Certificate.85

Step 6: Restoration of target company’s equity structure (in case equity swap fails)

In the event the equity swap is not completed within the required time limit, the last step in this process would be the restoration of the domestic company’s equity structure. Within six months from the issuance date of the Remarked Business License, if the domestic company and the overseas investor fail to complete the procedures for the equity swap, the Remarked Foreign Investment COA and the Overseas Investment COA shall automatically become null and void, and formalities shall then be handled with the SAIC for restoration of the domestic company’s equity structure back to its condition before the equity swap.86

4. Acquisition of Chinese Listed Companies

a) Background

As of today, the securities market in China has not yet been fully opened to foreign investors. Currently, foreign investors are permitted to purchase such shares as B-shares, H-shares, S-shares and N-shares,87 but, unless they are qualified foreign

83 Art. 35 M&A Regulations.
84 Ibid.
85 Ibid.
86 Art. 36 M&A Regulations.
87 In China, shares listed in stock exchanges are classified into categories such as A-shares, B-shares, H-shares, S-shares and N-shares, depending on the venue of listing and the classifications of investors. A-Shares refer to the shares of the companies incorporated in China which are traded in China’s A-share market. The price of A-shares is quoted in RMB. Generally, qualified purchasers of A-shares are limited to Chinese citizens and companies and selected QFIs (infra n. 88). B-Shares refer to the shares of the companies incorporated in China which are traded in China’s B-share markets (in Shanghai and Shenzhen respectively). The price of B-shares is quoted in foreign currencies. Before 2001, only foreigners were allowed to trade B-shares, but since 2001, Chinese
II. Major Issues

institutional investors (QFII)s, they are prohibited from directly engaging in the trading of A-shares (except in certain exceptional situations prescribed by law). Despite these general prohibitions, Chinese law does provide foreign investors with several limited means to acquire the shares of LCs.

Generally speaking, the overall progress of the opening of China’s securities markets is full of twists. This is partly attributable to a phenomenon unique to China’s securities market: shares of the same LC are divided into two categories – tradable shares and non-tradable shares. Within these two categories, the non-tradable shares are further divided into state-owned shares and legal person shares. As a result, the shareholders of the same LC do not enjoy the same rights because they hold different categories of shares. This phenomenon is commonly described as the “Split Shares Structure”. The Split Shares Structure hampers the healthy development of China’s securities market and is detrimental to pricing mechanisms in the Chinese securities markets. It is also damaging to the premise of corporate governance in LCs.

To eliminate the adverse effects of the Split Shares Structure and increase the liquidity of shares, the Chinese government launched the “Split Shares Structure Reform” in May of 2005. Under this reform, LCs are being restructured by converting almost all non-tradable shares into freely tradable shares. For the purposes of this reform, the Chinese government has

residents have been allowed to be engaged in the trading of B-shares. H-Shares, S-Shares and N-Shares refer to the shares of the companies incorporated in China but listed in Hong Kong, Singapore and New York respectively. The same naming method applies to the shares of companies incorporated in China but listed in stock exchanges of other countries.

88 Art. 2 Administrative Measures on Securities Investment of Qualified Foreign Institutional Investors in China, jointly promulgated by the CSRC, PBOC and SAFE on August 24, 2006 and entered into force on September 1, 2006. This provision defines QFII as a foreign fund management institution, insurance company, securities company or other asset management institution which has met the requirements set forth by the regulation, acquired CSRC approval to invest in China’s securities market and obtained an investment quota from the SAFE.

89 E.g., art. 20 Strategic Investment Measures. According to this provision, foreign investors shall not buy or sell A-shares on the stock exchanges in China other than under the following circumstances: (1) where foreign investors hold A-shares of an LC via strategic investment in the LC, such investors may sell the shares upon expiration of their committed term for holding such shares; (2) where foreign investors purchase, by means of offer, A-shares of an LC as required by Securities Law; (3) such investors may purchase the A-shares sold by the LC’s shareholders within the validity term of the offer; (3) where foreign investors have obtained the non-tradable shares of an LC before the Split Shares Structure Reform of the LCs, such investors may sell the shares upon completion of the reform and expiration of the three-year lock-up period; (4) where foreign investors have held shares of an LC prior to the initial public offering of the LC, such investor may sell such shares upon expiration of time limit for share selling; or (5) where the shares held by foreign investors prior to the expiration of their committed holding period shall be transferred for such specific reasons as bankruptcy, liquidation and mortgage, such investors may transfer the shares subject to MOFCOM approval.

91 “State-owned shares” refer to the shares of a joint stock limited company which are invested by an organization with state-owned assets with the authorization and on behalf of the state. As most of China’s current joint stock limited companies used to be SOEs, presently state-owned shares still make up a very significant portion in the total shares mix of LCs in China. “Legal person shares” refer to the shares of a joint stock limited company which are invested by legal persons (such as enterprises, public affairs agencies or social organizations) with their own assets.

92 Ye, 113.
Chapter 5. Mergers and Acquisitions

issued a series of regulations, primarily including: Several Opinions on Promoting Reform and Opening-Up and Stable Development of Capital Market,\(^93\) Administrative Measures on the Reform of Split Shares Structure of Listed Companies (hereinafter: Reform Measures)\(^94\) and Administrative Measures on Strategic Investments of Foreign Investors in Listed Companies (hereinafter: Strategic Investment Measures).\(^95\)

74 The Split Shares Structure Reform is a milestone in the evolution of the legal regime governing foreign investors’ acquisition of LCs. Prior to the reform, foreign investors’ acquisition of the shares of LCs was mainly realized by transfer of non-tradable shares by agreement; whereas after the reform the most common approach to foreign acquisition of an LC is by purchase of A-shares under a strategic investment arrangement.

b) Methods of LC Acquisition

75 (1) Acquisition of Non-Tradable Shares by Agreement. Prior to the Split Shares Structure Reform, acquisition of non-tradable shares by agreement used to be the main method for foreign investors to invest in LCs. In practice, this method of acquisition has gone through three phases.\(^96\) The first phase began in 1995 when foreign investors first started acquiring LCs. The beginning of this phase was marked by a series of acquisitions that were successfully culminated by foreign investors including the well-known Beilu transaction and Jiangling transaction.\(^97\)

76 The second phase began in October of 1995 when the State Council issued a circular suspending foreign acquisition of non-tradable shares of LCs.\(^98\) Foreign investors remained barred from the acquisition of non-tradable shares until November of 2002 when the government rescinded the October 1995 circular and once again allowed foreign acquisition of non-tradable shares.\(^99\)

77 After the commencement of the Split Shares Structure Reform in 2005, the acquisition of non-tradable shares by agreement began to lose its appeal to foreign investors again allowed foreign acquisition of non-tradable shares.\(^99\)

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\(^93\) (关于推进资本市场改革开放和稳定发展的若干意见), promulgated by the State Council on January 31, 2004 and entered into force on the same day.

\(^94\) (上市公司股权分置改革管理办法), promulgated by the CSRC on September 4, 2005 and entered into force on the same day.

\(^95\) Supra at n. 50.

\(^96\) Ye, 107–108.

\(^97\) “Beilu transaction” refers to foreign investors’ acquisition of non-tradable legal person shares of an LC, Beijing Beilu Automobile Manufacturing Co., Ltd. (Beilu) in 1995. In this acquisition, by a joint acquisition agreement, Isuzu Motors Co., Ltd. and Itochu Corporation became the largest joint shareholder of Beilu by acquiring 25 % of the LC’s non-tradable legal person shares. This is the first case of foreign investors’ acquisition of non-tradable legal person shares of an LC. Shortly afterwards, in August of 1995, the U.S. Ford Motor Company acquired 139 million B-shares (which accounts for 20 % of the total capital stock) of an LC, Jiangling Motors Co., Ltd. (Jiangling), and became the second largest shareholder of Jiangling. These two cases were followed by a surge of foreign investors’ acquisition of LCs. Guan, 669–670.

\(^98\) Circular of the General Office of the State Council Forwarding CSRC Consultations concerning Suspension of Transfer of State-Owned Shares and Legal Person Shares of Listed Companies to Foreign Investors (国务院办公厅转发国务院证券委员会关于暂停将上市公司国家股和法人股转让给外商请示的通知), issued by the State Council on September 23, 1995 and entered into force on the same day.

\(^99\) Circular on Relevant Issues concerning the Transfer of State-Owned Shares and Legal Person Shares of Listed Companies to Foreign Investors (关于向外商转让上市公司国有股和法人股有关问题的通知), jointly promulgated by the CSRC, the Ministry of Finance and the State Economic and Trade Commission on November 1, 2002 and entered into force on the same day.
investors. This is due in part to the fact that during the reform process holders of non-tradable shares of LCs can convert non-tradable shares into tradable shares by paying consideration for such shares. As a result, after the reform is completed, there will no longer be any non-tradable shares available for foreign investors to acquire.

(2) Strategic Investment in A-Share LCs. With the inception of the Split Shares Structure Reform, strategic investment in A-shares of LCs gradually became one of the major means for foreign investors to acquire LCs. This method of foreign-related acquisition is primarily regulated by the Strategic Investment Measures. The issues concerning this type of strategic investment will be discussed in details in the latter part of this chapter (infra at 84–99).

(3) Acquisition through QFIIs. As discussed above, QFIIs are permitted by law to trade A-shares on the stock exchanges in China, while all other foreign investors are prohibited to do so. Therefore, subject to certain legal limitations, QFIIs may be used by other foreign investors as a vehicle to acquire LCs. The primary legal basis for this method of acquisition is the Administrative Measures on Securities Investments of Qualified Foreign Institutional Investors in China (hereinafter: QFII Investment Measures).100

However, it is difficult for foreign investors to obtain control over LCs by investing through QFIIs due to two limitations imposed by a CSRC circular on QFIIs’ acquisition of A-shares.101 First, the shares of an LC held by a single foreign investor through QFIIs shall not exceed 10% of the LC’s total number of shares. Second, the total number of the A-shares of a single LC held by all of the LC’s foreign investors shall not exceed 20% of the LC’s total number of shares.102 These limitations make it virtually impossible for a foreign investor to obtain control over an LC through a QFII acquisition of A-shares.103

(4) Indirect Acquisition. Foreign investors may also acquire LCs indirectly by using one of the three following approaches:104 (i) acquire an equity interest in the parent/holding company of the target LC;105 (ii) acquire the target LC through an FIE previously established by the foreign investor;106 or (iii) acquire the target LC through a merger between the target LC and an FIE previously established by the foreign investor.107

These indirect acquisition methods have been widely used by foreign investors, particularly prior to the implementation of the Strategic Investment Measures because of certain advantages of indirect acquisition methods over direct approaches.

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100 Supra at n. 87.
101 The CSRC Circular on Relevant Issues concerning the Implementation of the Administrative Measures on Securities Investment of QFIIs in China (中国证券监督管理委员会关于实施《合格境外机构投资者境内证券投资管理办法》有关问题的通知), issued by the CSRC on August 24, 2006 and entered into force on September 1, 2006.
102 Art. 10, ibid.
103 Mei, 38.
104 Ye, 106–107.
105 The main legal basis of this approach is the M&A Regulations and the Provisional Regulations on Using Foreign Investment to Restructure State-Owned Enterprises (利用外资改组国有企业暂行规定), jointly promulgated by the State Economic and Trade Commission, the Ministry of Finance, the SAIC and the SAFE on November 8, 2002 and entered into force on January 1, 2003.
106 The major legal basis of this approach is the Provisional Regulations on Re-Investment of Foreign Invested Enterprises in China (supra at n. 8).
107 The main legal basis of this approach is the Provisions on Mergers and Divisions of Foreign Invested Enterprises (supra at n. 7).
First, foreign investors making indirect acquisitions of LCs are subject to fewer restrictions and requirements. For instance, the Strategic Investment Measures sets strict qualifications for foreign investors acquiring A-shares in LCs by direct strategic investment. These requirements are not applicable in an indirect acquisition scenario. Second, there are more forms of payment available to foreign investors making indirect acquisitions. Third, there is no re-sale lock-up period for indirect acquisitions while foreign investors making strategic direct investments in LCs face lock-up periods.

(c) Strategic Investment Issues

(1) Conditions of Strategic Investment. In general, the following types of investments are deemed to be strategic investments and thus are governed by the Strategic Investment Measures: (i) the target LC is either an LC that has completed the Split Shares Structure Reform or a new LC that turned into a public company after the enactment of the Split Shares Structure; (ii) the investment is a long or medium-term strategic investment of a certain scale; and (iii) the investment is for the acquisition of A-shares of the target LC.

In addition to the general description above, the Strategic Investment Measures provides further requirements and conditions to which a strategic investment shall be subject to. The purpose of these requirements and conditions is to ensure that these investments by foreign investors are made not for short-term gains, but for strategic purposes.

A strategic investment may be made in installments, but the shares acquired in the first installment shall not be less than 10% of the total outstanding shares of the LCs unless otherwise permitted by special requirements in a specific industry or approved by relevant government authorities. The Measures does not impose any ratio and schedule requirements on the subsequent installments of the transactions as those normally imposed by FDI laws and regulations.

Second, shares acquired by a strategic investment shall not be transferred for a period of three years following the acquisition. This three-year lock-up period is an important factor which should be taken into account before a foreign investor decides to make strategic investment in LCs.

Third, A-shares may only be acquired through strategic investment by means of transfer by agreement, private placement or any other method permitted by law. “Transfer by agreement” refers to the transfer of

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108 *Infra* at 91, 92 and 93.
109 These forms of payment may include, without limitation, convertible currencies, RMB profits generated from FDI in China, stocks or other assets approved by the SAFE. *Mei*, 39.
110 As per Art. 5 of the Strategic Investment Measures, the foreign investors who acquires A-shares of LCs by making strategic investment shall not sell such shares within three years after the acquisition.
111 Art. 2 Strategic Investment Measures.
113 Arts. 2, 4, 5 and 11 Strategic Investment Measures.
114 Arts. 2 and 5 Strategic Investment Measures.
115 Arts. 5 and 16 Strategic Investment Measures.
116 Art. 5 no. 2 Strategic Investment Measures.
117 Art. 5 no. 3 Strategic Investment Measures.
118 Art. 5 no. 1 Strategic Investment Measures.
existing shares of an LC to new investors by reaching an agreement between the shareholders of existing shares and the new investors. “Private placement” means the sale of newly issued shares to certain targeted investors rather than to the public. Although “other methods” are not elaborated upon in the Measures, it is clear that foreign investors are prohibited from making strategic investments in LCs by acquiring A-shares on the stock exchanges in China unless through QFIIs or in certain exceptional situations.\textsuperscript{119} It is believed that these “other methods” shall include acquisition by tender offer (\textit{要约收购}) (\textit{supra} Chapter 4 at 119–122).

Fourth, the foreign investors wishing to acquire A-shares through a strategic investment shall comply with the shareholding restrictions/limitations set by the FDI laws. Foreign investors shall not make strategic investment in LCs which are engaged in any industry/sector where foreign investment is prohibited.\textsuperscript{120} Furthermore, where a strategic investment involves state-owned shares, the laws and regulations regarding the administration of state-owned assets shall be complied with.\textsuperscript{121}

Fifth, the foreign investor shall initiate a strategic investment within fifteen days after its investment funds in foreign exchange are settled into RMB as per SAFE requirements. Additionally, the strategic investment shall be completed within one hundred and eighty days after the date of the MOFCOM official reply which, in principle, grants approval to the strategic investment (Official Reply) (\textit{原则批复函}).\textsuperscript{122} In the event the foreign investor fails to make the strategic investment according to the required schedule, MOFCOM approval shall become null and void automatically. Consequently, the foreign investor shall, subject to SAFE approval, convert the investment funds from RMB into foreign exchange and remit the same outside of China within forty-five days after MOFCOM approval becomes null and void.\textsuperscript{123}

\textit{(2) Requirements for Foreign Investors.} A foreign investor may make a strategic investment in A-share LCs either by itself or through a wholly owned subsidiary outside of China, provided that certain requirements under the Strategic Investment Measures are met.\textsuperscript{124} In the event the investment is made by a foreign investor via a subsidiary, the investor shall provide an irrevocable undertaking to the MOFCOM agreeing to bear joint and several liability for the acts of the subsidiary.\textsuperscript{125} According to the literal language of the Measures, the subsidiary used by a foreign investor for the purposes of strategic investment in A-shares can neither be an affiliate (under common control) nor an FIE (including an FFIC) established by the investor in China.

The Strategic Investment Measures provides for the following requirements for foreign investors who contemplate the acquisition of A-shares by strategic investment:\textsuperscript{126}

- The assets actually owned by the foreign investor outside of China shall not be less than USD 100 million, or the assets actually held by the foreign investor under management outside of China shall not be less than USD 500 million. In

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{119}] Art. 20 Strategic Investment Measures (\textit{supra} n. 90).
\item[\textsuperscript{120}] Art. 5 no. 4 Strategic Investment Measures.
\item[\textsuperscript{121}] Art. 5 no. 5 Strategic Investment Measures.
\item[\textsuperscript{122}] Art. 16 para. 1 Strategic Investment Measures.
\item[\textsuperscript{123}] Art. 16 para. 2 Strategic Investment Measures.
\item[\textsuperscript{124}] Art. 13 Strategic Investment Measures.
\item[\textsuperscript{125}] \textit{Ibid.}
\item[\textsuperscript{126}] Art. 6 Strategic Investment Measures.
\end{itemize}
\end{footnotesize}
the event the foreign investor makes strategic investments through a subsidiary, the subsidiary may rely on the parent company to satisfy these requirements.

- The investor has not been subject to any serious penalty imposed by the Chinese or overseas regulatory authorities in the past three years. Where the investment is made through a subsidiary of the investor, the subsidiary shall satisfy this compliance requirement. The foreign investor shall be a legally established, financially sound, creditable legal person or other entity with significant management experience, sound corporate governance, good internal control systems and standard operating rules.

These requirements are broad and flexible enough to provide many qualified foreign investors with opportunities to enter the Chinese stock market by strategic investment.

(3) Methods for Acquisition of A-Shares. As discussed above, “transfer by agreement” and “private placement” are the two major methods for acquisition of A-shares under the Strategic Investment Measures. Of these two methods, “private placement” is recognized by the Securities Law and other laws and regulations already, but is a fairly new concept for foreign investors to acquire A-shares in China. Regarding “transfer by agreement”, it should be noted that detailed operating rules have been provided by the Interim Rules for Listed Companies on Conducting Transfers of Tradable Shares by Agreement.

In addition to these two major methods, foreign investors wishing to make a strategic investment can also acquire A-shares of LCs by means of tender offer, although “acquisition by tender offer” is not expressly provided by the Strategic Investment Measures as a method for acquisition of A-shares. According to the Securities Law and the Administrative Measures on the Takeover of Listed Companies (hereinafter: Takeover Measures), an acquisition of 30% or a higher percentage of an LC’s shares will trigger an “acquisition by tender offer” except in cases of exemption. Since both the Securities Law and the Takeover Measures are applicable to foreign investors’ acquisition of LCs, in the abovementioned circumstance, “acquisition by tender offer” is a method that can be used by foreign investors to acquire A-shares in a strategic investment arrangement. Moreover, the legislative intent of the Strategic Investment Measures as reflected by its literal language is to include “acquisition by tender offer” as a method for acquisition of A-shares.

The Takeover Measures requires foreign investors to use tender offer to acquire the shares of an LC in any of the following circumstances (except in the cases of exemption), provided that the contemplated acquisition ratio is not lower than 5%

127 Art. 10 and art. 13 para. 2 Securities Law, promulgated by the SCNPC on December 29, 1998, revised on August 28, 2004 and October 27, 2005 respectively, and the last revision became effective on January 1, 2006.
128 Mei, 37.
129 (上市公司流通股协议转让业务办理暂行规则), jointly promulgated by Shanghai Stock Exchange, Shenzhen Stock Exchange and China Securities Depositary and Cleaning Corporation Limited on August 14, 2006 and entered into force on the same day.
130 Arts. 85 and 88 Securities Law.
131 Arts. 24, 47 and 56 Takeover Measures (supra at n. 50).
132 Art. 47 para. 3, Art. 56 para. 2 Takeover Measures.
133 E.g. Art. 20 no. 2 of the Strategic Investment Measures stipulates that in the event the investor is required by the relevant provisions of the Securities Law to conduct acquisition by means of tender offer, the investor may acquire A-shares from the shareholders within the validity term of the offer.
of all the outstanding shares of the target LC: (i) the foreign investor elects to acquire the shares of an LC by means of tender offer;\textsuperscript{134} (ii) the foreign investor has already acquired 30\% or more of all the outstanding shares of an LC and continues to acquire shares of the LC;\textsuperscript{135} or (iii) the foreign investor has acquired 30\% or more of all the outstanding shares of an LC by indirect acquisition.\textsuperscript{136}

(4) Procedure. The procedures to make a strategic investment transaction are as follows: (i) adopt resolutions by the board of directors/shareholders’ meeting of the LC accepting the foreign investor’ strategic investment through private placement or transfer by agreement; (ii) sign a contract for private placement/transfer by agreement by the LC and the foreign investor; (iii) file an application with the MOFCOM for its \textit{Official Reply} on private placement or its \textit{approval} on transfer by agreement; (iv) file an application with the CSRC for its \textit{verification} (核准) of private placement, or its \textit{record} of transfer by agreement (after formalities of confirmation and registration of share transfer has been settled with relevant institutions); (v) collect FIE approval certificate of the LC from the MOFCOM; and (vi) handle SAIC registration formalities concerning the change of shareholding structure of the LC and other corresponding matters.

Since foreign investor’s acquisition of A-shares of LCs by strategic investment is a special type of foreign-related equity acquisition transaction, it shall be subject to the requirements set forth in the M&A Regulations. Generally speaking, the procedure under the Strategic Investment Measures is more complex than that under the M&A Regulations, because an A-share acquisition in a strategic investment scheme involves both the MOFCOM and the CSRC, whereas an ordinary equity acquisition involves the MOFCOM only. Under the M&A Regulations, the M&A transaction approval procedure and the foreign investment approval procedure are unified into one integral procedure. By contrast, under the Strategic Investment Measures, these two procedures are separated from each other and are separated by the CSRC approval stage. In addition, in the event A-shares are acquired via transfer by agreement, extra formalities with respect to confirmation and registration of A-share transfer are required by the Strategic Investment Measures. Basically, there are no fundamental conflicts or inconsistencies between these two sets of procedures, but in practice, there still exist detailed procedural matters to be coordinated.

Furthermore, coordination between the Strategic Investment Measures and the Takeover Measures is also necessary because foreign investor’s strategic investment in A-share LCs is considered a special type of takeover. This coordination is more complicated than the coordination discussed above, as the procedure for a takeover itself is quite complex and even confusing or self-contradicting in many aspects. Further clarifications are needed from subsequent guidelines or rules or actual practice of the relevant government agencies as to how to implement the coordination. In practice, it is always advisable that the parties involved in such an A-share acquisition transaction consult with the competent government agencies on the procedural matters as early as possible.

\textsuperscript{134} Art. 23 Takeover Measures.
\textsuperscript{135} Art. 47 para. 2 Takeover Measures.
\textsuperscript{136} Art. 56 para. 2 Takeover Measures.
d) Interests Disclosure and Reporting Requirements

According to the Securities Law and in particular, the Takeover Measures, the investor and the relevant parties are, under certain circumstances, obliged to disclose and report to the public and/or the government agencies the interests they hold in the target and the changes thereof.\textsuperscript{137} In general, the higher the percentage of shares acquired by the investor in an LC, the stricter the disclosure and reporting obligations they shall bear. Such disclosure and reporting requirements vary depending on whether the transaction is conducted via transfer by agreement or via acquisition by tender offer.

101 (1) Transaction via Transfer by Agreement. The disclosure and reporting obligations of an investor who acquires the shares of an LC via transfer by agreement are dependent on: (i) the percentage of acquired shares to all outstanding shares of the LC, and (ii) whether the investor and the persons acting in concert\textsuperscript{138} are the largest shareholder of the LC or the \textit{de facto} controlling person.\textsuperscript{139}

- In the event the acquired shares account for less than 5\% of all the outstanding shares of the LC, there is no particular disclosure and reporting obligation imposed on the investor.

- In the event the acquired shares account for 5\% or more but less than 20\% of all the outstanding shares of the LC, and the investor and the persons acting in concert are not the largest shareholder or the \textit{de facto} controlling person of the LC, the investor and the persons acting in concert shall prepare a \textit{short-form report} on change of interests.\textsuperscript{140} The report is to be submitted to the CSRC and the stock exchange with a copy of the report being forwarded to the relevant local offices of the CSRC. The target LC shall be informed of the same situation and an announcement regarding the acquisition shall be published.

\textsuperscript{137} As per art. 12 Takeover Measures, “interests” held by an investor in an LC include shares in two categories, i.e. (i) shares registered in its name; and (ii) shares that, although not registered in its name, are under actual control of the investor in respect of voting rights. The interests held by an investor and the person(s) acting in concert in an LC shall be calculated collectively.

\textsuperscript{138} “Persons acting in concert” refers to the investors of an LC who act in alignment with each other via agreement or other arrangements for the purpose of magnifying the investors’ voting powers in the LC, e.g., investors with holding relationships with each other, investors controlled by the same entity, investors in partnership or other economic relationship. For details, see art. 83 Takeover Measures.

\textsuperscript{139} Arts. 14, 16 and 17 Takeover Measures. The Takeover Measures does not provide a definition of the term “control”. Instead, it enumerates a number of situations where an investor has “control” over an LC in art. 84, namely, (i) the investor is a controlling shareholder that holds more than 50% of the shares of the LC; (ii) the investor can actually control over 30% of the share voting rights of the LC; (iii) the investor is able to decide the appointment of more than half of the members of the board of directors through actual control of the share voting rights of the LC; (iv) the investor, by virtue of the share voting rights of the LC it actually controls, is able to have a major influence on the resolutions of the shareholders’ general meeting of the company; or (v) other circumstances recognized by the CSRC.

\textsuperscript{140} The short-form report shall contain the following information: (i) basic information of the investors and the persons acting in concert; (ii) purpose of share holding and whether to increase their interests in the LC in the forthcoming 12 months; (iii) basic information of the LC and the shares; (iv) when and how the percentage of interests held in the outstanding shares reaches or exceeds 5\%, or when and how the increase or reduction of such interests reaches or exceeds 5\%; (v) a brief description of the trading of the LC’s shares at the stock exchange during the six months prior to the change in interests; and (vi) other information that the CSRC or the stock exchange requires to be disclosed. For details, see art. 16 Takeover Measures.
In the event the acquired shares account for 5% or more but less than 20% of all the outstanding shares of the LC and the investor and the persons acting in concert are the largest shareholder or the de facto controlling person of the LC, or in the event the acquired shares account for 20% or more but less than 30% of all the outstanding shares of the LC, the investor and the persons acting in concert shall prepare a detailed report on change of interests. Their other disclosure and reporting obligations remain the same as the previous scenario.

In the event the acquired shares account for 20% or more but less than 30% of all the outstanding shares of the LC and the investor and the persons acting in concert are the largest shareholder or the de facto controlling person of the LC, in addition to preparing a detailed report on change of interests and fulfilling the other disclosure and reporting obligations as enumerated above, the investor and the persons acting in concert shall also engage a financial advisor to render opinions on the information disclosed in the above-mentioned detailed report on change of interests (subject to certain exceptions permitted by law).

Transaction via Acquisition by Tender Offer. An investor who acquires the shares of an LC by tender offer shall be subject to the following disclosure and reporting obligations:

- Prepare a report on the acquisition by tender offer;
- Engage a financial advisor to prepare a report and submit the report to both the CSRC and the stock exchange, with a copy of the report being forwarded to the relevant local office of the CSRC;
- Notify the target LC;
- Make a public announcement with an abstract of the report on acquisition by tender offer;
- Submit the report on acquisition by tender offer to the CSRC together with other supporting documentation; and
- Make a public announcement of the report on acquisition by tender offer, the financial advisor’s opinion and the lawyer’s legal opinion, provided that the CSRC expresses no objection to the information disclosed in the report.

As the Strategic Investment Measures requires that the minimum shareholding percentage of a strategic investor in an LC is 10%, the above-mentioned disclosure and reporting obligations are also applicable to a scenario where foreign investors make strategic investment in A-share LCs.

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141 The detailed report shall contain the following information (in addition to that required in the short-form report): (i) the controlling shareholder or the de facto controlling person of the investor and the persons acting in concert, and a chart reflecting the equity control relationship between them; (ii) information about the shares acquired, e.g., price, total amount, source of fund; (iii) whether there is any competition or affiliated transaction between the business of the LC and that of the relevant parties involved, and if there is any, whether arrangements have been made to avoid such competition or affiliated transaction and to ensure the independence of the LC; (iv) a follow-up plan for the adjustment of various aspects of the LC; (v) major transactions between the LC and the investor and the persons acting in concert in the preceding twenty four months; (vi) there does not exist any of the circumstances under which the investor shall not acquire LCs as specified in the regulation; and (vii) the ability to provide relevant documents to the MOFCOM as required by the regulation. For details, see art. 17 Takeover Measures.

142 Art. 17 para. 2 Takeover Measures.

143 Art. 28 Takeover Measures.
III. Concluding Remarks

Starting from the early 2000s, China’s M&A laws have entered into a phase of rapid development. Represented by the M&A Regulations, China’s M&A laws are now being gradually steered onto the track of granting similar treatment to foreign investors as to domestic investors, including opening up a growing number of domestic sectors where foreign investment used to be prohibited or severely restricted, and providing foreign investors with more and more means to acquire Chinese enterprises. This increasing degree of openness is particularly reflected in the evolving legislation concerning foreign investors’ acquisition of listed companies. Generally speaking, the overall direction of the progress of China’s M&A laws is to lessen restrictions on foreign investors and provide a fairer environment to conduct business with their Chinese counterparties.

Despite these advances, in the short or mid-term, foreign investors will still have to live with a bifurcated M&A legal regime in China. Under such a system, the Chinese investors may have obvious advantages over their foreign competitors in some aspects. This discrimination not only originates in the Industry Catalogue, but also derives from the Chinese government’s increasing awareness and sensitivity towards safeguarding national economic security and the failure, at times, to properly differentiate between issues of national economic security and issues of anti-trust.

IV. Relevant Laws & Regulations

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Chapter 6. Antitrust

I. Overview

1. Evolution History

The adoption of the Anti-monopoly Law (反垄断法, hereinafter: AML) on 30 August 2007, which became effective on 1 August 2008, may be called a milestone in the development of anti-monopoly legal regime in China. Prior to the enactment of the AML, there were several laws, rules and regulations dealing with various aspects of anti-monopoly policy, however, they are neither complete nor systemized. If one recalls the rather uneasy drafting process filled with turf battles, resulting in the unsolved problem of enforcement authorities and mechanism, it is certainly a legitimate question to ask what are the genuine motive and goals of Chinese lawmakers behind the creation of the AML. Among the multiple policy objectives outlined by art. 1 AML, including preventing and prohibiting monopolistic conduct, protecting fair market competition, promoting economic efficiency, safeguarding the interests of consumers and the public and promoting the healthy development of the socialist market economy, no clear enforcement priority can be identified. Some commentators either raise doubts about the likelihood of AML accomplishing these goals or challenge they being proper goals for an antitrust statute.

To be sure, the AML is expected to rein in widely reported anticompetitive practice of multinational enterprises. Considerable harms were claimed having already been caused to the public and domestic industries in China before the adoption of the AML. In retrospect, presenting those harms as a result of the absence of an adequate competition regime made the passage of the AML a pressing issue and gave Chinese legislator a significant impetus to reach consensus in the stagnated drafting phase, which can be traced back as early as mid-1990s. Foreign enterprises will remain one of the main targets of the implementation of the AML, as many commentators rightly pointed out. Nonetheless, the AML is also expected to solve many other domestic societal and economic ills, the foremost monopoly behavior of public utilities firms, local protectionism and market segmentation.

At current stage it is premature to predict whether the AML may live up to its expectations. In any event, in the first year following the implementation of the AML, the antitrust enforcement authorities have shown a determination to clamp down on anticompetitive practices.

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1 I.e. Anti-Unfair Competition Law (反不正当竞争法)(1993); Price Law (价格法) (1998); Tentative Measures on Acquisition of Domestic Enterprise by Foreign Investors ( supra Chapter 5 at n. 1); Interim Provisions (of the NDRC) on Prohibiting Monopolistic Pricing Behaviours (制止价格垄断行为暂行规定) (2003); Foreign Trade Law (对外贸易法) (as revised in 2004); see also Salil/Meng, 391–395; Samuels, 180–184.
2 For detailed summary: Berry, 140–143; Harris, 172 et seq.
3 Harris, 184–186; Howell et al, 60; Huo, 45–46.
4 To mention is first of all a report of the SAIC published in May 2004, which named Microsoft, Kodak and TetraPak as examples of multinationals susceptibility engaging in abuse of market power in China. Harris, 179–180.
5 Owen et al, 61–63.
6 Reasons for the stagnation see Huo, 35–39; also Owen et al, 131–133.
7 In 1994 first officially adopted in the China’s national legislative plan, for details Fang (2006), 7.
8 Harris, 171; Howell et al, 55–56;
9 Berry, 145–147; Samuels, 177–179.
10 Salil/Meng, 411.
11 Student, 505–506, 519–521.
AML, all involved enforcement agencies demonstrated a proactive approach in gathering expertise and improving the enforcement transparency and certainty. Drafts of implementing regulations and guidelines addressing various aspects of the AML have been circulated for public comment and some have already been adopted. A small number of decisions on merger control have been published and the relevant case law is slowly developing.

The anti-monopoly enforcement is essentially a state intervention into private autonomy. Such intervention does not always yield desirable results and may likely be counterproductive, therefore, the implementation of the broadly worded AML calls for caution and thorough economic analysis. The industrial and economic policy goals, which are closely linked to anti-monopoly enforcement, are to be clarified. At the same time, a “competition culture” – the awareness and appreciation of the value of competition – is to be nurtured. So far businesses in China were able to operate in an antitrust vacuum and have now to adjust themselves to legal restraints introduced by the AML.

The AML as enacted covers the three pillars of any modern antitrust statute: monopoly agreements, abuse of a dominant market position and merger control and is therefore a state-of-the-art competition law. Most regulations may find parallels in the U.S. or EU competition law. The degree to which foreign commentators and experts were involved in the drafting process of the AML is impressive. The consultation of foreign expertise served not only to draw on best practice and experience from other countries, but also to give foreign investors opportunities to express their concerns and thereby allay their apprehensions, who after all are to be affected by the AML virtually the most.

2. Scope of Application

The AML is applicable to all types of undertakings (art. 12 AML), including trade associations (art. 11 AML) (infra at 36 et seq.). Only farmers and agricultural economic organizations engaging in production, processing, sales, transport and storage of agricultural products are taken out from the application scope of the AML (art. 56 AML). The extraterritorial application of the AML principally follows international standard of the doctrine of effects (效果原则): the AML is applicable only when the elimination and restriction of competition has effects on Chinese domestic market, although it fails to set a substantiality threshold for such effects to trigger the extraterritorial jurisdiction (For details to mergers conducted outside of China infra at 43).

3. State-Owned Enterprises

Art. 7 para. 1 AML proscribes that the state shall protect legitimate business activities of SOEs that control industries concerning state economic vitality and national security and those activities of SOEs in industries with state monopoly,
supervise and regulate their business conducts and prices, safeguard the interests of consumers and foster technological progress. This provision is somehow confusing and may give the impression that qualifying SOEs are generally exempted from the application of the AML. Art. 7 para. 2 AML prohibits SOEs covered by art. 7 para. 1 AML from abusing their dominant positions or legal monopolies to the detriment of consumers and thereby clarifies that SOEs are not sheltered from the enforcement of the AML. Thus, art. 7 para. 1 AML probably serves to state the necessity of a likely lenient treatment of such SOEs.16

7 The AML itself does not expressly specify the industries to be covered by this provision. In light of a document issued by the SASAC in 2006,17 seven industries subject to absolute control of the state including national defense, electricity, petroleum/natural gas, telecommunication, coal, civil aviation and waterway transport fall in any event within the scope of art. 7 AML.18 State monopoly (国家专营专卖) exists with respect to wholesale of salt and tobacco etc., which means that a special license from the state is required for market entry in these sectors.

8 Almost each of these seven industries has its own sectoral regulator and is governed by a specific law, such as Electricity Law, Coal Law and Civil Aviation Law. Above of that is the SASAC which is entrusted to operate and supervise the management of SOEs according to the numerous legal regulations issued by the NPC, the State Council and the SASAC (infra Chapter 11 at 3 et seq.). Certainly as for SOEs in the government administered sectors, the AML as enacted is not explicitly subordinated to these administrative regulations and laws governing specific industries as suggested by one draft,19 any interference of the AML enforcement agencies without adequate coordination with the pertinent industry regulator and SASAC is nonetheless hardly feasible. This institutional arrangement basically keeps the status quo and, to the disappointment of the public, fails to bring about an effective tool to curb anticompetitive conduct of public utility companies holding lawful monopoly positions. The implementation of the AML in the strategically significant industries is also intertwined with administrative monopolies addressed in Chapter V of the AML, which is dealt with in this chapter later on (infra at 31 et seq.).

4. Enforcement Agencies

9 Chinese policymakers have managed to solve the question of anti-monopoly enforcement authorities just in time.20 On March 21, 2008, the State Council issued the Circular on the Establishment of Government Institution, following which the State Council issued three notices to define the respective responsibilities of the MOFCOM, NDRC and SAIC21 and thereby clarified the respective duties of the three

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16 Fang (2008), 128 et seq.
18 Fang (2008), 134.
19 Harris, 170–171.
20 Details on this point: Salil/Meng, 403–410.
government authorities in anti-monopoly work, i.e., the MOFCOM is responsible for merger review, the NDRC for the inspection of price monopoly, and the SAIC for the inspection of monopoly agreements and conduct of exclusion/restriction of market competition other than business concentration and monopoly pricing.

By a Notice dated of July 28, 2008 the State Council clarified the main functions and members of the Anti-monopoly Commission, which is designated by the AML to coordinate the implementation of the AML by the MOFCOM, SAIC and NDRC. According to this notice, the Anti-monopoly Committee consists of deputy officers from the State Council and its different ministries and commissions, as well as ministers from the MOFCOM, NDRC, and SAIC. The notice also specifically designates the MOFCOM as responsible for carrying out anti-monopoly work. The pertinent Working Rules of the Anti-monopoly Commission were published on September 13, 2008.

5. Definition of Relevant Market

a) State Council Guidelines

It is commonly accepted that relevant market constitutes the starting point in analyzing the impact of a conduct on market competition and thereby determining the application of the AML in the three main areas of AML, monopoly agreement, abuse of market dominance and merger control. Anti-monopoly intervention is usually triggered only when there is a noticeable competitive impact within a properly defined relevant market. Due to its complexity, the concept of relevant market was basically left open in the enacted version of the AML. This gap is filled by the Guidelines of the Anti-monopoly Commission of the State Council on the Definition of Relevant Market (国务院反垄断委员会关于相关市场界定的指南, hereinafter: Guidelines on the Definition) dated of May 24, 2009, which was released on July 7, 2009.

Although not explicitly articulated, it can be assumed that the Guidelines on the Definition are binding for all the three enforcement agencies, i.e. the MOFCOM, SAIC and NDRC. The issue of how to determine relevant market in a concrete case, which is essentially an artificial and hypothetical term built on certain economic theories, is a delicate task. Considering that China has almost no practical experi-
ence with delineating relevant market, it is understandable that the State Council Guidelines on the Definition chose to adopt the common international practice, instead of developing its own theoretical bases. As a principle, the Guidelines on the Definition emphasize the use of objective, existing data and encourage the use of economic analysis. Lacking precedents, following explanations on relevant market are inevitably almost entirely theoretical.

**b) Product Market and Geographic Market**

According to art. 3 of the Guidelines on the Definition a relevant market is the scope of products and the geographic area within which a business operator competes with others with respect to a specific product or service for a certain period of time. Therefore, the product market comprises of products which are substitutable from the demand perspective. The geographic market is the regional boundary within which a possible consumer is ready to acquire substitutable products, even at extra transport costs. In case that a product or service is offered only for a short period of time, for instance an exhibition, or for an unusually longer time, for instance complicated machinery, temporal factors such as production cycle, product life, seasonal features, fashion style or protection period of intellectual property rights have to be taken into account. With respect to technology transfer and licensing agreements, the Guidelines on the Definition provide the possibility of defining the relevant technology market, albeit with details to this point untouched.

**c) Methodology of Substitutability Analysis**

As revealed by the definition of relevant market, the product and geographic scope is to be determined based on the degree of substitutability, which may be further divided into “demand substitutability” and “supply substitutability”. The demand factors are proscribed in the Guidelines on the Definition as the primary criterion for the delineation of relevant market and the supply factors serve only as a supplement when the case requires. Experience from other countries shows that most notably in those cases in which the demand substitutability analysis with respect to heterogeneous products might result in a very narrow market, although the suppliers are able to switch to other substitutable products swiftly, the supply substitutability helps to correct the one-sided result.

Factors to be considered in the demand substitutability analysis include a product’s characteristics, quality, purpose, price and availability, while those in the supply substitutability analysis focus mainly on the market entry barriers, such as investment incurred for changing equipment, and risk of failure with the new product, time needed to entry the market of the new product.

If both the demand and the supply substitutability analysis fail to clearly identify the scope of the relevant market, the Guidelines on the Definition allow the use of the hypothetical monopolist test modeled after the so-called SSNIP test (small but significant non-transitory increase in price), which is set out in the 1992/97 U.S. Merger Guidelines and the 1997 EU notice on the definition of relevant market.

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26 Rittner/Kulka, § 6 at 49.
27 Art. 7 Guidelines.
28 Rittner/Kulka, § 6 at 47.
29 Notice of the Commission on the Definition of Relevant Market for the Purposes of Community Competition (97/C372/03), at 15–19.
Applying the demand and supply substitutability analysis to define a relevant product market, demand-related factors such as consumers shift purchases due to price change, the product’s overall characteristics and function, price variance and distribution channels and supply-related such as reaction of other suppliers to price change, difficulties of a production switch, the time required for a production switch, extra costs and risks associated with a production switch, the competitiveness of the products supplied after a switch and the distribution channels are to be considered.

Applying the demand and supply substitutability analysis to define a relevant geographic market, demand-related factors such as consumers potential shift to other geographic areas to purchase products caused by a price change, the product’s transportation cost and transportability, the actual regions in which the majority of consumers purchase their products and regional trade barriers, such as tariffs, local regulations, environmental factor, technological factor and supply-related factors such as other suppliers reactions over a price change and feasibility to supply or to distribute the relevant product from other geographic areas are to be considered. As the trade barriers suggest, a geographic market is likely to go beyond Chinese domestic market.

II. Major Issues

1. Monopoly Agreements

a) Prohibitions

Art. 13 AML encompasses an open-ended list of prohibited horizontal monopoly agreements: price fixing, restricting output or sales volume, division of sales markets or raw materials purchasing markets, restrictions on purchasing of new technology or new facilities or on the development of new technologies or products and joint boycotts. Bid-rigging, once provided in a draft, was removed from the final version of the AML and thus remains governed by the Unfair-Competition Law.

In terms of vertical agreements, art. 14 AML prohibits only resale price fixing and maintenance of minimum resale price. Distribution agreements are affected the most by this provision. Other restrictive trade practices, such as those used in selective distribution are not expressly barred. Nonetheless, China may claim credit for regulating vertical restrictions, the competitive impact of which is still a controversial issue, already in its first anti-monopoly statute after all. In addition, the SAIC may declare other types of vertical restraints illegal.

b) Exemptions

Art. 15 AML sets forth a non-exhaustive list of exemptions to all types of prohibited horizontal and vertical monopoly agreements:
– “technology cartel”: if the agreement serves the purpose of improving technologies, research and developing new products;
– “efficiency cartel”: if the agreement serves the purpose of improving product quality, reducing costs, promoting efficiency, unifying product specification and standard and carrying out professional division of labor;

30 Harris, 190.
Chapter 6. Antitrust

22 To claim such exemptions, the enterprise has to prove that market competition will not be severely restricted and the consumers may share the benefits derived from the agreement. These exemptions are designed to be self-executing, which means that businesses have to conduct self-assessment as to whether one of the exemptions is applicable in a specific case. Although discussed in the drafting process, the final version does not provide the possibility of prior notification and examination with the enforcement agencies.\(^{31}\) During the drafting process the legitimacy of nearly all the exemptions on this list was challenged.\(^{32}\) Whether the critiques are justified also depends to what extent the exemptions will be enforced vigorously and consistently. In any event, relevant guidelines and precedents are needed to give businesses more guidance and certainty.

2. Abuse of a Dominant Market Position

23 In the drafting process and after the enactment of the AML, discussion around the abuse of market dominance has been focusing on state-owned public utility companies\(^ {33}\), multinational retailers (supermarkets and chain stores)\(^ {34}\) and dominant IP holders\(^ {35}\), which appear to be the main enforcement target in this area for the moment. The issue of abuse of market power by retailers was addressed for the first time in 2006 by a regulation on fair trade of retailers and suppliers.\(^ {36}\)

a) Prohibitions

24 Art. 17 AML prohibits \textit{inter alia} imposition of unfairly high selling price or unfairly low purchasing price and without justification selling products at prices below cost, refusal to deal, restricting other party to choose trade partners, discriminatory treatment toward trade partners with equal standing. Also this list is subject to critiques, which centered on the economic justification for these limitations and the practical difficulties in finding a “fair” price.\(^ {37}\)

b) Market Dominance

25 The market dominance is legally presumed in the following cases: a single enterprise has a market share of at least 50\% in the relevant market; two enterprises

\(^{31}\) Harris, 193–194.
\(^{32}\) Bu, § 23 at 16 with further reference; Harris, 191–194; Huo, 47–49.
\(^{34}\) Xu/Tang, 35–39.
\(^{35}\) Howell et al, 74–77.
\(^{36}\) (零售商供应商公平交易管理办法), promulgated by Ministry of Public Security, MOFCOM, NDRC, STA and SAIC on October 13, 2006, entered into force on November 15, 2006.
\(^{37}\) Harris, 202–210.
have jointly a market share of at least 2/3; three enterprises have jointly a market share of at least 3/4. This legal presumption based on market share is allowed to be rebutted by countervailing evidence. In addition, an enterprise with a market share of less than 1/10 is excluded from being established as having a dominant market position in any event.

Although market share plays a dominant role in determining market dominance, art. 18 AML also enumerates other factors to be considered such as competitiveness of the relevant market, control of upstream and downstream markets, financial power and technical advantages, dependency of other business operators and market entry barriers, which enables the determination of market dominance even absent a significant market share.

3. Intellectual Property Rights (IPR)

Art. 55 AML states “The AML is not applicable to conduct of a business operator to exercise its IP rights in accordance with relevant IP laws and administrative regulations; however, the AML is applicable to abuse of the IP rights of a business operator eliminating or restricting competition.” Although the AML contains only this IPR-related provision, the relevant discussion on a likely curtailment of IPR by the emerging Chinese antitrust regime in form of nullifying a patent or granting compulsory license sparked considerable concerns among multinational, particularly U.S. high-tech enterprises in the drafting process.  

Chapter 6 of the Chinese Patent Law deals exclusively with the issue of compulsory license. During the last amendment of Patent Law in 2008 compulsory licensing regime has also undergone substantial changes, partly to accommodate the implementation of art. 55 AML. The State Intellectual Property Office (SIPO) is now explicitly authorized by art. 48 Patent Law to grant a compulsory license (1) in the event of a non-use or insufficient use of the patent without legitimate reasons in the first three years upon grant of the patent and four years have elapsed from the submission of the patent application or (2) as a measure to eliminate or mitigate the anticompetitive impact of an abusive conduct of the patentee. Although art. 48 (1) AML has its origin in Art. 5 A (4) Paris Convention, its wording is still very broad compared to art. 24 para. 1 German Patent Act, which requires public interest as a key element for granting compulsory license for “unworked” patents. The U.S. patent law even generally rejects the notion of mandatorily requiring the patentee to implement its patent. In addition, a compulsory license is available in China if a national emergency or public interest requires. In particular, a pharmaceutical patent may be subject to a compulsory license for public health purpose.

A compulsory license may be granted only on a non-exclusive basis and against the payment of an appropriate license fee, the amount of which is subject to negotiations of the patentee and the licensee. If the parties fail to reach an agreement in this regard, the SIPO may adjudicate this issue and order an amount. Other terms of a compulsory license such as the scope and duration are to be stipulated by the SIPO in conjunction with the order of granting such

38 Harris, 227–228.
39 Art. 50 Patent Law.
40 Art. 56 Patent Law.
41 Art. 57 Patent Law.
license.\(^{42}\) As a principle, a compulsory license shall predominately serve to meet the demand of the domestic market, unless it is granted as a remedy to violation of the AML or for public health purpose.\(^{43}\) Judicial review is available to decisions to grant a compulsory license and adjudications of the amount of the licensing fee.

Far before the adoption of the AML, the possible anticompetitive agreements in licensing contracts have already drawn Chinese legislator’s attention. A rudimentary regulation regime has evolved over time, which will be addressed later on in this book (infra Chapter 10 at 105 et seq.).

4. Administrative Monopolies

a) Prohibitions

Chapter V of the AML is solely dedicated to the issue of administrative monopolies (行政垄断), a term commonly referred to government restraints. According to art. 32 and 33 AML government agencies are prohibited from imposing restrictions on purchasing products from other regions and inflow of products from other regions by the way of price discrimination, discriminative technical standards, and additional administrative permission as well as market access barriers. Neither is allowed to exclude or restrict non-local undertakings from participating in local tendering and bidding, from making investment or setting up branches and to issue anticompetitive orders and to compel enterprises to commit anticompetitive conduct (art. 34–37 AML).

b) Enforcement

Administrative monopolies are a byproduct of the decentralization of the national economy in China carried out since 1978, in the course of which local governments obtained incentives to foster local economy and bolster tax revenues by protecting local champions from inter-regional competition. This usually results in the distortion of prices and resource allocation.\(^{44}\) Other forms of administrative monopolies include cartels organized by trade associations and anticompetitive conduct of regulators in government administered industries (supra at 8).\(^{45}\)

Although the currently prohibited forms of administrative monopolies were and still remain commonplace in China and the notion to curb the abuse of administrative power restricting competition between regions was widely accepted, the question was raised as to whether the AML is the right place to deal with it.\(^{46}\) Chapter V was even once completely carved out from the draft.\(^{47}\) Therefore, the incorporation of administrative monopolies can be viewed as a victory, albeit a symbolic one, achieved only by overcoming considerable resistance.\(^{48}\) It shows China’s determination and aspiration to establish a unified market inside the country.\(^{49}\)

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\(^{42}\) Art. 55 para. 2 Patent Law.

\(^{43}\) Art. 53 Patent Law.

\(^{44}\) Salil/Meng, 399–401.

\(^{45}\) Owen et al, 130–131.

\(^{46}\) Salil/Meng, 420; Wang (2004), 293–294.

\(^{47}\) Harris, 187–188, 214–216.

\(^{48}\) Huo, 50–51.

\(^{49}\) Salil/Meng, 411, “it [AML] is an antitrust law that also doubles as a free-trade agreement for China’s national-level market.”
From a functional perspective, the provisions on administrative monopolies are comparable to the Dormant Commerce Clause of the U.S. Constitution and the Article 81 of the EC Treaty (Treaty Establishing the European Community).\textsuperscript{50} In this regard, AML surely goes beyond the reach of conventional competition law in other developed economies with private action, not state action as the main enforcement target. However, this divergence alone does not necessarily argue against the incorporation of administrative monopolies into the AML. Critiques are primarily focusing on the weak enforcement mechanism.\textsuperscript{51}

According to art. 51 AML, in case of a government restraint the superior authority may order to rectify and impose disciplinary penalties on the direct responsible persons. The SAIC and its local agencies at the province level may merely make recommendation in this regard. This enforcement arrangement, which almost entirely defers to superior authorities, is less satisfactory and predetermines that the positive effects of the AML combating administrative monopolies will be limited.

c) Trade Associations

The AML addresses trade associations at two places: Art. 11 AML provides that trade associations shall enhance self discipline of the relevant industries and safeguard the market competitive order. Art. 16 AML prohibits trade associations initiating cartels among their members. To understand the legislator’s intention behind these two provisions, one must be aware of the unique background of the evolution of trade associations in China. Trade associations (行业协会) in the sense of art. 11, 16 AML refer to organizations many of which are used to be government agencies responsible for regulating certain industry sectors and were converted into self-governing bodies in the course of deregulation of centrally planned economy.\textsuperscript{52} The prominent ones such as China National Light Industry Council and China Textile Association are still funded by tax revenues, vested with administrative power and have the competence to issue regulations binding for their members.

By its nature, trade associations may very well attempt to engage in price fixing to avoid price war – prevalent in some industries in China – among their members, as they did in the past from time to time, occasionally even with government support.\textsuperscript{53} This is why trade associations adopting such price cartels neither considered this conduct illegal nor hesitated to make such decisions public.\textsuperscript{54} This activity is now outlawed by art. 16 AML. However, if a cartel is justified under one of the exemptions set forth by art. 15 AML, art. 11 AML offers policy room to accommodate such concern. The AML does not provide for specific exemptions tailored to trade associations.\textsuperscript{55}

Although not explicitly mentioned in the AML, it is conceivable to subject trade associations to Chapter V of the AML instead of Chapter II regarding cartels in the case of abusing administrative power. In case that a trade association engages in illegal cartels, both the trade association and its members may be sanctioned separately. The trade association may be imposed a fine up to RMB 500,000 and even be dissolved.

\textsuperscript{50} Howell et al., 86.
\textsuperscript{51} Salih/Meng, 394.
\textsuperscript{52} Howell et al, 87–88; Owen et al, 129; Zhang, 37–38.
\textsuperscript{53} Lu, 137–139; Zhang, 40–41; Liang, 95, in particular with respect to insurance industry.
\textsuperscript{54} Lu, 138.
\textsuperscript{55} Recommendations in this respect: Lu, 141–142.
5. Merger Control

Recently, the legal regime governing merger control in China has undergone significant developments. Most notably, the 2009 amendments to the 2006 M&A Regulations\(^{56}\) deleted the entire chapter in the M&A Regulations pertaining to anti-monopoly review,\(^{57}\) with the purpose and effect to resolve inconsistencies between the M&A Regulations and the AML and to clearly establish the AML as the primary body of law governing anti-monopoly review. Basically, the old merger control rules contained in the M&A Regulations have been replaced by those of the AML, the Provisions of the State Council on Thresholds for Reporting of Concentrations of Undertakings (hereinafter: Concentration Reporting Provisions),\(^{58}\) the Guiding Opinions on Reporting of Concentrations of Undertakings (hereinafter: Concentration Reporting Opinions)\(^{59}\) and other guidelines for the filing and review procedures.\(^{60}\) In addition to the 2009 amendments, the MOFCOM has also released a series of draft interim measures for public comment in an attempt to clarify certain procedural matters.\(^{61}\)

As a result of these recent legal developments, it is anticipated that a more consistent, reliable and functional merger control mechanism will take shape in China over the next few years.

a) Government Agency

Under the M&A Regulations, both the MOFCOM and the SAIC were concurrently responsible for merger control. However, since the 2009 amendment to the M&A Regulations, the MOFCOM has exclusive authority. Within the MOFCOM, the Anti-Monopoly Bureau of the MOFCOM (Anti-Monopoly Bureau) is the concrete responsible department.

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\(^{56}\) Regulations on Acquisition of Domestic Enterprise by Foreign Investors (关于外国投资者并购境内企业的规定), jointly promulgated by the MOFCOM, SASAC, STA, SAIC, CSRC and SAFE on August 8, 2006, and entered into force on September 8, 2006 (2006 M&A Regulations).

\(^{57}\) Art. 1 of the MOFCOM Decree No. 6 [2009] (商务部令2009年第6号), issued and entered into force on June 22, 2009.

\(^{58}\) (国务院关于经营者集中申报标准的规定), promulgated by the State Council on August 3, 2008, and entered into force on the same day.

\(^{59}\) (关于经营者集中申报的指导意见), promulgated by the MOFCOM on January 5, 2009, and entered into force on the same day.

\(^{60}\) These guidelines include: Guiding Opinions on Documents and Materials Required for Reporting of Concentrations of Undertakings (关于经营者集中申报文件资料的指导意见), promulgated by the MOFCOM on January 5, 2009, and entered into force on the same day; Working Guidelines on Anti-monopoly Review for Concentrations of Undertakings (经营者集中反垄断审查办事指南), issued by the MOFCOM on February 13, 2009; and Methods for Computing Turnover for Reporting of Concentrations of Undertakings in Financial Industry (金融业经营者集中申报营业额计算办法), jointly promulgated by the MOFCOM, PBC, CBRC, CSRC and CIRC on July 15, 2009, and entered into force on August 15, 2009.

\(^{61}\) These draft interim measures include: Interim Measures for Review of Concentrations of Undertakings (经营者集中审查暂行办法); Interim Measures for Reporting of Concentrations of Undertakings (经营者集中申报暂行办法); Interim Measures for Investigation and Handling of Concentrations of Undertakings under Filing Thresholds but Suspected as Monopoly (关于对未达申报标准涉嫌垄断的经营者集中调查处理的暂行办法); Interim Measures for Evidence Collection regarding Concentrations of Undertakings that are under Filing Thresholds but Suspected as Monopoly (关于对未达申报标准涉嫌垄断的经营者集中证据收集的暂行办法); Interim Measures for Investigation and Handling of Concentrations of Undertakings that are Not Reported as Required by Law (关于对未依法申报的经营者集中调查处理的暂行办法). Published on the website of the MOFCOM.
b) Definition of Business Concentration

Both the AML and the Thresholds Provisions define a “business concentration” as any of the following: (i) a merger; (ii) obtaining control over another business entity through acquisition of an equity interest or assets; or (iii) obtaining control or the power to exercise decisive influence over another business entity through the use of contractual means or other such means.

The AML does not provide a definition of “control”, but the draft Interim Measures for Reporting of Concentrations of Undertakings (hereinafter: Draft Concentration Reporting Measures) defines “control” as either: (i) acquiring over 50% of the voting shares or assets of another business entity; or (ii) possessing, through acquisition of an equity interest or assets or contractual means or otherwise, the power to (a) determine the appointment of one or more of the members of the board of directors and the key management personnel of another business entity or (b) determine the financial budget, operation, sales, pricing, material investment or other major management or operation policies of another business entity.62 While an effort has been made to define the concept of “control,” the concept of “decisive influence” remains undefined in both the AML and the Draft Concentration Reporting Measures.

The definition of “business concentration” was drafted in such a way as to include offshore transactions as well as domestic transactions in the scope of the AML. The AML grants extraterritorial jurisdiction to the Chinese government to carry out review of any foreign-to-foreign offshore transaction that meets the filing thresholds or restricts or restrains competition in China.63

c) Filing Obligation

Generally speaking, if a proposed transaction meets thresholds for merger control, the parties are required to seek a prior approval from the MOFCOM.64 However, there are exemptions to this requirement, such as (i) one party to the transaction possesses 50% or more of the voting shares or assets of every other party to the transaction; or (ii) one business entity that is not a party to the transaction possesses 50% or more of the voting shares or assets of every party involved in the transaction.65

Failure to seek the mandatory MOFCOM approval may be sanctioned by the Anti-Monopoly Bureau in the form of termination and/or unwinding the transaction or imposition of other measures to restore the pre-merger conditions66 and of fines of up to RMB 500,000.67 Additionally, the parties to the merger may be held liable to third parties for any losses attributable to the unapproved business concentration.

d) Filing Thresholds

Filing thresholds as defined in the Thresholds Provisions are based on the turnover of the parties to a merger. A mandatory filing obligation is triggered if:

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62 Art. 3 para. 1 of the draft Interim Measures for Reporting of Concentrations of Undertakings.
63 Art. 2 AML.
64 Art. 21 AML.
65 Art. 22 AML.
66 Art. 48 AML.
67 Ibid.
the combined worldwide turnover of all parties to the transaction exceeds RMB 10 billion in the preceding fiscal year, and the turnover within China of at least two of the parties exceeds RMB 400 million each in the preceding fiscal year; or
– the combined turnover within China of all parties to the transaction exceeds RMB 2 billion in the preceding fiscal year, and the turnover within China of at least two of the parties exceeds RMB 400 million each in the preceding fiscal year.68

The concept of “turnover” has been clarified by the Draft Concentration Reporting Measures as revenues net of taxes (other than enterprise income tax and deductible value-added tax). The concept of “turnover within China” is defined in the same draft measures as revenues generated from buyers of products and services located within China (excluding HK, Macao and Taiwan).69 In addition, any calculation of turnover for a party should include turnover from (i) all affiliates of such party, and (ii) all entities which are under the common control of any two or more than two of such party and the affiliates of such party.70

Roughly one year after the promulgation of the Thresholds Provisions, a guideline was jointly issued by the MOFCOM, PBC, CBRC, CSRC and CIRC on the special methods for calculating the turnover of entities in banking, securities, futures, funds, insurance and other sectors of financial industry for the purposes of this threshold analysis.71

These new threshold requirements represent a considerable improvement over those contained in the 2006 M&A Regulations.72 First, the new thresholds require that at least two parties to a transaction have a certain scale of business operations within China. By contrast, pursuant to the old thresholds, the business activities within China of one party alone could trigger a filing requirement. Second, under the M&A Regulations, there was a second alternative test that was based upon the market share of the parties to the transaction. As it was hard to predict the applicability of this market share test, it created a significant amount of legal uncertainty. The Threshold Provisions contains no such alternative test.

68 Art. 3 Thresholds Provisions.
69 Art. 4 of the draft Interim Measures for Reporting of Concentrations of Undertakings.
70 Art. 5 of the draft Interim Measures for Reporting of Concentrations of Undertakings. As per this article, an affiliate is referred to as an entity controlled by, controlling or under the common control of, such party.
71 The guideline referred to here is the Methods for Computing Turnover for Reporting of Concentrations of Undertakings in Financial Industry.
72 The anti-monopoly review chapter under the 2006 M&A Regulations applies to both onshore M&A scenario and offshore M&A scenario. As to the onshore M&A scenario, any of the following thresholds triggers a merger control review: (i) any party to a transaction and all its affiliates together had turnover of more than RMB 1.5 billion from the Chinese market in the most recent year; (ii) the foreign investor and all its affiliates together have acquired more than 10 Chinese companies in related industries in the most recent year; (iii) any party to a transaction and all its affiliates together have a market share of 20% or more in China; or (iv) any party to a transaction and all its affiliates together would have a market share of 25% or more in China following the proposed acquisition. Whereas, in respect of the offshore M&A scenario, the thresholds include any of the following: (i) any party to a transaction has assets of more than RMB 3 billion in China; (ii) any party to a transaction had turnover of more than RMB 1.5 billion from the Chinese market in the most recent year; (iii) any party to a transaction and all its affiliates together have a market share of 20% or more in China; (iv) any party to a transaction and all its affiliates together would have a market share of 25% or more in China following the proposed transaction; or (v) the proposed transaction would result in one party to the transaction holding, directly or indirectly, equity interests of more than 15 FIEs in related industries in China.
Notwithstanding the thresholds above, the MOFCOM has the discretion to investigate any transaction, even those that fall below the filing threshold, if such a transaction is believed to restrain or restrict competition in China. It remains unclear whether a transaction that does not meet the threshold requirements can be reviewed after it is completed.

e) Standard of Review

While conducting merger control, the MOFCOM is legally bound to principally analyze (i) whether the business concentration following the completion of the transaction has or is likely to have the effect of restraining or restricting competition; (ii) whether the favorable impact of the business concentration on competition outweighs its potential adverse impact; and (iii) whether the business concentration is in the public interest.

In addition to the basic principle, the AML generally sets forth the following factors to be taken into account:
- the market share of each transaction party in the relevant market and their control power over the market;
- the degree of concentration in the relevant market;
- the impact of the business concentration on market entry and technology improvement;
- the impact of the business concentration on consumers and other related business operators; and
- the impact of the business concentration on the development of national economy.

Furthermore, the AML, by inserting a catch-all clause, has granted the MOFCOM a broad discretion to examine any additional factors it deems appropriate for its review.

f) Filing Procedure

Below is a summary of the typical merger control based on existing guidelines (issues covered by the draft interim measures are also noted):

Step 1: Preparation for Filing

The preparation phase can be divided into the following sub-steps:

(i) Identification of the reporting party. Which party or parties of a transaction is required by law to make the filing is dependent on the type of the potential business concentration caused by the proposed transaction. Where the business concentration is conducted by way of a merger, all parties to the merger shall be responsible for the reporting. If the concentration is conducted by other means, the party that is in control of or is able to exercise a decisive influence over the transaction shall be responsible for submitting the filing to the MOFCOM although the other parties are required to co-operate with the filer to complete the submission.
(ii) **Preparation of filing documents and information.** The reporting party should start preparing the filing and supporting information once it is determined that the transaction meets one of the filing thresholds. Generally, the filing shall include: (i) a cover letter with general information about the transaction and the parties involved; (ii) documents that identify the reporting party (e.g., business license); (iii) an assessment of the impact of the business concentration on competition in the relevant market; (iv) the proposed agreements and/ or documents governing the business concentration; and (v) the audited financial statements of all of the parties for the preceding financial year.77

(iii) **Discussion with the Anti-Monopoly Bureau.** The reporting party may, by written application, make an appointment with the Anti-Monopoly Bureau to discuss issues pertaining to the business concentration.78 While not obligatory, such a meeting is strongly advised because these meetings provide the reporting party with greater clarity regarding filing thresholds, reporting requirements and procedural matters. More importantly, these initial meetings may provide the reporting party with insights on the internal views of the MOFCOM.

**Step 2: Filing and Acceptance**

56 Following Step 1, the reporting party will submit the filing to the Anti-Monopoly Bureau through the Administrative Service Centre of the MOFCOM.79 Upon receipt of the filing, the Anti-Monopoly Bureau issues a Form of Registration of Information regarding Anti-Monopoly Filing for Concentration of Undertakings, but the issuance of this form does not implicate that the submitted documents and information comply with the statutory requirements.80 The Anti-Monopoly Bureau still has the right to refuse to accept the submission if the filing fails to meet the statutory and regulatory requirements. Even if an acceptance of a filing has been issued, the Anti-Monopoly Bureau may revoke such acceptance in the event the reporting party deliberately withholds material information or provides false information.81

57 If filing is deemed to be incomplete or inaccurate, the reporting party has an opportunity to submit missing documents or information, or revise, clarify or explain the same by a deadline set by the Anti-Monopoly Bureau on a case-by-case basis.82

58 A mechanism for withdrawal of an AML filing is proposed by the draft Interim Measures for Review of Concentrations of Undertakings (hereinafter: Draft Concentration Review Measures). Such a request as proposed must be made in writing and is subject to MOFCOM’s approval. If a filing is withdrawn, the review process is terminated. However, the MOFCOM’s consent to withdraw an AML filing cannot be deemed as an approval of the business concentration.83

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77 Art. 23 AML; art. 8 Concentration Reporting Opinions; for detailed requirements and explanations: Guiding Opinions on Documents and Materials Required for Reporting of Concentrations of Undertakings.
78 Art. 1 Concentration Reporting Opinions.
79 Section of Procedures, Working Guidelines on Anti-monopoly Review for Concentrations of Undertakings. It is advised by the Anti-Monopoly Bureau that a reservation be made prior to the filing (Art. 4 Concentration Reporting Opinions).
80 Art. 5 Concentration Reporting Opinions.
81 Art. 6 Concentration Reporting Opinions.
82 Art. 14 AML; art. 6 Concentration Reporting Opinions.
83 Art. 3 Draft Concentration Review Measures.
Step 3: Preliminary Review

According to the AML, the Anti-Monopoly Bureau has a specific timetable for a preliminary review. Specifically, the Anti-Monopoly Bureau has thirty days to decide whether or not to conduct further review of a particular business concentration. This statutory timetable commences only upon the Anti-Monopoly Bureau’s acceptance of the filing.84

The preliminary review decision shall be issued in writing to the reporting party. A transaction involving a business concentration that meets the threshold requirements may not proceed before obtaining clearance from the Anti-Monopoly Bureau. Nevertheless, if the Anti-Monopoly Bureau determines within the 30-day preliminary review period that a further review is unnecessary, or it fails to issue a preliminary decision within this period, the parties are free to proceed with the transaction.85

Step 4: Further Review and Final Decision

If the Anti-Monopoly Bureau determines further review is necessary, the approval (or denial) of a business concentration is required to be made within ninety days of the issuance of the preliminary determination.86 This 90-day period is subject to an extension of no more than 60 days under certain circumstances.87 If the Anti-Monopoly Bureau does not issue a final decision within the required time period, the business concentration may proceed.88

With respect to the review process, the Draft Concentration Review Measures provide specific procedural arrangements for a number of important aspects pertaining to the review process. According to the Draft Concentration Review Measures, the reporting party has the right to defend its positions before the MOFCOM or submit additional briefs in support of their position.89 The MOFCOM may also solicit opinions from third parties, including other government agencies, trade associations, business entities and consumers,90 and sponsor public hearings to collect evidence opinions from relevant parties.91 Finally, in the event that the MOFCOM determines to issue a conditional approval, the parties may propose, amend and discuss with the MOFCOM any such conditions that the MOFCOM wishes to be imposed on the business concentration.92 While these codified procedural rights remain in draft form, many have already been adopted, to some extent, by the Anti-Monopoly Bureau.

There are three different types of final decisions: prohibition, approval or conditional approval.93 All final decisions are issued to the reporting party in writing but only denials and conditional approvals are publicly announced.

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84 Art. 25 AML.
85 Ibid.
86 Art. 26 para. 1 AML.
87 Art. 26 para. 2 AML. Such circumstances includes: (i) the partied involved in the transaction consent to the extension; (ii) the submitted documents and information are inaccurate and thus need further verification; and (iii) material changes occur to the parties after the filing.
88 Art. 26 para. 2 AML.
89 Arts. 5 and 10 Draft Concentration Review Measures.
90 Art. 6 Draft Concentration Review Measures.
91 Arts. 7 and 8 Draft Concentration Review Measures.
92 Arts. 11, 12 and 13 Draft Concentration Review Measures.
93 Arts. 28 and 29 AML.
g) Practice

During the period from August 1, 2008 (when the AML became effective) to June 30, 2009, the MOFCOM received fifty-eight business concentration filings. Of these, forty-six cases had been completed as of June 30, 2009. Of the forty-six completed cases, forty-three were unconditionally approved, two were conditionally approved and one was prohibited. As final approvals are not announced publicly, there is little detailed information available for the forty-three cases that were unconditionally approved during this time period. However, the published decisions for the remaining three cases provide valuable insight into the approval process and the approach the MOFCOM may take in the future to similar situations.

(1) Coca-Cola/Hui Yuan Case. The acquisition of 100% of the equity of China Hui Yuan Fruit Juice (Group) Co., Ltd. ("Hui Yuan") by Coca-Cola Company ("Coca-Cola") is to date the single M&A transaction that has been blocked by the MOFCOM’s anti-monopoly review since the AML entered into force.

Coca-Cola made its business concentration filing on September 18, 2008 and the filing was officially accepted by the MOFCOM for preliminary review on November 20, 2008. During the review, the MOFCOM conducted a series of investigations to examine potential monopoly power Coca-Cola could amass due to the proposed acquisition of Hui Yuan. Furthermore, the MOFCOM held several discussions with Coca-Cola seeking solutions to eliminate potential anti-competitive effects of the Hui Yuan acquisition. However, solutions proposed by Coca-Cola failed to alleviate the MOFCOM’s concerns. The MOFCOM also solicited the opinions of interested parties by sponsoring forums, public hearings, field investigations, third party investigations and communications with relevant government authorities, trade associations, upstream suppliers, fruit juice distributors and industry experts.

During the review, the MOFCOM attached special significance to the following factors:
- the market shares of Coca-Cola and Hui Yuan in the Chinese fruit juice market and their resulting dominance over the market;
- the degree of concentration in the Chinese fruit juice market;
- the influence that this business concentration might have on future market entry and technology development;
- the impact of the acquisition on consumers and other relevant third parties;
- the impact of the business concentration on the national economy; and
- the impact of Coca-Cola’s acquisition of the “Hui Yuan” brand on competition in the Chinese fruit juice market.

On the basis of the study of these factors, the MOFCOM came to the following final conclusions:
- following the acquisition, Coca-cola would be in a position to leverage its pre-existing dominant position in the carbonated beverage market, and this would

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II. Major Issues

result in an unfair exclusion of existing Chinese fruit juice competitors from the market, restrain further market competition and be detrimental to the interests of consumers;

– the acquisition would give Coca-Cola control of the prominent Hui Yuan brand and consequently allow Coca-Cola to gain such control over the fruit juice market as to ultimately prevent potential future competitors from entering into China’s fruit juice market; and

– the acquisition would harm small and medium-sized domestic fruit juice producers, limit their participation in the market and reduce innovation in the market.

As a result, efficient competition in China’s fruit juice beverage market and the sustained and healthy development of China’s fruit juice industry would be adversely affected.

These conclusions led to the MOFCOM’s final decision to prohibit the proposed acquisition to avoid what was determined to be an anti-competitive business concentration.

The announcement of the MOFCOM’s decision in this case immediately roused extensive interest and discussions. Some commentators claimed that the MOFCOM’s decision was a result of public pressure in China, while others said that it was influenced by such factors as political concerns, the global financial crisis and national protectionism. Obviously the decision was, to some extent, affected by pressures within China. In practice, such pressures may not always come from the public media, but be directly conveyed to the MOFCOM through its consultations with the domestic competitors, and this source of pressure may be more influential than public outcry.

There are also commentators who believe this case demonstrates the MOFCOM’s new approach to anti-monopoly review in that the MOFCOM took into consideration the actual and post-acquisition conditions of China’s fruit juice market rather than simply relying on the current market share indices. Regarding the new approach, they believe that the prominence of the Huiyuan brand was the key factor of the MOFCOM’s decision to block the acquisition. However, it seems unclear whether the MOFCOM considered this factor based on the broad discretion granted by the AML in business concentration review. It is arguable that the Huiyuan brand concern is actually a part of the national economic security review which is completely different and independent from the business concentration review. If this is the case, it is doubtful that there were massive political considerations involved in this decision that may have overridden or trumped the economic analysis involved, or at least, the political considerations may have been over emphasized in this case.

(2) InBev/Anheuser Busch Case. The acquisition of Anheuser-Busch Companies Inc. (“AB”) by Inbev N.V./S.A. (“Inbev”) constitutes the first published merger control

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99 Ibid.
Chapter 6. Antitrust

Inbev is the worldwide largest beer producer based in Belgium and has the largest market share in the beer industry in both Fujian and Zhejiang Provinces. AB is an American company which had a total investment of over RMB 14.6 billion in Tsingtao Brewery Co., Ltd. (Tsingtao Brewery) and Harbin Brewery Co., Ltd. (Harbin Brewery) and its own Wuhan subsidiary. Tsingtao Brewery and Harbin Brewery are China’s two top beer producers. As the revenue of Inbev and AB within China in 2007 (RMB5.76 billion and RMB4.49 billion respectively) had reached the filing thresholds, Inbev submitted the business concentration filing to the MOFCOM on September 10, 2008. The filing was officially accepted by the MOFCOM on October 27, 2008 following three supplemental filings made by Inbev.

The MOFCOM approved the transaction under following conditions on its approval in order to avoid potential damaging anti-competitive results of the transaction:
- AB’s existing 27% equity in Tsingtao Brewery shall not be increased;
- In the event the controlling shareholders of Inbev or any shareholder of said controlling shareholders are changed, the change shall be reported to the MOFCOM promptly;
- Inbev’s existing 28.56% equity in Guangzhou Zhujiang Brewery Group Co. Ltd. shall not be increased; and
- Inbev shall not seek to acquire any equity of China Resources Breweries Co., Ltd. or Beijing Yanjing Brewery Co., Ltd.

Although to-date the MOFCOM has not disclosed the quantitative analysis with which its final decision was made in this case, according to some experts in the beer industry, the business concentration between Inbev and AB would have enabled the post-business acquisition entity to hold over 50% of China’s beer market.

(3) Mitsubishi Rayon/Lucite Case. In the acquisition of Lucite International Group Ltd. (“Lucite”) by Mitsubishi Rayon Co. Ltd. (“Mitsubishi Rayon”), the MOFCOM approved the transaction subject to the following conditions:
- Lucite would spin off half of its PRC production capacity and sell Methylmethacrylate (“MMA”) products at cost to an unaffiliated third party within five years;
- The PRC-based MMA business of the two parties would be operated independently of one another until Lucite completed this spin-off of its production capacity; and

103 Ibid.
Mitsubishi Rayon would not set up new factories to manufacture certain types of MMC products or acquire manufacturers of such MMC products in the PRC within five years of the closing of the transaction. These conditions are aimed to address the following concerns:

- both of these companies had high market shares in the MMC industry;
- the proposed transaction would increase this degree of market concentration; and
- Mitsubishi Rayon would acquire a dominant position in the MMC industry resulting in a vertical monopoly.

Compared with the InBev/Anheuser Busch case, this publicly announced decision revealed much more detailed information regarding the MOFCOM’s underlying rationale. This may demonstrate the MOFCOM’s active response to the public’s demand for greater transparency and also its greater maturity in handling merger reviews. It is to note that the published decision contains a separate section about the relevant market. This section provides a brief analysis of the overlapping businesses of these parties within the territory of China. Another highlight of the decision is that the MOFCOM analyzed the impacts of business concentration on both horizontal and vertical markets. This focus on the relevant market and the horizontal/vertical market analysis was not included in the two other published decisions. This inclusion may indicate the MOFCOM’s gradual move towards conducting merger control reviews by using a more detailed analytical methodology.

6. Investigation

As to the investigation procedure regarding cartels and administrative monopolies, two regulations were issued on June 5, 2009 by the SAIC – Procedural Provisions for Investigating Monopoly Agreement and Abuse of Dominant Position Matters (工商行政管理机关查处垄断协议滥用市场支配地位案件程序规定) and Procedural Provisions for Prohibiting Abuse of Administrative Power to Eliminate and Restrict Competition (工商行政管理机关制止滥用行政权力排除限制竞争行为程序规定). The procedural rules of the MOFCOM and NDRC regarding merger review (supra at 39) and price-related anticompetitive conduct have also been circulated for public comments.106

a) Competence

With respect to monopoly agreement and abuse of market dominance, the SAIC may initiate an investigation procedure on its own initiative or based on voluntary reports, transferral from other agencies and delegation of superior authorities. The SAIC may conduct the investigation by itself or authorize, on a case by case basis, a provincial AIC to handle the case (including investigation and handing down the punishment decision), if the conduct takes place in one province or primarily in one province. The provincial AIC is not allowed to further delegate the investigation to AICs below province level. The rationale behind it is the intent to ensure somehow unified application of the AML and avoid potential local protectionism. For cases directly handled by the SAIC, actual investigation works may be carried out by an AIC.

105 Both regulations have entered into force on July 1, 2009.
at or below province level, which has easy access to the evidence, based on authorization of the SAIC, however the power to make decision remains with the SAIC.\textsuperscript{107}

With respect to administrative monopolies, the SAIC has the competence to make enforcement recommendations to the State Council in cases where the initiator is a department of State Council or a Provincial government. In case that the initiator is below this level, an AIC of the province may make suggestion to superior authority of the initiator.

b) Investigation Powers

The investigation powers of enforcement agencies are enumerated in art. 39 AML, which include the powers to conduct house search, to interrogate related persons, to investigate and duplicate relevant files and documents such as contracts, accounting records, correspondence, electronic data, to seize and retain evidence, to examine bank accounts of the suspect violator and to require additional documents. The enforcement agencies have discretion to temporarily suspend the investigation procedure in case that the investigation target undertakes to remedy the anticompetitive effects. The investigation may be reopened if the violator fails to fulfill the undertaking or the circumstances based on which the suspension was ordered have substantially changed or if the order was made based on incomplete or false information delivered by the violator.\textsuperscript{108}

c) Publication of Decisions

Art. 44 AML allows the enforcement agencies to publish the decision of punishment in case that an anticompetitive conduct is established. Making decisions publicly available may on one hand help to build on case law and on the other hand create certain deterrent to similar attempts of other firms.\textsuperscript{109}

7. Sanctions

a) Administrative Penalties

For violations against monopoly agreements and abuse of market dominance, the SAIC/NDRC may require the violator to cease the conduct, confiscate the illegal gains reaped from the conduct and impose fines between 1 % and 10 % of total annual turnover of the preceding year.\textsuperscript{110} However, the exact meaning of turnover remains to be clarified. In the case of unauthorized mergers, the MOFCOM may order the participants to restore the situation prior to the transaction in addition to fines up to RMB 500,000,\textsuperscript{111} which is actually a small amount in most of cases given the threshold for merger filings. Fines are to be fixed in accordance with the nature, extent and duration of the anticompetitive conduct.\textsuperscript{112}

\textsuperscript{107} Art. 9 para. 1 Procedural Provisions for Investigating Monopoly Agreement and Abuse of Dominant Position Matters
\textsuperscript{108} Art. 45 para. 3 AML; Critique see Harris, 221.
\textsuperscript{109} Owen et al, 144–145.
\textsuperscript{110} Arts. 46 para. 1 and 47 AML.
\textsuperscript{111} Art. 48 AML.
\textsuperscript{112} Art. 49 AML.
b) Civil Liability

An aggrieved party may claim damages caused by an anticompetitive conduct from the violator according to art. 50 AML. However, no injunctive relief is expressly provided for in case of civil action. A judicial interpretation dealing with the issues of jurisdiction, standing, injunction, damages and fact findings is now under deliberation of the SPC. In the past, private parties have already been able to avail themselves of civil lawsuits to recover for alleged violations of other existing competition-related provisions, such as patent and know-how licensing contract law (infra Chapter 10 at 105) and Anti-Unfair Competition Law. Several civil actions were also filed against administrative monopolies on the first day following the implementation of the AML. Taking these facts into account, private litigation appears to have the potential to develop into a major enforcement tool of the Chinese competition law regime. At least court may accept private litigations without the monopolistic conduct being established as illegal by any of the enforcement agencies, which encourages private parties to sue violators. However, it is unrealistic to believe that currently Chinese courts will take a leading role to break the entanglement of different ministries and challenge the large SOEs, given the lack of experience and training and the weak social standing of the judiciary.

c) Criminal Penalties

The AML does not impose criminal penalties on anticompetitive conduct, which constitutes a stark contrast to the U.S. competition law regime. A related party may be subject to criminal charges according to art. 53 AML only in cases where he refuses to co-operate in investigation proceedings, refuses to deliver documents or information, delivers false documents or information or destroys evidence.

d) Leniency Rules

Following the U.S. and EU model, art. 46 para. 2 AML also allows a reduction or exemption of the penalty in case a party involved in a monopolistic agreement reports the circumstances and provides material evidence to the enforcement agencies on its own initiative. The SAIC has introduced some detailed, albeit not comprehensive rules on the application of this leniency policy. An evidence is deemed material by the SAIC if it plays a determinative role in triggering the investigation or establishing the illegality of the monopoly agreement. The initiator of the cartel is not entitled to the lenient rule.

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113 For details: Jung/Qian, 162–166.
116 Qin (footnote 116).
117 Salil/Meng, 412.
118 Harris, 222.
119 Shen/Li, 66.
120 Art. 20 Procedural Provisions for Investigating Monopoly.
### III. Relevant Laws & Regulations

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### III. Relevant Laws & Regulations

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Chapter 7. Secured Transactions


I. Overview

Security rights under Chinese law essentially are guarantee (保证), charge (抵押), 1 pledge (质押), lien (留置), mortgage (让与担保), deposit (定金) and retention of title (所有权保留). The guarantee is a personal security right: the entire estate of the guarantor secures the fulfilment of the secured claim. Charge, pledge and lien are so-called real security rights (担保物权) – a legal term originating from the continental European legal system – by which the fulfilment of the claim is secured by the encumbered property, i.e. by immovable and movable properties as well as by certain rights. The deposit is a security right in money securing claims under a specific contract.

Most of these types of security rights have already been recognized by art. 89 of the General Principles of the Civil Law of 1986. In 1995, the Security Law was promul-
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gated, and the corresponding “Judicial Interpretation by the SPC on Some Issues regarding the Application of the Security Law of 2000” introduced more detailed rules on secured transactions. The most recent modification in this area has been the enactment of the Property Law of 2007, which consolidated and partly revised existing regulations on real security rights. While guarantee and deposit are still governed by the Security Law, charge, pledge and lien as real security rights are predominantly regulated by the Property Law. Where the provisions of the Security Law and Property Law regarding real security rights conflict with each other, the Property Law prevails. In addition, provisions regarding special security rights contained in special statutes such as the Negotiable Instruments Law or the Maritime Law generally also prevail over the more general provisions. Some security rights accepted in (legal) practice, such as mortgage and retention of title, are not specifically regulated. Due to the scope of this book, these security rights will not be discussed in this chapter. The treatment of security rights in insolvency proceedings is addressed later in this book (infra Chapter 8 at 98).

II. General Principles

1. Accessoriness of Security Right to Secured Claim

Security rights serve as a collateral for a limited or unlimited amount of claims, whether monetary or not. In Chinese law, they are deemed to be “accessory” to the claim they secure. “Accessoriness” – a concept adopted from the continental European law – implies that the validity and the terms of the security right depend on the validity and the terms of the secured claim. Applied to Chinese law, this means that the establishment, existence, disposition and extinction of these security rights are dependent upon the establishment, existence, disposition and extinction of the secured claim. Both the Security Law (art. 5) and the Property Law (art. 172) describe “accessoriness” with regard to the establishment and the existence of security rights as the accessoriness between the security agreement and the principal contract (主合同/主债权债务合同), i.e. the contract creating the secured claim; the security agreement stands or falls with the validity of the principal contract. This wording, however, is potentially misleading since it confuses the relationship between the security agreement and the secured claim with the relationship between the security agreement and the principal contract (though it is true that both will often correspond to each other). Furthermore, the secured claim could also be based on a statute and does not necessarily arise from a contract, such as a claim in tort. Under certain circumstances, art. 5 Security Law and art. 172 Property Law are to be interpreted as addressing the accessoriness of the security agreement to the secured claim. For example, these provisions do not cover the case of partial invalidity of the principal contract. The question in this case, i.e. whether the security agreement or the security right is valid or not, depends on the answer to another decisive question: Is the secured claim (or a relevant part of it) nevertheless validly established by a partially

1 (最高人民法院关于适用《中华人民共和国担保法》若干问题的解释), hereinafter: Judicial Interpretation of Security Law.
2 Art. 178 Property Law.
3 Pursuant to art. 177 no. 1 Property Law, the real security terminates when the principal claim is terminated; also Hu on art. 172.
invalid principal contract? If not, the security agreement is invalid as well; otherwise, the security agreement is valid despite the partial invalidity of the principal contract.

Pursuant to art. 5 Security Law, a security agreement may – in exceptional cases – remain valid despite the invalidity of the principal contract, provided that the parties have agreed on such independence of the security agreement from the principal contract. **Standby letters of credit** and **bank guarantees** on first demand may be cited as examples of such independent security rights. Both types are widely used in international trade and transactions. It was, and still is, intensely discussed in jurisprudence whether such independent security rights should only be used in international trade and transactions, or whether they may also be applied in trade and transactions within the Chinese domestic market. In its decision of 1998\(^4\), the Supreme People’s Court (SPC) stated that such independent security rights are not permitted for transactions within the Chinese domestic market (however, without a definition of such transactions). The Property Law, in addition, even rejects such independent security rights across the board, therefore also with respect to international trade. According to art. 172 para. 1 Property Law, the security agreement is strictly accessory to the principal contract unless otherwise provided by law. As stated by HU, the director of the Legislative Affairs Commission under the National People’s Congress Standing Committee (全国人大常委会法工委), lawmakers deliberately excluded this option to avoid misuse to the detriment of the security grantor if the grantor was to be responsible for a claim which in fact never existed.\(^5\)

Since charge, pledge and lien are governed by the Property Law, which prevails over the Security Law regarding these security rights\(^6\), they are strictly dependent on the existence of the secured claim. Guarantee and deposit, on the other hand, may be stipulated by the parties to a contractual agreement with respect to international trade and transactions to be independent of the secured claim according to the Security Law and the SPC’s legal practice.

Furthermore, the accessoriness of the security right to the secured claim also means that any amendment to, and/or disposition of, the claim will affect the security right, too. The transfer of the secured claim will usually entail the simultaneous transfer of the security right. With regard to real security rights, the termination of the secured claim will also usually result in the termination of the security right.\(^7\)

**2. Liabilities of Security Grantor**

In general, the grantor’s liabilities may be divided into two groups: 1) liabilities for the secured claim, i.e. if the debtor is in default of the secured claim, the creditor may enforce the security right in accordance with the security agreement and with relevant statutory provisions, and 2) liabilities for losses and damage suffered by the creditor due to the invalidity of the security agreement and/or the principal contract. Since the liabilities for the secured claim will be discussed later on with regard to each type of security right, the second group of the grantor’s liabilities will be addressed here first.

\(^4\) Hunan Machinery In- and Export (Group) Joint Stock Ltd. vs. Ningbo Dongfang Investment Joint Stock Ltd. (湖南机械进出口(集团)股份有限公司等与宁波东方投资有限公司代理进出口合同纠纷案), Judgement of SPC dated December 31, 1999 ((1998) 经终字第184号).

\(^5\) *Hu*, on art. 172.

\(^6\) *Supra* n. 2.

\(^7\) As regards real securities see art. 177 Property Law. Regarding guarantee *infra* at 42 *et seq.*
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7 Art. 5 para. 2 Security Law and art. 172 para. 2 Property Law in general stipulate that, if the security agreement is invalid, the parties to both the principal contract and the security agreement, i.e. the creditor, the debtor and the guarantor, shall bear due legal responsibilities proportionally according to the extent of the fault attributable to each of them for the invalidity of the security agreement. More details are provided by the Judicial Interpretation of Security Law, which also applies to art. 172 para. 2 Property Law:

8 (1) If the security agreement is invalid while the principal contract is valid and the creditor is not responsible for the invalidity of the security agreement, the would-be-grantor and the debtor will be jointly liable for any loss and damage caused to the creditor by the invalidity of the security agreement; if both the creditor and the would-be-grantor are at fault, the would-be-grantor’s liability will be limited to half of the outstanding portion of the secured claim which the debtor is not able to perform. The would-be-grantor is at default if he knew or should have known the invalidity of, or the cause for invalidity of, the security agreement; a lack of knowledge of the relevant legal provision due to which the security agreement is invalid cannot exculpate the parties to the security agreement from fault.

9 (2) If the security agreement is invalid due to the invalidity of the principal contract (i.e. because of the accessoriness of the security agreement to the principal contract) and the grantor is not at fault, i.e. he did not know and could not have known about the invalidity of the principal contract, he will not be liable for any claims of the would-be-creditor against the would-be-debtor. However, if the would-be-grantor is at fault, i.e. if he concluded the security agreement although he knew or should have known about the invalidity of the principal contract or the grounds for such invalidity, he will be held liable for up to one third of the outstanding portions of the claims of the would-be-creditor against the would-be-debtor arising from the invalidity of the principal contract, including the claim for repayment of the principal amount provided by the would-be-creditor performing the (invalid) principal contract and any claims for damages.

10 (3) With regard to his liability incurred vis-à-vis the creditor, the grantor may take recourse against the debtor.

11 However, if the principal contract is terminated by the parties to it, the guarantor nevertheless be liable for the creditor’s claims against the debtor arising from the termination of the principal contract unless otherwise agreed by the parties (Art. 10


9 Art. 7 Judicial Interpretation of Security Law.


12 Art. 8 Judicial Interpretation of Security Law.

13 Art. 8 Judicial Interpretation of Security Law; SPC 2005 (supra n. 11); Bank of China Branch Beijing vs. Lida Haiyangguan (中行北京分行诉利达海洋馆信用证垫款纠纷案), Judgement of the SPC dated February 2, 2004 ((2003) 民四终字第15号).

14 Art. 9 Judicial Interpretation of Security Law.
II. General Principles

Judicial Interpretation of Security Law.\textsuperscript{15} This provision is not to be regarded as an exception to the general principle stated in Art. 5 para. 2 Security Law and art. 172 para. 2 Property Law.\textsuperscript{16} Rather, it may be considered a statutory extension of guarantor’s liability for the secured claim. The creditor’s claim arising from the termination of the principal contract supersedes the initial secured claim. Extending the security right to further claims without any approval of the grantor can only be justified if the risk the grantor has taken when granting the security right already includes such further claims. That is the case if the scope and the nature of these further claims correspond to the scope and nature of the initially secured claims, e.g. where the repayment of the principal amount after the termination of the loan agreement corresponds to the initially secured claim for repayment of the principal amount after the expiration of the loan period. In light hereof, this provision should be restrictively construed to the effect that the guarantor is liable only for those claims of the creditor arising from the termination that correspond to the initially secured claim. It should be further construed that his liability in this case only extends to the scope of the initially secured claims, e.g. if the security right only secures the repayment of the principal amount, the grantor is not liable for the payment of any interest after the termination of the loan agreement. If the creditor is at fault regarding the termination of the principal contract, e.g. if the termination is caused by non-performance of the creditor, the creditor will nevertheless be protected by this statutory extension\textsuperscript{17}, provided, however, that he must not enforce the security right prior to the earliest date on which he would be entitled to enforce the security right had the principal contract not been terminated. Art. 10 Judicial Interpretation of Security Law is not applicable, if both the principal contract an the security agreement have been terminated.

3. Secured Claim

Unless otherwise stipulated in the security agreement, a security right covers the principal claim (主债权), interest thereon, any default fine, damages, as well as any expenses associated with the enforcement of such claims. In the case of real security rights, it also covers storage costs for the encumbered property (if any apply).\textsuperscript{18} Apart from the principal claim, which may be a non-monetary-claim, all these claims are monetary claims.

The principal claim is the claim created by the principal contract. It shapes the character of the principal contract and determines its classification, e.g. the obligation to transfer the sold goods and the obligation to pay the purchase price are the


\textsuperscript{17} Cf. opposite view of Liu Baoyu, 307.

\textsuperscript{18} Art. 21 Security Law and 173 Property Law.
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principal claims of a contract of sale. If the principal claim is a monetary claim, either contractual or statutory interest is covered by the security right. A default fine, validly agreed on in the principal contract, is also covered by the security right. If defective performance or non-performance caused the creditor’s losses, the security right extends to the damages claim, which also includes compensation for lost profits. Since such damages can, however, vastly exceed the amount of the secured claim, the grantor ought to make a conscious decision about whether he is willing to take on such broad responsibility. If not, a contractual provision excluding the damages claim from the scope of the security right would be advisable. Damage caused by the invalidity of the principal contract or the security agreement, however, is not covered by the security right.

4. Restrictions and Limitations on Security Rights

a) Upstream and Cross-stream Security

Where a company intends to grant a security right covering a claim against one of its shareholders or a non-shareholder who actually controls the company, this security right has to be approved by a shareholders’ resolution; the shareholder, or the shareholder dominated by the actual controller, whose debt shall be secured, has no right to vote on the issue in the shareholders’ meeting. The resolution requires the affirmative votes of more than half of the shareholders participating in voting. Without such approval, the security agreement is invalid and, according to the Judicial Interpretation of Security Law, the parties to the security agreement have to bear legal responsibilities to the extent of the fault attributable to each of them for the invalidity of the security agreement.

If the grantor is a listed company, security rights covering claims against parties associated with a shareholder or an actual controller also have to be approved by the board of directors and the shareholders’ meeting.

b) Creation of Security Rights in Favor of Foreign Creditors

In addition to the general legal framework, security rights granted by a Chinese domestic institution (including both foreign invested enterprises and domestic-funded enterprises) in favor of a foreign institution outside China or of a foreign-invested financial institution within China are governed by special administrative rules regarding foreign exchange regulations, which impose a number of restrictions on the provision of security rights to foreign creditors. The main restrictions are inter alia:

19 On the default fine please cf. also arts. 114–116 Contract Law.
20 Art. 16 paras. 2 and 3 Company Law (公司法).
21 Please cf. references in n. 19 and 22. Regarding securities provided by a company for claims against its sole shareholder, please refer to Wang/Zhang, 64, 65; according to Wang/Zhang’s opinion, the 100 % subsidiary can only provide real securities for debts against its sole shareholder and is not allowed to grant a guarantee for such debts.
22 Yunnan Shuntian Real Estate Development Ltd. vs. Yunnan Shiji Yangguang Jianzhu Sheji Ltd. (云南舜天房地产开发有限公司与云南世纪阳光建筑设计有限公司欠款合同纠纷上诉案), Judgement of the Higher People’s Court of Yunnan dated March 11, 2008 ((2008) 云高民终字第28号). With regard to the legal responsibility of the grantor, cf. also supra at 3 et seqq.
(1) Not every person or organisation is eligible to provide security rights to foreigners. Only Chinese institutions with special qualification are allowed to provide security rights to the benefit of foreigners, e.g., Chinese financial institutions authorized to provide security rights to foreign institutions and non-financial enterprises with the ability to repay debts and discharge liabilities on behalf of other persons.\(^\text{24}\)

(2) The types of security rights that may be provided to a foreign institution are limited. Domestic institutions are only permitted to grant guarantees, pledges and charges to foreign institutions; liens and deposits must not be granted.\(^\text{25}\)

(3) The scope of security rights that may be extended to foreigners is also limited. The aggregate amount of outstanding balances of any Chinese financial institution under i) granted security rights for foreigners, ii) granted security rights for domestic creditors in foreign exchange and iii) foreign exchange debts must not exceed twenty times the amount of its own foreign exchange funds.\(^\text{26}\) The maximum outstanding balance of security rights provided by any Chinese non-financial enterprise to foreigners is limited to 50% of the enterprise's net assets, and it is not allowed to exceed the amount of the enterprise's foreign exchange earnings in the previous year.\(^\text{27}\) The value of the net assets of a domestic-funded trading enterprise providing security rights to foreigners must not be less than fifteen per cent of its total assets; the value of the net assets of a domestic-funded non-trading enterprise providing security rights to foreigners must not be less than thirty per cent of its total assets.\(^\text{28}\)

(4) The types of claims which may be secured are limited. Security rights may only be granted to foreigners to secure monetary claims.\(^\text{29}\) Domestic-funded enterprises can only grant security rights to foreigners to secure claims against a wholly-owned subsidiary of the domestic security grantor or against a sino-foreign joint-venture enterprise up to an amount equal to the shareholding of the domestic security grantor of the foreign security right.\(^\text{30}\) No foreign security right may be granted to secure claims against an enterprise suffering business losses.\(^\text{31}\) No foreign security right may be provided to secure claims for payment of registered capital against a foreign investor.\(^\text{32}\)

(5) The validity of foreign security rights is subject to the approval of State Administration of Foreign Exchange (sAFC).\(^\text{33}\) If the security right is invalid for lack of approval, the grantor and the debtor both will be proportionally liable for any

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\(^{24}\) Art. 4 Administrative Measures for the Provision of Foreign Securities by Domestic Institutions (境内机构对外担保管理办法), hereinafter: Administration Measures of Foreign Securities.

\(^{25}\) Art. 2 para. 2 Administration Measures of Foreign Securities.

\(^{26}\) Art. 5 para. 1 Administration Measures of Foreign Securities.

\(^{27}\) Art. 5 para. 2 Administration Measures of Foreign Securities.

\(^{28}\) Art. 6 paras. 2 and 3 Administration Measures of Foreign Securities.

\(^{29}\) Art. 2 Administration Measures of Foreign Securities.

\(^{30}\) Art. 6 para. 1 Administration Measures of Foreign Securities.

\(^{31}\) Art. 7 Administration Measures of Foreign Securities.

\(^{32}\) Art. 8 para. 2 Administration Measures of Foreign Securities.

losses and damages to the extent of the fault attributable to each of them in respect of the invalidity of the security agreement. Such approval is not necessary if the domestic grantor of a foreign security right is a Wholly Foreign-Owned Enterprise (WFOE). The foreign security right has to be granted within six months as from the approval being issued. After a security right has been provided to a foreigner, the principal agreement may only be amended or varied with the consent of the grantor and the approval of the SAFE; otherwise, the security right is terminated upon the amendment or variation of the principal agreement. Finally, foreign security rights have to be duly registered with the SAFE.

5. Co-existence of Security Rights

a) Multiple Security Rights Securing the Same Claim

If a claim is secured by more than one guarantor, these guarantors are jointly and severally liable unless separate liability has specifically been agreed on. As between the joint guarantors themselves, they shall each be responsible for an equal portion of the unperformed secured claim unless they have agreed on a different proportionality. Once one guarantor has fulfilled the entire secured claim, he may seek contribution from the other guarantors to the extent that each of them is (internally) obliged to contribute to such fulfilment.

In the event that, in addition to the guarantee, the debtor himself has provided real security right covering the same claim, the creditor shall first seek satisfaction from the real security right. The guarantor then is only liable for the remaining amount outstanding after the real security right has been realized. If the real security right is provided by a person other than the debtor, the creditor may realize either the guarantee or the real security right at his sole discretion, subject only to contractual provisions to the contrary. After the guarantor has fulfilled the secured claim, he may claim recourse from the debtor. However, unlike art. 38 Judicial Interpretation of Security Law, which stipulates that the security grantor fulfilling the claim may seek contribution from the other security grantor, art. 176 Property Law is silent on the matter. It is disputed in judicial literature whether the silence of art. 176 Property Law means that the lawmakers of the Property Law have deliberately denied this possibility for the guarantor. SONG Xiaoming, chief judge of the second civil division of the SPC, addressed this dispute at a symposium concerning provisions about real security rights in Property Law and pointed out that it needs to be clarified by the judiciary. Should the creditor waive the real security right, or should the real

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35 Art. 8 para. 2 Rules of Administration Measures of Foreign Securities.
36 Art. 11 Rules of Administration Measures of Foreign Securities.
37 Art. 13 no. 2 Administration Measures of Foreign Securities.
39 Art. 12 Security Law.
40 Art. 21 para. 2 Judicial Interpretation of Security Law.
41 Art. 176 Property Law, art. 38 Judicial Interpretation of Security Law.
42 Art. 176 Property Law.
43 With regard to this controversy please see Zhou, 271, and Wang, I. c.
44 Song, I.c.
security right depreciate or be extinguished as a result of a circumstance for which the creditor is responsible, the guarantor is exempt from the liability under the guarantee up to the amount which would have been covered by the waived real security right or the amount by which the value of the real security right has decreased.\(^{45}\) The parties involved may, of course, make other contractual arrangements with regard to the relationship between co-existing security rights.

**b) Security Rights in the Same Property**

If the same property is encumbered by a lien and at the same time by other real security rights (such as a pledge or a charge), the lien ranks above these other real security rights. The lienor’s right to realize the lien has priority over the pledgee’s and chargee’s rights to realize their security rights.\(^{46}\)

Priority among several charges on the same property is defined by the rank of these charges.\(^{47}\) A registered charge always outranks a pledge.\(^{48}\) The priority between an unregistered charge on movables and a pledge is determined by the chronological order of their creation. However, since an unregistered charge on movables is not effective against a third party in good faith, a pledge of the same property obtains priority over an earlier created unregistered charge, if the pledgee has been in good faith when the pledge was created.\(^{49}\) Priority among several pledges on the same property is also defined by the rank of these pledges.

**III. Guarantee**

In China guarantee is widely used in domestic transactions and primarily regulated in Security Law, which has been further developed by SPC’s interpretations and case law. Guarantee in Chinese law has following particularities: first, all guarantees are joint responsibility guarantees (连带责任保证) unless the parties have specifically agreed on an ordinary guarantee (一般保证)\(^{50}\); second, the guarantee is in terms of its existence, scope and enforceability accessory to the principal contract without exception in all transactions concluded for transactions on the Chinese domestic market. Guarantees granted in international trade and transactions (e.g. guarantees on first demand, standby letters of credit) may be granted abstractly and independently from the validity of the secured claim.\(^{51}\)

**1. Guarantor**

In general, all natural or legal persons or other organisations with the capacity to enter into legal transactions are eligible to provide guarantees.\(^{52}\) State organs cannot act as guarantor, except for the sub-lending of loans granted by foreign govern-

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\(^{45}\) Art. 38 para. 3 Judicial Interpretation of Security Law. Cf. also *infra* at 78 concerning art. 194 Property Law.

\(^{46}\) Art. 239 Property Law. Cf. also art. 79 para. 2 Judicial Interpretation of Security Law.

\(^{47}\) In this regard *infra* at 77 *et seq*.

\(^{48}\) Art. 79 para. 1 Judicial Interpretation of Security Law.

\(^{49}\) *Infra* at 70.

\(^{50}\) *Infra* at 34 *et seq*.

\(^{51}\) *Supra* at 4.

\(^{52}\) According to art. 7 Security Law, a guarantor shall have the ability to repay debts and discharge liabilities on behalf of other persons. However, art. 14 Judicial Interpretation of Security Law
ments or international economic organizations that are approved by the State Council. Neither can institutions nor associations responsible for the furthering of public welfare act as guarantors. These prohibitions are intended to protect the functionality of state organs and social institutions against taking on unmanageable financial risks when granting guarantees.

2. Guarantee Contract

Art. 13 Security Law provides that the guarantee contract between the guarantor and the creditor has to be concluded in writing (e.g. by letter, e-mail or fax). The written form requirement is deemed to be satisfied if the guarantor’s offer is made in writing. It is still controversial whether this written form requirement is mandatory. In practice, parties should abide by the written form to ensure the validity of the guarantee contract. An oral guarantee contract is, however, valid if the guarantor has performed his principal obligation under the guarantee, i.e. paid the outstanding amount of the secured claim, and the creditor has accepted such performance.

The guarantee contract may be a stand-alone contract or a guarantee clause in the principal contract. Where a person executes as a guarantor a principal contract which does not contain a guarantee clause, a guarantee contract is nevertheless being concluded between this person and the creditor.

The guarantee contract is required to include references to the character, amount and performance period (履行期) of the principal claim, the modality, scope and term of the guarantee (保证期间) as well as other information deemed necessary by the parties (art. 15 Security Law). The provision also stipulates that, if any of the above-mentioned terms are missing, the parties may amend the contract subsequently and fill the gaps. It is, however, silent on the question: What is the legal consequence if parties cannot reach an agreement on the missing term and hence the contract remains incomplete? The answer depends on whether the missing term constitutes one of the essential aspects (essentialia negotii) of the guarantee agreement. The essential aspects of a guarantee agreement may be drawn from art. 22 para. 2 Judicial Interpretation of Security Law: As long as the parties to the

regulated that a security provided by a guarantor without such ability remains valid. With regard to guarantee granted to a foreigner, please refer to supra at 16 et seqq.

53 Art. 8 Security Law.
54 Art. 9 Security Law.
55 Art. 11 Contract Law.
56 Art. 22 para. 1 Judicial Interpretation of Security Law.
57 Li Guoguan, 142, Liu Baoyu, 151, and Zheng/Xiao/Li/He, 327 regard this form requirement as merely a permissive recommendation. According to Cao, 107, the guarantee contract is invalid if the written form requirement is not complied with. I tend to read the written form requirement as mandatory: The guarantee contract imposes on the guarantor severe financial risk, which, at the stage of conclusion of the guarantee contract, may appear harmless. The guarantor ought to be protected by the written form requirement from taking rash action. Furthermore, the provision of art. 22 para. 1 Judicial Interpretation of Security Law, according to which the written form requirement is deemed satisfied if the offer of the guarantor is made in writing, also permits the reverse conclusion that the written form requirement is mandatory because, otherwise, the clarification on this point would be superfluous.

58 Art. 36 Contract Law.
59 Art. 93 Security Law.
60 Art. 22 para. 2 Judicial Interpretation of Security Law.
61 Cf. supra at 27 and references in n. 58.
III. Guarantee

contract, i.e. the guarantor and the creditor, as well as the identity of the secured claim are agreed on, the guarantee contract is valid despite any missing terms. In the event that parties fail to reach an agreement on certain non-essential points, the gaps are to be filled by way of interpretation of the contract, by statutory provisions, as well as by good faith.

3. Guarantor’s Liability

a) General Scope of Guarantor’s Liability

If the principle debtor defaults on the secured claim, the guarantor is obliged to perform the principle debtor’s obligation in accordance with the guarantee contract. Upon discharging the principle debtor’s liability, the guarantor is entitled to claim recourse and may seek indemnity from the principle debtor.

If the secured claim is a monetary claim, the guarantor has to pay the outstanding amount of the claim to the creditor. If a non-monetary-claim is secured by the guarantee, the guarantor has to perform the obligation in lieu of the principle debtor, unless such performance is of strictly personal nature and thus impossible for the guarantor to achieve, e.g. if the principle debtor, a famous artist, is obliged to paint a picture. Where performance remains impossible, the guarantor shall compensate the creditor for his loss.

b) Ordinary Guarantee and Joint and Several Guarantee

Despite the name “ordinary guarantee”, all guarantees are joint responsibility guarantees unless the parties have specifically agreed on an ordinary guarantee resulting in separate responsibilities of debtor and guarantor.

Under an ordinary guarantee, the guarantor can be required to perform if the principle debtor fails to perform the secured obligation. The guarantor may raise the defence of prior execution, i.e. he may refuse to satisfy the creditor as long as the latter has not exhausted legal remedies against the principle debtor, unless

(1) the principle debtor has changed residence resulting in major difficulties regarding the execution of the secured claim,
(2) the execution procedure is suspended due to the opening of insolvency proceedings against the principle debtor, or
(3) the guarantor has waived the defence of prior execution.

Under a joint and several guarantee, the guarantor assumes joint responsibility with the principle debtor for the secured claim. If the principle debtor does not perform or fails to properly perform the secured claim when it falls due, the creditor is entitled to demand performance from the principle debtor and may at the same time hold the guarantor liable. If the fulfilment of the secured claim requires the performance of an act which can also be performed by the guarantor, the creditor may ask both principle debtor and guarantor to perform this act. Otherwise, the

62 Art. 6 Security Law. As regards the guarantor’s liability in the event of invalidity of the security agreement or/and principal contract, cf. supra at 6 et seqq.
63 Art. 31 Security Law.
64 Art. 13 Judicial Interpretation of Security Law.
65 Art. 19 Security Law.
66 Art. 17 Security Law.
67 Art. 18 Security Law.
guarantor is only obliged to compensate the creditor for his loss; in this case, the creditor may only seek satisfaction from the guarantor if he has actually suffered a loss as a result of the principle debtor’s non-performance or defective performance.

c) Maximum Amount Guarantee

A maximum amount guarantee (最高额保证) applies to claims arising from a series of – usually (but not necessarily) future – contracts. It covers all claims created by such series of contracts within a certain period called the determinate period (债权确定期间/决算期), and the guarantor’s liability is capped by a maximum amount.68

The actual number of the secured claims may be uncertain at the conclusion of the contract creating a maximum amount guarantee. The secured claims are being defined and concretised during the determinate period, within which all secured claims are created. Upon the expiration of the determinate period, the number and the extent of the secured claims are certain. If the determinate period is not stipulated in the guarantee contract, the guarantor may terminate the guarantee contract at any time by written notice to the creditor; however, the guarantee securing the claims created prior to the termination remains unaffected by the termination.69

The guarantor’s liability is capped by a maximum amount. Where the total amount of outstanding debts does not reach that maximum, the guarantor is liable only for the lower amount.70 A maximum amount guarantee can be either an ordinary or a joint liability guarantee.

d) Guarantee Term

The guarantee term defines the duration of the guarantor’s liability, within which the creditor has to enforce his claim arising from the guarantee contract against the guarantor. If the creditor fails to file litigation or arbitration requests against the principle debtor within the guarantee term, in case of an ordinary guarantee, the guarantor will be released from his guarantee liabilities.71 In case of a joint responsibility guarantee, the guarantor will be released from his liabilities if the creditor fails to request the guarantor to assume guarantee liabilities within the guarantee term;72 the creditor must assert his rights against the guarantor or remind the guarantor of these rights before the expiry of the term unless the guarantor has promised within said period to bear liability.73

If a guarantee contract does not stipulate the guarantee term, the statutory guarantee term applies: the term for both ordinary and joint responsibility guarantees is six months commencing as from the expiry of the performance period applicable to

69 Analogous application of art. 27 Security Law, please also refer to Guo/Fang/Zhang, 98, Fan, 78–80.
70 Art. 23 Judicial Interpretation of Security Law.
71 Art. 25 para. 2 Security Law.
72 Art. 26 para. 2. Security Law.
73 Reply of the SPC on the Request for Instructions on Whether or Not the Act of a Guarantor’s Affixing Its Signature to a Credit’s Right Transfer Agreement and Promising to Bear the Original Liabilities of Guaranty Could be Deemed as That the Relevant Creditor has Claimed the Creditor’s Right against the Guarantor as well as on the Determination of the Calculation of the Limitation of Actions for the Related Guaranty Contract, 8 September 2003 No. 25 (最高人民法院关于在保证期间内保证人在债权转让协议上签字并承诺履行原保证义务能否视为债权人向担保人主张过债权及认定保证合同的诉讼时效如何起算等问题请示的答复).
III. Guarantee

dthe principal claim.\textsuperscript{74} Where a contractually stipulated guarantee term expires before or on the same day as the expiry date of the performance period applicable to the principal claim, the guarantee term is deemed invalid and a statutory guarantee term of six month commencing as from the expiry of the performance period will apply.\textsuperscript{75} If the guarantee term is stipulated in the guarantee contract and if the relevant provision contains the wording “the guarantor shall bear liability until the principal claim and interest thereon have been paid in total by the principle debtor” (or a similar phrase), the applicable statutory guarantee term will be two years commencing as from the expiry of the performance period applicable to the principal claim.\textsuperscript{76}

In case of a maximum amount guarantee, the guarantee term has to be distinguished from the determinate period. The latter serves as a criterion for defining and limiting the claims secured by the guarantee. Where the guarantee term is not stipulated for a maximum amount guarantee, the guarantor may terminate the guarantee contract at any time by giving written notice to the creditor; however, the guarantee securing the claims created prior to the termination remains unaffected by the termination.\textsuperscript{77} Where the guarantee term of a maximum amount guarantee is not or not clearly stipulated, the statutory guarantee term of six months applies.\textsuperscript{78} The statutory guarantee term commences upon expiry of the performance period applicable to the secured claims; where such performance period is not stipulated, the statutory guarantee term commences upon the end of the determinate period or the date when the creditor receives the guarantor’s written notice of termination.\textsuperscript{79}

e) Changes affecting the Secured Claim\textsuperscript{80}

In general, after the guarantee contract has been entered into, any amendment to, or variation of, the secured claim will only impact the guarantor’s liability if he consents in writing\textsuperscript{81}, unless such amendment actually reduces the secured claim or is otherwise beneficial for the guarantor. Where amendments concerning the character of the secured claim (i.e. quantity, price, currency, interest rate or the like) have been effected without the guarantors’ consent, his liability is only to be adjusted accordingly if the secured claim is reduced by the amendment; otherwise, the guarantor’s liability simply remains unchanged.\textsuperscript{82} Subject to contractual provisions to the contrary, the accessoriness of the guarantee to the secured claim ensures that, when the creditor assigns or transfers the secured claim to a third party, the guarantor is simultaneously also being transferred to the assignee. Apart from the change of the creditor, the extent of the guarantor’s liability will not be affected by the transfer, it remains the same as provided for under the guarantee contract.\textsuperscript{83}

A change of principle debtor (i.e. the transfer of the secured debt or of part of it from the original principle debtor to a third party), on the other hand, has to be

\textsuperscript{74} Art. 25 para. 1 Security Law.
\textsuperscript{75} Art. 32 para. 1 Judicial Interpretation of Security Law.
\textsuperscript{76} Art. 32 para. 2 Judicial Interpretation of Security Law.
\textsuperscript{77} Art. 27 Security Law.
\textsuperscript{78} Art. 37 Judicial Interpretation of Security Law. With regard to the determinate notice \textit{supra} at \textit{et seqq}.
\textsuperscript{79} Art. 37 Judicial Interpretation of Security Law. See also \textit{Cao}, 122.
\textsuperscript{80} As regards the termination of the principal contract \textit{cf. supra} at \textit{et seqq}.
\textsuperscript{81} Art. 24 Security Law.
\textsuperscript{82} Art. 24 Security Law and Art. 30 Judicial Interpretation of Security Law.
\textsuperscript{83} Art. 22 Security Law and art. 28 Judicial Interpretation of Security Law.
approved in writing by the guarantor. Otherwise, upon such change of principle debtor, the guarantor is released from his liability as guarantor either with respect to the entire secured claim or with respect to that part of the principle debt which has been taken over by the third party.  

4. Guarantor’s Defences

Under both ordinary and joint responsibility guarantees, the guarantor is entitled to raise all defences available to the principle debtor, including those entitling the principle debtor to refuse performance. He may, moreover, even raise a defence if the principle debtor has waived it. The principle debtor’s defences include alleging the invalidity or the termination of the secured claim, limitation periods as well as the concurrent condition of performance by both parties. However, should the guarantee (only permissible in respect of guarantees in international trade) be valid despite the invalidity of the secured claim (due to the contractually stipulated independence of the guarantee from the existence of the secured claim), the guarantor is barred from asserting the invalidity of the secured claim: he is deemed to have waived this defence since he has consented to the independence of the guarantee from the secured claim. Similarly, a waiver of the defence of the statute of limitation is assumed where a guarantor, being aware of the fact that the claim is time-barred, provides a guarantee for such a claim.  

Apart from the principle debtor’s defences, the guarantor may also raise his own defences connected to the guarantee, e.g. concerning the invalidity or the termination of the guarantee. As already mentioned, the grantor of an ordinary guarantee may always raise the defence of prior execution.  

IV. Real Security Right

A real security right is a security right created in an immovable asset, movable asset or certain rights. The creditor for whose benefit the real security right is created is entitled to realize the security right by recourse to the encumbered property in the event that the secured claim is not duly performed. Real security rights are governed by both the Property Law and the Security Law; where the provisions of both statutes conflict with each other, the Property Law prevails.  

1. Substitutes for Encumbered Asset

The encumbered asset serves as collateral for the performance of the secured claim. If it is lost or damaged, any asset or right obtained in consequence of such loss or damage (e.g. damages claimed against an individual having committed a tort) shall take the place of the encumbered asset so that the creditor thereafter may seek

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84 Art.23 Security Law and art. 29 Judicial Interpretation of Security Law.
85 Art. 20 para. 1 Security Law.
86 Supra at 4.
87 Supra at 3 et seqq.
88 Art. 35 Judicial Interpretation of Security Law.
89 Supra at 34 et seq.
90 Cf. reference in n. 2.
satisfaction from such substitute (物上代位) (art. 174 Property Law). Note that if the creditor himself has caused the loss or damage by breaching his obligation to keep the property securely held as pledge or under a lien, the damages claim against him is no longer covered by the security right. This is to avoid circular action.

In the same way, the real security right also extends to the substitutes of such substitutes. For example, if a claim substituting the encumbered asset (e.g. a damages claim against a third party) is extinguished due to proper payment, the money received then substitutes the extinguished claim and serves in its place as a collateral for the secured claim. The same principle applies if the substituting proceeds are commingled with other assets of the same type, e.g. where banknotes paid in fulfilment of the substituting claim are not kept separately from other banknotes, the security right extends to the commingled mass to the extent of the proceeds' value. If the substituting claim has been fulfilled prior to the maturity date of the security right, i.e. the date on which the secured creditor may enforce the security right, the proceeds are to be transferred into an escrow.

Art. 174 Property Law shall also be applied by analogy in the event that the real security right ceases to exist on the encumbered asset as a result of an acquisition in good faith. The purchase price received shall substitute the encumbered asset and the real security right shall extend to the substitute.

Similarly, art. 174 Property Law shall also be applied by analogy to the proceeds obtained in the course of the enforcement of the real security rights, and to the proceeds obtained when the charged property is conveyed to a third party, thus the charge on the charged property is extinguished.

In the event that the substitute is cash or other monetary means, e.g. money in a bank, art. 174 Property Law shall be restrictively construed, i.e. the real security right should only extend to the substitute up to the aggregate amount of the secured claims – a broader extension of this rule will burden the owner of the money to an unnecessary extent.

2. Changes Affecting the Secured Claim

Where the real security right is provided by a person other than the debtor, a change of the debtor (i.e. the transfer of the debt, or part of it, to a third party) also has to be approved in writing by the grantor. Otherwise, the real security right is extinguished either with respect to the entire secured claim or with respect to that part of the debt which was taken over by the third party.

According to art. 177 Property Law, the real security right is being extinguished by the extinction of the secured claim. However, according to art. 10 Judicial Interpretation of Security Law, the grantor of the real security right is nevertheless liable for claims arising from and in connection with the termination of the principal contract if the principal contract is terminated by its parties. Art. 177 Property Law does not

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91 Arts. 215 and 234 Property Law; infra at 65 and 110 et seqq.
92 Hu on art. 174.
94 Infra at 73 et seqq.
95 Infra at 79 et seqq.
96 Supra at 12 et seq.
97 Art. 175 Property Law.
98 As regards art. 10 Judicial Interpretation of Security Law see also supra at 10.
prevail over art. 10 Judicial Interpretation of Security Law: The relationship between these two provisions is the same as the relationship between art. 10 Judicial Interpretation of Security Law and art. 52 Security Law, according to which a charge is extinguished when the secured claim is extinguished. Before the enactment of the Property Law, Upon the enactment of the Property Law, art. 10 Judicial Interpretation of Security Law was the more specific provision governing termination of the principal contract. Judicial practice applied art. 10 Judicial Interpretation of Security Law, and not art. 52 Security Law for cases, in which the principal agreement had been terminated.99 Upon the enactment of the Property Law, art. 177 Property Law now supersedes art. 52 Security Law. Since art. 177 Property Law does not differ from art. 52 Security Law as to its content and does not contain an explicit rejection of art. 10 Judicial Interpretation of Security Law, art. 10 Judicial Interpretation of Security Law will continue to prevail over art. 177 Property Law for those cases in which the principal contract is terminated.

3. Bona Fide Acquisition of Real Security Rights

In general, only a person with the power of disposition100 (处分权) over the property, e.g. the owner or the insolvent administrator, may effectively grant a real security right on the property. However, it is difficult to find out whether the grantor of a real security right is the real owner of, or has otherwise acquired the power of disposition over, the property, which leads to uncertainties in practice. To avoid such uncertainty and to protect the parties’ good faith, art. 106 Property Law adopts a general provision regarding the acquisition of real rights, i.e. “in rem”-rights, in good faith.

A creditor may acquire an effective real security right on a property even if the security grantor lacks the power of disposition over the property if the following conditions are fulfilled:

(1) Good Faith at the Completion of the Legal Transaction

The security grantee must be in good faith at the completion of the legal transaction. The legal transaction is considered to be completed, if all legally required contracts and all legally required actions (such as the registration of the real security right101 or the transfer of the possession of the property) have been completed.

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100 See Tian and Bu for a comprehensive discussion of the term “disposition” in Chinese law.

101 The security grantee has to be in good faith at the point in time when the security right is duly registered if the registration is required for the creation of the security right. Due to the unambiguous wording of art. 106 para. 1 Property Law (“at the point of time when the property is assigned to the transferee”), it is to be assumed that good faith only at the point of time of filing.
concluded and carried out. In other words, apart from the security grantor’s power of disposition, all other conditions necessary for the effective constitution of the real security right have to be fulfilled.

The security grantee is considered to be in good faith if he is not aware of the fact that the security grantor does not have the power of disposition over the property concerned and if this lack of awareness does not result from negligence on his part. If he has only learned about the security grantor’s lack of power of disposition after the transaction, his acquisition in good faith will not be affected.

(2) Payment of a Reasonable Price

The security grantee must have paid a “reasonable price” for the acquisition of the real security. Since the institution of acquisition in good faith interferes with the interests of the owner of the property, this condition restricts the scope of this interference. It makes sure that only arm’s-length transactions are protected. If, at first, only an unreasonable lower price is paid, this condition is nevertheless fulfilled if the margin between the paid price and a reasonable price has been paid afterwards, provided that this entirely occurs prior to the security grantee’s awareness that the security grantor lacks the power of disposition. This condition, however, is tailored to the acquisition of ownership of property. It is doubtful whether it should also be applied to the constitution of real security rights without any adjustment, since in commercial and legal practice, the secured creditor rarely pays any consideration to the real security right. Usually, he requires his counterparty (the debtor) to provide a charge or another type of real security right before entering into another legal relationship, such as granting a loan to the debtor. Therefore, the requirement to pay a reasonable price is not the appropriate criterion to determine whether the legal transaction creating a real security right is at arm’s length. This provision needs to be interpreted in light of its purpose. That, in turn, calls for taking a view at the constitution of the real security right and the secured underlying legal transaction as a whole in order to consider whether the whole transaction creating a real security right is at arm’s length. For example, if the claim is over-secured because it is sufficiently covered by other security rights, granting the real security right concerned should be deemed not to be at arm’s length.

(3) Registration or Delivery

Art. 106 no. 3 Property Law states: “The transferred immovables or movables shall have been registered, provided that the registration is required, or been delivered to the assignee if registration is not required.” It is disputed in the jurisprudential literature whether the registration or delivery is required even in those cases in which the constitution of the real security right does not require either delivery or registration, i.e. where the constitution of charges on movables are concerned: Since the charge is non-possessory, the constitution of a charge does not require delivery of the property; in addition, the constitution of the registration application is not sufficient for the acquisition in good faith because this preemption of the deciding point of time for the good faith without a statutory stipulation would not justify interference with the interests of the owner of the property.


103 Cf. Liu Baoyu, 387.
of a charge on movable property does not require the registration either, the registration is optional and, without the registration, the charge is only ineffective against a bona fide third party.\textsuperscript{104}

The wording of art. 106 no. 3 Property Law rather speaks for such way of interpretation that the acquisition in good faith requires either the registration or the delivery, irrespectively of whether the registration or delivery also required for the normal constitution of the respective real security right: If the registration or delivery should be necessary for an acquisition in good faith only in such cases where registration or delivery is also required for the constitution of such real security right, this requirement in art. 106 no. 3 Property Law would be superfluous since all conditions, apart from the power of disposition, necessary for the constitution of the real security right have to be fulfilled anyway in the case of an acquisition in good faith of such real security right. The acquisition in good faith is the protection of the good faith of the acquirer in the power of disposition of his counterparty that is based on the registration of the counterparty as such or the counterparty’s possession of the property. Should it be possible to acquire a real security right without a registration or delivery, the real owner of the property would not have any chance to prevent the encumbrance of his property by way of acquisition in good faith since everyone could allege that he was the owner of the property and create a real security right on the property if his counterparty is in good faith. Such interference, with the interests of the real owner would be unjustified. Since the constitution of a charge does not require the delivery of the property to be affected by the charge, in the author’s view, the acquisition in good faith regarding the charge on movables requires the registration of the charge with the respective register.

Furthermore, if an asset encumbered with a real security right is acquired by a third party in accordance with art. 106 Property Law, the real security right is extinguished as a result of the acquisition in good faith unless the acquirer, at the time of acquisition, is not in good faith with regard to the real security right.\textsuperscript{105}

V. Charge

The charge is a real security right which entitles the chargee/creditor to seek satisfaction of his secured claim through the property charged if the debtor fails to fulfil the secured claim when due. The difference between a charge and a pledge is that the charge is non-possessory, i.e. the creation and release of the charge does not require the possession of the charged property to be transferred. Unlike a mortgage, the charge does not require the charged property to be conveyed or assigned to the secured creditor. The creation of an effective charge solely requires the conclusion of an effective charge contract. In the event of a charge relating to immovable properties, the creation also requires the registration of the charge with the realty register.\textsuperscript{106}

\textsuperscript{104} Infra at 70.
\textsuperscript{105} Art. 108 Property Law.
\textsuperscript{106} As regards the registration of charge cf. infra at 69 et seqq.
V. Charge

1. Charged Property

a) Chargeable Property

Both movable and immovable property which the chargor is entitled to dispose of, may be subject to a charge unless there is express prohibition in a statute or in administrative regulations against the property being charged. In general, the chargor has the right to dispose of his own property, except where a moratorium on all dispositions has been issued, e.g. due to the insolvency of the chargor. Pursuant to the Property Law, the following properties are not chargeable:

1. Ownership of land
2. Using rights relating to cultivated land (耕地), sites of houses (住宅基地), land set aside for farmers to cultivate for their private use (自留地), hilly land allotted for private use (自留山) and other collectively-owned land, unless otherwise provided by law or administrative regulation
3. Facilities of institutions or associations devoted to public welfare
4. Assets the ownership or using rights of which are unclear or controversial
5. Properties which are legally confiscated or those which are seized or controlled by the State.

In China, the State is the owner of all urban land. The State may lease using rights as to state-owned land (国有土地使用权出让) to land users for a fixed period of time. For the construction of projects related to the public, the State may also allocate using rights (国有土地使用权划拨) to land users without a time limit, unless otherwise stipulated by law (using rights in bankruptcy proceedings infra Chapter 8 at 10–13). Since leased using rights are more important to the real estate industry, the following discussion will be limited to these kind of using rights. Before the construction of a building is completed, the real estate project’s investor may also charge the real estate project itself, i.e. his using right on the construction land, his ownership of the building under construction and all assets deployed in the project, in order to secure claims of the financing bank. Before a residential building is completed, the flats may – under certain conditions – be pre-sold (预售商品房). A purchaser of such a pre-sold flat may charge his expected (future) ownership of the flat to secure the facility claim of the bank financing the acquisition.

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107 Art. 180 Property Law.
108 Art. 184 Property Law.
109 Art. 47 Property Law.
110 Art. 8 Real Estate Administration Law. The maximum period of the land use right for industrial purpose is 50 years and for residential purpose 70 years: art. 12 no. 1 and 2 Interim Regulations concerning the Assignment and Transfer of Using Right of State-owned Land in the Urban Areas.
111 Art. 23 Real Estate Administration Law.
112 Art. 180 no. 5 Property Law.
113 Art. 3 para. 5 Measures of Administration of Pledge on Urban Real Estate.
114 Art. 180 no. 5 Property Law, art. 45 Urban Real Estate Administration Law.
115 Art. 3 para. 4 Measures of Administration of Pledge on Urban Real Estate.


b) Unity of Land Using Rights an Ownership of Building

Land using rights in urban areas entitle the holder of the rights to possess and use the land, and allow him to construct buildings and fixtures on it.\(^\text{116}\) It is of great importance to the Chinese real estate industry that both the using right on construction land and the ownership of the building (as well as parts of the building) erected on such construction land are chargeable\(^\text{117}\); also, a fractional share of co-ownership of real property may be charged\(^\text{118}\). The using right and the building (or part of the building) have to be charged together; if only one of these is charged, the other one is automatically regarded as being charged as well.\(^\text{119}\) In the event that there was no building on the land when the using right was charged, a building erected after the creation of the charge is not encumbered by the charge. However, when realizing the charged using right, the auction or sale of the charged using right also extends to the building, but the charge does not extend to the amount of money realized and attributed to the building.\(^\text{120}\)

c) Fruits of Charged Properties

Until the charged property being seized in execution, the charge does not extend to collected fruits (natural and civil fruits, the latter being proceeds obtained by virtue of a legal relationship, e.g. rent) of the charged property. Once the charged property is seized in execution by a court in the course of the realization of the charge, the charge also extends to all fruits collected thereafter. However, as to civil fruits – such as the rent income of a charged flat – the tenant is entitled to keep paying the rent to the chargor in fulfillment of his obligation to pay rent if he has not been informed by the chargee about the seizure of the charged flat.\(^\text{121}\) Once he has been informed about the seizure, he has to pay the rent to the chargee to fulfil his obligation.

d) Maintenance of the Charged Property

Once the property is charged, the chargor must adequately maintain the charged property in terms of value. The chargee is entitled to request the chargor or a third person to refrain from any act or omission which may result in a depreciation of the property.\(^\text{122}\) To the extent that it has already depreciated, the chargee may ask the chargor to restore the property or to provide a security right equal to the respective decrease in value. If the chargor fails to comply with this request, the chargee may demand the debtor to fulfil the secured claim immediately.\(^\text{123}\)

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\(^{116}\) Art. 135 Property Law.

\(^{117}\) Cf. art. 180 no. 1 and 2 Property Law. Note in Chinese law, unlike in some other jurisdiction where the land and the building erected on it are deemed one property, they are two separate properties. Private persons are only allowed to acquire property of buildings, while ownership of land is exclusively owned by the State or collectives. However, the land using right on a particular parcel of land and the building erected thereof are commonly not allowed to transferred separately.

\(^{118}\) Cf. art. 54 Judicial Interpretation of Security Law.

\(^{119}\) Art. 182 para. 2 Property Law; art. 4 of Measures of Administration of Pledge on Urban Real Estate (城市房地产抵押管理办法) release by the former Ministry of Construction.

\(^{120}\) Art. 200 Property Law.

\(^{121}\) Art. 197 Property Law.

\(^{122}\) Art. 193 Property Law. With regard to the claim against a third party see Guo/Fang/Zhang, 134, 135; Zhu/Gao/Chen, 586.

\(^{123}\) Art. 193 Property Law.
2. Charge Contract

To validly create a charge, the chargee and the chargor have to enter into a written charge contract. In general, a charge contract should contain references to the type, amount and the performance period of the secured claim, description of the charged property, as well as the scope of the security right. This provision is not mandatory, however, and only serves as an orientation. If a charge contract does not include all of the above-mentioned terms, this will not lead to its invalidity. The parties may amend the contract by adding the missing terms. If parties do not reach an agreement on a missing term, the contract nevertheless remains valid as long as its essential aspects (i.e. the parties to it as well as the identity of the secured claim and of the charged property) are expressly stipulated or may be determined by way of interpretation of the principal contract or the charge contract.

Prior to the expiry of the performance period applicable to the secured claim, the chargor cannot effectively assume the obligation vis-à-vis the chargee to convey the charged property to the chargee upon the debtor’s defaulting on the secured claim. This legal prohibition protects the chargor against losing his ownership of the charged property (which may, after all, be much more valuable than the secured claim). The lawmakers considered such protection necessary because, in practice, the negotiating position of the debtor and/or chargor will usually be weaker than that of the creditor/chargee.

3. Registration

Once a charge contract has been effectively concluded, the chargor is obliged to register the charge in cooperation with the chargee. This obligation originates from the concept of good faith. If the chargor fails to comply with it, he has to compensate the chargee for any consequent loss.

Apart from a valid charge contract, the creation of a charge relating to immovable property (such as buildings and easements) also requires the charge to be registered with the realty register. The charge is only completely created by such registration. The application for registration of charges relating to urban real estate (land using right and ownership of buildings) has to be filed with the registration authority, and it has to contain, inter alia, the charge contract, proof of identity of the parties and the certificate pertaining to the land using right and

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124 Art. 185 Property Law.
125 Art. 185 Property Law.
126 Art. 185 Interpretation of Property.
127 Cf. art. 56 para. 1 Judicial Interpretation of Security Law.
128 Art. 186 Property Law.
129 Art. 186 Interpretation of Property.
130 Art. 56 para. 2 Judicial Interpretation of Security Law.
131 Arts. 9 para. 1, 187 para. 1 and 180 sentence 1 no.1–3 Property Law.
132 Arts. 14 and 187 para. 2 Property Law.

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the ownership of the building concerned (or of the relevant part of the latter). If a charge is to be registered on pre-sold real property, the parties have to submit the pre-sale agreement as well. If the construction of the real property concerned is completed subsequently within the duration of the charge, the charge (previously created on pre-sold real estate or real property projects) will have to be re-registered – now reflecting a charge on a completed building.

The creation of a charge relating to movable property does not require registration. However, floating charges and charges on certain types of moveables, such as 1) manufacturing facilities, raw materials, products and semi-manufactured products, 2) transportation vehicles and 3) vessels or aircrafts under construction may be registered optionally with the respective register, though the creation of such charges does not require registration, but only the conclusion of a valid charge contract. However, without registration, the charge is not effective against a bona fide third party. A third party can thus acquire the charged property free of the charge, or may obtain a pledge outranking the charge.

In the event that the registration of a charge on real estate is not consistent with the material legal relationship, each of the chargor, chargee and any other person concerned may apply for the correction of the registration. If the parties agree on the correction of the registration, the registration authority shall correct the registration. If the parties dispute on the correctness of the registration, upon application, an objection to the registration can be registered with the register. The objection contests the correctness of the objected registration and destroys any good faith in the registration. The party applying the registration of the objection has to bring an action for correction of the registration within fifteen days from the registration of the objection; otherwise, the objection loses its effect and will be deleted. For example, if the charge is transferred together with the secured claim from the chargor/transferor to a third person/transferee, the registration of the charge is then no longer consistent with the material legal relationship. The transferee of the secured claim thus can apply for the correction of the registration; based on the concept of good faith, the transferee is obliged to file such application. The correction of registration of charges on moveables is provided in Measures for Registration of Charges on Moveables Art. 19 Property Law regarding the registration of objection shall apply to charges on moveables by analogy.

After the charge has been extinguished, the registration of the charge with the realty register has to be erased in accordance with art. 53 Measures for Land Registration.

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133 Art. 32 Measures of Administration of Pledge on Urban Real Estate.
134 Supra at 59.
135 Art. 27 Measures of Administration of Pledge on Urban Real Estate.
136 Art. 34 para. 2 Sentence 2 Measures of Administration of Pledge on Urban Real Estate.
137 Arts. 189 and 181 Property Law; as regards floating charge, cf. infra at 85 et seqq.
138 Arts. 188 and 180 sentence 1 no. 4–6 Property Law. As regards charges on means of transportation, cf. also art. 13 Maritime Law and art. 16 Civil Aviation Law (民用航空法).
139 Art. 188 and 189 Property Law. With regard to good faith cf. supra at 54 et seqq.
140 Art. 108 Property Law.
141 Supra at 23.
142 Art. 19 Property Law.
143 As regards transfer of charge cf. infra at 79 et seqq.
144 Cf. also; Art. 44 Measures for Land Registration.
145 Art. 6 and 7.
V. Charge

Registration released by the Ministry of Land Resources. The deletion of the registration with other registers, e.g. regarding charges on movable property, is stipulated in art. 8 Measures for Registration of Charges on Movables released by the State Administration for Industry and Commerce.

4. Chargee’s Rights

a) Enforcement of Charge

The chargee is entitled to enforce the charge upon non-performance by the debtor of the secured claim (after the expiry of the applicable performance period) or upon the occurrence of any contractually stipulated condition for enforcement (e.g. if the chargor breaches his duty to maintain the value of the charged property or, in the case of a floating charge, if the scope of the properties charged is reduced to a certain level). In general, there are two ways of realizing the charge: consensual enforcement and compulsory execution.

Consensual enforcement requires an agreement between the chargor and the chargee on the question of which of the following three modes of enforcement shall apply: (1) acquisition of the charged property by the chargee at market price of the property; (2) auction of the charged property or (3) private sale of the charged property, with the sale price being equal to the market price.

According to art. 177 no. 2 Property Law, the real security right is extinguished by its enforcement, i.e. the satisfaction of the chargee from the proceeds obtained in the course of the enforcement. In the interval between the aligned sale or auction of the encumbered property and the satisfaction of the chargee, the real security right continues to exist – not on the initially encumbered asset, but, following an analogous application of art. 174 Property Law, on the proceeds obtained. Therefore, the charge extends to the proceeds of the sale – as a substitute of the charged property – up to the aggregate amount of the secured claims. The remaining amount of money has to be paid to the chargor. In the event that this consensual enforcement of the charge adversely affects the interests of any other creditor of the chargor (e.g. if the charged property is sold below market price and the financial solvency of the chargor, therefore, is reduced at the expense of his creditors), this creditor may ask the court to invalidate the enforcement agreement between the chargor and the chargee. The creditor has to do so within one year as from the date at which he has obtained knowledge of the cause of invalidation, or within one year as from the date at which he ought to have obtained such knowledge. Once the enforcement agreement is invalidated by the court, the chargor may no longer seek enforcement of the charge. If he has already acquired the charged property, the acquisition has to be reversed. If the charged property has been sold to a third party, the sale is not affected by the invalidation, yet the chargor

146 *Infra* at 85 et seqq.
147 Arts. 170, 195 para. 1 Property Law.
148 Art. 195 para. 1 sentence 1 and para. 3 Property Law.
149 *Hu* on art. 177.
150 *Cf.* also *supra* at 48 et seqq.
151 Art. 198 Property Law.
152 Art. 195 para. 1 sentence 2 and para. 3 Property Law.
and chargee may be held liable jointly and severally for the consequential loss
thereby caused to the chargor’s other creditor(s).

76 If chargor and chargee fail to reach an agreement on a consensual enforcement
of the charge, the chargee may ask the court to auction or sell off the charged property
at market price, and he then may seek satisfaction from the proceeds.\textsuperscript{153} The
chargee has to exercise his right prior to limitations imposed on the secured claim;
otherwise, the right will not be protected by the court.\textsuperscript{154} The proceeds substitute
the charged property up to the aggregate amount of the secured claims so that the
chargee can seek satisfaction from them.

b) Ranking of Charges

77 The same property can be encumbered by several charges. When the charged
property is enforced, the chargees have to be satisfied from the proceeds in the same
order in which their charges are ranked. The secured claim of the highest-ranking
chargee has to be fulfilled first. The remaining amount of money will be paid to the
chargee next in line to the extent of his respective secured claim. If several charges
share the same rank and if the money received is not sufficient to fulfil all the claims
secured by these charges, satisfaction of the chargees will be proportionate to the
amounts of their secured claims. If charges on the same property mature at
different times, i.e. if the secured claims expire on different dates, the chargee of a
charge maturing earlier may enforce the charge immediately upon maturity (irre-
spectively of its rank). However, he may only be satisfied from the proceeds exceeding
the amount of all the claims secured by higher-ranking charges.\textsuperscript{155} If his claim
secured by the charge has not been fulfilled completely in first turn, the charge will
persist on the remaining proceeds up to the outstanding amount, but the respective
chargee may only seek satisfaction from the remaining proceeds after the higher-
ranking chargees have been satisfied. Any money left over after satisfaction has to be
deposited and, as the substitute of the charged property, be covered by the remaining
charges. If, therefore, a higher ranking charge matures before a lower-ranking one,
the remaining proceeds will be deposited as the substitute of, and available for
(future) satisfaction of, the lower-ranking charges.\textsuperscript{156} Among registered charges, their
ranking is determined by the chronological order of their registration.\textsuperscript{157} Registered
charges always outrank unregistered ones.\textsuperscript{158} As far as the relationship between
several unregistered charges is concerned, they are regarded as having the same
rank; accordingly, the satisfaction of the chargees has to be proportionate to the
amounts of the secured claims.\textsuperscript{159}

78 The parties involved are, of course, free to determine the ranking of co-existing
charges on the same property by contractual means; however, no one may be
disadvantaged by such agreement without his consent.\textsuperscript{160}

\textsuperscript{153} Art. 195 para. 2 and para. 3 Property Law.
\textsuperscript{154} Art. 202 Property Law.
\textsuperscript{155} Art. 78 para. 1 Judicial Interpretation of Security Law.
\textsuperscript{156} Art. 78 para. 2 Judicial Interpretation of Security Law.
\textsuperscript{157} Art. 199 no. 1 Property Law.
\textsuperscript{158} Art. 199 no. 2 Property Law.
\textsuperscript{159} Art. 199 no. 3 Property Law.
\textsuperscript{160} Art. 194 Property Law.
5. Transfer of Charge and Charged Property

The charge may not be transferred separately from the secured claim.\footnote{Art. 192 sentence 1 Property Law.} Subject to statutory or contractual provisions to the contrary, the charge is simultaneously transferred to the transferee of the secured claim when the secured claim is transferred. The chargor and the chargee may, for example, contractually stipulate that the charge extinguished upon the transfer of the secured claim to a third party.\footnote{Hu on art. 192.} This happens by operation of law (cessio legis);\footnote{Art. 192 sentence 2 Property Law.} the transfer of the charge does not require the registration of the transfer. As a consequence of the transfer of the charge to the transferee, the registration of the charge turns false and ought to be corrected.\footnote{Supra at 71.} If only a part of the secured claim is transferred, the transferee will also obtain a corresponding part of the charge.\footnote{Art. 72 Judicial Interpretation of Security Law.} The transferee and the initial chargee will be satisfied from the money obtained by the enforcement of the charge in proportion to the amounts of their portions in the secured claim; however, this does not apply for maximum amount charges prior to the exact determination of the secured claims.\footnote{Infra at 90 et seq.} Before all secured claims are determined, if a part of the already determined claims is transferred to a third party, the charge or part of it will not be simultaneously transferred unless all parties involved have contractually agreed otherwise.\footnote{Infra 87 et seq.}

The transfer of the charged property by the chargor to a third party has to be approved by the chargee in advance of it taking place.\footnote{Art. 191 para. 2 Property Law; art. 17 Civil Aviation Law, art. 17 Maritime Law.} If the chargee refuses to approve such transfer, the chargor, the debtor or the transferee may fulfil the secured claim to extinguish the charge in order to thus make the chargor’s approval unnecessary. If the charged property is transferred to a third party (with the approval of the chargee) the charge ceases to exist on the property.\footnote{If the charge is registered, the registration has to be erased, cf. supra at 70 et seqq.} Pursuant to an analogous application of art. 174 Property Law,\footnote{Art. 204 Property Law.} the proceeds (i.e. the purchase price paid by the third party) substitutes the charged property and the charge now has to be satisfied from the substitute. If the preconditions for the enforcement of the charge are not yet fulfilled, the proceeds have to be transferred to an escrow to ensure that the future enforcement of the charge remains possible unless the proceeds are immediately used to satisfy the chargee (as a premature enforcement of the charge).\footnote{Art. 91 para. 1 Property Law.}

The legal consequences following from a transfer of the charged property without the chargee’s approval are a subject of legal debate. The wording of art. 191 para. 2 Property Law only states that the chargor must not transfer the charged property

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\footnote{Art. 192 sentence 1 Property Law.} \footnote{Hu on art. 192.} \footnote{Art. 192 sentence 2 Property Law.} \footnote{Supra at 71.} \footnote{Art. 72 Judicial Interpretation of Security Law.} \footnote{Infra at 90 et seq.} \footnote{Infra 87 et seq.} \footnote{Art. 204 Property Law.} \footnote{Art. 191 para. 2 Property Law; art. 17 Civil Aviation Law, art. 17 Maritime Law.} \footnote{If the charge is registered, the registration has to be erased, cf. supra at 70 et seqq.} \footnote{If the charge is registered, the registration has to be erased, cf. supra at 70 et seqq.} \footnote{Supra at 70 et seqq.} \footnote{Supra at 73 et seqq.} \footnote{Art. 91 para. 1 Property Law.}
without such approval. This differs from the old rule in art. 49 Security Law which considered it “invalid”. Art. 191 para. 2 Property Law does not say whether an unapproved transfer is invalid or not, but only stipulates the consequential obligation of the chargor, i.e. a breach of this obligation will make him liable to pay damages from any loss sustained by the involved parties.

82 According to one opinion, an unapproved transfer is invalid: the chargor remains owner of the charged property, and the chargee keeps the charge on it. However, it is also recognized that acquisition of the property free of charge should be possible by a third party acting in good faith (i.e. if that party is not aware that a charge on the property exists and where its lack of awareness does not result from negligence on its part).\(^{174}\) According to another opinion, such a transfer ought to be valid and the charge ought to continue to exist on the property even if the transfer was unapproved.\(^{175}\) Again, if the transferee was in good faith regarding the non-existence of a charge on the property, he would obtain the property free of the charge. According to both views this means that if the *bona fide* transferee acquires the property free of the charge, the charge extends to the purchase price obtained as a substitute for the property (in accordance with an analogous application of art. 174 Property Law\(^{176}\)). And if this purchase price is lower than the property’s market value, the chargor will be liable to the chargee for any consequential loss.

83 The second opinion (transfer valid despite being unapproved) gives the chargor more flexibility in dealing with his property without unduly disadvantaging the chargee: the claim of the chargee remains secured by the charged property. The value of the security right is not affected by the transfer in any respect. Should the property in exceptional cases incur any depreciation in value as a result of the transfer, the chargor would be liable for the chargee’s consequential loss because, according to art. 191 para. 2 Property Law, he is not allowed to transfer the charged property without the latter’s approval. According to this view, the approval of the chargor as to the transfer may be interpreted as his consent to the substitution of the proceeds to the property: if he approves, the charge will extend to the money; if he does not approve, it will continue to encumber the property (of course, except it being acquired in good faith; in this case the charge will continue to exist on the proceeds\(^{177}\)). Furthermore, the transferee also benefits from this view. He has more options at hand than the first opinion would apply. In particular, he is able to acquire the property encumbered by the charge even if the chargor does not approve the transfer. The first view unnecessarily restricts the negotiability of the charged property and the commercial options of the parties involved.

84 In the author’s view the second opinion therefore is more convincing. Consequently, the transfer of the charged property without the chargor’s prior approval should be recognized as valid in all cases.

\(^{174}\) Guo/Fang/Zhang, 129.

\(^{175}\) Liu Baoyu, 407, 408; Huang, 572. With regard to this debate, cf. also Seminar of Chengdu Housing Property Regulatory Office.

\(^{176}\) Supra at 47 et seqq.

\(^{177}\) Supra at 54 et seqq.
6. Special Forms of Charge

a) Floating Charge

For the first time in the history of Chinese law, legislature has adopted the "floating charge (浮动抵押)" when passing the Property Law. This concept has initially been developed by the English courts of equity during the 19th century. In contrast to a fixed charge, the floating charge extends to a fund of changing assets held by the grantor. It "floats" until "crystallisation" occurs – at that point the floating charge is converted into a fixed charge. According to Property Law, all enterprises (any company or organisation registered as such), industrial and commercial individuals or households (个体工商户) (i.e. any natural person or family registered as such) or agricultural production operators (农业生产经营者) may grant floating charges on their manufacturing facilities, raw materials, products and semi-manufactured products as security for their own debts. These items of property may already belong to the chargor, or they may be owned by him in the future. Floating charges are only applicable to the aforementioned items of movable property. Real estate and intangibles such as rights are unusable to a floating charge.

Prior to the crystallisation of a floating charge the chargor is entitled to continue to dispose of the goods concerned in the regular course of his business. The items affected by the floating charge will change in their composition from time to time, i.e. they will be acquired or transferred to a third party (which is, in principle, possible without the chargee’s consent). However, according to art. 189 para. 1 Property Law, an item of property is only exempt from the floating charge if the third-party purchaser has obtained the ownership of the property in the chargor’s ordinary course of business and if he has paid a reasonable purchase price. If either of these preconditions is not fulfilled at the time of crystallisation, the property concerned will fall under the crystallised charge; it will not be exempt from the charge even if the missing condition is subsequently fulfilled. For example, if the transferee of an item of property affected by a floating charge pays the purchase price after crystallisation, the fixed charge will nevertheless be attached to the property concerned. If the transferee has not yet obtained ownership of the property, the conveyance after crystallisation has to be approved by the chargee. If the transferee has already obtained ownership of the item at the time of crystallisation, the crystallisation will not affect his ownership; however, the item will be encumbered by the crystallised charge.

Apart from transfers of the items covered by the floating charge within the ordinary course of business, the chargor may also dispose of the items in other ways, e.g. by creating a fixed charge on a specific item. However, this disposition does not exempt the property concerned from the floating charge.

By the crystallisation of the floating charge, the charge becomes a normal fixed charge and everything “freezes” in its then current state. The fixed charge encompasses all property covered by the floating charge at crystallisation, and the normal provisions governing fixed charges apply. The transfer of the charged property now needs to be approved by the chargee, and the chargee may seek satisfaction from the

178 Art. 181 Property Law; also Hu on art. 181.
179 Supra at 79 et seqq.
180 Cf. also Liu Guixiang, 25.
“frozen” items of property. The crystallisation is triggered by any of the following events:
1) default on the secured claim by the debtor after expiry of the applicable performance period,
2) insolvency of the chargor,
3) the occurrence of any contractually stipulated circumstance concerning the enforcement of the charge,\(^{181}\) and
4) any other circumstances seriously endangering the enforcement of creditor’s rights.\(^ {182}\)

89 The process of enforcing a floating charge is not specifically regulated by the Property Law, although, theoretically, provisions on the enforcement of fixed charges need to be complied with. There are, nevertheless, special circumstances in case a floating charge has to be realized. Since the instrument of a floating charge has been in existence in China for less than three years, there is a distinct lack of special expertise on it; legal practice is still in the process of establishing an effective system to enforce floating charges.\(^ {183}\)

b) Maximum Amount Charge

90 A maximum amount charge (最高额抵押) applies to claims arising from a series of contracts within a certain period.\(^ {184}\) The actual number and identity of principal contracts is usually uncertain at the point in time when the charge contract is concluded. They are defined and concretised upon the occurrence of the following circumstances:
1) expiration of the determinate period agreed for in the charge contract,
2) if a determinate period is not or not clearly stipulated, a request made two years after the creation of the maximum amount charge by either the chargor or the chargee to determine secured claims,
3) no new claim to be secured may arise,
4) sealing or seizing of the charged property,
5) insolvency of the debtor or the chargor, and
6) any other circumstances stipulated by law.\(^ {185}\)

91 Prior to the secured claims being determined, chargor and chargee may contractually amend the determinate period, vary the scope of the claims to be secured and/or the maximum amount, provided that these amendments do not cause any disadvantage to other chargees of the same charged property.\(^ {186}\) For example, if the maximum amount is increased, the charge with regard to the increased part will rank lower than all other charges created prior to the increase. Once the secured claims are determined, the charge converts into a normal charge; however, the charge is capped by the agreed maximum amount.

\(^ {181}\) *Infra* at 73 *et seqq.*
\(^ {182}\) Art. 196 Property Law.
\(^ {183}\) *Cf.* Liu Guixiang, p. 25.
\(^ {184}\) Art. 203 Property Law. With regard to the nature of maximum amount security *cf.* also the maximum amount guarantee in *supra* at 36 *et seqq.*
\(^ {185}\) Art. 206 Property Law.
\(^ {186}\) Art. 205 Property Law.
VI. Pledge

The difference between a charge and a pledge is that the pledge is a possessory right, i.e. the creation of a pledge requires the physical possession of the pledged property to be transferred to the pledgee. In contrast to a mortgage, the pledge does not require the transfer of title on the pledged property.

1. Pledged Property

a) Pledgeable Assets and Rights

Only movable assets and certain rights may be subject to a pledge. Movable properties (such as weapons) prohibited to be assigned or conveyed by law cannot be pledged. The following rights can be pledged: (1) commercial papers, i.e. money orders, cheques and cashier's cheques, securities and deposit receipts, warehouse receipts and bills of lading, (2) assignable interests in funds and shares in companies, (3) assignable intellectual property rights and (4) accounts receivable.

b) Fruits of Pledged Assets or Rights

Unless contractually stipulated otherwise, the pledge also covers the fruits collected during the period in which the property is pledged; they shall, however, cover the expenses for the collection of fruits in the first place.

2. Pledge Contract

To create a pledge, the pledgor and the pledgee have to enter into a written pledge contract. Usually, a pledge contract contains references to the type, amount and the performance period of the secured claim, the description of the pledged property, the scope of the security right and the time for delivery of the property intended to be pledged. Similar to the rules applying to charges, prior to the expiring of the performance period applicable to the secured claims, the pledgor can not effectively assume the obligation vis-à-vis the pledgee to convey the pledged property to the pledgee upon debtor's defaulting on the secured claim.

3. Creation of Pledge on Movable Properties

A pledge on movables is completely created by the delivery of the property to the pledgee, provided that a pledge contract has been effectively entered into. If the pledgee is already in possession of the property when the pledge contract is

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187 Art. 209 Property Law.
188 Art. 223 Property Law. As regards pledge of a commercial paper with an anti-assignment endorsement infra at 100 et seqq.
189 With regard to fruits please also refer to supra at 64.
190 Art. 213 Property Law.
191 Art. 210 Property Law.
192 Supra at 64.
193 Art. 211 Property Law.
194 Art. 212 Property Law.
concluded, the pledge is created by the effective conclusion of the pledge contract.\textsuperscript{195} If the property is in possession of a third party, the pledgor may also assign his claim against the possessor for return of the property to the pledgee instead of delivering the property.\textsuperscript{196} If the pledgor is in possession of the property, the delivery of the property cannot be substituted by an agreement between the pledgor and pledgee stipulating that the pledgor shall possess the property on behalf of the pledgee.\textsuperscript{197} After the creation of the pledge, the pledge does not extinguish if the pledgee returns the pledged property to the pledgor. However, once the pledgee has returned the pledged property, the pledge is no longer effective against a third party in good faith\textsuperscript{198} i.e. a third party may acquire the pledged property free of the encumbrance constituted by the pledge.\textsuperscript{199}

4. Creation of Pledge on Rights

The creation of a pledge on rights requires an effective pledge contract and the delivery of any relevant certificate of the right to be pledged or the registration of the pledge.\textsuperscript{200}

a) Pledge on Commercial Papers

According to the provisions in Property Law\textsuperscript{201}, the creation of a pledge on commercial papers requires the conclusion of an effective pledge contract and the delivery of the certificate of the claim to be pledged to the pledgee.\textsuperscript{202} In the event that such a certificate does not exist for the right to be pledged, as it is the case, certain securities traded on the stock exchange that are already paperless, the creation of the pledge has to be registered with the respective register.\textsuperscript{203} The aforementioned possibility to substitute the delivery of movable property\textsuperscript{204} is also applicable to the delivery of commercial papers.

However, the creation of pledges on money orders, a cheque or a cashier’s cheque is also stipulated in the Negotiable Instruments Law, according to which the creation of a pledge on such commercial papers requires the endorsement of “pledged” on the back of the pledged commercial paper and the delivery of the paper concerned.\textsuperscript{205} Due to contradictory provisions in the Negotiable Instruments Law and Property Law, it is controversial\textsuperscript{206} whether the endorsement of “pledged” on the back of the pledged commercial paper is necessary for the creation of a pledge on the paper. According to the Negotiable Instruments Law and the Judicial Inerpretation of Negotiable Instruments Law, the pledge on the paper is not effectively created without

\textsuperscript{195} Art. 25 Property Law.
\textsuperscript{196} Art. 26 Property Law.
\textsuperscript{197} Art. 87 para. 1 Judicial Interpretation of Security Law.
\textsuperscript{198} Art. 87 para. 1 Judicial Interpretation of Security Law.
\textsuperscript{199} Art. 108 Property Law.
\textsuperscript{200} As regards pledge on IP rights \textit{infra} Chapter 10 at 123 \textit{et seqq.}
\textsuperscript{201} Art. 224 Property Law.
\textsuperscript{202} Art. 224 Property Law; art. 27 para. 3.
\textsuperscript{203} Art. 224 Property Law.
\textsuperscript{204} \textit{Supra} at 96.
\textsuperscript{205} Arts. 35 para. 2, 80, 93 Negotiable Instruments Law, art. 55 SPC’s Judicial Interpretation of Negotiable Instruments Law (最高人民法院关于审理票据纠纷案件若干问题的规定), hereinafter: Judicial Interpretation of Negotiable Instruments Law.
\textsuperscript{206} \textit{Cf. The Second Civil Division of SPC, 83; Jiang/Luo, 99–102; Liu Baoyu, 564–569.}
VI. Pledge

such an endorsement. The provisions in the Property Law and the Judicial Interpretation of Security Law do not require such an endorsement for the creation of a pledge on the aforementioned commercial papers; the absence of such an endorsement does not affect the creation of the pledge, the pledge only loses the effectiveness against a third party in good faith.\footnote{Art. 98 Judicial Interpretation of Security Law.} Consequently, according to the provision in the Property Law and Judicial Interpretation of Security Law, in the case of a transfer of the pledged paper to a third party unaware of the existence of the pledge, the pledge is extinguished. Different concepts are suggested in judicial literature to deal with this contradiction.\footnote{Tengzhou Chengjiao Xinyongshe vs. Industrial and Commercial Bank of China Branch City Zhaozhuang (滕州市城郊信用社诉建行枣庄市薛城区支行票据纠纷案), Judgement of the Higher People’s Court of Shandong Province dated June 18, 2002 ((2002) available at http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=fnl&gid=117507779), regards the Judicial Interpretation of Negotiable Instruments Law and, therefore, arrivers the conclusion that the creation of a pledge, on the commercial paper does not require an endorsement of “pledged”. Without such endorsement, the pledge, however, cannot challenge a third party in good faith.}

Furthermore, it is also a subject of legal debate whether a pledge can be effectively created on a money order, a cheque or a cashier’s cheque containing an anti-assignment clause.\footnote{The Second Civil Division of SPC, Jiang/Luo and Liu Baoyu (supra n. 201) regard the contradictory provisions as two different and from each other independent ways for creation of a pledge on the commercial papers. Without the required endorsement, a pledge is created by way of endorsement and delivery of the paper in accordance with art. 35 para. 2, 80, 93 Negotiable Instruments Law. However, if the parties have concluded an effective pledge contract and delivered the paper in accordance with the provisions in Property Law and the Judicial Interpretation of Security Law, a pledge is nevertheless created. But the pledge cannot challenge a third party in good faith and, furthermore, the effective creation of the pledge is not proved by an unbroken chain of endorsements on the paper, i.e. the pledgee has to prove that the pledge is effectively created (art. 31 para. 1 Negotiable Instruments Law).} Some regard such commercial papers as inassignable and, therefore, unpledgeable.\footnote{Note that such anti-assignment clause remarked by the issuer of the commercial paper has to be placed on the front side of the paper, while such a clause remarked by the holder of the paper has to be endorsed on the back of the paper, otherwise such anti-assignment clauses are not valid. Cf. art. 30 Measures for Payment and Settlement (支付结算办法) issued by the People’s Bank of China; Shanghai Zhongfa Dianqi (Group) Ltd. vs. Bank of Communications Joint Stock Ltd. Branch Shanghai Pudong (上海中发电气(集团)有限公司与交通银行股份有限公司上海浦东分行), Judgment of Higher People’s Court of Shanghai (上海市高级人民法院) dated June 6, 2007 (沪高民二(商)终字第51号).} Contrary to this opinion, it is to be considered that art. 223 Property Law only requires in the case of shares, interests in funds and IP-rights that these papers have to be assignable to be pledgable; with regard to the pledgeability of other rights, the provision does not require their assignability.\footnote{Zhu/Gao/Chen, 723.} Moreover, the reason for the unpledgeability of inassignable property is that inassignable property cannot be sold, which makes the enforcement of the pledge impossible. But the aforementioned commercial papers all embody claims for payment; beside the possibility of enforcing the pledge by way of selling the claims affected, the pledgee may also seek satisfaction from the payment effect by the debtor of the claim pledged.\footnote{Supra at 93.} Hence, there is no

\footnote{Infra at 105 et seqq.}
need to prohibit the pledge of these commercial papers. In case a holder of the commercial paper (endorser) creates a pledge in spite of an anti-assignment clause endorsed by the preceding endorser, arts. 51 and 54 Judicial Interpretation of Negotiable Instruments Law recognize the creation of the pledge but limit the preceding endorser’s liability: the pledgee cannot hold the preceding endorser liable for the realization of the paper (arts. 61–72 Negotiable Instruments Law), i.e. he may not claim recourse if the payment to the paper has been rejected by the debtor.

101 The creation of a pledge on a corporate bond without the endorsement of “pledged” on its back cannot bind the company issuing the bond and any third party.213

b) Pledge of Interests in Funds and Shares in Companies

102 Only assignable interests in funds and shares in companies may be pledged.214 According to art. 72 Company Law, the transfer of shares of a limited liability company (有限责任公司) to any transferee other than its shareholders has to be approved by more than half of the other shareholders (unless otherwise provided in the articles of association of the company) (supra Chapter 2 at 37–46). Hence, the creation of a pledge on shares in a limited liability company in favor of someone other than the shareholders always has to be approved by more than half of its shareholders.215 Furthermore, the Company Law also imposes restrictions on the transfer of shares in a joint stock limited company (股份有限公司, JSLC), e.g. shares held by promoters (发起人) and members of the management such as directors, supervisors and senior officers of the company cannot be transferred within one year commencing as from the date of the company having been listed on a stock exchange (supra Chapter 2 at 69). Moreover, members of the management are barred from transferring their shares within half a year as from their dismissal from their management position.216

103 The creation of a pledge on interests in funds requires the registration of the pledge with the register of securities deposit and clearing institutions (证券登记结算机构). A pledge on stocks registered with the register of securities deposit and clearing institutions, e.g. stocks in listed companies, also has to be registered with this register. Pledging other shares of companies has to be registered with the register of the Administrative Department for Industry and Commerce (工商行政管理部门).217

c) Pledge of Accounts Receivable

104 To create a pledge on accounts receivable, the pledge has to be registered with the relevant credit rating institution (信贷征信机构),218 which is the credit rating centre of the People’s Bank of China.219 As this security instrument was newly introduced to China with the Property law, the relevant commercial practice is still unclear.

213 Art. 99 Judicial Interpretation of Security Law.
214 Art. 223 no. 4 Property Law.
215 Other opinion: Liu Baoyu, 603 et seq.
216 Arts. 142 Company Law.
217 Art. 226 para. 1 Property Law.
218 Art. 228 para. 1 sentence 2 Property Law.
219 Art. 2 para. 1 Measures for Registration of Pledge on Account Receivables (应收账款质押登记办法).
5. Pledgee’s Rights and Obligations

a) Enforcement of the Pledge

Upon default of the principal debtor on the secured claim or the occurrence of a contractually stipulated circumstance triggering the enforcement of the pledge, the pledgee may (1) acquire the pledged movable or right at market price and then offset the purchase price against the secured claim, or (2) seek payments received from an auction or private sale of the pledged property. The price of such a sale to the pledgee or to another person has to equal market price; if it is below market price, a third party suffering damage as a result (e.g. another creditor of the pledgor) may claim damages against the pledgor and the pledgee.

The pledgor may require the pledgee to realize the pledge in a timely manner once the pledge is mature. If the pledgee fails to do so, the pledgor may request the court to auction or sell off the pledged property. Should the pledgee be responsible for the delay in realizing the pledge, he will be liable for any loss caused to the pledgor thereby.

Both commercial papers and accounts receivable are rights of performance, i.e. rights under which an act of performance may be demanded. Beside the possibility of enforcing the pledge by way of selling the right affected, the pledgee may also seek satisfaction from performance by the debtor of the pledged right. If a right to payment is pledged, as it is the case of money orders, cheques, cashier’s cheques, securities, deposit receipts and accounts receivable, the pledge may be realized by direct payment by the respective debtor of the pledged right. The money paid by him substitutes the pledged right, which means that, up to the amount secured, the money shall be paid directly to the pledgee, and only any excess shall be paid to the pledgor. If a warehouse receipt or bill of lading is pledged, the goods concerned substitute the pledged claim, and the pledge is to be realized by way of commercialising these goods. If the performance date of a pledged commercial paper is set prior to the maturity date of the pledge, the pledgee may require the debtor of the pledge right to perform and, on the basis of a contractual agreement with the pledgor, seek enforcement of the pledge in advance or require the proceeds of the right (money paid or goods delivered) to be deposited. Similarly, if the performance period of any claim of accounts receivable expires before the end date of the performance period of the secured claim, the pledgee shall be entitled to seek enforcement of the pledge to the extent of such pledged claim in advance or require the proceeds to be deposited.

The pledgee of a money order, a cheque or a cashier’s cheque may exercise all rights of a holder of the commercial paper concerned. He can, inter alia, hold the endorser/pledgor and issuer of the paper liable for the realization of the paper.

Pledged interests in funds and shares of companies listed on the stock exchanges may generally only be sold via the stock exchange.

220 Cf. also supra at 73.
221 Arts. 219 paras. 2 Property Law.
222 Arts. 219 para. 3 Property Law.
223 Arts. 195 para. 1, 229 Property Law. Cf. also supra at 73 et seqq.
224 Arts. 220 para. 1 Property Law.
225 In an analogous application of art. 174 Property Law. Supra at 47 et seqq.
226 Art. 225 Property Law.
227 Arts. 35 para. 2, 61–72 Negotiable Instruments Law.
b) Maintenance of the Pledged Property

Since the pledged property is in possession of, and, therefore, under physical control of the pledgee, the latter is obliged to properly keep and maintain it. For this purpose, he is obliged to refrain from any action or prevent any omission of a third party which might harm the pledged property. The pledgee is not allowed to use or dispose of the pledged property without approval of the pledgor. Should the pledgor suffer any loss or damage due to the pledgee’s breach of his obligation to maintain the pledged property, the pledgee may be held liable for damages.\(^{228}\)

If any action or omission on the part of the pledgee is likely to cause damage to, or lead to the loss of, the pledged property, the pledgor or – if he performs the secured claim in advance – to return the pledged property.\(^{229}\)

Where, for a reason not attributable to the default of the pledgee, it is likely that the pledged property will depreciate, e.g. where it is probable that share prices plunge, the pledgee may require the pledgor to provide further security covering the potential depreciation of the pledge. If the pledgor refuses to do so, the pledgor is entitled to realize and secure the current value of the pledged property by way of auction or private sale.\(^{230}\)

If the pledge is extinguished without being realized, the pledgee is obliged to return the pledged movable\(^{231}\) or the certificates relating to the right affected (by delivery). If the pledge is registered, the pledgor and pledgee shall jointly apply for de-registration of the pledge.

c) Sub-Pledge

To secure a debt of his own, the pledgee may create a security right in the encumbered asset, with or without the consent of the pledgor, a so-called “sub-pledge (转质)”.\(^{232}\) The creation of the sub-pledge requires an effective pledge contract and the delivery of the property or the certificate to the sub-pledgee, or the registration of the right.\(^{233}\) A pledged money order, cheque or cashier’s cheque cannot be effectively sub-pledged.\(^{234}\)

In case the sub-pledge is created without the consent of the pledgor, it must not impair the legal position of the pledgor. The scope of the sub-pledge, therefore, must remain within the scope of the main pledge, and the enforcement of the sub-pledge must not take place prior to that point in time when the pledgee would be allowed to realize the main pledge.

The sub-pledge has priority over the main pledge.\(^{235}\) If the pledgor has the right to realize the main pledge prior to the sub-pledge being due, the money obtained from the sale or auction either has to be deposited to the extent of the claim secured by the sub-pledge or may (on a contractual basis) be paid out to the sub-pledgee in advance. If the sub-pledgee is allowed to realize the sub-pledge prior to the main

\(^{228}\) Arts. 214, 215 para. 1, 229 Property Law.
\(^{229}\) Arts. 215 para. 2, 229 Property Law.
\(^{230}\) Art. 216, 229 Property Law.
\(^{231}\) Art. 219 Property Law.
\(^{232}\) Art. 217 Property Law, Art. 94 para. 1 sentence 1 Judicial Interpretation of Security Law.
\(^{233}\) Supra at 95 et seqq.
\(^{234}\) Jiang/Luo, 99–102, Liu Baoyu, 567. Cf. also art. 51 Judicial Interpretation of Negotiable Instruments Law.
\(^{235}\) Art. 94 para. 1 sentence 2 Judicial Interpretation of Security Law.
pledge – which is only possible if the pledgor has consented to the sub-pledge – the proceeds will either be paid to the sub-pledgee to the extent of the claim secured by the sub-pledge, with the remaining amount of money being deposited, or (if stipulated so on a contractual basis) it may be paid out to the pledgee in advance of the main pledge falling due.

According to the Property Law, the pledgee may be held liable by the pledgor for damages if the pledgor has not consented to the creation of the sub-pledge and if the creation of the sub-pledge causes the destruction of, or any damage to, the pledged property.236 This provision permits the reverse conclusion that, if the pledgor has consented to the sub-pledge, the pledgee would not be liable for damages caused by the sub-pledgee’s misconduct.

**VII. Lien**

The lien is a statutory possessory real security right with regard to movable property. The creation of the lien is not based on an agreement of the parties involved, but takes place by operation of law.

1. **Creation of Lien**

   If a debtor is in default and culpably fails to perform his obligations when due, the creditor will obtain a lien on the debtor’s movable property in his possession, provided that this possession is lawful and is attributable to the same legal relationship as the unperformed debt. However, the possession and the debt do not have to be attributable to the same legal relationship if both debtor and creditor are enterprises.237 Movables cannot be encumbered by a lien if this is prohibited by law or has been stipulated so by the parties involved.238 The creditor and the debtor therefore may agree on such a prohibition.

   The lien also covers fruits collected during the period in which the property is encumbered by the lien; this, however, is actually intended to cover the expenses connected with the collection of fruits in the first place.239

2. **Lienor’s Rights and Obligations**

   a) **Enforcement of Lien**

      The lienor and the debtor shall agree on a period of time for the performance of the claim after the lien is taken into consideration to secure the claim. Where such a period has not been stipulated, a statutory period of two months applies; in cases, however, where the goods affected by the lien cannot be kept for this period of time (e.g. if they are easily perishable goods such as fresh fish), the statutory period is adjusted accordingly.240 If the debtor fails to perform after this period has expired, the lienor may realize the lien and seek preferred satisfaction. He may 1) contractually acquire the movable affected by the lien for a purchase price equal to its

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236 Art. 217 Property Law.
237 Arts. 230 para. 1 and 231 Property Law.
238 Art. 232 Property Law.
239 Art. 235 Property Law.
240 Art. 236 para. 1 sentence 1 Property Law.
market price and then offset the purchase price against the secured claim, or 2) seek preferred satisfaction from the money obtained by means of an auction or private sale. In the latter case, the private sale must not be concluded below market price.\textsuperscript{241}

122 The debtor may require the lienor to realize the lien in a timely manner upon expiry of the period stipulated for the lien. If the lienor fails to do so, the debtor may request the court to auction or sell off the property concerned.\textsuperscript{242}

123 Once the lienor loses possession of the property affected by the lien, the lien is extinguished. Where the debtor provides, and the lienor accepts, another security in order to secure the claim previously secured by the lien, the lien is also extinguished.\textsuperscript{243}

b) Maintenance of the Property Affected by the Lien

124 Since the property affected by lien is in the possession and therefore under the physical control of the lienor, he is obliged to keep and maintain it, and may be held liable if he fails to do so adequately.\textsuperscript{244}

VIII. Relevant Laws & Regulations

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\textsuperscript{241} Arts. 236 Property Law.
\textsuperscript{242} Arts. 237 Property Law.
\textsuperscript{243} Art. 240 Property Law.
\textsuperscript{244} With regard to the obligation to maintenance of the property, \textit{supra} also at 110 \textit{et seqq}. 

Changfeng Tu
### VIII. Relevant Laws & Regulations

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Chapter 8. Bankruptcy


I. Overview

China has undergone a prolonged process to develop its bankruptcy law. There was no bankruptcy legislation in China until 1906 when the Ministry of Commerce of
the Qing Dynasty enacted the first ever Chinese Bankruptcy Code as part of its legislative modernizing plan. In 1935, another Bankruptcy Law was enacted by the Nationalist government, which remains the main piece of bankruptcy legislation in Taiwan.\(^1\) Nevertheless, in 1949 when the People’s Republic of China was established, the new government abolished all legislation enacted by the nationalist government and set up a completely new legal regime that mirrored the Soviet Union’s model for serving a planned economy. Since bankruptcy legislation is unnecessary in a planned economy, there was almost no bankruptcy law in China from 1949 to 1986.\(^2\)

During the reforming process to a market oriented economy, it was crucial to find a way to make State-Owned Enterprises (SOEs) operate more efficiently. On January 31, 1986, the State Council approved the draft enterprise bankruptcy law, which was later challenged by the representatives of the Standing Committee of the NPC mainly on two points: (i) it was unfair to make managers and workers of an unprofitable SOE bear the result of bankruptcy for which they could not be blamed because the management of the SOE was significantly influenced by the government and other unreasonable factors\(^3\); and (ii) the accompanying legislation had not been enacted such as company law and labor law and there was no developed social welfare systems.\(^4\) Despite strong disagreement from the NPC, the State Council stayed firm in its commitment to bankruptcy reform and the then Premier made it clear that if the NPC deferred the enactment of the bankruptcy law the State Council would take a leading role instead.\(^5\) As a result, the NPC adopted Enterprise Bankruptcy Law (for Trial Implementation) (hereinafter: Old Bankruptcy Law)\(^6\) in 1986.

The rationale behind Old Bankruptcy Law was not to try to close many SOEs but to make SOEs aware of the possibilities of being bankrupt. It changed, at least in theory, the view that a SOE would not and could not be declared bankrupt regardless of how badly it operated. This, itself, was a great achievement. The provisions of Old Bankruptcy Law only applied to SOEs, but the absence of a well developed social welfare system significantly prevented the legislation from being properly implemented. As a result, Old Bankruptcy Law remained in trial status for the next 20 years.

Five years later, the applicable bankruptcy procedures for non-SOEs were set out in articles 199 to 206 Civil Procedure Law (hereinafter: Civil Procedure Law 1991)\(^7\). But the situation was further complicated by the enactments of other regulations, decrees, and SPC interpretations. For example, the SPC in November 1991 issued

\(^1\) Tomasic (2006), 132–133.

\(^2\) In October 1955, the Supreme Court (SPC) together with Ministry of Justice issued a “Response to Two Questions regarding the Bankruptcy Procedure of Private-owned Companies (关于私营企业破产还债程序中的两个问题的批复)”. In January 1957, the SPC issued a “Reply to A Few Questions in connection with Bankruptcy Liquidation (关于破产清偿几个问题的复函)”. After all private-owned companies were transferred to state-owned enterprises within a short period of time, there was no bankruptcy regime in China until 1986. An, 5.

\(^3\) For example, the product prices were fixed by the government rather than fluctuated in accordance with the market. Cao, 56.

\(^4\) At that time, a SOE took care of its employees in all aspects. It was common for a big SOE to operate its own hospital and school which were free to its employees. If a SOE declared bankrupt, it would be difficult to find another entity to look after that SOE’s employees.

\(^5\) Cao, 63.

\(^6\) (企业破产法(试行)), enacted on December 2, 1986 and came into effect on November 1, 1988.

\(^7\) (民事诉讼法), enacted on April 9, 1991 and came into effect on April 9, 1991. The Civil Procedure Law was amended in October 2007. In light of Bankruptcy Law, those articles were deleted from the revised Civil Procedure Law.
II. Main Issues

1. Scope of Application

a) Enterprise with Legal Person Status

Art. 2 Bankruptcy Law specifies that the new law only applies to enterprises with legal person status. Under Chinese law, “enterprise” is a very broad concept, which includes SOEs, EJVs, CVJs, WFOEs, domestic LLC, JSLC and partnership enter-

8 最高人民法院关于贯彻执行《中华人民共和国企业破产法(试行)》若干问题的意见, issued on November 7, 1991 and came into effect on November 7, 1991.
9 最高人民法院关于审理企业破产案件若干问题的规定, issued on July 30, 2002 and came into effect on September 1, 2002.
12 广东省公司破产条例, issued on June 13, 1993 and came into effect on August 1, 1993.
15 Which may be set up under Industrial Enterprises Owned by the Whole People Law (全民所有制工业企业法), enacted on April 13, 1988 and came into effect on August 1, 1988.
16 Supra Chapter 3 at 27.
prises, city collectively-owned enterprises, town collectively-owned enterprises, and individual proprietorship enterprises. The main difference between enterprises with or without legal person status is whether the investors of the enterprise have to bear unlimited or limited liabilities for the losses incurred by the enterprise. For instance, since at least one partner of a partnership enterprise or an investor of an individual proprietorship enterprise bears unlimited liabilities which are not capped at the original capital investment, neither of these enterprises has legal person status.

During the set-up process, an enterprise has to register with the local or state Administration of Industry and Commerce (AIC) and then the relevant AIC will issue it a business license. In general, an enterprise obtains legal person status immediately upon receipt of its business license.

b) SOE

The equal treatment of SOEs and non-SOEs is intended to boost both domestic and foreign investors' confidence in the Chinese economy as a fair and market driven one. Nevertheless, by the time Bankruptcy Law was passed in 2006, some SOEs had not yet been transformed into independent and autonomous companies or still bore huge losses previously caused by government policies. During the legislative process, the legislators faced tremendous pressure to grant SOEs special protection. As a result, Bankruptcy Law provides a carve out for those SOEs (art. 133): “the bankruptcy of stated-owned enterprises which are within the timeframe and scope set by the State Council before this law comes into effect shall be carried out according to the relevant regulations issued by the State Council.”

To understand the provisions of art. 133 Bankruptcy Law, it is necessary to be aware of the special bankruptcy regime set up by the State Council for SOEs before 2006. In normal bankruptcy proceedings, after the secured creditors have been paid there usually will not be sufficient money left to satisfy unpaid employees’ claims including wages and payment for health and social insurance premiums. Considering that most secured creditors were state-owned banks, and that, in most circumstances, it was morally difficult to blame the employees for the losses incurred by the troubled SOEs, it would appear unfair to put the state’s interests ahead of individual employees’ in bankruptcy proceedings. As a result, since under Old Bankruptcy Law the secured creditors’ claims were ranked ahead of the employees’ claims, it was almost impossible to implement the law without the government’s

17 Supra Chapter 2 at 1.
18 Which are set up under City Collectively-owned Enterprise Regulation (城镇集体所有制企业条例), issued on September 9, 1991 and came into effect on January 1, 1992.
19 Which are set up under Township Enterprise Law (乡镇企业法), enacted on October 29, 1996 and came into effect on January 1, 1997.
20 Which are set up under Individual Proprietorship Enterprise Law (个人独资企业法), enacted on August 30, 1999 and came in to effect on January 1, 2000.
21 There are two types of partnership enterprises in China: general partnership enterprises and limited liability partnership enterprises. Supra Chapter 2 at 115–117.
22 Under art. 2 Individual Proprietorship Enterprises Law, an individual proprietorship enterprise means a business entity which is invested by only one natural person and the sole investor assumes unlimited liabilities.
23 Art. 3 Administrative Regulations on the Registration of Enterprises with Legal Person Status (企业法人登记管理条例), which was issued by the State Council on June 3, 1988 and came into effect on July 1, 1988.
24 An, 322–323.
extra support. To ease the affected employees’ opposition, the State Council established a separate “policy bankruptcy” regime by issuing a number of administrative rules and notices including 1994 Notice and 1997 Notice. Under the “policy bankruptcy” regime, the government plays a key role in all aspects from preparing the broad bankruptcy plan, approving each individual case to settling employee claims.\footnote{Wang Weiguo, 387.} Furthermore, the proceeds from selling the land use rights, which is normally the most valuable assets of a bankrupt SOE, will be firstly used to satisfy the unpaid employees’ claims even if the land use rights have already been encumbered with security interest.\footnote{Art. 2 of 1994 Notice.} At the same time, the relevant state-owned banks are supplied with government subsidy to write off bad debts from their balance sheets.\footnote{Art. 6 of 1994 Notice.} Essentially, in the “policy bankruptcy” proceedings, it is the that bears the losses caused by the bankrupt SOEs. By the end of 2005, 3,658 SOEs had been closed under the “policy bankruptcy” regime.\footnote{According to news reported by First Business Daily on August 29, 2006, available at http://finance.people.com.cn/GB/1039/4750128.html.}

The “timeframe and scope set by the State Council” mentioned in art. 133 refer to the deadline of the “policy bankruptcy” regime and eligible SOEs to that regime. In accordance with the “State Council’s Notice on Further Improvement of the SOEs Policy Bankruptcy Work”\footnote{(国务院办公厅转发全国企业兼并破产和职工再就业工作领导小组关于进一步做好国有企业政策性关闭破产工作意见的通知), issued by the State Council on January 16, 2006.}, the deadline of “policy bankruptcy” regime is the end of 2008; there are still 2,116 eligible SOEs.\footnote{The total amount of debts owed to the state-owned financial institutions is RMB 227.16 billion and the number of employees involved is 3.51 million.} It is worth noting that the deadline of 2008 does not necessarily mean that all “policy bankruptcy” proceedings have to be completed by the end of 2008. Provided that the relevant bankruptcy proceedings had commenced before 2009, it would still be governed by the relevant “policy bankruptcy” rules, rather than Bankruptcy Law.

Although the “policy bankruptcy” regime is understandable both morally and politically, it violates the express provisions of Old Bankruptcy Law and may also weaken the foundation of the relevant security law. If the relevant secured creditors are unable to obtain sufficient protection in bankruptcy proceedings, the security provided by a borrower or trade counterparty in relation to the land use rights would become worthless, which may result in deterring lending and a massive increase in borrowing costs.

The first impression of art. 133 may appear to be worrying since it effectively excludes 2,116 SOEs from Bankruptcy Law and allows them to still follow the “policy bankruptcy” regime. However, in the previous drafts of Bankruptcy Law, there was a separate chapter of special provisions in relation to SOEs, which incorporates most rules from the “policy bankruptcy” regime.\footnote{Wang Weiguo, 390.} If that approach had been adopted, the “policy bankruptcy” regime would apply to all the SOEs in the future. By contrast, art. 133 on the one hand provides a cushion for certain seriously troubled SOEs and on the other hand sets a deadline and limited scope for applying the old regime. As a result, most SOEs are now subject to the bankruptcy proceedings set out in Bankruptcy Law.
c) Financial Institution

14 It is widely accepted in most jurisdictions that the bankruptcy proceedings of a financial institution such as a commercial bank, insurance firm or securities company should be governed by special rules due to its unique business model and the massive potential impact of its bankruptcy. The special rules could be very different from the normal bankruptcy rules (US approach) or quite similar to the general rules (UK approach).\(^\text{32}\)

15 Since financial institutions satisfy the requirement of being an enterprise with legal person status, they are also covered by Bankruptcy Law. However, art. 134 Bankruptcy Law authorizes the State Council to make special implementation rules for the bankruptcy proceedings of financial institutions.

16 Under Chinese law, there are already a number of special regulations which provide specific bankruptcy related rules applicable to the relevant financial institutions. For instance, in accordance with art. 71 Commercial Bank Law\(^\text{33}\), individual depositors are entitled to enjoy priority in distributing the bankruptcy estate of a bankrupt commercial bank.

d) Excluded Commercial Entities and Individuals

17 At present, there is no individual bankruptcy law in China. Under art. 4 SPC Rules 2002, enterprises, sole traders, partnerships and lease-holding farm households which do not have legal person status are not eligible to submit a bankruptcy petition to the court.

18 During the drafting process of Bankruptcy Law, some scholars and NPC representatives suggested an ambitious scope of application to also cover individual consumers, sole traders, partnerships and individual proprietorship enterprises. Some scholars held the view that the creation of the consumer bankruptcy regime would help to develop a sound credit environment.\(^\text{34}\) The draft bankruptcy law circulated by the NPC for comments in 2004 provided a position stating that the bankruptcy law applies to both enterprises with legal person status and non-legal person enterprises including partnerships, individual proprietorship enterprises and other profit organizations.\(^\text{35}\) The proposal to include 23 million individual consumers and sole traders was rejected on the basis that neither a personal property registration system nor a well developed individual credit environment in China.\(^\text{36}\) This proposed and moderately extended covering range was supported by the SPC to (i) facilitate the development of partnerships and individual proprietorship enterprises, and (ii) explore the feasibility of establishing individual bankruptcy regime in the future.\(^\text{37}\) This view, however, was vigorously opposed by some other

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\(^\text{32}\) Wood, 740.

\(^\text{33}\) (商业银行法), first enacted on May 10, 1995 and came into effect on July 1, 1995, and subsequently amended on December 27, 2003.

\(^\text{34}\) Wang Liming, 3.


\(^\text{36}\) Ibid.

\(^\text{37}\) Which was described in the report prepared by the law committee of the NPC on the amendments to the draft bankruptcy law. An, 315.
NPC representatives and scholars on the grounds that it would be unfair to only include partners and sole investors but exclude sole traders.

Although the finalized applicable scope of Bankruptcy Law is restricted to enterprises with legal person status, the relevant debate including the comments from the SPC demonstrates the desire to expand the coverage of bankruptcy law in the future. This view is also supported by art. 135 Bankruptcy Law. Under art. 135 the procedures set out in Bankruptcy Law will be applied by reference when an entity, other than an enterprise with legal person status, is liquidated as required by other laws.

At present, the relevant piece of legislation covered by art. 135 is the Partnership Enterprise Law. Under art. 92 Partnership Enterprise Law, in the event that a partnership enterprise is unable to repay its debts, its creditors are entitled to either apply to the court to initiate bankruptcy proceedings or require the general partners of that enterprise to repay the debts. If the creditors choose to start bankruptcy proceedings, the court will apply the relevant procedure rules set out in Bankruptcy Law, including imposing a stay on actions and possibly appointing an independent administrator to take over the debtor’s assets, which are beneficial to protect and maintain the debtor’s assets. As confirmed by the deputy chief justice of the SPC in a bankruptcy law forum in 2008, the court has already dealt with a few bankruptcy cases relating to partnership enterprises. However, after the partnership enterprise is declared bankrupt, the general partners of such enterprise still bear several and joint liabilities for outstanding claims. If any general partner is an enterprise with legal person status and it is unable to repay such outstanding claims, the creditors may then apply to the court to commence bankruptcy proceedings against that general partner. On the other hand, since there is no existing individual bankruptcy regime in China, if a general partner of the partnership enterprise is an individual, the creditors can only have a debt claim against that partner.

2. Jurisdiction

In Bankruptcy Law, art. 3 is the main provision dealing with the issue of jurisdiction. Art. 3 states: “the court located at the place of residence of the debtor has jurisdiction over the debtor’s bankruptcy proceedings”.

a) Territorial Jurisdiction

There is no definition of the place of residence in Bankruptcy Law. Two sets of SPC interpretations deal with the issue of the place of residence. Under art. 4 SPC Interpretation of the Civil Procedure Law, the place of residence of a legal person refers to either its principal place of business or the place where its main office is located. However, under art. 1 SPC Rules 2002 which was issued 10 years later, the place of residence of a debtor only refers to the place where its main office is located. In case where a debtor does not have a main office, the court where the debtor has its registered office will have jurisdiction to wind up the debtor.

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38 Xi, 1.
39 Art. 92 Partnership Enterprise Law.
40 (最高人民法院关于适用《中华人民共和国民事诉讼法》若干问题的意见), issued on July 14, 1992 and came into effect on July 14, 1992.
As a result of those contradictory rules, at present there are different interpretations of how the place of residence should be construed under Bankruptcy Law. According to interpretation given by the officials at the NPC, the place of residence of an enterprise legal person should be the same as set out in its business license. A SPC judge holds the view that the debtor’s place of residence only refers to the principle place of its business or the place where its main office is located. However, a leading Chinese bankruptcy scholar asserts that the place of residence mentioned in art. 3 should be construed as the place where the debtor’s main office is located. In addition, the SPC is also considering whether to add the place where the main assets are located to the jurisdiction provisions.

Under art. 37 Civil Procedure Law, if more than one court declares jurisdiction, the relevant courts are required to cooperate and consult with each other. If the issue cannot be resolved between them, a superior court will designate a court to hear the bankruptcy case.

b) Subject Matter Jurisdiction

Art. 3 Bankruptcy Law does not provide a clear answer to question as to on which level of courts should have jurisdiction. Under art. 2 SPC Rules 2002, in general, an enterprise, whose establishment is permitted by the town/district level AIC, should file its bankruptcy proceeding with the lowest local level People’s Court. In respect of an enterprise whose set-up is approved by regional, city or other higher level AIC, an Intermediate People’s Court usually has jurisdiction.

In practice, the complexity of a bankruptcy case does not necessarily align with the level of AIC that permits the enterprise’s set-up. In the event that a case subject to an inferior court’s jurisdiction under art. 2 is too complicated to be heard by that court, not only is that court entitled to submit such a case to its superior court, its superior court also has discretion to choose to hear the case by itself. This is authorized by art. 3 SPC Rules 2002 and art. 39 Civil Procedure Law.

Furthermore, under art. 5 Bankruptcy Law, the domestic bankruptcy proceedings are also binding on the debtor’s assets located outside the PRC. Considering that a increasing number of Chinese companies have invested or plan to invest abroad, this approach may cause complex international legal issues in cross-border bankruptcy cases. In respect of a foreign judgment made on bankruptcy proceedings involving assets located within the PRC, Bankruptcy Law has not distinguished a foreign main proceeding from a foreign non-main proceeding. Under art. 5, the relevant Chinese court decides whether to recognize and enforce such judgment based on (i) the relevant international treaties entered into between China and that foreign country or (ii) if there is no existing treaty between China and that country, the principle of reciprocity as long as the judgment does not contravene any fundamental principles of Chinese law, the state’s sovereignty, public interest or the lawful interests of creditors within the PRC. This gives the Chinese court significant discretion to refuse to recognize a foreign court judgment.

41 An, 15.
42 The court at the debtor’s place of incorporation may only have jurisdiction if designated so by the superior court. Wang Dongmin, 22.
43 Wang Weiguo, 9.
44 Xi, 2.
Although the provisions of art. 5 are still different from those set out in the UNCITRAL Model Law, they illustrate the ambition to establish the extraterritorial scope of Bankruptcy Law. It has been argued that the legislators take a narrow view regarding the inbound bankruptcy proceedings since China has not yet entered into any international treaties on cross-border bankruptcy. However, some scholars argue that the international treaties mentioned in art. 5 also refer to those international cooperative treaties on general civil proceedings, and before August 14, 2006 China had already entered into valid international bilateral treaties with more than 30 countries on judicial cooperation on civil and commercial legal proceedings.

3. Bankruptcy Petition

a) Criteria for Bankruptcy Liquidation

In order to prevent bankruptcy procedures being abused, in most jurisdictions certain criteria have to be met before the relevant bankruptcy proceedings could be accepted by the court. There are two ways to set out these criteria. The first option is to identify in the legislation the occurrence of any particular events such as failure to pay a matured debt within certain days. The second option is to outline some general requirements such as a cash flow test, balance sheet test or legitimate interest test.

Bankruptcy Law has adopted the second option. Art. 2 Bankruptcy Law provides a two limb test: cash flow test and balance sheet test. The cash flow test is satisfied if the debtor is unable to repay its debts as they fall due. The balance sheet test is satisfied either, if the debtor’s total liabilities exceed its assets, or if the debtor manifestly lacks the ability to repay its debts. Under Bankruptcy Law, the court will accept the petition for bankruptcy liquidation if both the cash flow test and the balance sheet test are satisfied.

The requirement for the cash flow test seems to be straightforward: whether the debtor is able to repay its debts when they fall due. However, there is no minimum threshold amount applicable for the cash flow test. Furthermore, under art. 2 there is neither a grace period nor minimum requirement on the number of creditors which the debtor has failed to pay. This means regardless of how small the amount of debt is, if the debtor cannot repay it on time, the test is satisfied.

A normal balance sheet test is to examine whether the debtor’s total liabilities exceed its total assets. However, it is not always easy to prove that the balance sheet test is passed, in particular, from a creditor’s point of view. Firstly, it is almost impossible for an ordinary creditor to obtain sufficient and timely information in

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45 Under the UNCITRAL Model Law, subject to international treaties and public policies, the presumed position is to recognize a foreign bankruptcy proceeding. UNCITRAL Legislative Guide on Insolvency Law, 297–306.
46 Kargman, 48.
47 Wang Xinxin/Wang Jianbin, 10–11.
48 For example, in Denmark and Germany, it is necessary for the creditor to prove that it has a legitimate interest to apply for bankruptcy proceedings against its debtor. The purpose is to prevent any bad faith or vexatious petition. Wood, 199.
49 In the event that the creditor is a commercial bank, under the underlying loan agreement, the bank may be able to require the debtor to supply its financial information on a regular basis and inform the bank if the debtor believes certain financial covenants will be or have been breached.
relation to a private company’s balance sheet. Secondly, the method of valuation used to examine the balance sheet is a contentious issue. In practice, there are different views on whether the mark to market value or the balance sheet value should be followed.\(^{50}\) Although it is easier to use the balance sheet value, the figures in an unaudited financial report can be misleading. Thirdly, in China, certain valuable assets owned by the debtor may not be easily transferable to another party or sold in the market due to legal restrictions, which adds further complication to the calculation of the total assets.

33 The legislators recognize the difficulties for a creditor to prove the normal balance sheet test. As a result, under art. 2, the balance sheet test will also be satisfied if the creditor can illustrate that the debtor manifestly lacks the ability to repay its debts. However, “manifestly lacks the ability to repay its debts” is not a clearly defined phrase in Bankruptcy Law. The difference between this requirement and the cash flow test needs to be clarified by the SPC in the future.

b) Eligible Applicant

34 Under Bankruptcy Law, both the debtor and creditors are entitled to apply to the court to commence bankruptcy liquidation proceedings.

35 (1) Debtor. In accordance with art. 7 Bankruptcy Law, if a petition is filed by the debtor, the debtor needs to prove that both the cash flow test and the balance sheet test have been satisfied. Under art. 8 Bankruptcy Law, in addition to the application form,\(^{51}\) the debtor should also provide the court with (i) a statement of its financial status; (ii) details of all the debts owed by it; (ii) details of all the debts owing to it; (iv) relevant financial and accounting reports; (v) a proposed employee resettlement plan; and (vi) the current status on the payment of its employees’ wages and social insurance premiums. Those requirements are intended to prevent the debtor from deliberately using the bankruptcy regime to evade its debts.

36 There used to be a special problem in China: Where supported by the local government, a company would transfer its valuable assets to a related company and then try to be declared bankrupt in order to avoid repaying loans borrowed from state-owned banks.\(^{52}\) In 2001, the SPC issued “the Emergency Notice on Preventing Debtors from Debt Evasion in Bankruptcy Trials”\(^{53}\) (hereinafter: 2001 Emergency Notice) which specifically requires the court to reject the bankruptcy petition if a significant amount of the debtor’s assets are missing or the debtor has already transferred its valuable assets to set up a separate enterprise.\(^{54}\) Art. 12 SPC Rules 2002 also states that the court shall reject the bankruptcy petition if the debtor has concealed or transferred its assets and submits the bankruptcy application for the purposes of debt evasion. Although those SPC interpretations were issued before the enactment of Bankruptcy Law, currently the court still holds conservative views on accepting bankruptcy petitions and will refuse to start the bankruptcy proceed-

\(^{50}\) Liu, 51.
\(^{51}\) Which should include information such as (i) the particulars of the applicant and the respondent; (ii) the purpose of the application; (iii) the relevant factual background and reasons for the application; and (iv) other matters which the court may deem necessary (Art. 8 Bankruptcy Law).
\(^{52}\) Liu, 64.
\(^{54}\) Art. 3 of the 2001 Emergency Notice.
ing if there is suspicion that the debtor is intentionally trying to avoid paying its debts by submitting bankruptcy petition.

Compared with bankruptcy laws of other jurisdictions, the most unusual document which needs to be submitted by the debtor for the bankruptcy petition is the employees’ resettlement plan. Although the proposed plan does not need to be approved by the general meeting of representatives of employees, the court normally requests the debtor to clarify in the plan the source and the amount of funds available to pay outstanding employees’ claims, the proposed mechanism to help its existing employees to find a new job and the way to take care of its retired employees’ pension payments and medical expenses. Since the social welfare system has not yet been fully developed throughout China, this requirement illustrates the additional responsibilities imposed on an enterprise. In practice, there are arguments that a non-SOE should not be required to submit a binding employees’ resettlement plan since it is normally the local government that is in charge of this matter.

(2) Creditor. In contrast, since it is difficult for a creditor to find out the debtor’s accurate financial conditions, Bankruptcy Law has released the burden of a creditor to prove the balance sheet test. When a creditor applies to the court to start bankruptcy procedures, it is only required to demonstrate that the debtor is unable to repay its debt which is due.

However, it is not entirely clear whether a secured creditor is entitled to apply to start the bankruptcy proceedings against the debtor. The provisions in Bankruptcy Law are very general and have not expressly excluded secured creditors’ right in this regard. One argument against granting such rights to secured creditors is that it would be unfair to the debtor if a secured creditor were allowed to wind up the debtor’s whole business while there is already an existing option agreed by both parties to satisfy the secured creditor’s claim by only enforcing the specified security collateral. However, some other scholars hold the view that secured creditors are just one kind of creditors and therefore should have equal petition rights. In practice, since secured creditors’ claims are subject to certain employees’ claims under bankruptcy proceedings and bankruptcy proceedings are also more time consuming, it is unlikely that a secured creditor will have any motive to start the bankruptcy procedures, provided that its claim could be sufficiently protected by realizing the relevant security collateral.

Under art. 10 Bankruptcy Law, if the bankruptcy petition is initiated by a creditor, the court will notify the debtor within five days. If the debtor disagrees with the creditor’s petition, it is required to submit its opposition to the court within seven days of receipt of the notice and the court will make a decision on whether to accept the bankruptcy application within ten days after the expiry of the seven day period.

If it is disputable whether the debtor actually owes any money to the applicant or at the time of the petition it is uncertain whether the debt is due, the court is likely

55 Wang Weiguo, 23.
56 Wang Dongmin, 52.
58 Art. 7 Bankruptcy Law; Liu, 90–92.
59 Liu, 91.
60 Wang Dongmin, 49–50.
61 Art. 132 Bankruptcy Law.
to dismiss the creditor’s application\(^{62}\) and the creditor then needs to apply for a separate legal proceeding to determine the debt claim. Since both the cash flow test and the balance sheet test need to be satisfied before bankruptcy liquidation proceedings can be initiated, if the debtor illustrates that the relevant balance sheet test has not been passed, the debtor is also entitled to request the petition to be rejected. In addition, pursuant to art. 108 Bankruptcy Law, at any time before the court declares the debtor bankrupt, the court is required to terminate the bankruptcy proceedings, if the debtor is able to procure the occurrence of the following events: “(i) a third party provides guarantee for all the debts of the debtor or a third party repays all the debts owed by the debtor which fall due; or (ii) the debtor has repaid all its debts that are due.” If a creditor intends to damage the debtor’s reputation and jeopardize fair competition by applying to commence bankruptcy proceedings, art. 12 SPC Rules 2002 also requires the court to reject the bankruptcy petition and according to art. 20 Anti-Unfair Competition Law (反不正当竞争法)\(^{63}\), the debtor is then entitled to damages from that creditor.

42 Although Bankruptcy Law provides the debtor with the opportunity to argue against the bankruptcy petition submitted by creditors, in practice, it is not unusual that the debtor’s management personnel may run away or it is difficult to ascertain the debtor company’s actual financial condition. In this regard, the SPC issued in August 2008 the “Reply to the Question of Dealing with the Bankruptcy Petition where the Debtor’s Relevant Personnel are Missing or the Condition of the Debtor’s Assets Is Unclear”\(^{64}\) to require the court to accept the bankruptcy petition by the creditors regardless whether the debtor has submitted the relevant material as required by art. 11 Bankruptcy Law. In addition, within two years of the debtor being declared bankrupt, the creditor may still apply to the court to redistribute any subsequently located debtor’s assets.\(^{65}\)

43 (3) Director. In some other countries, directors of a company are obliged to submit a bankruptcy petition if they become aware that the company has satisfied the bankruptcy criteria under the relevant bankruptcy law.\(^{66}\) Under Chinese law including Bankruptcy Law, there is generally no such express obligation imposed on directors. This means that even if a Chinese company is having serious financial difficulties, its directors normally do not have to voluntarily start the bankruptcy procedures. However, the directors may have an obligation to start the bankruptcy procedures in one special circumstance – liquidation process.

44 The obligations imposed on a company’s management team are different when that company is dissolved, but has not been liquidated or is in the process of being liquidated. If the shareholders decide to dissolve the company in accordance with art. 181 Company Law (supra Chapter 2 at 93), art. 184 Company Law requires the company to set up a liquidation committee which is in charge of the liquidating process.\(^{67}\) Under art. 187 Company Law, during the liquidation process, the

\(^{62}\) Wang Dongmin, 47.

\(^{63}\) Promulgated by the SCNPC on September 2, 1993, effective on the same day.

\(^{64}\) (关于债权人对人员下落不明或者财产状况不清的债务人申请破产清算案件如何处理的批复), issued by the SPC on August 7, 2008 and came into effect on August 18, 2008.

\(^{65}\) Ibid.

\(^{66}\) Wood, 566–567.

\(^{67}\) In respect of a limited liability company, the liquidation committee should consist of shareholders; and in respect of a joint stock limited company, the liquidation committee should be
company’s creditors will be notified and the company is not allowed to carry out any other business. The shareholders are not entitled to receive any dividends or distributed assets until all relevant liquidation fees, employees’ claims, unpaid tax, and debts owed by the company have been paid or settled.68 Pursuant to art. 189 Company Law, after all the company’s assets have been duly distributed, the liquidation committee is required to submit a liquidation report to the shareholders’ meeting or the court and apply to the relevant authority to strike off the liquidated company from the registry of companies.

In practice, it is possible that a company has applied to cancel its business license without carrying out the proper liquidation process. It is important to note that in accordance with the relevant notice69 issued by the AIC, when the debtor company applies to the AIC to cancel its business license, the AIC is not obliged to check whether the debtor company should apply to start the bankruptcy proceedings. In this regard, the SPC issued in 2000 a “Reply to the Question regarding the Bankruptcy Petition when a Relevant Party’s Business License is Revoked”70. Under that document, the SPC made clear that the court is bound not to reject a bankruptcy petition submitted by a creditor just because the debtor company’s business license is revoked. Furthermore, in accordance with art. 18 of “the Provisions of the SPC on Some Issues regarding the Implementation of the Company Law (II)71, if a company fails to set up a liquidation committee in time, resulting in the devaluation or losses of the company’s assets, the creditors of that company are entitled to apply to the court to require the companies’ shareholders72 and directors to compensate the creditors for the relevant losses incurred by them. This is intended to force both the directors and shareholders to duly start the liquidation process and prevent a company from being dissolved without liquidation.

During the whole liquidation process, if the liquidation committee finds out that the company’s assets are not sufficient to repay all of its debts, the liquidation committee is obliged to apply to the court to start the bankrupt liquidation.73 The bankrupt liquidation means the distribution of the company’s assets in accordance with the rules set out under Bankruptcy Law. The rationale is that, when the company has sufficient assets to repay all of its debts, less disagreements or conflicts may arise between the company and its creditors in relation to the liquidation. Nevertheless, if there is no enough money to repay all of the debts, it would be better to follow the relevant bankruptcy procedure to ensure that every party’s interest is fairly protected. As a result, if one of the company’s directors is also a

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68 Art. 187 Company Law.
71 (最高人民法院关于适用《中华人民共和国民公司法》若干问题的规定(二)), issued on May 12, 2008 and came into effect on May 19, 2008.
72 In respect of a limited liability company, all the shareholder; in respect of a limited joint stock company, only controlling shareholders.
73 Art. 188 Company Law.
member of the liquidation committee and during the liquidation process he or she becomes aware that the company’s debts exceed its assets, that director is then under an obligation to apply to start the bankruptcy proceeding.

47 (4) Court & Regulator. It is also important to understand that under Chinese law, a court is not required to use its initiatives to commence the bankruptcy proceedings even if during other court proceedings it is clear that the debtor is unable to repay all of its debts. In accordance with art. 15 SPC Opinion 1991, the SPC held the view that the court should only inform the debtor to submit the bankruptcy petition to the relevant court, but the court itself should not start the bankruptcy procedure without the application from either the creditor or the debtor.

48 However, under art. 134 Bankruptcy Law, if a financial institution has financial difficulties, the relevant financial supervisory authority is entitled to submit the bankruptcy petition to the court.74

4. Bankruptcy Commencement and Declaration

a) Commencement

49 Pursuant to art. 11 Bankruptcy Law, if the court decides to accept a bankruptcy petition, it will notify the applicant within five days from the date on which the decision is made (hereinafter: Commencement Date). Under art. 14 Bankruptcy Law, the court bears the duty to make a public announcement of its ruling and notify all known creditors within 25 days of the Commencement Date.

b) Bankruptcy Declaration

50 Under Bankruptcy Law, even after the court has accepted the bankruptcy petition, apart from applying for composition or reorganization, the debtor is still allowed to negotiate a private solution with the creditors.75 However, if the debtor cannot secure a private solution and the composition agreement or the reorganization plan (if applicable) has also failed, the court is required to make a public ruling to declare the debtor bankrupt. Thereafter, under art. 107 Bankruptcy Law the debtor is referred to as a bankrupt and the debtor’s assets is referred to as the bankruptcy estate. The debtor’s business will not be managed as a going concern and there are no longer any means to rescue the debtor or terminate the bankruptcy procedures.

51 Under Bankruptcy Law, the administrator is responsible for drafting the valuation plan and the distribution plan76 of the bankruptcy estate which then needs to be approved by the creditors’ meeting and/or77 the court.78

74 In addition, the bankruptcy petition of certain financial institution needs approval from the relevant financial authority. For example, under art. 71 Commercial Bank Law, any commercial bank’s bankruptcy petition needs to be approved by China Banking Regulatory Commission in advance.

75 If the debtor does reach an agreement with all the creditors before the declaration of bankruptcy, it is entitled to apply to the court to terminate the court-based bankruptcy procedures. Art. 105 Bankruptcy Law; Wang Weiguo, 302.

76 Under arts. 112 and 114 Bankruptcy Law, in general, the bankruptcy estate should be sold by means of public auction and then distributed among creditors by monetary payments unless decided otherwise in the creditors’ meeting.

77 In case that the creditors cannot agree on the valuation plan, it will be determined by the court. In respect of the distribution plan, even if it has been passed by the creditors, it still needs to be approved by the court.

78 Arts. 111 and 115 Bankruptcy Law.
5. Stay on Actions

a) Restriction on Creditor

From the Commencement Date, there is an automatic stay on creditors’ actions including legal proceedings against the debtor. Any existing actions or measures on preserving the debtor’s assets should be released and any enforcement procedures against the debtor should be suspended. This is to prevent the value of the bankruptcy estate being reduced by creditors’ individual actions. Unlike some other jurisdictions, such as England and Wales, where the stay commences immediately upon bankruptcy petition or filing, under Bankruptcy Law the stay starts from the Commencement Date on which the court has accepted the bankruptcy petition.

It has been argued that the general stay is not applicable to secured creditors because art. 109 Bankruptcy Law grants secured creditors priority rights in relation to the security collateral. However, this view is inconsistent with other provisions of Bankruptcy Law. For instance, art. 96 Bankruptcy Law states that secured creditors are entitled to enforce their rights against the debtor after the court has approved the composition agreement. If secured creditors are not restricted by the stay on actions from the Commencement Date, there is no need to release them from the stay after the composition plan is approved. In addition, art. 75 Bankruptcy Law clearly states that the stay remains valid on secured creditors during the reorganization process. As a result, it seems reasonable to conclude that until the court has approved the composition procedures or the secured creditor can prove to the court that the stay has significantly damaged its rights over the relevant security, the secured creditors are prohibited from enforcing their claims against the debtor during the period between the Commencement Date and the date on which the debtor is actually declared bankrupt by the court.

It is also important to note that the stay only applies to enforcement action that has not been completed. It is crucial to understand the meaning of completion. According to Art. 23 Property Law and art. 133 Contract Law, for normal movable assets, the titles of the assets are transferred when possession has changed. In respect of immovable assets, such as land and property, the titles are transferred when the relevant required registrations have been completed.

b) Restriction on Debtor

After the Commencement Date, the responsibility and authority to manage the debtor company is transferred from the debtor’s existing management to the administrator. In addition, the debtor is not allowed to repay any individual creditor for the debt owed by it. Any such repayment made by the debtor is void. The

79 For example, in accordance with arts. 92–94 Civil Procedure Law, if the debtor is in a civil dispute with another party, that party may apply to the relevant court for a freezing order over the debtor’s assets.
80 Art. 19 Bankruptcy Law.
81 S. 130(2) Insolvency Act 1986 (c. 45).
82 An., 150–151.
83 Art. 75 Bankruptcy Law.
84 Wang Weiguo, 319.
85 Supra Chapter 7 at 58.
86 Art. 9 Property Law.
87 Art. 16 Bankruptcy Law.
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c) Restriction on Legal Proceeding

In accordance with art. 20 Bankruptcy Law, after the Commencement Date all civil litigation or arbitration involving the debtor, which has already started but not been completed, are suspended until the administrator has taken over the debtor’s assets. This is to ensure the administrator’s involvement in all the relevant legal proceedings. Also, after the Commencement Date, any new civil litigation relating to the debtor is only allowed to be submitted to the court that accepts the debtor’s bankruptcy proceedings.

The purpose of starting or continuing those legal actions after the Commencement Date is not to distribute any of the debtor’s assets but to determine the validity of the relevant claims against the debtor or to ascertain whether a third party owes any debts to the debtor or possesses the debtor’s property. Even if a creditor has obtained a court ruling or an arbitration award against the debtor after the Commencement Date, under art. 19 Bankruptcy Law the creditor is not entitled to enforce it against the debtor.

d) Restriction on Senior Management

Under art. 15 Bankruptcy Law, from the date on which the court’s ruling is delivered to the debtor until the date on which the bankruptcy proceedings end, apart from complying with the normal fiduciary obligations the legal representative of the debtor and other relevant senior managers as decided by the court are obliged (i) to remain at their places of residence unless otherwise granted permis-

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88 Wang Weiguo, 46. Under Bankruptcy Law, if the debtor’s guarantor or the debtor’s joint obligor has already paid the relevant debt on behalf of it, that guarantor or joint obligor is then allowed to file the claim with the administrator. If the guarantor or the joint obligor has not repaid the debt for the debtor, they may still file with the administrator for the potential claim against the debtor provided that the relevant creditor has not filed a claim for the total amount of the relevant debt. (Art. 51 Bankruptcy Law).

89 Art. 21 Bankruptcy Law.

90 If it proves to be a valid claim, the counterparty will be treated as a creditor in the bankruptcy proceedings.

91 If a court or an arbitration tribunal decides that a third party is obliged to pay certain amounts of money or transfer some kinds of assets to the debtor, those assets will belong to the debtor’s bankruptcy estate.

92 Such as safeguarding the corporate assets, corporate seals, account books and documents which are held and controlled by them; acting in accordance with the instructions from the court and the administrator; attending the creditors’ meetings and honestly replying to the creditors’ enquiries (Art. 15 Bankruptcy Law).
sion to leave by the court; and (ii) not to take up any new appointment as director, supervisor or other senior management position of any other enterprise.

6. Administrator

The concept of an administrator was introduced by Bankruptcy Law, replacing the “liquidation committee” used in Old Bankruptcy Law. In order to facilitate the development of this new concept, the SPC has issued two sets of rules: (i) “Provisions on Appointing the Administrator in the Trial of Enterprise Bankruptcy Cases” (hereinafter: Appointment Rules) and (ii) “Provisions on Determining the Administrator’s Remuneration in the Trial of Enterprise Bankruptcy Cases” (hereinafter: Remuneration Rules).

a) Appointment

To ensure its impartial role, under Bankruptcy Law, following the recommendation of the IMF, the administrator generally needs to be appointed by the court from the list of available qualified professional intermediary firms or individuals. However, it has been argued by some Chinese scholars that an administrator appointed by the court is more likely to ignore the creditors’ interest. During the legislative process, there used to be a popular view that the administrator should be appointed directly by the creditors. The pro-creditor approach was later rejected by the NPC on the grounds that it is equally important to protect the employees’ interest and it is better to keep the administrator as impartial as possible. Under art. 13 Bankruptcy Law, the court is required to appoint an administrator at the same time as it decides to accept the bankruptcy petition. Since the administrator is appointed from the beginning of the bankruptcy procedure, this seems to have solved the problem of delay in setting up the liquidation committee under Old Bankruptcy Law.

(1) Types of Administrator Candidates. Under art. 24 Bankruptcy Law, there are three different types of administrator candidates: a professional intermediary firm, an individual professional, and a liquidation committee.

Art. 1 Appointment Rules states that apart from exceptional circumstances, the administrator normally should be selected from a list of available administrators.

93 Under Art. 8 Old Bankruptcy Law, a SOE is not entitled to submit a bankruptcy petition to the court unless its supervising government department has approved it. The debtor’s assets are managed by the liquidation committee. Since most members of the liquidation committee are government officials, in practice, creditors normally have little control of the bankruptcy process. Even if the liquidation committee’s inappropriate decision has jeopardized the creditors’ interest, the creditors are unlikely able to claim damages from the liquidation committee. Wang Liming, 6–8.

94 (最高人民法院关于审理企业破产案件指定管理人的规定), issued on April 12, 2007 and came into effect on June 1, 2007.

95 (最高人民法院关于审理企业破产案件确定管理人报酬的规定), issued on April 12, 2007 and came into effect on June 1, 2007.

96 IMF, Orderly and Effective Insolvency Procedures: Key Issues, 64; Wang Weiguo, 62.

97 Including law firms, accountancy firms, or bankruptcy liquidation firms.

98 Cheng, 337.


100 Cheng, 337.

101 Under art. 24 Old Bankruptcy, the liquidation committee only needs to be appointed after the debtor is declared bankrupt by the court.

102 An individual professional has to belong to a professional intermediary firm.
Although both professional intermediary firms and individual professionals are permitted to act as an administrator, preference is given to professional intermediary firms. In accordance with art. 17 Appointment Rules, an individual professional may only be appointed by the court to act as the administrator, if (i) the relevant facts are clear; (ii) the debts or claims involved are straightforward; and (iii) the debtor’s assets are relatively closely located. In practice, one of the biggest obstacles for an individual to act as an administrator is to obtain individual professional insurance. Under art. 25 Law on Lawyers, an individual lawyer is also not entitled to sign an engagement agreement on behalf of himself/herself with the client.

The liquidation committee embodies a special meaning in China. This concept was created under Old Bankruptcy Law and governmental officials always play a crucial role in a liquidation committee. Under Bankruptcy Law and as further clarified by art. 18 Appointment Rules, a liquidation committee should be appointed by the court: if (i) a liquidation committee has been set up before the court accepts the bankruptcy petition; (ii) the bankruptcy case is subject to the “policy bankruptcy” regime as mentioned in art. 133 Bankruptcy Law; (iii) other relevant law requires the debtor company to set up a liquidation committee; and (iv) the occurrence of other events considered by the court to be appropriate for the appointment. The last catch-all provision has granted the court significant discretion on this issue and from the creditors’ perspectives, this has increased the level of uncertainty of whether and how the relevant government will be involved in bankruptcy procedures.

To ensure the appointment process is fair and impartial, in most circumstances the court is required by art. 20 Appointment Rules to appoint an administrator randomly from the lists of available administrators by means of rotation, roster or drawing lots. The disadvantage of this method is that it is difficult to locate the most suitable administrator for a specific case. The SPC acknowledged this drawback and under the Appointment Rules the relevant court is permitted to invite qualified professional intermediary firms to bid for the appointment in complicated bankruptcy cases. Under art. 21 Appointment Rules, complicated bankruptcy cases include (i) a case where the debtor is a financial institute; or (ii) a case that has significant nationwide impact including the involvement of complex legal relations or the debtor’s assets being located in different places. In practice, since the court will only use the random method to choose an administrator for simple cases in relation to which the possible administrator fees are relatively low, many administrator candidates are not interested in the roster procedure.

It is also possible for a court to appoint more than one professional intermediate firm to jointly act as the administrator. For instance, in the bankruptcy case of

103 Art. 16 Appointment Rules.
104 It is equally difficult to persuade a professional intermediate firm to cover by the firm’s professional insurance an employee’s personal appointment as an administrator.
105 (律师法) enacted on October 28, 2007 and came into effect on June 1, 2008.
106 The court has to invite at least three professional intermediate firms.
Beijing Wu Gu Dao Chang Food & Technology Development Ltd\textsuperscript{108}, the court has appointed the relevant local government, a bankruptcy consultancy firm and a law firm to jointly act as the administrator.\textsuperscript{109}

(3) Disqualification and Replacement. Under Bankruptcy Law, only the court is entitled to appointment an administrator. Creditors are not even allowed to recommend an administrator to the court. However, under art. 22 Bankruptcy Law, if the creditors have decided at the creditors’ meeting that the administrator cannot perform its duties in a lawful and impartial manner or that the administrator is incompetent in some aspects, the creditors may apply to the court to replace the administrator. Although this grants the creditors some protection against the administrator’s misbehavior, it is clear that the court is not obliged to follow the creditors’ recommendation to replace the administrator.

In accordance with art. 24 Bankruptcy Law, an administrator candidate is prohibited from acting as an administrator if (i) the candidate has been found guilty and penalized for a crime committed with deliberate intention; (ii) the candidate’s professional practice license has been revoked, and it does not matter whether the authority has granted another practice license at a later date\textsuperscript{110}; (iii) the candidate has a personal interest in the relevant bankruptcy case; (iv) the candidate is involved in material debt disputes; or (v) the occurrence of other circumstances which, as determined by the court, makes the candidate inappropriate to act as the administrator. Arts. 9 and 26 Appointment Rules set out example of those other circumstances: (A) within the last three years, the relevant administrative authority, regulatory institute or profession self-regulatory organization has imposed any administrative penalty or disciplinary sanction on the candidate for its deliberate act or gross negligence during the course of practice or business; (B) the candidate is investigated by the relevant authority for suspected illegal behavior; (C) the candidate was removed by the court from the list of available administrators less than three years ago; and (D) the candidate lacks the professional ability to act as an administrator or lacks the ability to bear civil liabilities.

The Appointment Rules also set out the circumstances where the court is required to change the administrator. Apart from those similar to the disqualifying conditions, there are two additional circumstances which will trigger the replacement: (i) in respect of a professional intermediate firm, it is about to be dissolved, become bankrupt or in respect of an individual administrator, he is missing, dead or unable to carry out the duties of an administrator due to health reasons; or (ii) when performing the duties as the administrator, its deliberate act or gross negligence has jeopardized the creditors’ interest.\textsuperscript{111}

Both the disqualifying and replacing conditions include the existing or potential conflict of interest for acting as the administrator. The SPC has provided detailed examples in this regard. Under art. 23 Appointment Rules, an administrator is deemed to have a personal interest which may affect its performance of the

\textsuperscript{108} (北京 fünf道-gang 场食-guǐ 品技-gǔ 魄开-huò 限公-hù 复). The bankruptcy petition was submitted to Beijing Fangshan District Court in October 2008. On February 12, 2009, the court approved the reorganization plan.
\textsuperscript{110} Liu, 141.
\textsuperscript{111} Arts. 26, 33 and 34 Appointment Rules.
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administrator’s duties, if that administrator has unsettled debt or claim with the debtor or the creditors; or if within three year period before the court accepts the bankruptcy petition, the administrator has provided relatively regular services to the debtor, has been the controlling shareholder or the person having actual control of the debtor or any creditor, or has been the financial advisor or legal advisor of the debtor or any creditor. Under art. 24 Appointment Rules, in respect of a member of the liquidation committee or a professional intermediary firm or an individual administrator, a personal interest may also arise if that person has been a director, supervisor or other senior manager of the debtor or any creditor within a three year period before the court accepts the bankruptcy petition; or he has family relations with the controlling shareholder, director, supervisor or other senior manager of the debtor company or any creditor.

The black letter law is clear on the issues of appointing or replacing an administrator. However, the main practical problem identified by the practitioners in implementing this new concept is the absence of a special supervising authority. It has been argued that it is inappropriate for the court to not only make the rules, but also appoint the administrator, decide its remuneration and be in charge of the bankruptcy proceedings. Some scholars have proposed establishing a similar quasi-governmental organization like the Official Receiver’s Office in HK or the Office for U.S. Trustees.

b) Powers and Duties

Bankruptcy Law has granted the administrator a variety of managing powers throughout the bankruptcy procedure.

In accordance with arts. 15 and 25 Bankruptcy Law, from the Commencement Date, the administrator will take over all the debtor’s assets, corporate seals, account books and relevant corporate documents; and the debtor’s existing management is required to cooperate with the administrator. Under art. 15 Bankruptcy Law, if the debtor refuses to hand over the relevant assets, the administrator is entitled to apply to the court to enforce the debtor to do so.

After the administrator has taken over the debtor’s assets, it is required to investigate the debtor company’s financial status and prepare a report which will be used by the court and the creditors. Since some administrators do not necessarily have a background in finance, art. 28 Bankruptcy Law allows the administrator to, with the court’s prior approval, engage necessary experts to help to prepare the report.

After the Commencement Date, the administrator is also entitled to decide whether to rescind or continue performing any contract that has been entered into

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113 Cheng, 6, 338.
114 Art. 25 Bankruptcy Law; Wang Weiguo, 72.
115 In practice, since “administrator” is still a relatively new concept in China, it will take quite a long time to be accepted by the public. For example, in the first bankruptcy case under Bankruptcy Law, the local commercial bank refused to open a special administrator account replacing the debtor’s company account on the grounds that the local bank had not received the relevant new instructions from the People’s Bank of China. According to a report by Economic Observer News published on September 7, 2007, available at http://www.eeo.com.cn/eeo/jjgcb/2007/09/10/82474.shtml.
by the debtor but has not been performed by both the debtor and the other counterparty. Under art. 18 Bankruptcy Law, the relevant contract will be deemed to be rescinded if the administrator fails to inform the relevant counterparty of its decision within two months of the Commencement Date or within 30 days of receipt of a request from the counterparty. However, if the administrator decides to perform the debtor’s existing contractual obligations, the counterparty may require the administrator to provide a guarantee. Under art. 18, if the administrator fails to do so, the contract will still be deemed to be rescinded by the administrator.

If the administrator chooses not to rescind a contract and provides the relevant counterparty with requested guarantee, art. 18 then obliges the relevant counterparty to keep performing its contractual obligations. This article is clearly drafted in favor of the bankrupt debtor. The administrator may choose to perform contracts that are profitable and reject the others. However, if there are any losses incurred by the counterparty due to the cancellation, under art. 53 Bankruptcy Law the relevant counterparty is entitled to file a claim for damages with the administrator. In practice, an administrator is more likely to choose to terminate a contract in order to reduce the administrative burden and ascertain the amounts of all the relevant claims as soon as possible.

Regarding normal business and operational matters, the administrator has been authorized to make decisions on the debtor’s internal management affairs including finance control, asset management and personnel administrator. In accordance with art. 26 Bankruptcy Law, before the first creditors’ meeting, it is also the administrator that determines whether to continue the debtor’s business provided that the administrator’s decision is later approved by the court.

In addition, apart from the first creditors’ meeting, the administrator is allowed to convene all other creditors’ meetings. After the distribution plan has been approved by the court, the administrator is responsible for executing the plan to distribute the assets among the creditors.

During the reorganization procedure, after the reorganization plan has been approved by the court, the debtor’s existing management team may be allowed to resume control of the company and implement the reorganization plan. Nevertheless, under art. 90 Bankruptcy Law, the administrator is still responsible for supervising the implementation of the plan.

Considering that significant powers are granted to the administrator, art. 27 Bankruptcy Law also imposes due diligence duties on an administrator to perform its job in a diligent, responsible and honest manner. Furthermore, in accordance with art. 29 Bankruptcy Law, upon appointment the administrator is not allowed to resign without justifiable reasons, and any resignation has to be approved by the court. However, if an administrator is aware that there is any potential conflict of

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116 Art. 18 Bankruptcy Law. This article, however, does not authorize the administrator to rescind a contract if either party has already performed its contractual obligations.

117 Liu, 216.

118 Wang Weiguo, 72.

119 The court will convene the first creditors’ meeting. Art. 62 Bankruptcy Law.

120 Accepted reasons include the physical incompetence caused by illness or accident, and the complexity of a particular case exceeding the administrator’s qualification or experience. Wang Weiguo, 80.

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interest arising for it to keep acting as the administrator, it is required by art. 25 Appointment Rules to apply to the court to be removed from the relevant bankruptcy case.

81 Under Old Bankruptcy Law, there are no express penalties applicable to the liquidation committee. In contrast, art. 130 Bankruptcy Law specifically authorizes the court to impose a fine on an administrator if that administrator fails to perform its duties diligently and honestly. In addition, if such failure causes the debtor, creditors or any third party to suffer any losses, the administrator is required to compensate those losses accordingly.

82 However, Bankruptcy Law has not provided detailed explanations on the scope of the administrator’s diligent duties. It is also unclear as to whom the administrator owes its duties. In practice, if any creditor or related third party is allowed to claim that an administrator has not duly performed its duties, the administrator will be exposed to enormous potential risks, which are likely to deter an administrator from acting objectively.

c) Remuneration

83 Similar to most jurisdictions, in China the administrator’s remuneration is also regarded as common debt and enjoys priority over normal creditors’ claims. If the value of the bankruptcy estate is not sufficient to pay the aggregate amount of the administrator’s remuneration and the relevant expenses incurred by the administrator, the administrator is required by art. 43 Bankruptcy Law to apply to the court to terminate the bankruptcy proceedings. Thereafter the bankruptcy proceedings may only continue if the creditors, the shareholders of the debtor, the administrator, or other relevant party are willing to pay those costs on behalf of the debtor.121 However, it is worth noting that any government official seconded to the liquidation committee is not allowed to receive any administrator remuneration.122

84 In accordance with art. 1 Remuneration Rules, the trial court is not only responsible for appointing the administrator, but is also in charge of the remuneration package payable to the administrator. The justification for authorizing the court to do so is to maintain the impartial role of the administrator.123 Although the creditors are not authorized to determine the remuneration package, they are permitted to negotiate with the administrator over the remuneration package which is then subject to the court’s approval.124 If the creditors disagree with the court’s decision, they are entitled to raise any objections to the court.125

85 In accordance with art. 5 Remuneration Rules, the permitted range of an administrator’s remuneration, which is linked to the final value of the bankruptcy estate, is the cap of fees which may be charged by the administrator even if the administrator is a professional intermediary firm and appointed by the court through a public bidding process. Also, under art. 2 Remuneration Rules, the value of the security collateral over which the secured creditors have priority claims is not included in the total value of the bankruptcy estate for the purpose of deciding the

121 Any of those payments will then be treated as bankruptcy expenses which may be paid out of the debtor’s assets from time to time (Art. 12 Remuneration Rules and art.43 Bankruptcy Law).
122 Art.15 Remuneration Rules.
123 An, 38–39.
124 Art. 7 Remuneration Rules.
125 Art. 28 Bankruptcy Law.
administrator’s remuneration. The permitted ratio between the remuneration figure and the value of the bankruptcy estate ranges from 12 % (for the portion of the bankruptcy estate which is less than or equal to RMB 1 million) to 0.5 % (for the portion exceeding RMB 500 million). If necessary, a high court is allowed to vary the permitted range up to 30 %.

Since remuneration is linked to the final value of the bankruptcy estate and in reality the final value of the bankruptcy estate is normally quite low, the administrator’s total income in many bankruptcy cases is even less than the wages which have to be paid by the administrator. This inevitably discourages professionals from acting as administrators. Some scholars and judges have already proposed dividing the bankruptcy cases into profitable and unprofitable ones and set up a public social fund to provide finance to pay administrators on unprofitable cases.

d) Relations with Creditors

Since the court appoints the administrator and under art. 23 Bankruptcy Law the administrator reports its work directly to the court, it is clear that the administrator does not act as an agent of the creditors. However, in order to make creditors feel comfortable about the protection of their rights in a bankruptcy case, Bankruptcy Law does provide the creditors with certain control over the administrator. For example, art. 23 Bankruptcy Law expressly states that the administrator is under the supervision of both the creditors’ meeting and the creditors’ committee. Under art. 58 Bankruptcy Law, the list of claims prepared by the administrator also needs to be submitted to the first creditors’ meeting for approval. If necessary, the creditors’ meeting is entitled to apply to the court to replace the administrator or question the administrator’s remuneration package.

The administrator is required to attend the creditors’ meetings and answer enquiries raised by creditors. If requested by the creditors’ committee, the administrator is obliged to clarify the matters relating to its duties and supply the creditors’ committee with relevant documents. In addition, pursuant to art. 69 Bankruptcy Law, regardless of whether the creditor’s committee has requested so, an administrator is required to report certain key decisions in a timely manner including (i) transferring land, property or other real estate rights; (ii) transferring other property rights such as mine exploration rights, mining rights and intellectual property rights; (iii) transferring the whole stock or the business operation; (iv) borrowing money; (v) creating security over the debtor’s assets; (vi) transferring claims and securities; (vii) performing obligations arising from a contract when the relevant contractual counterparty has not completed its contractual obligations; (viii) waiving rights; (ix) taking back collaterals; (x) and other of the debtor’s assets which may materially affect the creditors’ interests. However, there are different views...
on whether the above requirements are just post-decision reporting\textsuperscript{131} or prior approval conditions\textsuperscript{132}.

89 In respect of foreign creditors, due to foreign exchange restrictions, it is common to lend money to an offshore holding company of a Chinese operating company. As a result, if the borrower has encountered financial problems, the offshore lenders are likely to appoint an offshore receiver to enforce their rights outside of China. For example, in the first high profile Chinese cross-border bankruptcy case after the Bankruptcy Law had come into effect, the bankruptcy case of Ferro China Limited (hereinafter: Ferro China Case)\textsuperscript{133}, PricewaterhouseCoopers was appointed by the offshore lenders as the receiver.\textsuperscript{134} But in respect of the bankruptcy and reorganization proceedings of its five key subsidiary companies in China, a local law firm, Zhuhui Law Firm, was appointed as the administrator by Changshu Intermediate Court on 22 November, 2008.\textsuperscript{135} Since “receiver” is not an established concept in China, it would be interesting to observe how the Chinese administrator works together with a foreign receiver.

7. Creditors’ Meeting

90 Since a bankrupt enterprise does not have sufficient assets to repay all of its debts, there are unlikely to be any assets left to be distributed to the debtor’s shareholders. As a result, during normal bankruptcy proceedings, economically speaking, the real owners of the debtor are its creditors.\textsuperscript{136} In order to make the bankruptcy regime more creditor friendly, Bankruptcy Law has granted the creditors’ meeting a variety of powers.

a) Formation of the Creditors’ Meeting

91 Under art. 59 Bankruptcy Law, in general, creditors (including secured creditors) who have filed their claims in accordance with Bankruptcy Law are entitled to take part in the creditors’ meeting and have voting rights. If a creditor’s claim has not been ascertained,\textsuperscript{137} that creditor is not entitled to vote in the creditors’ meeting unless the court is able to decide on a temporary amount for voting purposes.\textsuperscript{138}

92 Under art. 48 Bankruptcy Law, creditors are required to file their claims with the administrator within the period set out in the court’s notice published on the Commencement Date. However, in accordance with art. 56 Bankruptcy Law, if a creditor fails to submit its claims to the administrator on time, the claim may still be

\begin{footnotesize}
\begin{enumerate}
\item Wang Weiguo, 199–200.
\item Cheng, 301.
\item The company is listed in Singapore but its main assets and key subsidiary companies are located in China.
\item Only in composition or reorganization, the shareholders’ interests may still be affected provided that the debtor eventually avoids being declared bankrupt.
\item For instance, it is unclear whether a particular claim exists or it is difficult to determine the exact amount of the claim.
\item In practice, the court is rarely willing to do so in case there is any reasonable doubt on the validity of a claim. Wang Weiguo, 170–171.
\end{enumerate}
\end{footnotesize}
recognized if the claim is filed before all the bankruptcy estate has been distributed, but the creditor is not entitled to any previous distribution. This is different from the rules set out in Old Bankruptcy Law (art. 9), which treated the creditors’ failure to duly file their claims as a waiver.

Other attendees of a creditors’ meeting include the administrator and the representatives of the debtor’s employees and the workers’ union members. Although employees are authorized by art. 59 Bankruptcy Law to attend the creditors’ meeting and provide the creditors with their opinions on the relevant issues, it is not entirely clear, apart from the reorganization plan, whether they are entitled to vote on any other matters. During the legislative process, the majority view was against granting employees additional voting rights but in practice this issue needs to be resolved by the SPC interpretation.¹³⁹

Despite the fact that the creditors’ meeting is a self-governing entity, in accordance with art. 60 Bankruptcy Law, the chairman of the creditors’ meeting is appointed by the court from the creditors that have voting rights. The legislators used to consider granting the creditors’ meeting the right to appoint its chairman, but finally chose to only allow the court to appoint the chairman in order to protect the rights of minority creditors.¹⁴⁰

b) Secured Creditors

Under Bankruptcy Law, a secured creditor is entitled to attend and vote at the creditors’ meeting. However, it is not allowed to vote on the composition agreement and the distribution plan of the bankruptcy estate without waiving its priority right to be paid out of the relevant security collateral.¹⁴¹ Although secured creditors are unlikely to dominate the creditors’ meeting in normal circumstances, since a resolution of the creditors’ meeting needs to be agreed by creditors representing more than half of the total amount of unsecured claims, secured creditors’ participation rights are enhanced nevertheless in Bankruptcy Law.¹⁴²

A secured creditor has to comply with all the relevant registration requirements in order to uphold its security collateral during bankruptcy proceedings. In particular, regarding foreign secured creditors, a security instrument is invalid absent due filing with the State Administration of Foreign Exchange (SAFE) in accordance with the relevant rules, such as “Detailed Rules for the Implementation of Regulations on Statistics and Supervision of Foreign Debt”¹⁴³ issued by SAFE on October 11, 1989. The practical problem is that SAFE is reluctant to register any foreign security instrument which appears to be used by foreign investors to

¹⁴¹ Art. 59 Bankruptcy Law. Since neither the composition agreement nor the distribution plan deals with secured assets, secured creditors’ interest will not be negatively affected by not voting on those matters. Also, if a secured creditor’s claim cannot be recovered in full by enforcing the collateral, the creditor is then allowed to vote on the composition plan or the distribution plan in respect of the proportion of the uncovered claim.
¹⁴² Under art.13 Old Bankruptcy Law, secured creditors are excluded from the bankruptcy procedures and not entitled to vote on any matters in the creditors’ meeting.
¹⁴³ (外债统计监测实施细则), issued on September 24, 1997 and came into effect on January 1, 1998.
speculate on the exchange rate of the Chinese currency. For example, it is almost impossible to get an upstream guarantee being registered with SAFE.\footnote{Evans; Supra Chapter 7 at 21.}

In the widely reported bankruptcy case of Guangdong International Trust and Investment Corporation (hereinafter: GITIC Case)\footnote{(广东国际信托投资公司). GITIC was closed down by the Central Bank of China in October 1989 and declared bankrupt by the Guangdong Provincial High Court in January 1999. The total amount of outstanding creditors’ claims was about RMB 46.7 billion.} in 1999, most of GITIC’s foreign debts, lacking registration with SAFE or approval from SAFE, were firstly rejected by the Chinese court.\footnote{Tomasic (ed.) (2006), 117.} However, the liquidation committee eventually decided to recognize 50 per cent value of the foreign guarantees which did not have the SAFE approval on the grounds that both GITIC and the relevant foreign creditors should be blamed for the invalid guarantee.\footnote{Huen/McGinty, III 9.11.}

Due to the difficulties of obtaining SAFE registration, foreign investors often have to invest in China by way of an equity injection which does not enjoy priority protection in bankruptcy proceedings. Since the Chinese government intends to encourage more domestic finance and develop the internal bond market, it is unlikely that the restriction on offshore lending will be relaxed in the foreseeable future.

c) Procedure Rules of the Creditors’ Meeting

Under art. 62 Bankruptcy Law, the first creditors’ meeting is convened by the court within 15 days after the deadline for filing claims has expired. Thereafter, the creditors’ meeting may be convened by the court, the administrator, the creditors’ committee or the creditor(s) holding more than a quarter of the total amount of the claims.

The court-appointed chairman is in charge of the procedures of the creditors’ meeting. In general\footnote{Different mechanisms and rationales apply to the reorganization plan and the composition agreement (Arts. 84 and 97 Bankruptcy Law).}, under art. 64 Bankruptcy Law a resolution of the creditors’ meeting needs to be approved by more than half of the creditors entitled to vote and present at the creditors’ meeting whose claims are more than half of the total amount of unsecured claims. The purpose of requiring majority consent in terms of both the value of the claims and the number of the creditors is to maintain the balance between the majority creditors and minority creditors.\footnote{Wang Weiguo, 183–184.} This improves the minority creditors’ bargaining power since the number of minority creditors often exceeds that of the majority creditors.

Under art. 64 Bankruptcy Law, within 15 days from the date on which a resolution is passed, a creditor is entitled to apply to the court to revoke that resolution and request the creditors’ meeting to adopt a new one in case that resolution has violated the applicable law (including both the procedure rules and substantial law)\footnote{Wang Weiguo, 184–185.} and jeopardizes the interests of the relevant creditor.

d) Powers of the Creditors’ Meeting

The rights of the creditors’ meeting are broadly divided into two categories: supervising the administrator and making key decisions in relation to the debtor’s assets.
Under art. 61 Bankruptcy Law, the creditors are entitled to apply to the court to replace the administrator or question the administrator’s remuneration. Art. 61 also authorizes the creditors’ meeting to verify claims against the debtor, i.e. the list of claims prepared by the administrator; decide whether to continue the debtor’s business operation; and pass various agreements or plans including the reorganization plan, the composition agreement, the management plan of the debtor’s assets, the valuation plan of the bankruptcy estate and the final distribution plan.

The powers of the creditors’ meeting might appear to be extremely wide, but in practice, if creditors are unable to agree on certain key decisions in time, it will inevitably delay the bankruptcy proceedings and affect the chance of the creditors as a whole to realize their claims out of the bankruptcy estate. To facilitate the progress, the court is authorized by Bankruptcy Law to make decisions on behalf of the creditors under certain circumstances, for example, if the management plan of the debtor’s assets or the valuation plan of the bankruptcy estate has not been passed in the creditors’ meeting, or if the distribution plan is vetoed twice in the creditors’ meeting. However, there is no statutorily prescribed fixed deadline by which the administrator has to submit those plans to the creditors’ meeting for approval and the court therefore has broad discretion to decide when to step in to determine those plans on behalf of the creditors.

In practice, the actual veto rights are more important than rights merely to be consulted, because it is possible that an unreasonable plan is deliberately provided for the creditors’ meeting to veto and then the court will have discretion to determine the final plan. Under art. 66 Bankruptcy Law, any creditor is allowed to appeal against the court’s decision on the valuation plan and management plan within 15 days after the decision is made or that creditor is notified. In respect of the court’s decision on the distribution plan, the creditors’ standing is recognized only if the creditors that hold more than half of the total amount of the unsecured claims object to the court’s decision. However, the creditors’ objection is submitted to the same court instead of a superior court and does not prevent the implementation of the court’s decision.

Despite certain ambiguous matters that need to be further clarified by the SPC, Bankruptcy Law generally divides the rights arising out of the bankruptcy proceedings among the court, the administrator and the creditors. At least from the legislation itself, the government’s involvement has been reduced to a minimum. This is in contrast with Old Bankruptcy Law under which the relevant supervising government has much more control of the bankruptcy procedure. However, there is always a mismatch between parties on the ground and people in lawmaking. In reality, the local government’s involvement in a significant bankruptcy case is almost inevitable. Sometime, the creditors actually prefer to consult with the local government before submitting a bankruptcy petition. In the Ferro China Case, both local and provincial governments were engaged by the creditors from the very beginning. When the debtor company’s directors fled, it was the local govern-

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151 Wood, 231–232.


153 Halliday/Carruthers, 1152.

mentation that comforted the employees and negotiated with creditors. Until a well developed credit check and control system has been established, it appears that support from the relevant government may facilitate the bankruptcy procedures.155

e) Creditors’ Committee

107 The administrator is obliged to seek approval from the creditors’ meeting in relation to most key decisions in bankruptcy proceedings. However, creditors often have difficulties maintaining effective supervision on the administrator only through the creditors’ meeting, which cannot be convened on a frequent basis. To assist creditors to exercise their rights, Bankruptcy Law introduced another new concept, the creditors’ committee, as an instrument to supervise the administrator.156 In China, it is the creditors’ right rather than obligation to establish the creditors’ committee.157

108 Under art. 67 Bankruptcy Law, there should be no more than nine members in the creditors’ committee. An uneven number of committee members is not required because, in general, the committee will only be entitled to convene the creditors’ meetings to discuss the relevant matter instead of deciding on any material issue by itself.158 Apart from representatives of creditors which are appointed by the creditors’ meeting, under art. 67 the creditor’s committee must also include either one employee representative or one worker union representative. Although the main function of a creditors’ committee is to act as the agent of the creditors’ meeting, the appointment of its members still needs to be approved by the court in writing.159

109 The creditors’ committee mainly supervises the administrator and the debtor with respect to the daily management and disposal of the debtor’s assets and the distribution of the bankruptcy estate. In accordance with art. 68 Bankruptcy Law, the committee is entitled to request the administrator and the relevant personnel of the debtor to explain or provide relevant documents relating to the performance of their duties. Also, regardless of whether the creditors’ committee has requested so, the administrator is obliged to report to the creditors’ committee certain key decisions as set out in art. 69 Bankruptcy Law. In the event of a refusal to comply with the creditors’ committee’s request, art. 68 authorizes the committee to seek judicial relief and the court has to make a ruling within five days.

8. Debtor’s Assets

110 Before the bankruptcy declaration, the debtor’s assets serve two purposes: the repayments of debts and the possible rescue of the debtor. Under art. 107 Bankruptcy Law, after the debtor is declared bankrupt (supra at 50), the debtor’s assets are referred to as the bankruptcy estate which are only used to be distributed among the creditors.160

155 However, in order to avoid unemployment, most local governments will prefer to rescue the debtor company through composition or reorganization instead of a direct liquidation.

156 Wang Weiguo, 190.

157 Art. 67 Bankruptcy Law. Since a creditors’ committee will incur extra costs and expenses, it may not be in the creditors’ best interests to have one for a simple bankruptcy case.

158 Unless specifically authorized by the creditors’ meeting in accordance with art. 68 Bankruptcy Law, the creditors’ committee is not allowed to make important decisions on behalf of the creditors.

159 Art. 67 Bankruptcy Law.

160 Wang Weiguo, 83.
a) Scope of the Debtor’s Assets

Under art. 30 Bankruptcy Law, the debtor’s assets include both the assets that belong to the debtor when the court accepts the bankruptcy petition and those assets which the debtor or the administrator acquires thereafter but before the completion of the whole bankruptcy proceedings. For instance, the administrator may choose to perform certain existing contracts during the bankruptcy procedure and the benefits or losses arising from those contracts will also be included in the debtor’s assets. The inclusion of the assets acquired after the Commencement Date is intended to maximize the overall value of the debtor’s assets.161

It is important to note that under art. 17 Bankruptcy Law, after the Commencement Date, anyone who owes debts to the debtor or holds any debtor’s assets is required to pay back the debts or deliver the assets (as applicable) to the administrator. If a relevant third party deliberately breaches the requirement and still repays the debts or deliver the asset to the debtor and as a result the creditors have suffered losses, that party’s duty remains unreleased and under art. 17 the administrator is still entitled to require that party to perform the relevant obligations.

b) Excluded Assets

In bankruptcy proceedings, it is generally difficult to deal with two types of assets: land and other state-affiliated facilities including schools and hospitals owned and operated by the debtor company.162

Although land use rights are normally the most valuable assets of a SOE, it is possible that the debtor company has occupied a piece of land allotted by the state for free. In April 2003, the SPC issued the “Reply to the Question on Whether the Use Rights of the State Owned Land by Allotment Should Be Included in the Bankruptcy Estate” (hereinafter: SPC Reply 2003)163. In the SPC Reply 2003, the SPC made it clear that the use rights of the state-owned land are not included in the debtor’s bankruptcy estate. The charge over such state owned land is void until it has been both registered with and approved by the relevant government or the land administrative authority.164 In addition, under art. 56 Security Law, even if the charge has been upheld by the court, the proceeds of selling the assets should be firstly used to pay the land transfer premium to the government. To make things more complicated, under the SPC Reply 2003, the land use rights of a SOE that belongs to the policy bankruptcy regime will be dealt with in accordance with relevant administrative rules. Under art. 2 of the 1994 Notice, regardless of how the relevant land use rights are originally acquired, it is allowed to transfer or sell those rights for a fee which will then be used to settle the employees’ claims. After all the employees’ claims have been repaid, the remaining transfer fee will be distributed to the creditors. As a result, for those SOEs, the land use rights are clearly part of their bankruptcy estate. In practice, the creditors have to negotiate with the relevant government regarding the land use rights on a case by case basis.

161 An, 49.
164 Ibid.
Art. 71 SPC Rules 2002 sets out nine types of assets which are excluded from the bankruptcy estate including other parties’ assets possessed or used by the debtor for storage, custody, borrowing, repairing, marketing, sale and renting; assets encumbered with mortgage, pledge or lien; insurance premium or compensation for the lost security collateral; assets subject to priority rights (infra at 117); assets delivered to the other party but not yet registered; paid but not delivered assets; hire purchase assets; assets owned by the workers’ union; and state owned assets. Although the SPC Rules 2002 were made before Bankruptcy Law was enacted, they are commonly used as general guidance before the SPC issues a new set of interpretation. In order to fully understand the meaning of those assets excluded by art. 71 SPC Rules 2002 and the relevant provisions under Bankruptcy Law, it is important to be aware of the following five points.

Firstly, although security collateral is not included in the bankruptcy estate, it is still part of the debtor’s assets before the bankruptcy declaration and, therefore, the administrator is entitled to manage them during that period. Under art. 37 Bankruptcy Law, the administrator may also choose to take back the relevant security collateral by repaying the debt or providing other required security guarantee.

Secondly, the assets subject to priority rights mentioned in art. 71 refer to those assets required by law to be paid firstly to the relevant creditors. For example, under art. 286 Contract Law, if the construction contractor has not been paid in time by the employer, the contractor is entitled to apply to the court to sell the relevant construction project (if appropriate) by auction and be paid out of the selling proceeds ahead of other creditors of that employer.

Thirdly, in spite of the fact that China is a civil law country, there is a valid trust regime in China. Under art. 2 Trust Law, a trust means “the acts whereby the settlor, based on his trust in the trustee, entrusts the rights in his property to the trustee and the trustee manages or disposes of such property in its own name in accordance with the wishes of the settlor for the benefit of the beneficiary or for a specified objective”. In accordance with art. 16 Trust Law, although the trust property is managed in the trustee’s own name, it is separated from the trustee’s assets when the trustee is declared bankrupt.

Fourthly, title finance is permitted under Chinese Law. In accordance with art. 242 Contract Law, the assets rented to the “purchaser” are not included in the “purchaser’s” bankruptcy estate. In addition, during the bankruptcy procedures, any title finance transaction, such as a hire purchase agreement, is not treated as a security instrument. Under art. 71 SPC Rules 2002, the owner of the asset (financier) is allowed to take back the relevant assets from the administrator.

Finally, in respect of unpaid goods, art. 39 Bankruptcy Law expressly provides that if on the Commencement Date a seller has already dispatched the goods to the debtor but the debtor has not yet received the goods and has not paid the full purchase price, the seller is entitled to claim back such goods. Under art. 133 Contract Law, in general, the title of the goods are transferred to the buyer upon delivery. If the buyer becomes bankrupt after having received the goods, the seller will only have a debt claim against the debtor. However, art. 134 Contract Law permits the contractual

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165 (信托法), enacted on April 28, 2001 and came into effect on October 1, 2001.
166 Art. 237 Contract Law.
167 Wang Weiguo, 106.
parties to agree in the contract that the titles of the goods are not transferred until the price is paid in full. In that case, although the goods have been received by the debtor, the seller is still entitled to claim them back.\textsuperscript{168} Therefore, if a trade creditor intends to retain the title of the goods until paid, it is advisable to insert an express title retention clause into the relevant sale and purchase agreement. If the seller has already received the purchase payment, the purpose of the transaction is achieved from the seller’s perspective and it would be unfair to still allow the seller to claim back the goods. This is why art. 39 authorizes the administrator to choose to pay the full purchase price and then request the seller to deliver the goods. As a result, it is not entirely clear whether under Bankruptcy Law a seller is still able to take back those paid but not transferred assets in accordance with art. 71 SPC Rules 2002. The SPC is currently preparing a new set of interpretation rules on Bankruptcy Law, which hopefully will resolve this ambiguous issue.\textsuperscript{169}

Under art. 38 Bankruptcy Law, from the Commencement Date a third party is entitled to take back from the administrator its assets which are possessed or managed by the debtor. This timing does not encourage the potential rescue of the debtor between the Commencement Date and the declaration of bankruptcy. In the draft bankrupcy law, a third party is only entitled to claim back its assets after the debtor is declared bankrupt.\textsuperscript{170} However, the current revised timing does not reflect the original drafting purpose and is allegedly caused solely the order of the relevant articles under Bankruptcy Law having been changed for formatting purposes.\textsuperscript{171}

c) Unpaid Registered Capital

Under Chinese Law, registered capital refers to the amount of equity investment to an enterprise which is registered with the relevant AIC and are promised to be paid by the shareholders. The registered capital of an enterprise is allowed to be contributed by the shareholders in installments (\textit{supra} Chapter 2 at 25).\textsuperscript{172} Art. 35 Bankruptcy Law allows the administrator to request the relevant shareholders to contribute the outstanding amount regardless of whether the shareholders are required to do so at that time under the permitted investment timeframe.

d) Vulnerable Transactions

In order to ensure the fair treatment of creditors, it is common practice that the bankruptcy legislation authorizes the administrator or the court to claw back certain acts or transactions which might negatively affect the total value of the debtor’s assets.\textsuperscript{173} Bankruptcy Law not only sets out the transactions that could be clawed back but also renders certain acts or transactions void automatically.\textsuperscript{174}

\textsuperscript{168} Liu, 187.
\textsuperscript{169} Xi, 3.
\textsuperscript{170} Art. 119 draft bankruptcy law. An, 305.
\textsuperscript{171} Wang Weiguo, 108.
\textsuperscript{172} Generally, the minimum registered capital of a limited liability company is RMB 30,000. Before the company is registered with the relevant AIC, the shareholders need to pay at least 20\% of the registered capital or the required minimum amount of the registered capital, whichever is more. In respect of a limited joint stock company, the minimum registered capital is RMB 5 million and the initial equity investment has to be no less than 20\% of the registered capital (Arts. 26 and 81 Company Law).
\textsuperscript{173} UNCITRAL Legislative Guide on Insolvency Law, 135–136.
\textsuperscript{174} Old Bankruptcy Law only sets out void transactions. Wang Weiguo, 94.
(1) Void Transactions. Under art. 58 General Principles of Civil Law, there is no need for the affected creditors or the administrator to apply to the court to revoke any void transaction because such transactions are deemed void from the moment they took place. In contrast, a voidable transaction is valid until it is revoked by the relevant party or the court. While void transactions contravene public interest and/or mandatory rules, voidable ones are only relevant to the internal relations among the creditors.

Under Bankruptcy Law, there are three kinds of void conducts or transactions. Art. 33 Bankruptcy Law, sets out two of those conducts or transactions which are void regardless of when they occur: (i) the debtor conceals or transfers assets to evade its liabilities; and (ii) the debtor falsifies debts or acknowledges falsified claims. By admitting non-existent debts, the debtor effectively transfers its assets to related entities and this will result in the reduction of the debtor’s assets available to be distributed to other real creditors. Art. 33 emphasizes not only the conduct of a transaction but also (and maybe more importantly) the dishonest intention to carry out such conduct, because preventing the debtor from fraudulently concealing or transferring its assets is the main object of the avoidance of preferences regime in most jurisdictions.

In accordance with art. 16 Bankruptcy Law, the repayments made by the debtor to a particular creditor is also void automatically if it occurs after the court has accepted the bankruptcy petition. The rationale behind it is that allowing a preferential treatment of a particular debtor will impair the possibility of other creditors being fully repaid. The focus on this void conduct is on the issue of preference and therefore bad faith is not a necessity to avoid such preferred payment.

(2) Voidable Transactions. Under Bankruptcy Law, there are, broadly speaking, two types of voidable transactions: transactions which take place within six months before the Commencement Date and those which take place within one year before the Commencement Date.

Pursuant to art. 32 Bankruptcy Law, the repayment to a particular creditor is the only voidable transaction that needs to occur within six months before the Commencement Date and the administrator is not entitled to apply to the court to revoke such payment unless at the time when the payment is made the bankruptcy criteria set out in art. 2 Bankruptcy Law are satisfied. In addition, if the repayment is beneficial for the debtor’s assets, the administrator is restricted from revoking such transactions. The main reason to set a shorter claw back period and add additional requirement is to maintain the certainty of transactions. However, it is important to note that the repayment under art. 32 refers to repayment of a matured debt. If the debtor prepays a debt that is not due, the one year claw back period will become applicable under art. 31 Bankruptcy Law.

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175 葛民，通则，enacted on April 12, 1986 and came into effect on January 1, 1987.
176 Wang Dongmin, 184.
177 Since art. 33 refers generally to conducts in relation to the debtors’ assets; an administrator’s act to conceal the debtor’s assets is also void. Wang Dongmin, 188.
178 Wood, 458.
179 Such as payments for utility bills necessary to maintain the operation of the debtor’s business.
Apart from the voidable repayments, other types of voidable transactions all have a one year claw back period before the Commencement Date: 180

(i) The debtor transfers its assets without any consideration or waives a debt claim against another party. The wording “transfer the assets” should be interpreted broadly. In practice, if the debtor provides a guarantee 181 for an unrelated third party for free, it will also be treated as transferring assets without consideration.

(ii) The debtor enters into a transaction at an obviously unreasonable price. The unreasonable price includes both buying at a high price and selling at a low price. 182 The transaction referred to here does not only cover selling or buying products, but also other types of behavior. 183

(iii) The debtor grants security collateral for unsecured debts. The registration time of the relevant security collateral is normally used to determine when the new security instrument is provided. In this regard, it is important to note other mandatory rules applicable for creating valid security collateral under Security Law and Property Law. The unsecured debts here refer to previously existing debts. If the security collateral is provided for new money borrowed after the Commencement Date, the administrator is not entitled to revoke the relevant security collateral. 184 However, in practice, it is common for banks to renew previous loans and it is arguable that collateral provided for renewing a previously unsecured loan should be treated as security for new money. Otherwise, the banks can easily choose not to renew an existing loan but provide a new loan immediately upon the expiry of the previous loan.

(iv) The debtor prepays a debt that is not yet due. It is not entirely clear what the court’s view is on a bank’s accelerating rights in accordance with the terms of a loan agreement. For instance, in a standard international loan agreement, such as the standard template prepared by the Loan Market Association, it is common to specify the lender’s entitlement to treat the debtor’s potential bankruptcy as an event of default and then accelerate the relevant payment mechanism and bring the loan to an early ending. There are some arguments that the administrator should still be able to revoke the payment under the accelerated loan agreement to the extent that the payment is not authorized by a court ruling or arbitration award. 185

Furthermore, it is important to distinguish the voidable transactions under Bankruptcy Law from those under Contract Law. Under art. 74 Contract Law, a creditor has similar rights to apply to the court to claw back the debtor’s conduct to the extent that the debtor has waived its matured claims or has transferred its assets for free or under value 186 which results in the creditor’s interests being jeopardized. In general, under Contract Law, a creditor is only allowed to challenge a transaction up to the value of its claim against the debtor. In bankruptcy proceedings, since the administrator is managing all of the debtor’s assets, it is unlikely that the debtor or

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180 Art. 31 Bankruptcy Law.
181 In China, guarantee is the most common form of security instruments between companies.
182 Wang Weiguo, 89.
183 For example, where, although being to perform a contract, the debtors chooses not to comply with its contractual obligations. This will also be treated as a transaction under value. Wang Dongmin, 192.
184 Wang Weiguo, 90.
186 For the transfer under value claims, the relevant third party needs to be aware of the nature of the transaction (Art. 74 Contract Law).

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the third party can run the same argument to restrict the revocation value. Another key difference is that under Contract Law, the assets which are clawed back will be used to satisfy the particular creditor’s claim against the debtor. However, the benefit of revoking a transaction during bankruptcy proceedings belongs to all the creditors regardless of whether the process is initiated by a particular creditor or the administrator. Finally, under art. 75 Contract Law, the creditor is required to exercise its revoking rights within one year of the creditor becoming aware of or is deemed to be aware of the relevant transaction. In contrast, there is no express time bar by which the administrator has to decide whether to revoke a transaction under Bankruptcy Law.

e) Bankruptcy Set-Off

Set-off normally means the discharge of reciprocal obligations between the parties to the extent of the smaller obligation. A normal set-off between solvent parties will not change the final result of the transactions since the net amount received by either party is equal to the amount he would have received without the set-off.

The attitude towards bankruptcy set-off varies in different countries. Some jurisdictions completely prohibit bankruptcy set-off while some others, such as England and Wales, make it compulsory. If one creditor is allowed to set off the debt it owes to the bankrupt debtor against the debt owed to it by that debtor, this will place that creditor in a priority position compared with other creditors that do not owe any debt to the bankrupt debtor. If the bankruptcy set-off is not allowed, an unsecured creditor needs to repay any debts it owes to the debtor in full while that creditor is unlikely to recover the full amount of its claims against the debtor. As a result, whether the bankruptcy set-off is allowed dramatically changes the positions among the creditors. It is also a key indicator to illustrate whether a bankruptcy regime is pro-debtor or pro-creditor. Although those opposed to this concept may assert that it damages the equal treatment between creditors, it has already been used by many countries as a crucial mechanism for reducing the systemic financial risks.

Art. 40 Bankruptcy Law expressly permits bankruptcy set-off, which was also allowed under Old Bankruptcy Law. However, it is also clear that the bankruptcy set-off neither is mandatory nor occurs automatically. Under art. 40 a creditor has to inform the administrator about its intention to set off the debt which that creditor owes to the debtor and incurs before the Commencement Date. This leads to another relevant question: whether the due registration of its claim with the administrator within the permitted period is a pre-condition for a creditor to exercise its set-out right. Art. 56 Bankruptcy Law generally states that a creditor is prohibited from exercising the relevant rights in accordance with Bankruptcy Law unless it has duly filed its claims with the administrator. Although there is no express provision requiring the set-off creditor to file its claim with the administrator, in practice it is generally accepted that the set-off creditor should also file its

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131 Wood, 404.
133 Wood, 403.
134 For example, in the GITIC case, the Guangdong Provincial High Court, in accordance with art. 33 Old Bankruptcy Law, approved the set-off between GITIC and other commercial banks. Cheng, 353; Liu, 59.
claim in the same way as other creditors. This view is also confirmed by a few bankruptcy cases. For example, in the bankruptcy case of Chongqing Chuanran Chemistry & Industry Group Factory (重庆川染化工总厂破产案) in 2003, Chongqing No. 1 Intermediate Court held that the set-off of mutual claims were not permitted unless the relevant creditor had duly filed its claim in advance and such claim had been approved by the creditors’ meeting.

There are significant differences between a bankruptcy set-off under Bankruptcy Law and a normal set-off under Contract Law. Firstly, pursuant to art. 99 Contract Law if the same kind of matured claims are owed between parties, the set-off becomes valid directly after the claiming party notifies the counterparty of this decision, but under art. 100 Contract Law in respect of the set-off of different kinds of claims or properties, it has to be agreed by both parties. In contrast, art. 40 Bankruptcy Law generally permits the parties to set-off different and undue claims. Under Bankruptcy Law, it does not matter whether the claims are similar to each other since creditors are not entitled to force the debtor to actually perform the relevant obligations and all the claims are converted into money claims. It is also irrelevant whether the claim has matured in accordance with the underlying contractual arrangement since, under art. 46 Bankruptcy Law, all claims are deemed matured since the Commencement Date. Secondly, both contractual parties are entitled to initiate the set off mechanism under Contract Law. However, Bankruptcy Law only allows the creditor to propose the set-off.

Furthermore, in order to ensure the fair implementation of bankruptcy set-off, set-off is expressly prohibited by art. 40 Bankruptcy Law, if: (i) the creditor acquires the claim against the debtor from a third party after the court has accepted the bankruptcy petition. Since a party that owes the debtor is required to pay such debt to the administrator in full, allowing that party to buy a claim against the debtor after the Commencement Date at a discounted price due to the low potential recovering ratio and then set off against its own duty owed to the debtor will significantly reduce the debtor’s remaining assets and the rescue possibility. (ii) When the relevant creditor incurs debts to the debtor, it is aware of the debtor’s inability to repay its debts or has applied to commence the bankruptcy proceedings unless the debt is incurred in accordance with the relevant law or due to reasons that occur at least one year before the bankruptcy petition. It is important to note that it is the reason of the debt, such as the underlying contract, that needs to occur at least one year in advance and it does not matter whether the actual debt is due before the bankruptcy petition. (iii) Any debtor of the bankrupt debtor acquires debt claims against the bankrupt debtor when it is aware that the bankrupt debtor is unable to repay its debts or has applied to commence the bankruptcy proceedings unless the debt claim is obtained in accordance with the relevant law or due to reasons that occur at least one year before the bankruptcy petition. The situation (i) above is a complete ban on debt acquired after the Commencement Date and does not consider the relevant party’s intention. However, circumstances (ii) and (iii) require the administrator or the court to ascertain whether the relevant party incurs or acquires the debt with bad faith.

192 Liu, 191–194.
193 Wang Weiguo, 113.
194 Wang Dongmin, 206.
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9. Reorganization

Reorganization is a new rehabilitation regime in China established by Bankruptcy Law. Compared with the composition regime set out in Bankruptcy Law, it provides the debtor with better protection since its procedures bind both secured and unsecured creditors and there is an effective stay imposed on secured creditors from enforcing their rights against the debtor during the reorganization period. If properly implemented, it will give the debtor an effective breathing period.

From the debtor’s point of view, there are also disadvantages in choosing the reorganization procedure. For example, it is more difficult to pass the reorganization plan since, under art. 82 Bankruptcy Law, the plan needs to be approved not only by the creditors but also the debtor’s employees and the relevant tax authority. In contrast, under art. 97 Bankruptcy Law the composition agreement only needs to be approved by more than half of the unsecured creditors entitled to vote and present at the creditors’ meeting whose claims are more than two thirds of the total unsecured claims. Also, the involvement of the administrator and the court will not end even if the reorganization plan has been approved by the court. Whereas, if the composition agreement has been approved by unsecured creditors, the appointment of the administrator will end shortly after all the assets have been returned to the debtor.

195 (最高人民法院关于破产债权能否与未到位的注册资本抵销问题的复函), issued on April 10, 1995 and came into effect on April 10, 1995.
196 Unlike a private solution, the composition agreement between the debtor and unsecured creditors is recognized by the court and binding on all unsecured creditors. But the composition regime does not comprimer secured creditors.
197 Chapter 9, Bankruptcy Law (arts. 95–106).
198 Only one month after Bankruptcy Law came into effect, Beijing Haidian District Court approved the first ever reorganization plan under Bankruptcy Law in the bankruptcy proceedings of Xianju Hospital (仙琚医院) (Xianju Case) on June 1 2007. Before the bankruptcy petition was submitted to the court, a major creditor of Xianju Hospital, its landlord, had already applied to the court to enforce its claim against the Hospital. The attempted enforcement would not only reduce the assets available for other creditors but also destroy a proposed share sale of Xianju Hospital. The forecast recovery ratio of an unsecured creditor by an immediate sale was about 20 %. The enforcement action was later suspended after the bankruptcy petition was accepted by the court. In the reorganization plan passed by the creditors’ meeting, all the shares of Xianju Hospital were transferred to another company, Victoria Company, which promised to repay the agreed percentage of Xianju Hospital’s debt to each creditor. Through the reorganization, the actual average repayment ratio was about 41 %. As a result, in the first reorganization proceeding under Bankruptcy Law, the relevant procedure was actually used to complete a corporate take-over. According to news reported by Legal Daily on August 12, 2007, available at http://www.legaldaily.com.cn/bm/2007-08/12/content_678734.htm.
199 Although the administrator is required to return the debtor’s assets and business to the debtor after the reorganization plan is approved by the court, the implementation of the plan is still under the administrator and the court’s close supervision (Arts. 90 and 91 Bankruptcy Law).
a) Entry Application

The debtor, its creditors and the debtor’s shareholders are all entitled to apply to the court to start the reorganization procedure. In contrast, under art. 95 Bankruptcy Law only the debtor is allowed to apply for composition.201

In accordance with art. 70 Bankruptcy Law, both the debtor and the creditors may apply directly to the court to commence the reorganization procedure. The debtor may submit the application either if the bankruptcy liquidation criteria including both the cash flow test and the balance sheet test are satisfied, or if there is a clear possibility that the debtor may lack the ability to repay its debts.202 A creditor is permitted by art. 7 Bankruptcy Law to petition the court to reorganize the debtor, if the debtor is unable to repay its due debts. Although, there is no threshold, such as to the number of applying creditors or the minimum proportion of the debtor’s total liabilities, imposed on the creditor for the reorganization submission, some judges have proposed to require a feasibility study before the court decides whether to accept the reorganization request.203

Under art. 70 Bankruptcy Law, if the creditors apply to the court to commence the bankruptcy liquidation proceedings and the court has accepted that application, the debtor or the shareholders of the debtor that contribute more than one tenth of the debtor’s registered capital204 may still submit the reorganization application to the court before the debtor is declared bankrupt.205 However, this implies that the shareholders are not permitted to apply for reorganization directly on their own initiative but can only apply for reorganization after the creditors have filed the bankruptcy petition. This restriction on shareholders has been criticized on the grounds that it may unreasonably delay the initiation of the reorganization.206

b) Management of the Debtor’s Business

After the court has commenced the reorganization procedure, either the debtor or the administrator may be responsible for managing the debtor’s assets and business operation.207

201 Neither the court nor the creditors are allowed to commence the composition procedure on their own initiative. This is because the legislators hold the view that the composition procedure works like an offer-acceptance model for a normal contract and that only the debtor is entitled to present the offer to the creditors.
202 Arts. 2 and 70 Bankruptcy Law.
203 According to a summary of a seminar organized by Wuxi Intermediate People’s Court, which was reported by People’s Court Daily on May 14, 2009, available at http://rmfyb.chinacourt.org/public/detail.php?id=128341, in some cities, the court has already implemented procedures for feasibility studies as a pre-condition for reorganization.
204 During the legislative process, some experts were against setting a fixed percentage since the shareholding structure in every company is different. Liu, 295.
205 Art. 70 Bankruptcy Law. However, it is not entirely clear whether other creditors are entitled to apply for the reorganization procedures if the bankruptcy liquidation application is submitted by a creditor. In the bankruptcy case of East Star Airlines Ltd (东星航空), the bankruptcy liquidation application was submitted by some creditors and Wuhan Intermediate Court has rejected twice the reorganization application by other creditors. An appeal against these decisions was submitted to Hubei Provincial High Court on June 23, 2009. The case update was reported by China Economic Weekly on July 19, 2009, available at http://www.ceweekly.cn/Html/magazine/200929B/200971913699170.html.
207 Arts. 73 and 74 Bankruptcy Law.
Under art. 73 Bankruptcy Law, the debtor is permitted to apply to the court to manage its assets and business during the reorganization period. If the court approves the debtor’s application, the administrator will return the debtor’s assets and business to the debtor, and art. 73 Bankruptcy Law, also requires the debtor to perform all the relevant duties of the administrator such as convening the creditors’ meetings. This is similar to the “debtor-in-possession” mechanism under Chapter 11 of the US Bankruptcy Code. However, this does not mean that the debtor will have complete control of its assets and business, because in accordance with art. 73 the management of those assets and business by the debtor during the reorganization period is still subject to the administrator’s constant supervision.

In the event that the debtor has not submitted the application to the court or the court has dismissed its application to manage the company, the administrator is still responsible for managing the debtor’s assets and business. Under art. 74 Bankruptcy Law, if necessary, the administrator is authorized to hire the relevant management personnel of the debtor to be in charge of the debtor’s business during the organization period. The appointment does not require approval from the court and the relevant costs incurred will be treated as bankruptcy costs under art. 41 Bankruptcy Law.

Under art. 89 Bankruptcy Law, if the reorganization plan is approved by the court, the administrator that has already taken over the debtor’s assets and business is then required to return those to the debtor. Although the debtor itself is responsible for carrying out the reorganization plan, during the supervision period, it is still obliged to report to the administrator about the implementation of the plan and its financial condition. When the supervision period expires, the administrator will submit a supervision report to the court and the administrator’s supervisory duty ends thereafter.

c) Stay on Claims

Pursuant to art. 75 Bankruptcy Law, during the reorganization period, secured creditors’ rights to enforce the debtor’s relevant assets are automatically suspended. Since the security collateral is normally the debtor’s most valuable asset, the restriction on secured creditors is essential to rescue the debtor’s business. Nevertheless, art. 75 allows a secured creditor to apply to the court to resume exercising its rights over the relevant collateral if the relevant assets are damaged or the value of those assets have significantly decreased to the extent that that creditor’s interest is likely to be jeopardized. This is similar to the protection recommended by UNCITRAL: “allowing the stay to be lifted…where the value of the secured claim is more than or close to the value of the encumbered assets.”

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208 The debtor in possession under Chapter 11 has all the powers of a bankruptcy trustee and can may the business as if under normal circumstances, but will need to obtain the court’s approval for material disposal of assets. Under Chapter 11, an outside trustee is only appointed to the debtor company’s management for exceptional reasons. McCormack, 80–81.

209 Since the debtor’s business will remain operating during the reorganization procedure, it is beneficial for the administrator to receive assistance from someone familiar with the business.

210 Every reorganization plan is required to include a supervision period. (Art. 81 Bankruptcy Law).

211 Art. 90 Bankruptcy Law.

212 Upon the administrator’s application, the court may decide to extend the supervision period. (Art. 91 Bankruptcy Law).

213 The UNCITRAL Legislative Guide on Insolvency Law, 94–95.
In respect of the debtor’s shareholders, during the reorganization period they are prohibited from seeking dividends even if the debtor’s business has generated sufficient profits.\textsuperscript{214} Since in normal bankruptcy procedures there are unlikely to be any assets left to be distributed among shareholders, it would be unreasonable that the shareholders are able to obtain privileges in reorganization when the creditors’ rights are restricted.

In respect of the directors, supervisors and other senior managers of the debtor, regardless of whether they are involved in the reorganization, they are not allowed to transfer the debtor’s shares they hold to a third party unless permitted by the court.\textsuperscript{215} This restriction aims to urge the senior management of the debtor to keep making efforts to rescue the debtor’s business as those shares would become worthless if the reorganization fails and the debtor is declared bankrupt.

In normal bankruptcy proceedings, under art. 38 Bankruptcy Law, a third party whose assets are possessed by the debtor is entitled to take back those assets from the administrator, which will not be included in the bankruptcy estate. However, in reorganization that third party can only request those assets to be returned in accordance with the previously agreed conditions.\textsuperscript{216} For instance, if the agreed period during which the debtor is authorized to manage those assets has not expired, that third party is not entitled to take back the assets in reorganization unless there is a contrary contractual arrangement.\textsuperscript{217}

In addition to those restrictions on existing creditors, art. 75 Bankruptcy Law authorizes the debtor or the administrator to grant security over new debts incurred for operating the business during the reorganization period.

d) Reorganization Plan

Under art. 79 Bankruptcy Law, either the debtor or the administrator\textsuperscript{218} is required to submit a draft reorganization plan to both the court and the creditors’ meeting within six months from the date on which the court makes the ruling to commence the reorganization procedure. After the six month period expires, if there are justified reasons, the debtor or the administrator may apply to the court to extend the period for another three months. Although the debtor’s shareholders are permitted to apply for reorganization under certain circumstances, they are not authorized to prepare and submit the reorganization plan. It has been argued that due to such inconsistency the administrator or the debtor may not be active in preparing the reorganization plan in a shareholder initiated reorganization.\textsuperscript{219}

Art. 80 Bankruptcy Law sets out the detailed items that need to be included in the draft reorganization plan: (i) an operating plan of the debtor’s business; (ii) the classification of the creditors’ claims;\textsuperscript{220} (iii) a debt adjustment plan;\textsuperscript{221} (iv) a debt

\textsuperscript{214} Art. 77 Bankruptcy Law.\textsuperscript{215} Art. 77 Bankruptcy Law. However, the management is allowed to transfer the debtor’s shares among themselves. \textit{Wang Weiguo}, 230.\textsuperscript{216} Art. 76 Bankruptcy Law.\textsuperscript{217} Such as a termination event being triggered by the reorganization.\textsuperscript{218} Whoever is responsible for managing the debtor’s assets or business in reorganization (i.e., the debtor or the administrator), is required to prepare a draft plan. (Art. 80 Bankruptcy Law).\textsuperscript{219} \textit{Wang/Xu}, 67–69.\textsuperscript{220} Creditors need to be divided into different classes for voting purposes.\textsuperscript{221} Under art. 83 Bankruptcy Law, apart from the basic pension and the basic medical insurance, the reorganization plan is not allowed to reduce other types of employee insurance payments. Those
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repayment plan; (v) a timetable for implementing the reorganization plan; (vi) a set period for supervising the implementation of the reorganization plan; and (vii) any other proposals which are beneficial to the reorganization of the debtor.

153 In practice, many different structures can be adopted in the reorganization plan including a debt-equity transfer, issuing new shares, increasing registered capital or even setting up a new company. Currently, the debt-equity transfer is the most controversial method. Some argue that the debt-equity transfer should not be permitted in the reorganization plan, because the unpaid capital investment is barred from being set off against the debt owed by the company by the SPC Reply 1995. Others assert that the court should approve the debt-equity transfer in reorganization, as the new capital injection by transferring existing debt is not the same concept of setting off the existing commitment to invest against the debt owed by the debtor and Company Law has not expressly prohibited new capital injection by way of converting existing debts.

154 Under art. 84 Bankruptcy Law, within 30 days of the date on which the draft reorganization plan is submitted to the court, the court will convene a creditors’ meeting to vote on the plan. For this purpose, the debtor’s creditors are generally divided into four groups: (i) secured creditors; (ii) the debtor’s employees; (iii) the relevant tax authority; and (iv) unsecured creditors. If necessary, art. 82 Bankruptcy Law authorizes the court to set up a sub group composed of small claim creditors within the group of unsecured creditors. If the draft reorganization plan affects or adjusts the interests of the debtor’s shareholders, under art. 85 Bankruptcy Law, the court should also set up another group composed of shareholders to vote on the draft plan. During the legislative process, whether to allow shareholders to vote was heatedly debated in light of the likelihood of shareholders to pass a reorganization plan which may prejudice the creditors’ interests.

155 In accordance with art. 86 Bankruptcy Law, the draft reorganization plan has to be approved by every voting group of creditors. The plan will be passed in one voting group if (i) more than half of the creditors of that group which attend the meeting have approved the draft plan; and (ii) those creditors hold more than two thirds of the total value of claims filed against the debtor within that group. This means that the majority creditors are able to cram down dissenting minority creditors.

156 Under art. 59 Bankruptcy Law, a creditor is entitled to appoint an agent to vote on behalf of it. At present, for some listed companies, it is even possible for shareholders to vote online through the stock exchange’s communication system.

157 After the reorganization plan is approved by creditors, the debtor or the administrator is required to apply for the court’s approval within ten days. If the court include unemployment insurance, work-related injury insurance and birth insurance. (Art. 73 Labour Law (劳动法), first enacted on July 5, 1994 and came into effect on January 1, 1995).

222 The relevant creditor has effectively downgraded itself on the distribution ladder.


224 In respect of claims for unpaid salaries, medical benefits, injury and disability allowances, compassionate fees, basic pensions and medical insurance premiums which should be transferred to the employees’ personal account, and other compensation payments which are required to be paid to employees under the relevant laws and administrative rules. (Art. 82 Bankruptcy Law).

225 Liu, 310–311.

226 Art. 84 Bankruptcy Law.

approves the plan, the court is required by art. 86 Bankruptcy Law to make a public ruling within 30 days and terminate the reorganization procedures.

According to statistics published by an international accountancy firm\(^{228}\), between June 2007 and November 2008, 14 out of 211 Chinese listed special treatment (ST) companies (\textit{supra} Chapter 4 at 89)\(^{229}\) started reorganization procedures. It took 11 companies less than 100 days to pass the reorganization plan and the quickest company only used 37 days to agree the reorganization plan.

However, if the debtor is a listed public company, in accordance with “the Administrative Measures for the Significant Asset Reorganizations of Listed Companies”\(^{230}\), the debtor’s decision to dispose of major assets needs to be approved by China Securities Regulatory Commission (CSRC). In contrast, under Bankruptcy Law, the reorganization plan becomes valid immediately after the court has approved it. As a result, the judiciary still has to clarify how the provisions of Bankruptcy Law interplay with other administrative rules on this matter.\(^{231}\)

Under art. 87 Bankruptcy Law, if the draft plan is not accepted in certain voting groups, the debtor or the administrator may renegotiate the draft plan with creditors from those groups provided that the revised plan should not jeopardize other voting groups’ interests. In the event that the reorganization plan is rejected again by some voting groups or the relevant voting group refuses to vote, pursuant to art. 87 the debtor or the administrator may still apply to the court to approve the plan, if all of the following six conditions are satisfied:

(i) Either the voting group of secured creditors has approved the draft reorganization plan; or in accordance with the draft plan, the secured creditors will be repaid in full up to the value of the relevant collateral to which they are entitled, any losses incurred due to delay in repayment will be fairly compensated, and their rights over the relevant security have not been materially impaired.

(ii) Either the voting groups of the debtor’s employees and the relevant tax authorities have approved the draft plan, or the relevant employee or tax claims will be repaid in full under the draft plan.

(iii) Either the voting group of unsecured creditors has approved the draft plan, or in accordance with the draft plan the recovery ratios of unsecured creditors are not worse off than they would have been without a reorganization plan.

(iv) Either the voting group of the debtor’s shareholders has approved the draft plan, or the shareholders’ interest has been adjusted fairly and equally under the draft plan.

(v) The members of each voting group are treated equally under the draft plan and the priority payment order among the voting groups complies with the normal bankruptcy distributing order set out in Bankruptcy Law.\(^{232}\)

(vi) The draft business plan is feasible.


\(^{229}\) I.e., companies which have incurred losses for more than two years and are exposed to delisting risks.

\(^{230}\) (上市公司重大资产重组管理办法), issued by the CSRC on April 16, 2008 and came into effect on May 18, 2008.

\(^{231}\) Xi, 3.

\(^{232}\) The order is set out in art. 113 Bankruptcy Law.
In accordance with art. 87, if the court determines that all the above conditions have been satisfied, it will approve the reorganization plan and terminate the reorganization procedures accordingly despite the fact that the plan has not been approved by certain groups of creditors. This significantly increases the likelihood of passing a reorganization plan in case certain creditors act unreasonably to veto the plan. But it may put the public interest ahead of the secured creditors’ interest since secured creditors are more likely to veto the reorganization plan in order to resume their rights to enforce the relevant security collateral.

After the reorganization plan has been approved by the court, it binds both the debtor and all of the debtor’s creditors. A creditor that has not duly filed its claim is prohibited by art. 92 Bankruptcy Law from enforcing its right against the debtor in any way during the period when the reorganization plan is being implemented. However, after the implementation of the reorganization plan has been completed, art. 92 permits that creditor to enforce its claim in accordance with the terms and conditions applicable to similar claims under the reorganization plan.

e) Failure of Reorganization

It may be in the debtor’s shareholders and the debtor’s existing management team’s interest to protract the reorganization period because they are unlikely to be entitled to any material distribution upon the debtor’s bankruptcy. But to protect the creditors’ interest, it is important to convert the reorganization process back to normal bankruptcy procedures as soon as it is clear that there is no hope to rescue the debtor.

During the reorganization period, upon the application of the administrator or a stakeholder, the court may still terminate the reorganization procedure and declare the debtor bankrupt if: (i) the business and financial condition of the debtor remains deteriorating and there is no prospect of recovering; (ii) the debtor acts fraudulently and reduces its assets in bad faith or acts in any other manner that obviously jeopardizes the interest of the creditors; or (iii) the administrator is unable to carry out its duties due to the debtor’s acts.

Under art. 93 Bankruptcy Law, upon the application of the administrator or a stakeholder, the court will also issue a ruling to terminate the implementation of the plan and declare the debtor bankrupt if the debtor is unable to or fails to carry out the reorganization plan. In that case, repayments which have already been made by the debtor remain valid, but the creditor, whose recovering ratio is higher than the other creditors from the same voting group, is not allowed to be paid further out of the debtor’s bankruptcy estate until the recovering ratios of those other creditors have matched its recovering ratio.

Without any application, the court itself is required by art. 88 Bankruptcy Law to declare the debtor bankrupt if: (i) the debtor or the administrator fails to submit the draft reorganization plan within six months from the date on which the court decides to commence the reorganization period; (ii) the draft reorganization plan has not been approved by all the creditors’ groups and the court has not exercised

233 Liu, 319–320.
234 Art. 78 Bankruptcy Law.
235 Art. 93 Bankruptcy Law.
236 Which may be extended for another three months by the court (Art. 79 Bankruptcy Law).
II. Main Issues

its right under art. 87 to approve such plan; or (iii) the draft reorganization plan has been approved by the creditors but is subsequently rejected by the court. Those rules are similar to the recommendations introduced by the UNCITRAL.237

10. Priority of Claims

a) Secured Creditors vs. Employees

It is commonly accepted that secured creditors should be better protected than unsecured creditors in bankruptcy procedures. Art. 109 Bankruptcy Law also grants secured creditors priority rights to be repaid out of the relevant security collateral.238 During the legislative process, whether to allow secured creditors to be paid before the debtor’s employees was a very controversial topic. Discussion of this issue itself delayed the enactment of Bankruptcy Law for a couple of years.239

Pursuant to arts. 32 and 37 Old Bankruptcy Law, secured creditors enjoy priority over employee claims in the bankruptcy proceedings of a SOE. The same payment ladder is confirmed in arts. 203 and 204 Civil Procedure Law 1991 which applies to the bankruptcy of non-SOEs. In light of the fact that normally there would not be sufficient bankruptcy estate left available to all the outstanding employee claims after having paid secured creditors, the State Council set up the “policy bankruptcy” regime by issuing the 1994 Notice and the 1997 Notice to pacify dissatisfied employees. Under the two notices, different priority rules were adopted which ranked employees’ claims ahead of the secured creditors in respect of the proceeds of selling the land use rights.

At the initial drafting stage of Bankruptcy Law, the majority view was that the “policy bankruptcy” regime was just a temporary mechanism which should be abolished in the new bankruptcy law. As a result, in the draft new bankruptcy law submitted to the Standing Committee of the NPC in June 2004, arts. 127 and 131 reinstated the priority ranking between secured creditors and employees’ claims as stated in Old Bankruptcy Law. This approach, however, was heavily criticized by many NPC representatives and policy commentators.240 Consequently, in the next revised version of the draft bankruptcy law, art. 127 was amended to state that secured creditors’ claims should be subject to the amount of any unpaid employees’ wages, social insurances and other legal compensations which exceed the value of the unsecured bankruptcy estate.241 The amended payment ladder mirrored the one used in a “policy bankruptcy” and was intended to illustrate the importance of protecting employees in a socialist country. This view was opposed by other NPC representatives and scholars who held such rankings of claims would seriously weaken the foundation of security law and then jeopardize the further development of the market oriented economy in China.

After a few additional rounds of discussion, the finally settled position in Bankruptcy Law was to split the unpaid employees’ claims into two parts.242 The unpaid

238 If a secured creditor is not being paid in full by realizing the secured assets, the amount of the unpaid portion will be treated in the same way as unsecured claims (Art. 110 Bankruptcy Law).
239 Unemployment and social instability following bankruptcy is always the overriding concern.
240 An, 319.
241 Wang Weiguo, 383.
242 Art. 132 Bankruptcy Law.
employees’ claims that occurred before the date when Bankruptcy Law was promulgated (August 27, 2006) have priority over the secured creditors’ claims to the extent that these would not be paid in full if the secured creditors had already been paid. On the other hand, the outstanding employees’ claims that occurred after August 27, 2006 rank after the secured creditors’ claims. This approach tried to conciliate two contradicted public opinions and accommodate requirements from both sides.

171 Some scholars are against the approach of using Bankruptcy Law to solve social problems and argue that the development of a social welfare system, the implementation of labor law and contract law may be more beneficial to protect the employees’ interest. There are also negative knocks on the impacts of such arrangements because banks have to recalculate their lending risk model and may try to avoid providing new loans to an enterprise which has difficulties in paying its employees’ salaries on time.

172 However, it seems unreasonable to judge the arrangement set out in Bankruptcy Law as simply right or wrong because that reflects the current situation and conflict of different interests in China. In practice, if a SOE does not have sufficient assets to cover the outstanding employees’ claims and the government fails to work out an arrangement accepted by the employees, the court would normally refuse to accept the bankruptcy petition. This is because the court is also “politically responsible to social stability”. It has already been suggested that China should start to set up an emergency fund financed by all solvent enterprises to pay outstanding employees’ claims of bankrupt enterprises. If the proposal is approved by the NPC or the State Council, it may significantly release the pressure on secured creditors in bankruptcy proceedings.

b) Other Claims

173 Apart from secured creditors and those priority employees’ claims incurred before August 27, 2006, art. 113 Bankruptcy Law sets out the following payment priority ladder for distributing the bankruptcy estate among other claims:

(i) bankruptcy expenses and common interest debts incurred for the mutual benefit of the creditors;

(ii) employees’ salaries, medical benefits, allowance for disability and compensation payments, basic pension insurance and medical insurance payment, and other employee compensation required by law;

(iii) other social benefit payments and outstanding tax; and then

(iv) unsecured debts.

Under art. 43 Bankruptcy Law, bankruptcy expenses and common interest debts can be repaid from time to time before the bankruptcy declaration. If the debtor’s assets are not sufficient to pay both the bankruptcy expenses and the common

243 According to an interview with Prof. LI Shuguang, which was published by People’s Daily Online on September 21, 2006, available at http://www.people.com.cn/GB/32306/54155/57487/4843557.html.
III. Concluding Remarks

interest debts, art. 43 provides that the bankruptcy expenses should be paid first. In accordance with art. 41 Bankruptcy Law, the bankruptcy expenses include the relevant court fees; expenses for the management, sale and distribution of the debtor’s assets; and the administrator’s remuneration and expenses. The common interest debts refer to the debts incurred after the Commencement Date for the mutual benefits of the creditors which include the liabilities incurred due to the administrator or the debtor requesting a contract counterparty to perform an existing contract; liabilities to pay employees’ wages incurred for the purpose of continuing the debtor’s business; and other liabilities incurred by the administrator in performing its duties or arising out of the debtor’s assets.247

Granting those costs the priority position is necessary to ensure the proper operation of the bankruptcy procedures. For example, it would be difficult to appoint a law firm or accountancy firm to act as administrator if their professional fees can only be paid after the debtor is declared bankrupt.248 However, it is not entirely clear whether bankruptcy expenses can be paid out of the security collateral provided to secured creditors. In practice, it has been argued that bankruptcy expenses do enjoy payment priority over secured claims in relation to the proceeds of security collateral.249

Similarly, the relationship between priority payment rights mentioned in art. 71 SPC Rules 2002 (such as the project construction fees) and the bankruptcy expenses are still ambiguous. In the “SPC’s Reply to the Question on the Priority Repayment Rights of the Construction Project Fees”250, the SPC clarified that the priority payment rights of project construction fees and expenses can be exercised before the relevant secured claims, provided that such priority rights have to be exercised within six months after the construction project is completed. As a result, even if the bankruptcy expenses can be paid out of the security collateral, it is still arguable whether they can be paid out of the collateral which is subject to those priority payment rights.

III. Concluding Remarks

Compared with Old Bankruptcy Law which only has 42 articles, Bankruptcy Law has incorporated many modern bankruptcy concepts, such as the administrator and the reorganization regime, and therefore deserves applause. Although some rules set out in Bankruptcy Law are still inconsistent with the international standard, this actually reflects the ability of the Chinese legislators and the Chinese government to resist external pressure and draft a piece of legislation that not only has its preferred normative modes offered by different development banks, international financial institutions and foreign aid programs, but also has distinct Chinese characteristics.251

In most developing countries, “implementation remains a defining feature of success in using global norms at the local level”.252 This statement is also applicable

247 Art. 42 Bankruptcy Law.
248 Under art.12 Remuneration Rules, the administrator’s remuneration should be paid out of the debtor’s assets prior to other claims.
250 (最高人民法院关于建设工程价款优先受偿权问题的批复 (法释[2002]16号)), issued on June 20, 2002 and came into effect on June 27, 2002.
251 Halliday/Carruthers, 1192.
252 Tomasic (2007), 240.
to Bankruptcy Law. The successful implementation of Bankruptcy Law in China will rely upon the court’s ability to handle complicated bankruptcy cases and the availability of experienced administrators. Furthermore, it is crucial to take into account the cultural context in which the law operates. For example, at present, the local government’s involvement in significant bankruptcy cases is almost inevitable, but it often facilitates bankruptcy proceedings.

The SPC is currently preparing a new set of interpretation rules which hopefully will clarify a number of ambiguous issues under Bankruptcy Law. It would also be interesting to observe other further development of Bankruptcy Law including the expansion of the scope of application to individuals, the creation of expedited bankruptcy procedures, and the enactment of special bankruptcy rules for financial institutes.

### IV. Relevant Laws & Regulations

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Chapter 9. Labor Relations and Labor Disputes

I. Overview

1. Although the first Labor Union Law came into effect on June 29, 1950 (repealed on April 3, 1992) and the first Constitution of the People’s Republic of 1954 declared the right to work to be one of the basic citizens’ rights (art. 91 sentence 1), the first real step towards a sophisticated legislative scheme in the field of labor law after the foundation of the People’s Republic on October 1, 1949 was not taken until 1956. The Labor Ministry of that time established an expert group in order to draft a Labor Law. However, only one year later the drafting work was discontinued due to the “Anti-Rightist Campaign” in 1957. Under the planned economy at that time, no labor law in the modern sense existed in China. Rather, labor relations were governed by administrative laws and regulations. Although the employees and workers were not granted real freedom of profession, they enjoyed the so called “Iron Rice Bowl”; they were promoted primarily according to how long they had been working, not according to their performance. Hence, the motivation of employees and the productivity of enterprises was severely suppressed.

2. Following the “Reform and Open Door Policy” in 1978, labor legislation in accordance with a regulated market economy was back on the agenda in 1979. As a result of severe controversy at the beginning of the reform, drafting work was forced to be suspended. Nevertheless, the attempt to introduce a labor contract system was not discontinued. On February 22, 1983 the then Ministry of Labor and Personnel issued the “Notice on Active Trial Implementation of the Labor Contract System”. This Notice criticized various deficiencies in the existing employment system and intended a firm and incremental implementation of the labor contract system in China in a bid to break the “Iron Rice Bowl”, to enhance the motivation of employees, and to raise productivity.

3. Subsequent to this Notice, the “Provisional Regulations on the Implementation of a Labor Contract System in State-Owned Enterprises” of the State Council, the “Notice on Expanded Trial Implementation of the Labor Contract Institution for All Staff” of the then Labor Ministry as well as the “Notice on the Full Implementation of the Labor Contract System” of the then Labor Ministry were issued successively, thus fully implementing the labor contract system nationwide and only exempting certain regions and a few special cases by the end of 1996.

4. While the labor contract system was introduced to replace the existing fixed employment system, the introduction of the second Labor Union Law of 1992 (promulgated on and in force since April 3, 1992; last amended on August 27, 2009), the “Regulations on Settlement of Labor Disputes in Enterprises” and a series of labor protection regulations formed the shape of a modern Chinese labor law regime including individual labor law, collective labor law, and settlement of labor disputes.

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1. (劳动人事部关于积极试行劳动合同制的通知), repealed on November 11, 1994.
2. (国营企业实行劳动合同制暂行规定), issued on July 12, 1986; in force since October 1, 1986 and repealed on October 6, 2001.
3. (关于扩大试行全员劳动合同制的通知), issued on and in force since February 25, 1992; repealed on November 11, 1994.
4. (关于全面实行劳动合同制的通知), issued on and in force since August 24, 1994.
5. (中华人民共和国企业劳动争议处理条例), issued by the State Council on July 6, 1993 and in force since August 1, 1993.
On this basis and after five years of preparation, the Labor Law was promulgated on July 5, 1994. With its coming into effect on January 1, 1995, it became a milestone in the course of development of Chinese labor law. The Labor Law contains general provisions for nearly all areas of labor and social security law, i.e., the promotion of employment, labor and collective contracts, working time, rest, vacation and wages, occupational health and safety, special protection for female and juvenile workers, vocational training, social insurance and welfare, labor disputes, supervision and inspection. Additionally, the then Labor Ministry, the Supreme People’s Court and local governments issued a series of implementation rules or interpretations during the following years; in 1994, 17 rules were promulgated by the then Labor Ministry alone. Furthermore, the Labor Union Law was amended on October 27, 2001 and the Production Safety Law was promulgated on June 29, 2002 and has been in force since November 1, 2002.

However, the application of the Labor Law was far from optimal. Often, the lack of written labor contracts, poor labor conditions, deadly occupational accidents, defaults of payment, violations of personal dignity, discrimination, child labor and even slavery were not uncommon in China and heavily damaged the interests of employees, reduced social stability and lowered the perceived value of laws and regulations. However, being a member state of the United Nations, the International Labor Organization and the World Trade Organization, China was compelled to transpose internationally recognized rules into its national laws and regulations.

In 2007, the Chinese legislator promulgated the Labor Contract Law, the Employment Promotion Law as well as the Law on Labor Dispute Mediation and Arbitration successively, all of which came into effect in the first half of 2008, and set milestones for Chinese labor legislation. These new laws and additional rules of the State Council and the Ministry of Human Resources and Social Security codify past court judgments and administrative practices, detail rights and obligations, and strengthen the protection of employees as well as the responsibility and liability of employers with an aim to build and develop “harmonious” and stable labor relations. Legislation in other areas such as remuneration, labor protection, vocational training, collective contracts, and labor inspections is expected in the near future.

The Chinese labor law regime consists of a number of laws, regulations and rules which have been issued by the national legislator, the central government and local legislators and governments as well as by courts. Since listing all these legal sources would go beyond the scope of this chapter, only the most important laws and regulations at national level are listed below (for details please see “Relevant Laws and Regulations”):

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7 According to the International Labor Organization (ILO, available at http://www.ilo.org/ilolex/english/newratframeE.htm), China has presently ratified 22 Conventions of the ILO, 4 of which belong to the fundamental human rights conventions regarding the elimination of discrimination with respect to employment and occupation (Convention 100 and Convention 111) and the abolition of child labor (Convention 138 and Convention 182). Convention 87 and Convention 98, covering the freedom of association and collective bargaining, as well as Convention 29 and Convention 105, covering the elimination of forced and compulsory labor, have not yet been ratified by China.
8 Cf. Lin (2001), 56.
9 Individual Labor Laws:
- Labor Contract Law
- Regulation on the Implementation of the Labor Contract Law

Collective Labor Laws:
- Labor Union Law
- Interpretation of the Supreme People’s Court on Several Issues concerning the Application of the Labor Union Law in the Civil Trials
- Provision on Collective Contracts

Laws on the Resolution of Labor Disputes:
- Law on Labor Dispute Mediation and Arbitration
- Interpretation of the Supreme People’s Court on Several Issues about the Application of Laws for the Trial of Labor Dispute Cases – I
- Interpretation of the Supreme People’s Court on Several Issues about the Application of Laws for the Trial of Labor Dispute Cases – II
- Trial Rules for Arbitration of Labor and Personnel Cases

General Laws and Special Protections:
- Employment Promotion Law
- Provision on Employment Services and Employment Management
- Labor Law
- Opinion on Several Issues about the Implementation of the Labor Law
- Production Safety Law
- Law on the Prevention and Treatment of Occupational Diseases
- Regulation on Paid Annual Leave for Employees
- Measure on the Implementation of the Regulation on Paid Annual Leave for Employees in Enterprises
- Provision on Working Time for Employees

10 Similar to the labor law regime of most other jurisdictions, the Chinese labor law regime may be roughly divided into three categories: individual labor law, collective labor law and the law on the resolution of labor disputes. Since collective labor law in China is still in its infancy and is heavily influenced by the Chinese political system9, individual labor law is playing a major role in China’s labor law regime.

II. Main Issues of Individual Labor Law

1. Definition of Employee and Labor Relationship

Pursuant to art. 2 of the Labor Law and the Labor Contract Law, Chinese labor law applies to the establishment of a labor relationship between employees and enterprises, individual economic organizations, private non-enterprise entities and certain other organizations within China (including state organs, public institutions and social organizations), and to the conclusion, fulfillment, modification, termination of labor contracts.

This provision is to some extent illogical in that its wording solely provides for the scope of the term “Employer (yong ren dan wei 用人单位)”, omits a definition of the terms “Employee (lao dong zhe 劳动者)” and “Labor Relationship (lao dong guan xi 劳动关系)”.10 An employer in terms of Chinese labor law is, in principle,

9 Infra at 94–116 for Chinese collective labor law.
10 Li, 24.
an organization with a business license issued by the competent Administration of Industry and Commerce within China. Therefore, only someone employed by a qualified employer on the basis of a labor relationship is considered an “Employee” in terms of Chinese labor law. Lacking an explicit and logical legal definition of “Employee”, a “Labor Relationship” is hard to determine. Furthermore, the employees of an enterprise not considered an employer are not protected as employees by Chinese labor law. These groups of employees include, but are not limited to, employees of enterprises located in foreign countries, service personnel working exclusively for private persons and migrant workers engaged by individual business contractors without a business license.

In theory, only the Contract Law and the General Principles of Civil Law apply to the aforementioned cases; these relationships may be legally regarded to be general service relationships and as such are not regulated by the protective rules of labor law. However, in order to avoid abuse of this categorization by non-qualified employers, art. 93 Labor Contract Law provides for a “quasi-employee” status for employees who have worked for enterprises not lawfully qualified to be an employer, i.e., with such entities lacking a registration with the competent Administration of Industry and Commerce. The relevant provisions of the Labor Contract Law provide that in such a “deficient employment relationship” the employer or its capital contributors are to pay to the employee remuneration, severance payment or indemnities as well as damages. Economically, the employees of unqualified employers are, therefore, to be treated equally as employees in terms of Chinese labor law.

According to this solution, unqualified employers have to observe labor law regulations even when they only entered into a factual labor relationship. This breakthrough is justified with regard to employee protection. However, it fails to address the root of the problem. With this solution, no legal criteria are provided to determine what a labor relationship is, what distinguishes a labor relationship from a general service relationship, and whether a factual labor relationship legally exists if the underlying labor contract is invalid. At the same time, an employee working for an unqualified employer is – according to this solution – entitled to remuneration, compensation and damages under Chinese labor law. Hence, this solution could also (at least theoretically) be misused by a mere service provider who solely enters into a service relationship with an unqualified employer in order to enjoy stringent labor protection, whereas this solution aims primarily at protecting employees employed by legally unqualified employers.

The absence of a legal definition of an “Employee” and of a “Labor Relationship” therefore results in significant ambiguities for the contractual partners as well as for courts applying the law. Since Chinese courts rigidly apply laws and regulations in adherence with their wording, numerous factual employees have been excluded from labor law protection, whereas a number of mere service providers are protected by labor laws and regulations. For instance, employed work-study

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11 Ke, 11.
12 Cf. CHEN Weili vs. LAI Guofa, 2000, Intermediate People’s Court of the City Deyang Province Sichuan.
13 Wang/Huang, 25.
14 With respect to factual labor relationships, infra at 63–67.
15 Hou/Wang, 72.
16 Li, 24 et seq.
students and retirees as well as employees employed directly by representative offices of foreign enterprises in China – which are not allowed to employ employees directly – are, in practice, not recognized to be employees although there are sensible reasons to justify this recognition. On the other hand, general managers of enterprises who are able to determine their work independently are, in principle, treated like simple employees. In practice, the essential criterion to determine the existence of a labor relationship in China is whether a person is required to contribute to social insurance. Being required to make a social insurance contribution is, however, the result and not the precondition of being an employee.

16 This flaw of Chinese labor law has been recognized by scholars and the legislator. The so-called definition of an “Employee” in Chinese labor law has been described as a closed system of uncertain content that fails to characterize employee status. The definition of an employee based on the character of personal dependency towards the employer has been intensely discussed and strongly suggested. Whether personal dependency exists, should be determined on the basis of examining all relevant circumstances, such as the employer’s right to instruct, integration of the employee into the employer’s workplace, constancy of the relationship as well as on the economic dependency of individual employees. In the Draft of the Labor Contract Law published on March 20, 2006 and intended to solicit public opinion, the lawmaker attempted for the first time to include a legal definition of a “labor relationship” in the Law so as to eliminate doubt arising out of the meaning of the term. Art. 3 para. 1 of this Draft defines a labor relationship to be a relationship of rights and obligations, whereby an employer employs and integrates an employee as a member of its organization, and whereby the employee provides work for remuneration for the employer and under its management. The existence of a private contract is being assumed, while the Public Official Law applies to public service relationships.

17 Until the systematic deficiency with regard to a legal definition of “Employee” and “Labor Relationship” is rectified, the “personal dependency” doctrine, which is the prevailing opinion amongst scholars, should be used to determine whether a (factual) labor relationship exists.

2. Labor Contract

a) Duty of Disclosure

18 The parties to a labor contract bear a pre-contractual duty of disclosure. The employer must truthfully inform the employee of work requirements, working conditions and location, occupational health and safety, safety level of the product, remuneration as well as other information of which the employee asks to be

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18 Li, 24 et seq.
19 Hou/Wang, 72.
21 Hou/Wang, 73.
22 Tian, Explanation about the Bill of the Labor Contract Law, December 24, 2005.
informed about.\textsuperscript{23} Whether such “other information”, if requested by the employee, is directly related to the labor relationship or not is irrelevant according to the wording of the Labor Contract Law. Since the duty of disclosure of employers might therefore be extended without limit, and since violation of this duty of disclosure could invalidate the entire labor contract in a severe case (\textit{infra} at 34), employees should confirm in writing that they have been advised to their full satisfaction by their employer of all information required by law and requested by them, as well as that they have fully understood this information. This is especially necessary since employers carry, \textit{de facto}, the burden of proof in labor disputes (\textit{infra} at 124).

On the other hand, employers are also entitled to receive basic information about the employees directly related to the labor contract. The employees must truthfully provide such information and, where applicable, verify this with documents.\textsuperscript{24} However, employers are prohibited from retaining the citizen identity card or other certificates as well as from requesting from employees a security deposit of any kind.\textsuperscript{25} In contrast to the duty of disclosure of employers, employees are only obliged to provide basic information directly relevant to their employment. In practice, personal and contact data, health condition, working experience, knowledge and skills as well as the state of current employment are regarded to be such basic information.\textsuperscript{26} Beyond this, employees have no obligation to provide a (truthful) statement in response to employers’ questions. Nonetheless, Chinese employers may request information from employees that would generally not be allowed in many other jurisdictions, \textit{e.g.}, a question concerning pregnancy which is prohibited in the member states of the European Union.\textsuperscript{27} Where the position must, for legal reasons, not be held by a pregnant woman, a question concerning pregnancy might be asked by referring to the woman’s “health condition”. Whether this kind of question is to be treated as an act of (indirect) discrimination due to gender and, therefore, ought to be invalidated needs clarification by court practice.

A labor contract in violation of the duty to disclose is null and void, if the conclusion of the labor contract is a result of one party having been deceived.\textsuperscript{28} This provision contradicts the general provisions of the Contract Law which, in general, allow a deceived party to modify or rescind a contract within one year beginning from the date on which the deceived party is or should be aware of the facts that constitute grounds for rescission.\textsuperscript{29} Thus, the contract in question should not be regarded to be automatically void, but only voidable. The Labor Contract Law also provides that a deceived party may terminate a labor contract which is invalid due

\textsuperscript{23} Art. 8 Labor Contract Law; art. 12 para. 1 Provision on Employment Services and Employment Management.

\textsuperscript{24} Art. 8 Labor Contract Law; art. 7 Provision on Employment Services and Employment Management.

\textsuperscript{25} Art. 9 Labor Contract Law.

\textsuperscript{26} Art. 7 Provision on Employment Services and Employment Management; art. 8 para. 2 Regulation of Shanghai Municipality on Labor Contract (issued on November 15, 2001; in force since May 1, 2002); art. 10 Provision of Beijing Municipality on Labor Contracts (issued on December 24, 2001; in force since February 1, 2002).

\textsuperscript{27} Judgment of the European Court of Justice delivered on February 3, 2000 – Case C-207/98 Mahlburg [2000] ECR I-549.

\textsuperscript{28} Art. 26 para. 1 no. 1 Labor Contract Law.

\textsuperscript{29} Art. 54 para. 2 and art. 55 no. 1 Contract Law. Some scholars consider this a “breakthrough of traditional theory of contract law”, \textit{cf.} Wang/Huang, 22, 29.
to deception by the other party, so that the deceived party may choose to terminate or continue the invalid labor contract.\(^{30}\) According to this arrangement, a deceived employee may terminate the invalid labor contract with immediate effect even after the one-year term of rescission pursuant to the Contract Law.\(^{31}\) However, although the contract is – according to the Labor Contract Law – theoretically already null and void, a deceived employer is forced to undergo complicated procedures for the termination of the contract in question so as to safeguard its rights (with regard to termination of labor contract by employers, \textit{infra} at 74–93).

Obviously, this arrangement or so-called “breakthrough” of the traditional theory of contract law\(^{32}\) has confused legal notions of invalidity, rescission and termination of a contract. According to the general provisions of art. 52 Contract Law, if the contract in question does not violate the country’s, collective and third party’s interests by means of collusion, or the compulsory provisions of laws and administrative regulations of the State Council, and is not contrary to public policy, it should not be invalidated automatically.\(^{33}\) Under individual circumstances, a deceived party (employee or employer), may, but does not have to make use of rescission or termination to render the contract null and void.\(^{34}\) Furthermore, upon invalidity or rescission, a contract is, strictly, null and void from the moment it has been concluded;\(^{35}\) an (additional) formal termination of this contract is under these circumstances completely illogical and unnecessary.\(^{36}\) If anything at all is required, a formless statement of termination or a confirmation by a competent court or a competent arbitration institution for the purpose of legal clarity and security should suffice.

If the invalidity of a labor contract has been confirmed, the employer must pay remuneration for the work thus far performed by the relevant employee. The amount of this remuneration is to be determined by reference to the remuneration of employees holding the same or similar positions with the employer.\(^{37}\) If the employee terminates the labor contract invalidated due to deception by the employer, he or she is also entitled to be paid a statutory severance by the employer (\textit{infra} at 90–93).\(^{38}\)

\textbf{b) Data Protection}

Personal information and materials of an employee obtained by an employer during employment must be kept confidential; without the employee’s previous consent in writing, his or her personal information and materials must not be publicized and his or her technical and intellectual achievements must not be used.\(^{39}\)

To enhance efficiency in practice, standardized labor contracts or other enterprise rules usually contain a clause granting the employee’s general consent to

\(^{30}\) Art. 38 para. 1 no. 5, art. 39 no. 5 in association with art. 26 para. 1 no. 1 Labor Contract Law; \textit{cf.} Wang/Huang, 29.

\(^{31}\) Wang/Huang, 29; with regard to the termination of labor contract by employees, \textit{infra} at 73.

\(^{32}\) Wang/Huang, 22, 29.

\(^{33}\) He, 94 et seq.

\(^{34}\) He, 94 et seq.; Xie, 61.

\(^{35}\) Art. 56 sentence 1 Contract Law. Although, for the sake of employee protection, a labor contract should be considered invalid from the time invalidity or rescission is declared, \textit{infra} at 63–67.

\(^{36}\) Xie, 61.

\(^{37}\) Art. 28 Labor Contract Law.

\(^{38}\) Art. 46 no. 1 in association with art. 38 para. 1 no. 5 and art. 26 para. 1 no. 1 Labor Contract Law.

\(^{39}\) Art. 13 Provision on Employment Services and Employment Management.
publish personal information or other relevant material within different enterprises of the same group of employers, or under other circumstances “as demanded by operational necessity”. However, the validity of such a clause is very questionable since a labor contract is deemed invalid or partly invalid pursuant to art. 26 para. 1 no. 2 Chinese Labor Contract Law if the employer is exempted from its legal liabilities and the rights of the employee are being excluded (infra at 34). Employees should be able to reserve and change their opinion about an employer using their personal information and materials at any time and in each individual case. A general consent declaration of employees in labor contracts and enterprise rules may be considered to exempt employers from their obligation to obtain employees’ consent in individual cases, and to exclude the right of employees to protect their data. Therefore, a separate written consent of the employee should be obtained before personal information and materials are published or transferred in order to avoid any lack of compliance with this data protection requirement.

c) Non-Discrimination

Although the Chinese Constitution and the Labor Law guarantee the right to equal employment to all Chinese citizens, discrimination in the course of employment is prevalent in practice, e.g., it is not uncommon for a job advertisement to read “only for applicants who are male, healthy, have a residence booklet of a certain city ("hu kou bu 户口簿") and are not carriers of the Hepatitis B virus”.

In response to such clear violations of the constitutional right to equality, the new Employment Promotion Law and the Provision on Employment Services and Employment Management provide a set of anti-discrimination measures. These comprise basic principles: All employees shall enjoy the right to equal employment and to the freedom of occupational choice; in the course of employment no employee shall be discriminated against due to ethnicity, race, gender, religious belief or any other impermissible reason; no discriminatory content may be contained in any recruitment brochure or job advertisement. Further details regarding anti-discrimination, e.g., indirect discrimination, positive discrimination against disadvantaged groups, justifiable grounds for discrimination as well as the amount of compensation to be paid in case of discrimination are expected to be outlined by the courts.

With regard to gender discrimination, it is prohibited to refuse to employ women or set thresholds for recruitment according to gender, unless the position is categorized to be inappropriate for women in accordance with laws and regulations. Restrictions in a labor contract for female employees preventing them from marriage or from bearing a child have also been banned.

Moreover, discrimination against ethnic minorities, migrant workers or carriers of infectious pathogens (except for certain cases stipulated in laws and regulations) and people with disabilities is also prohibited in the course of recruitment.

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40 Art. 33 para. 2 and art. 48 Constitution as well as arts. 12 and 13 Labor Law.
42 Art. 3 Employment Promotion Law; arts. 4, 6 and 20 Provision on Employment Services and Employment Management.
43 Art. 27 Employment Promotion Law; art. 16 Provision on Employment Services and Employment Management.
Where an employee is being discriminated against, the victim may file a lawsuit.\textsuperscript{45} Pursuant to art. 120 para. 1 General Principles of Civil Law, where personal rights have been violated, the aggrieved person is entitled to demand cessation of the infringement, rehabilitation of his or her reputation, elimination of ill effects and/or an apology announcement; he or she may also demand compensation for losses. In cases leading to “severe consequences” the compensation for loss includes both economic damages and emotional damages.\textsuperscript{46} Since employers, in practice, bear the burden of proof, they are well advised to adequately document and implement their lawful conduct; all employers should examine compliance of their entire employment procedure with anti-discrimination requirements.

d) Form and Content

A written labor contract is to be concluded at the establishment of a labor relationship, \textit{i.e.}, it is to be signed or stamped by the employee and the employer within one month after the employee commences work.\textsuperscript{47} The labor contract is to include certain minimum contents.\textsuperscript{48}

Despite their stringent wording, these provisions only have a declaratory and verifying effect,\textsuperscript{49} since, according to the Labor Contract Law, a labor relationship begins with the actual commencement of work by the employee.\textsuperscript{50} If the remuneration, labor conditions and/or other standards are not expressly and precisely stipulated in the labor contract, and disputes arise, the parties must first attempt to renegotiate the contract; if an agreement is not reached, the relevant collective contract applies; if no collective contract exists or if there are no relevant provisions in the collective contract governing the issue, the principle of equal pay for equal work and state provisions apply.\textsuperscript{51}

Although failure to observe the mandatory written form for a labor contract will not jeopardize the validity of the labor contract itself, it is now associated with serious sanctions: if an employer fails to conclude a written contract within one month after an employee commences work,\textsuperscript{52} the employer must pay to that employee twice the monthly wages from that point in time until a written labor contract is concluded, but no longer than for a maximum of eleven months.\textsuperscript{53} During these eleven months the requirement to conclude a contract with the employee persists; if the employer fails to do so, any contract concluded thereafter

\textsuperscript{45} Art. 62 Employment Promotion Law.
\textsuperscript{46} Art. 1 para. 1 no. 3 and art. 8 para. 2 Interpretation of the Supreme People’s Court on Problems regarding the Ascertaining of Compensation Liability for Emotional Damages in Civil Torts (issued on March 8, 2001; in force since March 10, 2001); Reply to question 10 of the Interpretation and reply of the Supreme People’s Court to several questions in Trials of Cases about Infringement of Reputation (issued on and in force since August 7, 1993).
\textsuperscript{47} Art. 10 paras. 1 and 2 Labor Contract Law.
\textsuperscript{48} Art. 17 para. 1 Labor Contract Law.
\textsuperscript{49} Cf. Wang Quanxing, 12; Wang/Huang, 23, 26.
\textsuperscript{50} Art. 7 sentence 1 Labor Contract Law; cf. no. 2 Opinion on Several Issues about the Implementation of the Labor Law; cf. Wang/Huang, 22 et seq.
\textsuperscript{51} Art. 18 Labor Contract Law.
\textsuperscript{52} Art. 97 para. 2 Labor Contract Law. For labor relationships already in existence prior to January 1, 2008, this date is considered the date the employee commenced work.
\textsuperscript{53} Art. 82 para. 1 Labor Contract Law; art. 6 Regulation on the Implementation of the Labor Contract Law.
must be concluded for an indefinite period of time beginning one year after the employee’s commencement of work.54

If the employer notifies the employee within one month of the employee’s commencement of work that a written contract is available for conclusion, and the employee fails to conclude this contract, the employer may terminate the labor relationship in writing without paying any extra severance other than remuneration.55 If the employee fails to conclude a written labor contract after the one-month period, but less than one year after commencing work, the employer may terminate the labor relationship in writing, however, severance payment is to be paid (with regard to severance payment, infra at 90–93).56

In addition to the formal requirements pursuant to art. 26 para. 1 Labor Contract Law, a labor contract is invalid or partially invalid if

- a party concludes or modifies a labor contract by deception of, coercion of or by unfairly disadvantaging the other party;
- the employer is exempted from its legal liabilities and the rights of the employee are excluded; or
- mandatory provisions of laws or administrative regulations are violated.

Moreover, since it is common for employers to use standard term labor contracts, the special legal requirements therein need to be adhered to, too (arts. 39–41 Contract Law).57

Apart from the aforementioned requirements concerning the form and content of a labor contract, employers must register any new labor relationship with the competent labor administration within 30 days, and prepare a roster of employees for the purpose of inspection, including the employee’s name, gender, citizen identity card number, registered residential address and current address, contact data, commencement date and term of employment.58

e) Full-Time Labor Contract

A full-time labor contract may be concluded for a fixed term, without a fixed term or be tied to the accomplishment of certain tasks. Fixed term labor contracts were introduced by politicians and lawmakers at the very beginning of the reform of the labor system to break up the former fixed employment regime (固定用工制) of the planned economy.59 This kind of labor contract played a major role in the past.60

A fixed term labor contract refers to a labor contract in which both parties to a labor relationship agree on the time of termination of the contract.61 An employer may elect to engage an employee continuously for a fixed term less than 10 years, or

54 Art. 14 para. 3 Labor Contract Law; art. 7 Regulation on the Implementation of the Labor Contract Law.
55 Art. 5 Regulation on the Implementation of the Labor Contract Law.
56 Art. 6 Regulation on the Implementation of the Labor Contract Law.
57 Cf. Wang Quanxing, 11.
59 Notice Pertaining to Active Trial Implementation of the Labor Contract System (issued by the then Ministry of Labor and Personnel on February 22, 1983; repealed on November 11, 1994); art. 20 Labor Law.
60 Wang Quanxing, 13.
61 Art. 13 para.1 Labor Contract Law.
for two successive fixed terms totaling less than 10 years, or for several discontinued fixed terms, without providing any objective reasons for this decision.\textsuperscript{62} Otherwise, a labor contract without a fixed term must be concluded (\textit{infra} at 44). Therefore, the distinction between the labor relationship being “in succession” or not is vital to determine whether a fixed term labor contract is lawful and valid. In practice, some enterprises made use of this uncertain situation and interrupted labor relationships with their employees before the new Labor Contract Law came into effect. For instance, Huawei Technologies Co., Ltd. (the largest networking and telecommunications equipment supplier in China) “encouraged” its employees to “voluntarily” resign from employment and to sign new contracts in return for a more favorable severance payment. This led to the conclusion of new fixed term labor contracts to “enhance competitiveness” among staff and to the interruption of continuous service periods before the new Chinese Labor Contract Law came into effect.\textsuperscript{63} Other enterprises followed this example and were heavily criticized by experts, labor unions and the media who suspected the law being circumvented.\textsuperscript{64} Nevertheless, there is no record of any disputes arising out of this conduct.\textsuperscript{65}

In order to avoid the abuse of this uncertain situation, the People’s High Court and the Labor Dispute Arbitration Committee of Guangdong Province have attempted to develop the concept of “continuity of employment”. According to their Guiding Opinion, the following actions shall be invalidated, if taken by employers with the intent to circumvent art. 14 Labor Contract Law:

- To compel employees to resign and then execute a new labor contract in order to cause their period of service to be zero
- To establish an affiliate in order to change the employer’s name when executing new labor contracts with employees
- To make use of an illegal labor service dispatch
- To engage in other actions of circumvention that clearly violate the principles of good faith and fairness.\textsuperscript{66}

For any of the above items, the relevant employee’s period of service shall not be considered zero and the relevant labor contracts shall be considered to be continuous.\textsuperscript{40} Moreover, the Regulations on the Implementation of the Labor Contract Law, issued by the State Council, provide that the period of service of an employee with one employer shall be added to the period of service with a subsequent employer where this employee had been transferred to the subsequent employer for reasons not attributable to himself or herself (\textit{infra} at 69).\textsuperscript{67}

Whether a continuous labor relationship exists is being determined by considering all relevant circumstances of the disputed individual case, \textit{e.g.}, the real intention of the parties and the measures taken by them, the fact and length of interruption of

\textsuperscript{62} Cf. Art. 14 para. 2 sentence 2 Labor Contract Law.

\textsuperscript{63} Bai, 15.

\textsuperscript{64} Cf. \textit{Wang/Huang}, 27, 28; Bai, 15; Huawei Suspends the Resignation of Staff for Renewed Employment by Competition (华为中止员工辞职再竞岗), People’s Daily Overseas Edition (人民日报海外版) November 12, 2007, 4.

\textsuperscript{65} No “Renewed Employed” staff of Huawei Quits “N+1” Compensation (Program) (华为“再就业”员工无人退出“N+1”补偿), The Beijing News (新京报) December 25, 2007.

\textsuperscript{66} Art. 22 para. 1 Guiding Opinion on Several Issues concerning the Application of the Law on Labor Dispute Mediation and Arbitration and the Labor Contract Law (issued by the High People’s Court and the Labor Dispute Arbitration Committee of Guangdong Province on June 23, 2008).

\textsuperscript{67} Art. 10 sentence 1 Regulation on the Implementation of the Labor Contract Law.
employment, the effect of such acts as well as other evidence. Instead of attempting to list all possible abuses and then rigidly applying this list in accordance with its exact wording, more attention should be paid to a systematical, teleological and historical interpretation method in addition to the strict literal interpretation. Otherwise, similar conducts to those of Huawei (supra at 38), may not be covered by the Guiding Opinion from Guangdong Province because they do not included elements such as “to compel” and “in order to cause their period of service to be zero”. However, pursuant to art. 58 para.1 no. 7 General Principles of Civil Law and art. 52 no. 3 Contract Law, a civil act/contract, which has been performed/ concluded under the guise of legitimate forms and conceals illegitimate purposes, is null and void. If the “encouragement”, “voluntariness” and “enhancement of competitiveness” in Huawei’s act were solely used to conceal and reach illegal aims such as the interruption of the period of service and the unjust dismissal of employees, the relevant act should be invalid.  Therefore, not only the form of such acts, but above all the real purposes of such acts should be scrutinized and determined by means of proper interpretation.

While the fixed term labor contract was being preferred politically and legally at the very beginning of the reform of the Chinese labor law regime, it has, in practice, been used frequently for discrimination purposes or to avoid the stringent provisions regarding contract termination. Labor contracts with a fixed term of a few months or a maximum term of one to two years were not uncommon in China and undermine the stability of labor relations.

Today, employers are obligated to conclude a labor contract without a fixed term with employees where any one of the following circumstances applies (and unless the employee requests a fixed term labor contract on his or her own initiative):
- The employee has been working for the employer for a full ten years continuously.
- The employer initially implemented the labor contract system or a state-owned enterprise re-concluded the labor contract due to restructuring, the employee has worked for this employer for ten full years and will enter into statutory retirement in less than ten years.
- Fixed term labor contracts have been concluded twice in succession and no personal or behavior-based circumstances exist in relation to the employee which could provide grounds for a termination of the contract by the employer.
- The employer fails to conclude a written labor contract with the employee during the first year following commencement of work by the employee.

Where an employer fails to conclude a labor contract without a fixed term in any of the aforementioned cases, the employee is entitled to demand twice the monthly wage from the date on which the labor contract without a fixed term should have been concluded to the date of actual conclusion, ex post, of a written labor contract without a fixed term.

In addition, the parties to a labor relationship may also conclude a labor contract that is limited to the accomplishment of certain tasks; with the accomplishment of these tasks the labor contract terminates. Since the accomplishment of certain

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68 Cf. Wang/Huang, 27, 28.
69 Wang Quanxing, 13.
70 Art. 14 para. 2 sentence 2 and para. 3 Labor Contract Law.
71 Art. 82 in association with art. 14 para. 2 sentence 2 and para. 3 Labor Contract Law.
72 Art. 15 para. 1 Labor Contract Law.

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tasks constitutes the termination condition, these tasks should be specified in the labor contract as clearly and precisely as possible, especially with regard to purpose, character, content, scope, duration, location, and criteria governing the accomplishment of work. Otherwise, the labor contract in question might be treated as a labor contract without a fixed term, and, consequently, may only be terminated in accordance with the statutory termination procedure.

f) Part-Time Labor Contract

A “part-time labor relationship” generally refers to a labor relationship where the remuneration is calculated on an hourly basis and the pay period does not exceed 15 days; where the average working hours of an employee per day for one and the same employer do not exceed four hours; and where the accumulative working hours per week for one and the same employer do not exceed 24 hours.73

The flexibility of this part-time employment regime is legally specified and characterized. No written labor contract is mandatory,74 no probation period is allowed;75 the employment may be terminated by any party at any time without providing any written notification or termination reasons to the other party; and an employer is not required to provide severance payment to the employee if the employment is in fact being terminated.76

However, being a double-edged sword, these flexible provisions may – without necessary restrictions – also be misused to circumvent relevant provisions of the labor law; such as the documentary proof provided by a written labor contract, protection of employees from unjust termination of their employment, and protection from discrimination against female employees and migrant workers who frequently work on a part-time basis. The current regime of part-time employment in the Labor Contract Law could stimulate the lawful circumvention of laws and regulations to some extent, rather than making the employment market more flexible. A judicial or legislative adjustment thereto to favor employee protection is expected.

g) Labor Dispatch Service

In light of the gradual augmentation of employer’s responsibilities and liabilities, many employers in the past resorted to employing labor dispatch services, which were not regulated by the Labor Law until the promulgation of the Labor Contract Law.77

Pursuant to art. 57 Labor Contract Law, the labor dispatch service provider must be a limited liability corporation or joint-stock corporation with a minimum registered share capital of RMB 500,000.00. The labor dispatch service providers are employers in terms of the Labor Contract Law and shall conclude a labor contract with a fixed term of not less than two years with the employees to be dispatched.78 The labor dispatch service provider and the actual employing unit shall conclude an agreement on labor dispatch services covering such issues as the

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73 Art. 68 and art. 72 para. 2 Labor Contract Law.
74 Art. 69 para. 1 Labor Contract Law.
75 Art. 70 Labor Contract Law.
76 Art. 71 Labor Contract Law.
77 Wang Quanxing, 14, 15.
78 Art. 58 para. 1 sentence 1 and para. 2 Labor Contract Law.
location and number of the dispatched employees, dispatch term, amount and method of payment of remuneration and social insurance contributions as well as liabilities for a breach of contract. In spite of its theoretical non-employer position, an actual employing unit has to assume a set of obligations and liabilities:

- Labor dispatch services shall only be used for temporary, auxiliary or substitute positions.
- Employers are not allowed to dispatch the dispatched employees to any other employing units, or to establish themselves any employee dispatch service providers to dispatch employees to themselves or their subsidiaries.
- The dispatch period shall be determined by the actual requirements of the position and shall not be divided into several short-term dispatch agreements.
- The dispatched employees shall not be employed on a part-time basis.
- The actual employing unit must provide labor conditions and protection in accordance with government standards, advise any dispatched employee of working requirements and remuneration, pay overtime remuneration, performance bonuses and benefits as appropriate, provide necessary training and implement a normal wage adjustment system for those employees in continuous employment.
- Dispatched employees are entitled to equal pay for equal work with the actual employing unit and may organize or join a labor union.
- The actual employing unit may (only) return the dispatched employee unilaterally to the labor dispatch service provider upon personal or behavior-based statutory grounds for the termination of labor contracts by employers (operations-based statutory reasons are not included; in respect of the termination of labor contracts by an employer, infra at 74–93).
- The actual employing unit is joint and severally liable (in conjunction with the labor dispatch service provider) for compensation to the dispatched employees in case of injury.
- In a labor dispute between the labor dispatch service provider or the actual employing unit and the dispatched employee, the labor dispatch service provider and the actual employing unit shall be a joint party in opposition to the employee.

In practice, most well known labor dispatch service providers for foreign-invested enterprises in China have updated their standardized terms of labor dispatch services and labor contracts in accordance with the Labor Contract Law. The intention concealed in the updated terms is to shift the employers’ responsibilities and liabilities strengthened by the Labor Contract Law as much as possible to the actual employing unit. For instance, the following clause has been adopted into many labor dispatch service agreements: “Should the actual employing unit return the dispatched employee without personal or behavior-based statutory grounds ahead of schedule, the actual employing unit is obliged to assume all expenses incurred thereby, including, but not limited to, the statutory compensation for the

79 Art. 59 para. 1 Labor Contract Law.
80 Art. 65 para. 2 in association with art. 39 and art. 40 nos. 1 and 2 Labor Contract Law.
81 Arts. 59 para. 2 et seq. and art. 92 Labor Contract Law; arts. 28 et seq. Regulation on the Implementation of the Labor Contract Law; art. 22 para. 2 Law on Labor Dispute Mediation and Arbitration.
82 Cf. art. 65 para. 2 in association with art. 39 and art. 40 nos. 1 and 2 Labor Contract Law.
dispatched employee, damages for the employee and the dispatch service provider as well as costs (e.g. remuneration and social insurance premium etc.) for the maintenance of the labor relationship between the employee and the dispatch service provider.”

Consequently, this strongly restricts actual employing units from taking action towards the dispatched employees where solely an operational necessity exists. In view of the significant obligations and liabilities of the actual employing unit and in light of the complicated legal relationships between three parties (as compared with a simple labor relationship between employer and employee), the adoption of a labor dispatch service should be considered with caution, unless this is expressly required by law or regulations (i.e., where employees are employed by the Chinese representative office of a foreign enterprise) or demanded for by operational necessities, e.g., for seasonal work.

h) Labor Conditions: Probation Period and Annual Leave

Compared with previous labor laws and regulations, the Labor Contract Law and additional provisions do not include many changes with respect to labor conditions. For instance, the statutory working time remains 8 hours per day and 40 hours per week; flexible working time is subject to government approval; overtime payment is calculated at 150% of the normal remuneration; 200% of the normal remuneration is to be paid for work on a day of rest, unless a compensatory day of rest can be arranged; and 300% of the remuneration is to be paid for work on public holidays. Remuneration comprises all monetary income paid by an employer to an employee and must not be less than the local minimum wage; with regard to production safety, the Production Safety Law and other special laws and regulations are applicable, such as provisions for the protection of female and juvenile employees.

However, the legislator included significant reforms with regard to the probation period and paid annual leave. Although the maximum probation period remains to be six months, this six-month term can now only be utilized with respect to labor contracts for a fixed term of at least three years, or contracts without a fixed term. For a labor contract with a fixed term of at least one year, but less than three years, the probation period must not exceed two months. If the term of a labor contract is at least three months, but less than one year, the probation period must not exceed one month. For labor contracts with a fixed term of less than three months, for labor contracts limited to the accomplishment of certain tasks, and for part-time labor relationship, no probation period is allowed. The probation period may only be agreed to once between the parties to a labor relationship. The remuneration during the probation period may not be lower than 80% of the minimum wage for a non-probationary employee in the same position with the same employer, or 80% of the wage agreed to in the labor contract, nor shall it be less than the local minimum wage. The labor contract of an employee during the probation period may only be terminated by the employer for statutory personal or behavior-based reasons (operations-based reasons are not included; in respect of the termination of labor contracts

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83 Extract from a standard labor dispatch service agreement with slight modifications.
84 Arts. 36 et seq. Labor Law and art. 3 Provision on Working Time for Employees.
85 Infra at “Relevant Laws & Regulations”.
86 Regarding the probation period, see arts. 19 et seq. Labor Contract Law and art. 15 Regulation on the Implementation of the Labor Contract Law.
by the employer, *infra* at 74–93). These provisions intend to better protect employees against potential misuse by employers during the probation period.

Most significantly, the State Council has for the first time specifically laid down paid annual leave. According to previous labor laws and regulations, employees were, in principle, entitled to an annual leave of a maximum of two weeks after having worked continuously for at least one year; no minimum annual leave or specific measures in this regard had been laid down. Pursuant to the new “Regulation on Paid Annual Leave for Employees” (issued by the State Council on December 14, 2007; in force since January 1, 2008) and the “Measure on the Implementation of the Regulation on Paid Annual Leave for Employees in Enterprises” (issued by the Ministry of Human Resources and Social Security on and in force since September 18, 2008), an employee is generally entitled to paid annual leave in accordance with the length of time he or she has worked accumulatively (but not necessarily for the same employer), provided he or she has been working for a minimum of one year and with the exception of a few statutory cases. Paid annual leave is five working days for employees who have accumulatively been working for at least one year, but less than ten years; ten working days if the length of accumulative working period amounts to at least ten years, but covers less than twenty years; and fifteen working days, if the accumulative working period amounts to at least twenty years. An employer shall arrange the annual leave of its employees on the basis of the individual production and employment situation and with consideration to the employee’s will. Where an employer finds that it cannot arrange annual leave due to work-related circumstances, the written consent of the employees thereto must be obtained and 300% of the normal daily wage must be paid to the employee for each day of annual leave due but not taken. If an employer arranges annual leave, but the employees request in writing not to take it due to personal reasons, the employer may pay only normal wages. If an employer fails to arrange annual leave or to pay 300% of the normal daily wage to the employee, although it had been warned by the competent Labor Administration, that employer has to pay 600% of the normal daily wage to the relevant employee as remuneration (300%) plus compensation (300%). In case of termination of a labor contract by the employer, the unused annual leave days have to be compensated proportionally.

In view of the statutory “obligation of employers to arrange annual leave” and the sanctions levied on employers in the event of failure to do so, the relevant clauses in a labor contract and enterprise rules should be thoroughly drafted; the entire procedure regarding the arrangement of annual leave, *i.e.*, its planning, notification, application, waiver, approval and rejection, is to be adequately documented.

i) **Contractual Penalty in Special Cases**

In contrast to contractual penalties in general civil and commercial contracts, a penalty clause against an employee for breach of contract may only be included in a labor contract in China to the extent that it protects the employer from damages in the two following special cases.88

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87 Art. 45 Labor Law; no. 72 Opinion on Several Issues about the Implementation of the Labor Law; no. 2 sentence 1 and no. 4 Notice concerning Annual Leave for Employees (issued by Central Committee of the Chinese Communist Party and the State Council on June 15, 1991).

88 Art. 25 in association with arts. 22 and 23 Labor Contract Law.
Where an employer pays expenses for special training and provides special technical training to an employee, an agreement outlining the employee’s minimum period of service and containing a contractual penalty may be concluded. Where the employee leaves his or her employer before the end of this service period, the employee has to pay the stipulated contractual penalty, which may not exceed the training expenses, including all directly verifiable expenses provided by the employer; the penalty required to be paid shall not exceed the training expenses attributable to the period of service not performed by the employee. In the event that the employee terminates the labor contract because of one of the reasons specified in art. 38 Labor Contract Law, i.e., because of a reason for which the employer is responsible, this termination shall not be treated as a violation of the period of service clause. On the other hand, if the employer terminates the labor contract for important reasons (i.e., art. 39 nos. 2–6 Labor Contract Law) for which the employee is responsible (infra at 79), the contractual penalty is to be paid by the employee.

If an employer entrusts an employee with confidential information such as business secrets or intellectual property, the labor contract may also include a non-disclosure agreement with a post-contractual non-competition clause and a contractual penalty to take effect in the event of violation of the non-competition clause. A valid post-contractual non-competition clause in a labor contract must fulfill a number of legal requirements. Firstly, confidential information (i.e., business secrets) in terms of Chinese law solely include technical and operational information with reference to business which is not accessible to the public, can bring about economic gain to the holder of rights, and for which the holder of rights has taken measures to protect this information. Secondly, pursuant to art. 24 Labor Contract Law, a non-competition clause may only be concluded with special subjects, such as senior management, technical personnel and certain other persons, who have the obligation to maintain confidentiality. With respect to content, such a clause must contain an appropriate “waiting allowance” to be paid monthly; the scope, geographical area and time limit of non-competition may be agreed by parties in compliance with laws and regulations. The period of non-competition after termination of the labor contract, must not exceed two years; non-competition in this context refers to the former employee being employed by a competitor, or to independently conducting business, or to selling products of the same kind.

In various local regulations there are different additional provisions on the minimum content of such a clause and the waiting allowance to be paid. The Draft

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89 Art. 22 para. 1 Labor Contract Law.
90 Art. 22 para. 2 Labor Contract Law; art. 16 Regulation on the Implementation of the Labor Contract Law.
91 Art. 26 para. 1 Regulation on the Implementation of the Labor Contract Law.
92 Art. 26 para. 2 Regulation on the Implementation of the Labor Contract Law.
93 Art. 23 Labor Contract Law.
94 Art. 10 para. 2 sentence 2 Law Against Unfair Competition (promulgated on September 2, 1993; in force since December 1, 1993); cf. Ma, 122.
95 Cf. Wang Fei, 65; Ma, 122, 123.
96 Cf. Wang Fei, 66; Ma, 124.
97 Cf. Wang Fei, 65, 66; Ma, 123, 124.
98 Cf. Wang Fei, 66; Ma, 124.
of the Labor Contract Law published on March 20, 2006, provides in art. 16 that the area within which competition is prohibited shall be limited to those areas which have an actual competitive relationship to the employer; that the amount of the waiting allowance shall not be less than the annual remuneration of the employee; and that the amount of the contractual penalty shall not exceed three times the amount of the waiting allowance. Due to serious disagreements among legislators, especially with regard to the amount of the waiting allowance and the contractual penalty, no exact limit as to the scope, the amount of the waiting allowance or the contractual penalty has been stipulated in the final version of the Labor Contract Law. Nevertheless, a reference could be made to the aforementioned limits of the Draft of the Labor Contract Law if no relevant local provisions exist.

To avoid legal uncertainties, any non-competition clause should be carefully drafted with reference to the facts of the individual labor relationship, the relevant market situation, and special local rules. An unqualified object, an inappropriate subject, an inappropriately low waiting allowance, or an improperly extensive scope or area limitation as well as a disproportionately high contractual penalty could affect the validity of such a clause.99

j) Factual Labor Relationship

In practice, it is not uncommon that an employee provides work to the employer although the underlying legal basis, i.e., the labor contract, is erroneous. This was especially true in the past, when the existence of a labor contract in writing was considered to already constitute the labor relationship according to the Labor Law and when the employee had been working although no labor contract in writing existed.100 However, pursuant to no. 2 of the "Opinion on Several Issues about the Implementation of the Labor Law" (issued by the then Labor Ministry on and in force since August 4, 1995), where a labor relationship has been established, i.e., where an employee has in fact become a member of an enterprise or an individual economic organization within China and has provided work, the Labor Law applies. This kind of legal relationship without a written labor contract was, therefore, treated in practice as a factual labor relationship under the Labor Law. Since the written form of a labor contract now carries a mere declaratory effect, in that under the Labor Contract Law the labor relationship begins with the beginning of the work, a labor relationship without a written labor contract is recognized to be valid from the very beginning of the employee’s work.101

The question remains whether a labor relationship really exists and which legal consequences arise, if the underlying labor contract is invalid. According to art. 2 Labor Contract Law, only certain organizations – broadly speaking those undertakings with a business license – may be a qualified employer in China. Minors aged 16 or under may, in general, not be employed as employees.102 Art. 26 para. 1 Labor Contract Law lists other grounds for invalidity (supra at 34).

In general, there are two opinions among Chinese scholars as to this question. According to one opinion, if the underlying labor contract is invalid, the labor

99 Cf. Wang Fei, 66; Ma, 122 et seq.
100 Ke, 11; Wang/Huang, 24.
101 Art. 7 sentence 1 Labor Contract Law; no. 2 Opinion on Several Issues about the Implementation of the Labor Law; Wang/Huang, 24.
102 Art. 38 para. 1 Law on the Protection of Minors.
relationship is not a factual labor relationship, but an unlawful labor relationship. This opinion argues that a factual labor relationship is a labor relationship which is formally flawed (e.g., because no written labor contract exists), but meets all other material legal requirements. This school of thought tends to apply labor laws and regulations to the unlawful labor relationship, provided the employee is not at fault, because the employee has already irrevocably provided his or her work and can otherwise only be compensated according to provisions of unjust enrichment.

Another opinion argues that, once the criteria for a labor relationship are met (i.e., work for remuneration and personal dependency), a factual labor relationship exists, even if the underlying labor contract is invalid; labor laws and regulations, in this opinion, shall apply for the sake of employee protection.

66 Labor Contract Law does not provide a clear answer to this question. In particular, since the legislator has failed to define “Employee” and “Labor Relationship”, no sound legal basis for a factual labor relationship exists. Nonetheless, the legislator has provided two different measures for those employees who have provided work on the basis of an invalid labor contract according to the Labor Contract Law and for those employees who have worked for an unqualified employer. Where a labor contract has been confirmed to be invalid according to art. 26 para. 1 Labor Contract Law (supra at 34), the employer must pay remuneration to the employee equal to the remuneration paid for the same or a similar position; the party at fault is liable for compensation of damages caused to the other party. In this case, a legal relationship based on an invalid labor contract is to be treated as a service relationship in which service is provided in return for remuneration. By contrast, where the employee has already worked for an unqualified employer, the employer shall pay the employee remuneration, severance payment and/or indemnities as well as any damages according to the Chinese Labor Contract Law. In this case, employees of unqualified employers are to be treated as employees in terms of Chinese labor law by applying an economic perspective. However, where a factual labor relationship caused by an invalid labor contract is solely regarded to be a service relationship, employers will be encouraged to misuse such invalid labor contracts since they will be exempt from stricter liabilities and obligations under labor laws and regulations. Consequently, this approach harms the interests of factual employees rather than protecting them. Moreover, there are no compelling arguments for the unequal treatment in these two cases, because both of them do not constitute a valid labor relationship according to the Labor Contract Law.

67 From my point of view, the key to resolve the problem concerning factual labor relationships would be legal definitions of what constitutes an “Employee” and a “Labor Relationship”. In order to determine whether a labor relationship has been in fact established and how to treat this relationship in legal terms, these definitions are indispensable. No. 2 of the “Opinion on Several Issues about the Implementa-

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103 Zhu, 118 et seq.
104 Zhu, 120.
105 Cf. Hou/Wang, 74; Wang/Huang, 28 et seq.; cf. Ke, 11.
106 Arts. 28, 86 Labor Contract Law.
107 According to Wang/Huang, 28 et seq. employers shall assume other labor liabilities and obligations in addition to paying remuneration in that the invalid labor contract should be deemed valid for the purpose of employee protection.
108 Art. 93 Labor Contract Law.
tion of the Labor Law” (issued by the then Labor Ministry on and in force since August 4, 1995) does, nonetheless, list three characteristics of a labor relationship: the employer must be an economic organization in China; work is provided in exchange for remuneration; and the employee is integrated into the organization. However, the legal effect and contents of this provision are not unproblematic. Being a departmental provision, it carries no real general legal effect since it is neither a national law, nor an administrative regulation, nor a local regulation. Regarding its content, limiting the term “Employer” to enterprises or individuals legally and economically organized in China will exclude from labor law protection numerous employees working for entities that are not categorized as employers. Thus, a legal definition of an “Employee” or a “Labor Relationship” based on the aforementioned elemental characteristics, i.e., a private legal relationship, work for remuneration and personal dependency, should be established (supra at 16, 17). A factually established labor relationship lacking a valid labor contract or qualified subjects should, then, for the purpose of employee protection legally be treated as a valid labor relationship because work has been irrevocably provided. An exception should apply where the parties do not deserve such protection, e.g., where the content of the labor relationship is contrary to public policy or the provisions with a prohibitive nature, where there has been malicious collusion between the parties to violate the interests of a third party, or where the invalidity of the labor contract is attributable to the employee’s own fault.

3. Modification of a Labor Contract

Upon negotiation and agreement, both parties to a labor relationship may also modify the content of the labor contract; any such modification must be made in writing. Where the employer is subject to a merger or is split up into different enterprises, the original labor contracts remain valid; the successor of the rights and obligations of the original employer must continue to perform the obligations as set out in the original labor contracts. However, parties are not prohibited from modifying the original labor contracts before or after the transaction.

These kinds of transactions may affect the calculation of the employee’s period of service. The period of service shall, in general, include any time before the transaction, if the transfer of the employee is not due to reasons attributed to the employee himself or herself. The calculation of the period of service is fundamental to determine a number of issues, such as whether a labor contract without a fixed term must be concluded (after continuous ten-year work, supra at 44) and for how many months the statutory severance payment shall be paid when the labor contract is terminated (infra at 93). Regarding the latter, the State Council permits an interruption of the calculation of the period of service, if the original employer has already paid severance to the employee. The laws and regulations are silent on whether this provision may also be applied analogically to the first question, i.e., whether the

109 “Where an employee in fact has become a member of an enterprise or an individual economic organization within China and provided labor service to it, the Labor Law shall apply.”
110 Arts. 71 and 82 Legislation Law (promulgated on March 15, 2000; in force since July 1, 2000).
111 Art. 35 para. 1 Labor Contract Law.
112 Art. 34 Labor Contract Law.
113 Art. 10 sentence 1 Regulation on the Implementation of the Labor Contract Law.
114 Art. 10 sentence 2 Regulation on the Implementation of the Labor Contract Law.
period of service performed with the new employer is to be calculated without reference to the period of service performed with the original employer, if severance has been paid upon termination by the original employer (“buying-up the period of service”). For the purpose of employee protection and with regard to the period of service already performed (e.g., in case of continuous ten-year work), the period of service should not be subject to being “bought up” by paying severance; the purpose of the law requires it to be calculated continuously. Otherwise, this protective provision would be easy to circumvent by employers offering an attractive severance payment to diminish the period of service and to further employ employees on a fixed-term basis. To prevent the law from being circumvented, it is most likely that labor administrations or courts will carefully scrutinize cases in which the labor contract between the original employer (transferor) and the employee has been (lawfully and “voluntarily”) terminated and a new labor contract has been subsequently concluded by the employee and the new employer (transferee).

4. Termination

a) Consensual and Mandatory Termination

The consensual termination of the labor contract by both parties is explicitly permitted. However, if the agreement on the termination of the labor contract is concluded on the initiative of the employer, the employee is entitled to receive a statutory severance payment; on the contrary, if the employee initiates the termination, the employer does not need to pay any severance (infra at 90–93). Although there is no explicit statutory requirement to this effect, the agreement to terminate the labor contract should be in writing, since the termination of a labor contract resembles, in a broader sense, a contractual modification of the labor contract which requires written form, and since the employer has, de facto, the burden of proof as to upon whose initiative the contract had been terminated (infra at 124). Furthermore, employers are legally required to issue a certificate of termination at the termination of a labor contract; this certificate must contain the terms of the contract, the date of termination of the contract, the position of the employee, and the period of time the employee worked for the employer (i.e., the period of service).

Pursuant to art. 44 Labor Contract Law, a labor contract also terminates, if any one of the circumstances listed below is being fulfilled:

– The term of the labor contract has lapsed, i.e., a fixed-term contract has expired or the accomplishment of a certain task as provided for in the contract has been achieved.
– The employee receives statutory basic pension.
– The employee is deceased, or a court declares him or her dead or missing.
– The employer is bankrupt.
– The employer’s business license is revoked, its business is ordered to be closed down or dissolved, or the employer decides to dissolve ahead of schedule.
– Other circumstances as prescribed by laws and administrative regulations apply.

115 Art. 36 Labor Contract Law.
116 Art. 35 para. 1 Labor Contract Law.
117 Art. 50 para. 1 Labor Contract Law; art. 24 Regulation on the Implementation of the Labor Contract Law.
Apart from the aforementioned circumstances, no other contractual terms pertaining to the termination of a labor contract are allowed to be agreed on. This prevents employers from using contractual termination terms to circumvent the statutory termination requirements (infra at 74–93).118 This prohibition applies to both employer and employee.

b) Termination by Employee

An employee may terminate a labor contract without providing any reasons to the employer, provided that he or she notifies the employer of the termination in writing 30 days in advance (or three days in advance, if the probation period has not yet expired).119 The strict wording of this provision allows neither a contractual extension nor a reduction of the notification term, even if this alteration were in favor of the employee. The employee may also terminate the contract without previous notification for severe breach of contract by the employer.120

c) Termination by Employer

An employer in China, regardless of its size, may only terminate a labor contract on account of statutory grounds, in compliance with the necessary formalities, and if accompanied, in most cases, by a severance payment.

In general, an employer may terminate a labor contract after having notified the employee 30 days in advance of the impending termination, or with immediate effect in severe cases, provided that a relevant statutory ground for each kind of termination exists.121 With this relatively short uniform notification term the legislator, however, fails to take an employee’s period of service into consideration. Therefore, an employee with a longer period of service will be not favored over a newcomer. This situation is obviously not justifiable and should be modified. The statutory grounds for termination may be roughly divided into three categories: personal, behavior-based and operations-based reasons. As their names suggest, the grounds or facts allowing a termination by employers need to arise from the personal situation or the behavior of the employee, or from the operational needs of the employer. In addition, some groups of employees enjoy special legal protection from certain forms of termination of their labor contracts when such termination had been initiated by the employer (infra at 78).

As mentioned above, a labor contract may be terminated by an employer upon written notification 30 days in advance (or immediately if it is accompanied by an extra month’s remuneration), if any one of the following personal or operations-based circumstances is fulfilled:

- The employee is sick or injured for a non-work-related reason, and can neither resume his or her position after the expiration of the prescribed medical period nor assume any other position arranged for by the employer.
- The employee is incapable for his or her position and would remain to be incapable after training or a change of position.

119 Art. 37 Labor Contract Law.
120 Art. 38 Labor Contract Law.
121 Art. 40 Labor Contract Law.
The objective situation, on which the conclusion of the labor contract had been based, has changed so immensely that the performance of the labor contract is impossible, and both parties cannot reach an agreement on the modification of its contractual contents.\textsuperscript{122} Furthermore, an employer may conduct a so-called “economic retrenchment of personnel” by dismissing at least 20 employees at once, or less than twenty employees but at least 10\% of the entire staff\textsuperscript{123} if any one of the following operations-based grounds applies:

- The employer is being reorganized according to the Enterprise Bankruptcy Law.
- The employer suffers from serious difficulties in its production and business operation.
- The enterprise changes production, undergoes important technological renovation, or adjusts methods of business operation, and a retrenchment of personnel is still necessary although labor contracts have been modified.
- The objective situation, on which the conclusion of the labor contract is based, has changed seriously, so that the performance of the labor contract becomes impossible.\textsuperscript{124}

However, these two kinds of termination, \textit{i.e.}, termination upon prior 30-day notification in writing or economic entrenchment of personnel, are not available with respect to all employees. An employee’s contract may not be terminated in any one of the following cases:\textsuperscript{125} an employee is in these cases entitled to have his or her contract extended with a fixed term until the relevant circumstance no longer persists (special lay-off protection).\textsuperscript{126}

- The employee engages in operations exposing him or her to occupational disease and hazards, and has not undergone an occupational health check-up before he or she has to leave, or he or she is suspected of having an occupational disease and is being diagnosed, or otherwise under medical observation.
- The employee has totally or partially lost his or her capability to work because of a disease contracted due to his or her occupation or a work-related injury.
- The employee is ill or injured for a non-work-related reason and the prescribed period for medical treatment has not expired.
- A female employee is pregnant, giving birth or breastfeeding.
- The employee has continuously worked for the employer for a full 15 years, and will enter into statutory retirement in less than five years.
- Other circumstances as prescribed by laws and administrative regulations apply, \textit{e. g.}, contracts of labor union personnel while in office or of staff representatives in the course of collective bargaining must not be terminated.\textsuperscript{127}

\textsuperscript{122} Art. 40 Labor Contract Law.
\textsuperscript{123} It is questionable whether this rule also applies to small enterprises which have only 10–20 employees. If it is applicable to these according to the wording of the provision, this would result in extra expenses for the dismissal of one to two employees at once due to operations-based grounds. Therefore, the scope of application of this provision should be limited accordingly.
\textsuperscript{124} Art. 41 para. 1 Labor Contract Law.
\textsuperscript{125} With regard to protection against dismissal for labor union personnel and staff representatives, \textit{infra} at 97, 106.
\textsuperscript{126} Art. 45 Labor Contract Law.
\textsuperscript{127} Art. 42 Labor Contract Law.
Even in the aforementioned cases, the legislator does not prohibit a consensual termination by both parties. Moreover, termination by an employer with immediate effect is always possible in any one of the following cases:

- During the probation period there is proof that the employee does not meet the recruitment conditions.
- The employee seriously violates the employer’s rules and regulations.
- Severe damages are caused to the employer because the employee in question seriously neglects his or her duties (dereliction of duty), seeks his or her private benefit or commits a fraud.
- The employee enters into another labor relationship and this seriously affects the accomplishment of tasks with the current employer, or the employee refuses to rectify the second employment after the employer has indicated its desire for the employee to do so.
- The labor contract is invalid in that the employer has concluded or modified it due by deception or coercion or having its difficulties taken advantage of by the employee.
- The employee has been held liable for a criminal offence.\textsuperscript{128}

In spite of the seemingly clear categories of circumstances in which an employer can terminate a labor contract with immediate effect, these provisions are not able to comprise all termination grounds. In addition, problems of interpretation of these are in practice unavoidable. Apart from the expressions “seriously violates”, “severe damages” and “serious dereliction of duty” which are to be interpreted in the context of individual cases and on the basis of employee protection, attention should also be paid to the “employers’ rules and regulations”. The question to be asked is: “Are the contents and issuance procedures of these enterprise rules and regulations in compliance with government laws and regulations?”\textsuperscript{129} If the answer to this question is negative, then the legal basis of a serious violation of these enterprise rules and regulations by the employee is removed. For pre-emptive purposes, “serious violation”, “severe damages” and other comparable expressions should be defined properly in the labor contract and/or the enterprise rules passed lawfully.\textsuperscript{130} A previously agreed and lawful standard can be of assistance to the arbitration committee or court in the event of a dispute to determine whether relevant statutory grounds for termination exist.\textsuperscript{131}

Furthermore, it constitutes an excessive sanction imposed on an employee, violating his or her occupational freedom,\textsuperscript{132} if he or she may be dismissed immediately upon refusing to end subsidiary employment, after an employer’s request to do so, where this subsidiary employment does not have any adverse effect on the primary employment. According to art. 91 Labor Contract Law, an employer has to bear compensation liability jointly and severally with an employee, where it employs this employee while the employee is still a party to a valid labor contract with another employer and where this causes damage to the employee’s current employer. Therefore, in the course of recruitment both parties should carefully examine and consider the current employment situation of the employee. Before establishing a labor contract, the employer should ensure that the employee does not violate the terms and conditions of his or her current employment contract, and that the new employment relationship does not interfere with the fulfillment of the employee’s duties to the current employer.

\textsuperscript{128} Art. 39 Labor Contract Law.
\textsuperscript{129} With regard to the procedure to pass enterprise rules, \textit{infra} at 100–103.
\textsuperscript{130} \textit{Cf.} no. 87 sentence 1 \textit{Opinion on Several Issues about the Implementation of the Labor Law.}
\textsuperscript{131} \textit{Cf.} no. 87 sentence 2 \textit{Opinion on Several Issues about the Implementation of the Labor Law.}
\textsuperscript{132} Art. 3 para. 1 Employment Promotion Law.
relationship, the employer should ask for a written representation from the employee outlining his or her current employment situation and/or a written verification or approval from the current employer. The employee is best advised to obtain an approval from his or her current employer, in order to avoid termination of the labor contract upon a relevant request being made by that employer.

Another unresolved question is why an already invalidated contract should be terminated once again. In this case, if a dispute arises, a confirmation of invalidity by a competent arbitration committee or court should suffice. Even before this confirmation procedure there appears to be no interests to be protected by having the employer follow the entire termination procedure in the event the employer concludes or modifies a labor contract due to deception, coercion or having had its difficulties taken advantage of by the employee (supra at 20, 21 and 34). The employer, in such a case, should be able to rescind the labor contract without having to waste time and resources for conducting the termination procedure.

Finally, a sensible system to protect employees from being laid off should not separate the types of grounds for termination into those grounds requiring prior notice for termination and those grounds allowing termination with immediate effect. All types of grounds for termination should give rise to both remedies. The appropriate remedy in an individual case is to be determined according to the severity of the particular ground and its specific impact on the labor relationship. Unfortunately, the Chinese legislator has adopted a different, less logical system. Termination of a contract by an employer following prior written notice applies, as discussed, only to the personal and operations-based reasons set forth in the Labor Contract Law. However, immediate termination by an employer is only possible when an employee’s acts or omissions constitute behavior-based statutory grounds. Therefore, if the behavior does not meet the grade of severity as required by the Labor Contract Law to justify an immediate termination, the employer is not even entitled to terminate the labor contract following prior written notice. This situation is inappropriate for employers. Furthermore, an employee in his or her probation period and a dispatched employee may solely be dismissed/returned on personal and behavior-based grounds pursuant to the Labor Contract Law (supra at 51, 55). Where the basis of a labor contract lapses or is significantly modified, or where employees are subject to an “economic retrenchment of personnel”, this group of employees not fully tested, or employed only for interim, auxiliary and replaceable positions will in fact be protected from dismissal. At the same time these employees will be favored over other skilled employees employed on the basis of a normal labor relationship with a longer period of service. This result is, from a legal perspective, neither logical nor economically justifiable.

d) Formalities

Even if adequate grounds for a termination of a labor contract exist as set out in the Labor Contract Law, an employer is only able to dismiss an employee by complying with a series of statutory formalities.

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133 Art. 26 para. 2 Labor Contract Law.
134 Arts. 21 and 65 para. 2 in association with art. 39 and art. 40 nos. 1, 2 Labor Contract Law.
135 Art. 66 Labor Contract Law.
Where the labor relationship is being unilaterally altered by a termination of the underlying labor contract, the affected employee is entitled to receive a termination certificate from the employer. The termination certificate is to be provided at the time of termination and must include, *inter alia*, the terms of the relevant contract, the date of termination, the position of the employee, and his or her period of service – the grounds for termination do not need to be included.\(^\text{136}\)

According to the wording of the relevant legal provisions the termination notification must not always be in writing and its formal requirements depend on the circumstances. For instance, the law does not expressly require a termination notification in writing in case of immediate termination by the employer and for economic retrenchment.\(^\text{137}\) A written notification is legally required, however, when a termination follows the 30-day notice of termination.\(^\text{138}\) As any amendments to a labor contract must be in writing,\(^\text{139}\) the termination of a labor contract may be considered a contact modification in a broader sense and should hence be notified in writing. Whether the termination certificate may at the same time be considered a termination notification is legally unclear. Since the termination certificate and the termination notification serve different legal purposes, namely to verify the ending of a labor contract and to declare the intention to terminate the labor contract, respectively, they should not be confused with and substituted for each other. Furthermore, as employers bear the burden of proof with respect to the fact that a termination of a contract had been carried out in accordance with the law (*infra* at 124), it is suggested that a written termination notification should in each case be provided to the employee in addition to the termination certificate.

Where a labor union exists in an enterprise, the employer must inform the labor union of the grounds for termination prior to any unilateral termination it intends to take.\(^\text{140}\) The labor union is entitled to request the employer to rectify any violation of laws, regulations or the contract with regard to the termination of the contract.\(^\text{141}\) The specific format in which the information is to be provided to the labor union and the timeframe for a response by the labor union have not been set forth in laws or regulations. However, the employer must respond to any concern or request of the labor union in writing.\(^\text{142}\)

When the termination is due to an economic retrenchment of personnel, the employer must explain the situation to either the labor union or the entire staff within 30 days before declaring the lay-off. The employer must provide information and materials about the state of production and operation, as well as the plan of retrenchment to be followed – this information must include a list of those employees to be retrenched, a time table for the retrenchment, the steps to be implemented to carry out the retrenchment, and on the amount of severance to be paid. Thereafter,

\(^{\text{136}}\) Art. 50 para. 1 Labor Contract Law; art. 24 Regulation on the Implementation of the Labor Contract Law.

\(^{\text{137}}\) Arts. 39 and 41 Labor Contract Law.

\(^{\text{138}}\) Art. 40 Labor Contract Law. An exception thereto being when the employer wants to terminate immediately and is prepared to pay one month of remuneration. In this case a notification in writing is not expressly required by law.

\(^{\text{139}}\) Art. 35 para. 1 sentence 2 Labor Contract Law.

\(^{\text{140}}\) Art. 43 sentence 1 Labor Contract Law; art. 21 para. 2 Labor Union Law.

\(^{\text{141}}\) Art. 43 sentence 2 Labor Contract Law; art. 21 para. 2 Labor Union Law.

\(^{\text{142}}\) Art. 43 sentence 3 Labor Contract Law; art. 21 para. 2 Labor Union Law.
the employer must solicit the opinion of those to whom the situation was explained and modify its plan taking account any recommendations. After these steps have been taken, the employer must report the plan and the opinions of the labor union or staff to the competent labor administration and solicit its opinion thereto. If the labor administration does not object, the plan may be implemented and labor contracts may be terminated; no official approval is expressly required by law. With respect to the plan for retrenchment, the following groups of persons are to be favored: employees with a labor contract for a relatively long fixed term; employees with a labor contract without a fixed term; and employees who are the only employed person in their family having to support seniors or minors in need of support. However, this may only serve as a rule of thumb; whether staff may be divided into different groups according to qualification, performance and the enterprise’s personnel structure is to be clarified by jurisprudence. Although the legislator has not prescribed the entire procedure of retrenchment to be in written form, the employer should document all steps in writing in order to fulfill the formal requirements of modification of a labor contract, which may be applied extensively, and for the purpose of proof. It should be additionally noted that, if an employer intends to employ employees within six months after the implementation of a retrenchment, the employees dismissed during the course of retrenchment are to be informed thereof and to be favored over other applicants under the same conditions.

After issuing a certificate of termination, the employer terminating the labor contract must transfer the employee’s file and social insurance relationship to the new employer or relevant administration, and register the termination with the competent labor administration within 15 days. Terminated labor contracts must be stored by the employer for two years for the purpose of inspection. The dismissed employee shall complete any work to be handed over as agreed to between both parties; until his or her work has been handed over, the statutory severance payment must not be paid. Failure to comply with these post-termination procedures does not affect the validity of the termination; it might, however, cause operational difficulties or economic losses to the employer. Therefore, the requirements of the post-termination procedure should be strictly observed. It may be advisable settle these procedures preemptively, e.g., provisions as to the work to be handed over in the event of termination of the contract could be included in the labor contract or enterprise rules.

e) Severance Payment/Damages

In the event of an invalid termination of the labor contract by an employer, the employee is entitled to the labor contract being continued or to a payment of

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143 Art. 41 para. 1 Labor Contract Law; art. 27 para. 1 Labor Law; no. 25 Opinion on Several Issues about the Implementation of the Labor Law.
144 Art. 41 para. 1 Labor Contract Law; art. 27 para. 1 Labor Law; no. 25 Opinion on Several Issues about the Implementation of the Labor Law.
145 Art. 41 para. 2 Labor Contract Law.
146 Art. 35 para. 1 sentence 2 Labor Contract Law.
147 Art. 41 para. 3 Labor Contract Law; art. 27 para. 2 Labor Law.
148 Art. 50 para. 1 sentence 2 Labor Contract Law; art. 62 para. 1 sentence 3 Provision on Employment Services and Employment Management.
149 Art. 50 para. 3 Labor Contract Law.
150 Art. 50 para. 2 Labor Contract Law.
damages. This payment is to be twice as high as the statutory severance payment, if the employee does not desire to continue the labor contract, or if it is impossible to be continued.\textsuperscript{151} Whether the labor contract is impossible to be continued, is to be determined by a competent arbitration committee or court by considering all relevant circumstances and in light of employee protection.

With a view to China lacking an extensive social security system and in light of employee protection, the Labor Contract Law’s system of compensation is designed to make employers assume an obligation to provide appropriate aid for dismissed employees where their labor relationships end involuntarily.\textsuperscript{152} Therefore, statutory compensation shall be paid by the employer to the employee in any one of the following situations:

- The employee terminates the labor contract with immediate effect due to important grounds for which the employer is responsible.
- The employer initiates a consensual termination of the labor contract.
- The employer terminates the labor contract following 30 days notice, or immediately by paying an extra month’s wage.
- Economic retrenchment of personnel is being carried out.
- A labor contract limited to a fixed term expires, unless the employee has not agreed to renew the contract under the same or improved conditions.
- A labor contract is terminated due to the employer’s bankruptcy, revocation of its business license, mandatory close-down and dissolution, or when the enterprise is preemptively dissolved by the employer.
- A labor contract limited to the accomplishment of certain tasks is terminated upon the completion of these tasks.
- Other situations as prescribed by laws and regulations apply.\textsuperscript{153}

Upon termination of a labor contract, the employer will be exempt from the payment of the statutory severance only when the labor contract terminates due to the employee’s entering into statutory retirement; terminates because the employee is deceased, or declared deceased or missing; has been terminated by consensus by both parties based on the employee’s initiative; if limited to a fixed term expires and the employee has not agreed to renew the contract under the same or improved conditions; has been terminated by the employee in writing without any reason within the statutory notification period; or has been terminated by the employer with immediate effect on important grounds for which the employee is responsible.\textsuperscript{154}

Statutory severance payment is calculated based on the period of service of the employee. In general, for each twelve months’ period the employee will receive the equivalent of his or her average monthly wage as calculated over the past twelve months and including all monetary payments by the employer. There are, however, upper and lower limits: if the average monthly wage is less than the local minimum wage, the local minimum wage is to substitute the employee’s average monthly wage.\textsuperscript{155} If, however, the average monthly wage is three times higher than the

\textsuperscript{151} Art. 48 Labor Contract Law; art. 25 sentence 1 Regulation on the Implementation of the Labor Contract Law.
\textsuperscript{152} Cf. Dong (2008), 44 \textit{et seq.}
\textsuperscript{153} Art. 46 Labor Contract Law; art. 22 Regulation on the Implementation of the Labor Contract Law.
\textsuperscript{154} Cf. Dong (2008), 47.
\textsuperscript{155} Art. 47 para. 1 sentence 1 and para. 3 Labor Contract Law; art. 27 Regulation on the Implementation of the Labor Contract Law.
(general) local average monthly wage of all employees as declared by the relevant municipal government, i.e., the government of that municipality in which the employer has its company seat, and not the municipality where the employee performs his or her work, the employee’s average monthly wage is to be capped at three times the (general) local average monthly wage of all employees and the statutory severance payment is to be paid for a period of no more than 12 years of work.\footnote{156} To calculate the period of service, a period of less than six months is taken to be a period of six months, a period of more than six months, but less than one year is taken to be a period of one year and so on.\footnote{157} Statutory severance payment shall be paid to the employee, as mentioned above, at the time of his or her handing over work. In the event of default of payment, the employer will be ordered by the relevant labor administration to make the payment within a certain time period. If the employer refuses to pay, a further order requiring a damage payment of an additional 50\% to 100\% of the statutory severance payment may be issued.\footnote{158}

III. Main Issues of Collective Labor Law

1. Labor Union

a) Nature

A labor union in China is an organization of the “worker’s class” formed freely by employees. It may carry out its activities independently and freely in accordance with the Chinese Constitution.\footnote{159} All employees within China are entitled to join and form labor unions, regardless of their ethnic group, race, gender, occupation, religious belief, or level of education; nobody may hinder or restrict employees from joining or forming a labor union.\footnote{160} Where an employee’s or union official’s labor contract has been terminated due to his or her participation in union activities or the performance of his or her duties as a union official, a competent court may order the labor contract to be resurrected or the employer to pay compensation amounting to twice the employee’s normal annual income.\footnote{161}

However, labor unions in China must abide by and safeguard the Chinese Constitution, make the Constitution the basic standard against which to measure their activities, focus on economic growth, adhere to socialism and the People’s democratic dictatorship, foster the leadership of the Chinese Communist Party and the guidance of Marxism Leninism, Mao Zedong Thought and Deng Xiaoping Theory, and persevere in reforming and opening up China.\footnote{162} Therefore, Chinese labor unions are not only organizations for the purpose of safeguarding employees’ rights and interests, but, moreover, political organizations which comply with China’s current political system.

\footnote{156}{Art. 47 para. 2 Labor Contract Law.}
\footnote{157}{Art. 47 para. 1 sentence 2 Labor Contract Law.}
\footnote{158}{Art. 85 no. 4 Labor Contract Law.}
\footnote{159}{Art. 2 para. 1 and art. 4 para. 1 Labor Union Law.}
\footnote{160}{Art. 3 Labor Union Law.}
\footnote{161}{Art. 52 Labor Union Law; art. 6 Interpretation of the Supreme People’s Court on Several Issues concerning the Application of the Labor Union Law in Civil Trials.}
\footnote{162}{Art. 4 paras. 1 and 3 Labor Union Law.}
b) Organization

Labor union organizations are established according to a committee system. A basic labor union committee is an entity with at least 25 labor union members.\(^\text{163}\) This committee system comprises a number of organizational levels; the members of labor union committees at all levels are elected, replaced and dismissed by the relevant general assembly of labor union members, or the assembly of members’ representatives.\(^\text{164}\) Labor union organizations at a higher level instruct labor union organizations at a lower level.\(^\text{165}\) The establishment of labor unions at a lower level must be approved by those of higher level. If a labor union at a higher level assigns personnel to assist and direct staff with regard to establishing a labor union at basic level, this assistance may not be refused by the employer.\(^\text{166}\) Since joining and organizing labor unions constitutes a right of employees, this provision should be interpreted as an obligation for employers to cooperate with their employees’ request for the organization of a labor union at the basic level.\(^\text{167}\) An association of basic level labor unions may be established in towns or urban areas with a high density of enterprises.\(^\text{168}\) At county level or higher, an umbrella federation of labor unions encompassing all levels within this county (or another larger political region) must be established.\(^\text{169}\) Labor unions may also organize themselves at the local or national level according to the branches of industry.\(^\text{170}\) Finally, at the national level there is the All-China Federation of Labor Unions.\(^\text{171}\)

c) Basic Level Labor Union Committee

Where a basic level labor union committee is established lawfully, has its own name, seat, organizational rules and necessary funds, and is empowered to assume liabilities independently, its legal personality is a “social group”.\(^\text{172}\) The term of office of a basic level labor union committee is three or five years.\(^\text{173}\) Close relatives of the principals of an enterprise may not be elected members of an enterprise labor union committee at the basic level.\(^\text{174}\) A labor union for an entity with at least 200 employees may establish a full-time labor union chairman and employ other union personnel on a full-time basis.\(^\text{175}\) As of the day on which the full-time chairman, deputy chairman or committee members of a committee of a labor union at the basic level take their posts, the terms of their labor contracts are to be extended automatically; the extended term must be equal to their respective office terms. If, however, these persons are employed on a non-full-time basis and their labor contracts run shorter than their terms of office, the labor contract shall be extended

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\(^\text{163}\) Art. 10 para. 1 sentence 1 Labor Union Law.

\(^\text{164}\) Art. 9 paras. 2 and 3 Labor Union Law.

\(^\text{165}\) Art. 9 para. 5 Labor Union Law.

\(^\text{166}\) Art. 11 Labor Union Law.


\(^\text{168}\) Art. 10 para. 2 Labor Union Law.

\(^\text{169}\) Art. 10 para. 3 Labor Union Law.

\(^\text{170}\) Art. 10 para. 4 Labor Union Law.

\(^\text{171}\) Art. 10 para. 5 Labor Union Law.

\(^\text{172}\) Art. 14 para. 2 Labor Union Law; art. 37 General Principles of Civil Law.

\(^\text{173}\) Art. 15 sentence 1 Labor Union Law.

\(^\text{174}\) Art. 9 para. 2 sentence 2 Labor Union Law.

\(^\text{175}\) Art. 13 Labor Union Law.
only until their terms of office expire. Nevertheless, the labor contracts of any labor union personnel terminate with statutory retirement, or if these employees are dismissed with immediate effect by their employer on the grounds of gross negligence. A labor union committee at the basic level must be dissolved, if the enterprise ceases to exist and its dissolution must be reported to the union at a higher level which approved its establishment.

Labor unions are funded by membership contributions, monthly allocations of 2% of the total gross wages of staff of the enterprise in which the union is established, income created by any union subsidiaries, governmental subsidies, and other sources. Moreover, the enterprise in which the union is established is obliged to provide the necessary facilities, operating space and other material conditions required for the union’s operation and activities.

d) Rights and Obligations of Labor Unions

Labor unions are to organize and supervise the democratic management of the enterprise in, e.g., assemblies of staff representatives. They assist employees in concluding individual labor contracts, but also represent employees collectively by conducting negotiations on behalf of all members, and by concluding collective contracts with employers. They also monitor the performance of collective contracts. Labor unions are entitled to a hearing where employees are to be punished or where employers unilaterally terminate labor contracts. Where employees’ rights are violated, labor unions are entitled to assist aggrieved employees by bringing an action and to represent employees that demand a rectification from their employer or the intervention by the government. They conduct investigations into and supervise work safety, participate in investigations concerning work-related accidents and other hazards to employees’ health. Where work has been significantly slowed or stopped, the unions represent employees in negotiating with employers, give opinions as to possible solutions and assist employers in restoring order. Furthermore, the unions take part in mediation and arbitration of labor disputes as well as in tripartite negotiations with employers and governments where major problems with labor relations arise. Employers are, in principle, obliged to reply in writing and without delay to the opinions of the unions; otherwise, this may result in severe administrative, legal and economic consequences.

2. Enterprise Rules

One of the most significant modifications made by the Labor Contract Law are the statutory procedures to pass enterprise rules. Where an employer wants to formulate, modify or implement rules pertaining to important issues directly related to employees’ interests, such as remuneration, working time, rest and vacation,
work safety and sanitation, insurance and welfare, training of staff, labor discipline, or the management of any production quota, these rules must be discussed by the assembly of staff representatives or with the entire staff, if an assembly of staff representatives does not exist). The employer must submit proposals and opinions, and negotiate “on an equal basis” with the relevant labor union or staff representatives in order to agree on these rules. These rules must be publicized or notified to the staff by the employer.

This procedure strengthens, on the one hand, the right of the employees to actively participate in the decision-making process within their enterprise; on the other hand, it requires a careful preparation, conduct and documentation by employers, as well as additional funds to cover extra expenses.

If this procedure is not met adequately, these rules are formally flawed and will not constitute a legal basis for action taken by an employer. This even applies, if the contents of the rule do not conflict with any legal provisions. For instance, an employer may not dismiss an employee on account of his or her violation of an unduly passed enterprise rule.

However, the scope of the so called “enterprise rules” must be defined more precisely by courts in practice. Only enterprise rules in certain areas which relate directly to the interests of all or the majority of staff should be agreed on and issued by this legal procedure. Enterprise measures, such as a stock option plan for only a limited group of senior managers and affecting only their interests should not need the same procedure. Otherwise, the employer’s right to instruction and the efficiency of its business operation will be improperly restricted. Furthermore, the legislator has failed to provide a solution for a situation in which the employer and the labor union or staff representatives are unable to reach an agreement on these rules. In this event it is only possible to apply to the government for mediation or intervention; if a party alleges the violations of legal rights or obligations, it may directly file a civil action. If the contents of these enterprise rules violate laws or regulations, the relevant labor administration may order the employer to rectify the problem, or issue an official warning to the employer; the employer may even have to pay damages to the employees concerned.

3. Collective Contracts

a) General

Whereas the enterprise rules delineate the extent of the right of employers to direct employees and stipulate the details for employees’ work, a collective contract in terms of Chinese labor law refers to a written agreement concluded between an employer and its staff following negotiation, on an equal footing, of issues such as remuneration, working time, rest and vacation, labor safety and hygiene, occupational training, insurance, benefits and other issues. The parties may also conclude a specific collective contract pertaining to only one particular issue. At

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182 Art. 4 para. 2 Labor Contract Law.
183 Art. 4 para. 4 Labor Contract Law.
184 Cf. art. 49 Labor Union Law.
185 Art. 80 Labor Contract Law.
186 Art. 3 Provision on Collective Contracts; art. 51 para. 1 sentence 1 Labor Contract Law.
the county level or below, labor unions and the representatives of employers may also conclude industrial collective contracts or regional collective contracts. A collective contract has a term of one to three years and is during this term legally binding for the employer and its staff. It also comprises the minimum standards of labor conditions and remuneration in the relevant enterprise – labor conditions and remunerations in each individual labor contract may not be lower than the standards set forth in the relevant collective contract. A dispute arising from the performance of a collective contract must be submitted for arbitration before a labor dispute arbitration committee if parties fail to resolve it by consensus.

b) Parties

The parties to a collective contract must send delegations with an equal number of representatives (at least three) of which one representative is to be designated as the delegation’s chief representative. Whereas the delegates of the employer are designated by the enterprise’s legal representative and under his or her leadership or under the leadership of another person authorized in writing by the legal representative, the staff delegates are representatives of the labor union in the enterprise and are under the leadership of its chairman. A maximum of one-third of the representatives of each party may be outside professionals, but these may not act as chief representatives; dual representatives are not allowed.

During the performance of their duties, staff representatives enjoy special lay-off protections: their contract term is to be extended automatically until they complete their duties as a representative; they may only be relocated for a proper reason; and they may only be dismissed with immediate effect on the grounds of severe negligence.

c) Collective Bargaining and Collective Action

Each party may, in writing, request the other party to take part in collective bargaining. The party receiving the demand is allowed a period of 20 days from receipt to reply in writing and may not refuse to negotiate without sufficient reasons. However, the legislator has not provided adequately effective legal remedies against an improper refusal to negotiate. This is particularly inconvenient for employees. In the event that an employer refuses to negotiate, the affected employees may apply to the relevant labor administration which may issue an administrative order against the employer. If in theory, however, the employer still refuses to negotiate, then there are no further effective legal steps that may be taken. The law does provide that such a refusal is to be handled according to the relevant

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187 Art. 3 Provision on Collective Contracts; arts. 52 and 53 Labor Contract Law.
188 Arts. 6 and 38 para. 1 Provision on Collective Contracts; art. 55 Labor Contract Law.
189 Art. 55 Provision on Collective Contracts.
190 Art. 19 para. 2 Provision on Collective Contracts.
191 Art. 20 Provision on Collective Contracts. If no labor union exists, the delegation consists of staff representatives elected with more than 50 % affirmative votes of the entire staff.
192 Art. 21 Provision on Collective Contracts.
193 Art. 23 Provision on Collective Contracts.
194 Art. 24 Provision on Collective Contracts.
195 Art. 28 Provision on Collective Contracts.
196 Art. 32 Provision on Collective Contracts.
laws and regulations, but no relevant provision has been passed until now.197 Labor dispute arbitrations are only intended to resolve disputes arising from the performance of collective contracts, yet not for the negotiation of such contracts.198 There is a legal obligation to attend collective bargaining upon demand, but no legal consequences exist where this obligation is ignored. This situation may, especially in the eyes of the employees, lead to growing disrespect for the law.

If the obligation to participate in collective bargaining may not be enforced by law, the right to take collective action, especially in terms of the right of employees to strike and the right of employers to a lock-out, should be legally recognized and regulated, so that each party may legally impose pressure on the other to observe obligations.

However, the Chinese legislator has chosen not to confront this issue directly in light of the current political discussions and increased social unease in China: The government is encouraging the population to interact as a “Harmonious Society”, whereby all members of this society are urged to refrain from any form of conflict in order to support China’s economic development. In China collective action, e.g., strikes and lock-outs, is neither explicitly permitted nor prohibited. However, some legal provisions do, in effect, exclude the right of labor unions to organize strikes, e.g., one provision states that no party may take extreme actions in the course of collective bargaining or when concluding collective contracts,199 another provision states that when work has stopped or has been slowed significantly, labor unions are to represent staff in negotiations with employers, at the same instance they are also to assist employers to return to normal levels of work activity as quickly as possible.200 In the latter case, labor unions are not legally entitled to actively organize strikes, but are, rather, obliged to play a passive role to restore peace and order in enterprises.201 Collective action is, de facto, not encouraged and protected by Chinese labor law and is associated with civil, administrative, and even criminal liabilities.202

Thus, if negotiations falter and tensions escalate, labor unions will be reluctant to organize collective actions due to severe liabilities, since so-called “spontaneous mass incidents” initiated by discontented employees may erupt, thus making government intervention almost always inevitable.203 Therefore, the absence of legislation in the area of collective action does not secure social stability, but rather renders collective action subject to an unregulated realm and complicates it.204 The grass-roots protests in the taxi sector in China in 2007 and 2008, for example, have had heavy impacts on social stability and underline the necessity to enact legislation on collective action.205 Lawful collective action is an effective and efficient force to secure the right to coalition and to collective bargaining

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197 Art. 56 Provision on Collective Contracts; art. 53 no. 4 Labor Union Law.
198 Art. 55 Provision on Collective Contracts.
199 Art. 5 no. 5 Provision on Collective Contracts.
200 Art. 27 Labor Union Law.
201 Some Chinese scholars regard this provision to be a compromise with regard to strike legislation which legally recognizes the right to strike and the status of labor union in the course of the strike. Cf. Chang (2005), 52, 53; Shi, 45.
202 Chang (2005), 46.
203 This is also true for disputes arising once negotiation has begun, cf. arts. 49 et seq. Provision on Collective Contracts.
204 Chang (2005), 51, 53; Shi, 49, 50, 55.
205 Jian (2008), 5.
as well as to resolve collective labor disputes. In line with an influential scholars’ proposal for relevant legislation, which is strongly influenced by German law regarding collective actions, it is submitted that collective action in China should be legally protected and – as a last resort – solely organized by labor unions or employers’ associations to negotiate and conclude collective contracts; thereby, social and economic stability and security must be ensured.

d) Procedure

Before a negotiated collective contract can be concluded, a draft thereof must be discussed at an assembly of staff representatives or by the entire staff. This assembly is to comprise the attendance of at least two thirds of those entitled to vote. The collective contract has been agreed to, if more than 50% of votes are given in the affirmative. The collective contract is then executed by the chief representatives of both parties. Following execution, the employer must within ten days submit the collective contract (in triplicate) to the competent labor administration for the purpose of examination and registration. The labor administration is to examine the contract, and where any objection persists, it must deliver an opinion thereon within 15 days. Thereafter, the points of objection must be renegotiated and the contract must once again be discussed, passed, executed and submitted in accordance with the foregoing procedure. If the relevant labor administration does not object within 15 days, a collective contract automatically takes effect and needs to be provided by the representatives to their respective principals by proper means.

4. Co-Determination

Co-determination in a broader sense comprises the influence exerted by employees on entrepreneurial decisions at all levels, including individual labor conditions, enterprise rules, regulations concerning employees’ personal interests and benefits, and enterprise management decisions. In practice, the term “co-determination” is frequently used to describe the employees’ role in the management of an enterprise. As a general principle, any enterprise in China is to solicit the opinions of the labor unions when important issues arise regarding the operational management and development of the enterprise; labor unions are also to assist enterprises in exerting their right to operational management.

With respect to co-determination, corporations in China, i.e., limited liability or stock corporations, must assume stricter legal obligations regarding operational management. They are considered to bear a general corporate social responsibility, the content and scope of which is not stipulated in any laws or regulations.
According to the general understanding of this corporate social responsibility, a corporation shall not only pursue the maximum interests for its shareholders, but also take into account the interests of, *inter alia*, its staff.\textsuperscript{217} Chinese corporations must, therefore, implement a democratic management system by establishing an assembly of staff representatives or other bodies (\textit{e.g.}, an assembly of staff).\textsuperscript{218} Where decisions on restructuring are to be made, where important issues about the corporation’s operational management need to be discussed, or where important enterprise rules are to be drafted, a corporation must not only solicit the labor union’s opinions, but also the opinions of its staff; proposals its staff may voice in the assembly of staff representatives or in other relevant bodies are to be taken into consideration.\textsuperscript{219}

As to corporation organs, co-determination means that staff representatives should participate in the board of directors being the corporation’s operational organ, and in the supervisory board being its oversight organ. However, a private limited liability company or a stock company is not legally obliged to establish any seats for staff representatives on the board of directors. If such seats exist and need to be filled by staff representatives, these are to be democratically elected by the assembly of staff representatives, or by the staff as a whole, or by another relevant staff body.\textsuperscript{220} For a state-owned liability company, regardless of its size, seats for staff representatives are mandatory. However, there is no provision regarding their number or further co-determination procedures.\textsuperscript{221} If a corporation has established – regardless of its legal form – a supervisory board, staff representatives that have been democratically elected by staff must fill at least one-third of all seats.\textsuperscript{222} Whereas a stock corporation must establish a supervisory board, a limited liability corporation does not need to do so, but may appoint one or two supervisors instead if it only has relatively few shareholders or is relatively small.\textsuperscript{223} Therefore, this legal provision may allow, for instance, a Chinese limited liability corporation which is a subsidiary of an international conglomerate to avoid co-determination in its supervisory board: Since it has only one shareholder – the conglomerate, it may opt against a supervisory board, even though it may employ hundreds of thousands of employees.

Thus, although there is a rough structure in place outlining co-determination of staff in China, the legislator has yet to perfect and provide the details of this system. This is especially true with regard to the equal treatment between private- and state-owned corporations, to the size of the enterprise as well as to the number, appointment and special labor protection of staff representatives.\textsuperscript{224} These improvements are necessary to make co-determination work in accordance with its original purpose; otherwise, it may remain a modern, yet abstract symbol.

\textsuperscript{217} Zeng, 118.
\textsuperscript{218} Art. 18 para. 2 Corporation Law.
\textsuperscript{219} Art. 18 para. 3 Corporation Law.
\textsuperscript{220} Art. 45 para. 2 and art. 109 para. 2 Corporation Law.
\textsuperscript{221} Art. 45 para. 2 and art. 68 para. 2 Corporation Law.
\textsuperscript{222} Art. 52 para. 2 and art. 118 para. 2 Corporation Law.
\textsuperscript{223} Art. 52 para. 1 sentence 2 Corporation Law.
\textsuperscript{224} Cf. Zeng, 120 \textit{et seq.}
IV. Resolution of Labor Disputes

1. Scope of Labor Disputes

The procedure for labor dispute resolution primarily focuses on individual labor disputes and applies only to those labor disputes legally stipulated below:\(^{225}\)
- Disputes arising out of the confirmation of labor relationships
- Disputes arising out of the conclusion, performance, modification and termination of labor contracts
- Disputes arising out of the dismissal, lay-off, resignation and leave of employees
- Disputes over working time, rest and vacation, social insurance, benefits, training and labor protection
- Disputes arising out of the payment of remuneration, medical expenses for work-related injuries, severance payment and damages
- Any other labor dispute prescribed by law or regulation, such as disputes arising out of the performance of collective contracts\(^{226}\).

2. Basic System

Where a labor dispute occurs, both parties may first try to resolve it by means of consensual negotiation. If this fails, e.g., where one or both of the parties refuse to actually negotiate or if any resulting agreement is not honored, parties may refer the labor dispute to a mediation organization for mediation. If mediation fails, too, the labor dispute may be referred to the competent labor dispute arbitration committee for arbitration. An arbitral award may be contested by filing a lawsuit, unless the Law on Labor Dispute Mediation and Arbitration provides otherwise.\(^{227}\)

This “one arbitration instance plus two instances of court trial” regime aims at effectively and efficiently resolving labor disputes by mediation and arbitration at the basic level.\(^{228}\) However, due to its longevity, high expenses, low efficiency and awkward coordination between arbitration committees and courts, it is not able to optimally serve its original purpose.\(^{229}\) Despite all material deficiencies, the new Law on Labor Dispute Mediation and Arbitration only modified this system by improving the mediation mechanism, changing the burden of proof, extending the limitation period, reducing resolution expenses and finalizing the arbitral award in certain cases; the legislator would have been better advised to completely reform the system by abolishing compulsory arbitration procedures and establishing a special court system for labor disputes.\(^{230}\)

In addition to this basic dispute resolution system, employees may directly complain to the competent labor administration about a default on payment of remuneration, medical expenses for work-related injuries, severance payment or damages. If the labor administration finds the complaint to be justified, it may order the employer to rectify this default within a time limit. Where the employer fails to

\(^{225}\) Cf. Zhang, 47; art. 2 Law on Labor Dispute Mediation and Arbitration.

\(^{226}\) Art. 56 Labor Contract Law; art. 55 Provision on Collective Contracts.

\(^{227}\) Art. 5 Law on Labor Dispute Mediation and Arbitration.

\(^{228}\) Cf. Wang/Yang, 41.

\(^{229}\) Cf. Lin (2006), 38; Wang/Yang, 42.

\(^{230}\) Cf. Lin (2006), 39; Wang/Yang, 43, 44.
comply, it may be ordered to pay the employee an extra payment of 50 % to 100 % of the amount previously payable.\textsuperscript{231}

3. Mediation

Labor dispute mediations may be conducted by either an internal or external mediation organization.\textsuperscript{232} A written mediation settlement is to be executed by the parties and the mediator within 15 days after the receipt of a mediation application and will be binding on both parties; formally, it requires the signature of the mediator and the seal of the mediation organization. If such a settlement is not executed, parties may apply for arbitration.\textsuperscript{233} This is also the case, if one or both of the parties fail to honor the executed mediation settlement.\textsuperscript{234} However, if the employer fails to pay remuneration, medical expenses for work-related injuries, severance payment or damages, the employee may, based on the mediation settlement, apply directly to a relevant court for a payment order.\textsuperscript{235} Nevertheless, if the employer objects to the payment order within 15 days after receipt, the payment order will automatically become invalid.\textsuperscript{236} Thus, employees cannot easily avoid arbitration or litigation in the quest to realize their rights.\textsuperscript{237}

4. Arbitration and Litigation

A labor dispute arbitration committee established in the district where the labor contract is being performed or in the district where the employer has its registered seat may decide on a labor dispute; if such a committee exists in both districts, the labor dispute arbitration committee established where the labor contract is being performed shall hear the arbitration.\textsuperscript{238}

The statute of limitation for the arbitration of a labor dispute is one year, starting from the date when the aggrieved party is or should be aware of the violation of its rights; the statute of limitation may be discontinued and/or suspended under certain circumstances provided by law.\textsuperscript{239} Where a dispute arises out of default on payment of remuneration during the existing labor relationship, an employee’s application for arbitration shall not be limited by this one-year limitation period. If the labor relationship has been terminated, any such aforementioned application must be submitted within one year from the date of its termination.\textsuperscript{240} However, the overriding preclusive period of 20 years is to be applied in all cases.\textsuperscript{241}

Under the former labor law regime, employers had to bear the burden of proof in disputes arising from the dismissal and termination of labor contracts, the reduc-

\textsuperscript{231} Art. 9 Law on Labor Dispute Mediation and Arbitration; art. 85 Labor Contract Law.
\textsuperscript{232} Art. 10 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{233} Art. 14 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{234} Art. 15 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{235} Art. 16 sentence 1 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{236} Arts. 193, 194 Civil Procedure Law.
\textsuperscript{237} Cf. Zhang, 48.
\textsuperscript{238} Art. 21 para. 2 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{239} Art. 27 paras. 1, 2 and 3 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{240} Art. 27 paras. 1 and 4 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{241} Art. 137 sentence 2 General Principles of Civil Law.
tion of remuneration, and the calculation of the period of service.\textsuperscript{242} In all other cases the general principle applied, that a party shall be responsible for providing all evidence necessary to back up its claims (\textit{necessitas probandi incumbit ei qui agit}); since employees were personally dependent on their employers, this brought about significant practical difficulties to employees.\textsuperscript{243} The new Law on Labor Dispute Mediation and Arbitration confirms the application of the aforementioned general rule of burden of proof. However, employers must, according to this Law, provide evidence controlled by them, failure to do so may have adverse consequences.\textsuperscript{244} Hence, if employees can prove the fact that evidence is being controlled by their employers, which is usually the case in labor relationships, the burden of proof is, \textit{de facto}, unfavorably shifted to the employer. This legal provision requires employers to keep records diligently and to adequately document any developments in a labor relationship.\textsuperscript{245}

125 During the arbitration procedure another attempt at mediation shall be made.\textsuperscript{246} Any mediation record shall take effect after being signed by both parties.\textsuperscript{247} An effective mediation record is binding upon both parties and may be enforced by a court upon application.\textsuperscript{248} In the event that this mediation fails or that any party withdraws its decision before the mediation record is served, the arbitration tribunal must render an arbitral award in a timely manner, i.e., within 45 days after the date of acceptance of the arbitration application (or, in exceptional cases, within 60 days with regard to complicated cases).\textsuperscript{249}

126 To avoid the painfully tedious “one arbitration instance plus two instances of court trial” regime and to enhance the efficiency of labor disputes, arbitral awards for the following types of labor dispute now take effect and are binding on employers from the date of the delivery of the award:

- Disputes on recovery of remunerations, medical expenses for work-related injuries, severance payment or damages for amounts which do not exceed 12 times the local minimum monthly wage
- Disputes on the implementation of state labor standards with respect to working time, rest and vacation, and social insurance.\textsuperscript{250}

127 Where an employee objects to an arbitral award for a labor dispute (including arbitral awards for disputes of the aforementioned kind), or where an employer objects to an arbitral award, which is not finally binding, the respective unsatisfied party may file a lawsuit within 15 days after the date the arbitral award has been delivered.\textsuperscript{251} Otherwise, an arbitration award takes effect upon the expiration of the allowed period to bring an action.\textsuperscript{252} With regard to finally binding arbitral awards for employers relating to the aforementioned types of disputes, an employer may only

\textsuperscript{242} Art. 13 Interpretation of the Supreme People’s Court on Several Issues about the Application of Laws for the Trial of Labor Dispute Cases.
\textsuperscript{243} \textit{Wang/Yang}, 41.
\textsuperscript{244} Art. 6 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{245} Cf. Liu, 89 \textit{et seq}.
\textsuperscript{246} Art. 42 para. 1 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{247} Art. 42 para. 3 sentence 3 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{248} Art. 51 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{249} Art. 42 para. 4 and art. 43 para. 1 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{250} Art. 47 Law on Labor Dispute Mediation and Arbitration; cf. Lin (2006), 38, 39.
\textsuperscript{251} Arts. 48 and 50 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{252} Art. 50 Law on Labor Dispute Mediation and Arbitration.
apply within 30 days after delivery of the award to the relevant court (where the labor dispute arbitration committee is located) for revocation of the award on the basis of an incorrect application of the substantive law or procedural provisions.\textsuperscript{253} If a court ruling revokes the award, each party may, within 15 days, file a lawsuit for the court to decide on the dispute.\textsuperscript{254}

In contrast to normal arbitration procedures, labor dispute arbitration is to be conducted publicly, except where otherwise agreed to by the parties, or in cases concerning state, business or private secrets.\textsuperscript{255} It is also free of charge,\textsuperscript{256} which may stimulate employees to become more vigilant in protecting their rights by making use of labor arbitration. These measures may, however, trigger numerous labor disputes.

\section*{V. Concluding Remarks}

China has built a labor law regime consisting of individual labor law, collective labor law and labor dispute resolution within a remarkable 30 years of development. These legal provisions are permanently being updated to keep up with social and economic developments in China. Consequently, the protection of employees’ rights is currently being improved incrementally, making it more difficult to violate labor laws and regulations. However, there are still several fundamental and systematical issues to be dealt with by the legislator and/or the judiciary, such as the definition of the legal terms “Employee” and “Labor Relationship”, discrimination against part-time employees, arrangement of termination grounds, the right to collective action, specific procedures of co-determination, and the reform of the labor dispute resolution system. If these issues fail to be resolved, they may impact the effectiveness and efficiency of laws and regulations as well as the people’s trust in the labor law system – a development counter-productive to China’s strive for economic development and social stability.

\section*{VI. Relevant Laws & Regulations}

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\textsuperscript{253} Art. 49 para. 1 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{254} Art. 49 para. 3 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{255} Art. 26 Law on Labor Dispute Mediation and Arbitration.
\textsuperscript{256} Art. 53 sentence 1 Law on Labor Dispute Mediation and Arbitration.
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<td>Interpretation of the Supreme People’s Court on Several Issues concerning the Application of the Labor Union Law in Civil Trials (最高人民法院关于在民事审判工作中适用《中华人民共和国工会法》若干问题的解释)</td>
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<td>Interpretation of the Supreme People’s Court on Several Issues about the Application of Laws for the Trial of Labor Dispute Cases (最高人民法院关于审理劳动争议案件适用法律若干问题的解释(二))</td>
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<td>Trial Rules for Arbitration of Labor and Personnel Cases of the Ministry of Human Resources and Social Security (人力资源和社会保障部劳动人事争议仲裁办案规则)</td>
<td>1/1/2009</td>
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Guang Li
Chapter 10. Intellectual Property in Transactions

Chapter 10. Intellectual Property in Transactions

I. Overview

The protection of Intellectual Property Rights (IPR) in China is perceived as one of the greatest challenges in doing business in China, which is evidenced by the sheer amount of investment guides addressing this topic. With respect to the substantive IPR law, the gap between China and western countries is narrowing. In particular, in the anticipation of the accession to WTO, China improved its IPR regulatory framework to comply with the requirements of the TRIPs in 2001 (supra Chapter 1 at 7). The third wave of adjustment of major IP statutes has already begun with the amendment of Patent Law in December 2008. As generally reckoned, the genuine problem of the deficit of IPR protection in China lies in the weak enforcement. Occasionally, foreign right holders are not aware of the fact that the protection of IPR is territorial in nature and failed to register their rights timely in China, which makes it impossible to seek redress in infringement cases.

This chapter does not aim to cover all aspects of IPR protection in China, but instead to focus on IPR in business transactions. It begins with a brief introduction to IPR protection regime in China. It is to note that the fundament of Chinese IPR framework was laid down just in the early 1980s until the early 1990s. The basic IPR statutes such as the Trademark Law, Patent Law, Copyright Law, Law against Unfair Competition and related implementation rules were all enacted during this period. Over time, the Supreme People’s Court (SPC) promulgated numerous judicial interpretations setting out detailed rules on the application of these laws, which constitute a major component in the general legal framework of IPR protection in China. A list of relevant legal sources is attached at the end of this chapter.

The administrative agencies responsible for IPR registration and administration include the Trademark Bureau (TMB) for trademarks, the State Intellectual Property Office (SIPO) for patents and the National Copyright Administration (NCA) for copyrights.

1. Trademark

a) Prerequisites for Protection

Chinese trademark law adopts the first-to-file principle, which means that the protection of a trademark normally requires the registration with the TMB. The registration itself is only possible if the trademark is distinctive and does not collide with prior right of third parties nor otherwise is barred by law.\(^1\) The Trademark Law sets out two types of restrictions on registrability of trademarks: Trademarks bound by the first type of restriction are barred from being used and can principally

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\(^1\) Art. 9 Trademark Law.
never be registered; trademarks bound by the second type of restrictions are principally illegible to registration, but the use is not barred; upon acquisition of secondary meaning through marketing measures, the registration is possible. In other words, trademarks of the second type are capable of distinctiveness, but the TMB will reject such applications if the trademarks are not distinctive at the time of registration, while trademarks of the first type are per se barred with no exception.

The per se barred trademarks are enumerated in art. 10 and 12 Trademark Law, which include trademarks that are ethnically discriminatory, exaggeratory, deceptive, immoral or have any negative connotation or those using the same or similar signs of sovereignty and intergovernmental organization such as national names, flags and emblems or official quality seal may not be registered without authorization. The authorization could be an implied one. In the case “EverSwiss”, the trademark was accepted for registration because an implicit authorization is assumed based on the fact that the same trademark has already been registered in Switzerland. Certain geographic terms are also excluded from use and registration.

The second type of restriction is specified in art. 11 Trademark Law, which excludes generic terms, generic shape, generic description of type, description of quality, main ingredients, functions, weight and quantity from trademark registration unless such a term or shape has acquired a secondary meaning. Although the wording of art. 12 Trademark Law implies that a three-dimensional sign that consists exclusively of the shape that results from the nature of the goods itself, the shape that is necessary to obtain a technical result, or the shape that gives substantial value of the goods belongs to the first type of restrictions.

If a registered trademark contains one of these generic terms, the trademark owner cannot prevent others from reasonably using this element. If a non-distinctive part of a trademark is comprised of generic or descriptive terms, the registrant may acknowledge the genericness of such term and waive exclusive rights thereon by adding a disclaimer in the application to facilitate registration procedure.

b) Geographic Term as Trademark

Generally speaking, geographic terms are unsuitable for trademark registrations. Such a term is normally either descriptive in cases where it is generally associated with the origin of the product and if the product indeed originates from this place, or misleading if the product is not from this place. Furthermore, geographic terms should be available to the public for unrestricted use and not preempted by one person. On the other side, a number of trademarks containing geographic terms have already been registered such as “London Fog”, “Montblanc” and there exist certain legitimate needs to allow this type of trademark. The regulations on geographic terms as trademarks are essentially a balance of these two interests.

(1) Registration. The permissibility of a geographic trademark depends on the administrative hierarchy and reputation of the place. The name of an administrative division at or above the county level in China or foreign geographical name known to the public can only be admitted for registration in case that it has an inherent second meaning or is used as part of a collective or certification mark. In practice, the

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2 Art. 10 para. 1 Trademark Law.
4 Infra at 8 et seqq.
existence of second meaning is frequently controversial because in most cases it is possible to construe a geographic term differently than mere geographic significance. The test employed so far is whether the second meaning or the geographic significance prevails in the public perception, which often depends on the publicity of the geographic term. For instance, Washington is deemed to have no second meaning although it also constitutes a surname. In the dispute concerning the trademark “Hong He (红河)”, the appellate court ruled that “Hong He” is indeed the name of a county in Yunnan Province, but in China it commonly also refers to a river in Vietnam and could also be understood as “red river”. Although in Vietnam this river is called differently, the court viewed the general association of the term “Hong He” with this river suffice the precondition that “Hong He” has a second meaning and the term is therefore registrable. It is to note, under current trademark law in China, the second meaning cannot be a secondary meaning acquired by use of the geographic term as trademark in association with a specific product, but has to exist stand-alone.

The name of an administrative division below the county level in China and a foreign geographical name unknown to the Chinese public are generally available for registration without further restriction. However, such terms shall neither be descriptive nor misleading. In order to fulfil this requirement, the geographic term shall not be perceived by the consumers as origin of the product. To enhance the distinctiveness of a geographic trademark, the applicant may consider adding additional pictures and words and style treatment. The fact that a geographic term has been registered in other countries may serve only as an evidence of the registrability. As a foreign name is rarely used in China in its original form, but in the translated Chinese form, the question of whether a foreign name is deemed well-known is to be decided in accordance to which form is applied for trademark registration. For instance, Zurich is in China well-known in its translated form, but may not be in its original form.

As an exception, the use of a country name or a geographical name as a non-distinctive part of a trademark is permissible, if the applicant or the products come from this specific country or place. This approach is comparable to disclaimers on generic terms (supra at 4). It is also to note that art. 10 no. 2 Trademark Law (Art. 8 no. 2 Trademark Law of the 1993 version) contains a grandfather provision with respect to geographic trademarks registered before 1993, which are not subject to the general restrictions on the registrability of geographic terms.

(2) Fair Use. Geographic trademarks are subject to restrictions imposed by the fair use doctrine. The owner of a geographic trademark may not prevent a bona fide third party from using the same geographic term as indication of this third party’s

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5 Part I, Section 11 of the Trademark Examination and Adjudication Guidelines (商标审查审理标准) dated of December 31, 2005
6 Rui (2008), 51; It is to note there is no special provision on the registrability of surnames under the Trademark Law.
7 Rui (2003), 104. However, that this second meaning is then a foreign geographic term known to the Chinese public, which actually renders the term incapable of being registered again, has not been addressed by the court.
8 Huang Hui, 51; Rui (2008), 52–53.
9 Liu Chunlei, 26–27.
10 Liu Chunlei, 27; Rui (2008), 53.
11 Part I, section 11 no. 5 Trademark Examination and Adjudication Guidelines; Art. 16 Trademark Law.
product’s origin, provided such use does not constitute a use in a trademark sense *(infra at 58)* and would not cause confusion of the relevant public. It is often a delicate issue to ascertain the exact scope of fair use in a concrete case. Courts usually consider whether the third party uses the registered geographic term prominently, and whether the consumer confuses the products of the third party and the trademark owner as well as the reputation of the trademark, i.e. whether the consumer associates the geographic name primarily with a particular product or primarily with its significance as a place indication.12 In the previously mentioned dispute concerning the trademark “Hong He” *(supra at 9)*, the court ruled that trademark owner may not prevent the defendant, which is indeed located in Hong He County, from using its trade name which contains “Hong He” as the main identifier,13 but he may enjoin the defendant’s use of the sign “Hong He” prominently on products.14

13 **(3) Distinction to Geographic Indication.** A geographic trademark is to be distinguished from a geographic indication (GI), which currently is in China also protected by the Trademark Law, not a special statute. A GI may be registered as certificate trademark or collective trademark. However, only qualified organizations – usually the pertinent producers’ associations – are entitled to submit the trademark applications.15 As a result, a private person may not acquire a geographic trademark, if the involved geographic term is deemed as a GI for a specific product. Although the rules may appear straightforward, there are certain ambiguities in its application. It is sometimes hard to tell whether a particular geographic term should be treated as a GI or a normal trademark.

c) **Registration of Trademarks and Opposition Proceeding**

14 Trademark applications are subject to substantive review by the TMB, a practice that distinguishes China from many other countries. The other difference is that the opposition proceeding takes place prior to the final registration. A trademark application will be published if it passes the preliminary review by the TMB, which examines whether the applied trademark is distinctive and dissimilar with existing marks of another registrant on same or similar goods. Otherwise the application will be rejected. Within three months upon publication anyone may raise objections against the application.16 The grounds for opposition include lack of distinctiveness, conflict with prior rights and preemptive registration of an unregistered mark of a third party *(infra at 52)*.17 Against the decision of rejection of an application or a decision rendered in an opposition proceeding, the losing party may apply for a review with the Trademark Review and Adjudication Board (TRAB). Against the decision of the TRAB it is possible to appeal to Beijing Intermediate Court no. 1 within 30 days.

13 *Rui* (2003), 104.
14 Yunnan Honghe Guangming Co. Ltd. vs. Shandong Taihe Century Investement Co. *(云南红河光明股份有限公司与山东泰和世纪投资有限公司等侵犯商标权纠纷上诉案)* et al., Judgment of Guangdong High Court dated February 2, 2008 *(2006)粤高法民三终字第121号*.
15 Arts. 4, 5 of the Measures concerning the Administration and Registration of Collective Marks and Certification Marks *(集体商标证明商标注册和管理办法)*, promulgated on April 17, 2003, effective on June 1, 2003.
16 Art. 30 Trademark Law.
17 Art. 31 Trademark Law.
With the significant increase of applications and chronic understaffing of the TMB, it takes in average three years to have a trademark registered in China.

d) Trademark Rights

The rights of trademark owners are similar to those in other countries. Trademark owner may prevent others from using identical or similar marks on identical or similar goods/services and selling goods attached with such infringing marks.\(^{18}\) Art. 52 no. 4 Trademark Law also prohibits removing the original trademark from the goods and putting it into market after attaching another trademark, the so-called “reverse counterfeiting”. The initial term of protection for trademarks is 10 years. It is unlimitedly renewable for another 10 years six months prior to the expiration.

e) Use Requirement and Defensive Trademarks

In China, a trademark may be cancelled\(^{19}\) for non-use for three consecutive years without justifiable grounds\(^{20}\). However, the requirements imposed on the use of trademark are lenient so far.\(^{21}\) In most cases it suffices to sustain a registration in a particular class by publishing an advertisement in which the trademark is mentioned in association with that particular class of goods/services. For this reason, it is possible to register defensive trademarks in China and prophylactically prevent others from registering similar marks around the mark actually used. The authorized use of the mark by a third party also accounts as use by the right holder.

2. Patent

a) Prerequisites for Protection

Chinese Patent Law has undergone a partial revision in 2008. In China, invention patents, utility models and design patents (also called industrial designs) are governed by one and the same statute – the Patent Law. The three elements of patentability – novelty (新颖性), utility (实用性) and nonobviousness (创造性) – are also proscribed with respect to patents and utility models. China has adopted the notion of “absolute novelty” in the amended Patent Law, which means that the invention or utility model does not belong to prior art that includes all information

\(^{18}\) According to art. 9 of the Interpretation of the SPC on Some Issues regarding the Application of Law in the Trial of Civil Disputes over Trademarks (最高人民法院关于审理商标民事纠纷案件适用法律若干问题的解释) (hereinafter: Judicial Interpretation on Trademark Disputes), promulgated on October 12, 2002, effective on October 16, 2002, “identical” means that there is no optical difference between the alleged infringing and infringed marks and “similar” means that due to the similarity of the shape, pronunciation, meaning of the words or of the structure or colors of the designs, or of the whole combination of the elements or of the combination of the three-dimensional shape or color, the relevant public is easily confused about the origin of the goods or led to believe that there exist considerable association between the goods and the goods of the plaintiff.

\(^{19}\) A trademark may also be cancelled on other grounds, such as assignment of registered trademark without proper registration, for details Wang Ze (2007), 94–97; also n. 74.

\(^{20}\) The exception of justifiable grounds is not expressly stipulated in the Trademark Law, but in art. 39 Implementation Rules of Trademark Law (商标法实施条例), promulgated by the State Council on August 3, 2002, effective on September 15, 2002. Force majeure, government policy restrictions and liquidation proceedings are listed as examples in Part II, Section 6, 5.4 of the Trademark Examination and Adjudication Guidelines.

\(^{21}\) Liu Xiaojun, 77–78; Yang Wei, 54–55; Part II, Section 6, 5.3 of Trademark Examination and Adjudication Guidelines.
that has been made available to the public inside and outside China before the date of application or the priority date in case that priority is claimed.22 A third party’s pending patent application that is filed in China before the application date and published thereafter also constitutes prior art.23 The element of utility requires that the invention or utility model can be implemented and produce positive effect, which is met in most cases. The requirement of nonobviousness is fulfilled if an invention applied for patent possesses significant substantive features and has achieved obvious improvement. As to the utility model, it is only required that the technology demonstrates substantive features and improvement.24

Like other countries, certain subject matter including scientific discoveries, rules and methods for mental activities, methods for the diagnosis and treatment of diseases, substances gained by nuclear transformation and animal and plant varieties is excluded from patentability.24 Subject to certain restrictions, business method as new method of doing business25 and computer software26 may also be patented in China. An invention made by illegal or unmoral means or in violation of public interests is not patentable. Gene-based inventions are also excluded from patenting if the genes are illegally retrieved or exploited.27

A design patent can be granted if it is novel, nonobvious and does not collide with other prior rights.28 The novelty requirement is the same as with patent and utility model. The element of nonobviousness is fulfilled if the applied design distinguishes itself obviously from existing designs and design combinations. After the revision of the Patent Law, two-dimensional prints of designs, colors or the combination of the two for the purpose of identifying a merchandise such as labels and prints on the outer packing are no longer patentable.29 However, purely decorative prints without identifier’s function are supposed to remain eligible for design patent. This limitation is introduced to address the significant increase of application for such kind of designs, the vale of which is doubted by the lawmaker.30

b) Registration of Patents

Also in patent law, China follows the first-to-file principle. In China, applications for invention patents are subject to substantive examination, therefore it takes the applicant normally two to four years to obtain the grant of patent. In contrast,
utility models and design patents are granted based on a preliminary review. As a strategy, the inventor may choose to apply for both invention patent and utility model for the same invention and will be able to avail himself of the protection afforded by the utility model that is granted more quickly (usually within one year). Upon the grant of the invention patent he may opt to drop the utility model and only retain the invention patent.\(^{31}\) However, it is to note that utility model may not be granted to a method.

c) Scope of Protection

Art. 11 Patent Law enumerates following exclusive rights for patentees: right to make, use, offer to sell, sell or import the patented product, use the patented process, use, offer to sell, sell, or with respect to patent on method the right to import products directly obtained by the patented process for production and business purpose. Holders of utility models and registered industrial designs are granted similar rights. A patent is protected for 20 years and a utility model and industrial design for 10 years.\(^{32}\) The term of protection is measured from the actual date of filing and is unavailable for extension.

The recent revision of the Patent Law clarified the contradictory court practice regarding clinical trials\(^{33}\) and allows explicitly the exploitation of a patent for the purpose of obtaining and providing information required for the regulatory approval of drugs.\(^{34}\)

3. Copyright

Copyrights and neighboring rights are protected in China upon the creation of the work. Computer software is protected by Copyright Law and specific provisions on computer software.\(^{35}\) Originality is the only prerequisite for copyright protection. A foreigner’s copyright is protected if he is a citizen of a country that is a member of the Berne Convention. Art. 10 Copyright Law sets out following personal and economic rights of an author: right to publication, authorship, alteration and the integrity of the work, to reproduction, to distribution, to release, to exhibition, to performance, to show, to broadcasting, to dissemination through Internet, to film, to compilation, to translation etc. A work is protected for the life time of the author plus 50 years after his death.\(^{36}\) Work authored by a legal person or an organization, cinematographic work and work produced by means similar to cinematographic and photographic work is basically protected for 50 years from the date of first publication. Fair use of copyrights is covered by art. 22 Copyright Law, which includes \textit{inter alia} private use, quotation, use in news, use for academic teaching and research in schools. Currently, China has three collective copyrights management organizations: Music Copyright Society of China, China Written Works Copyright Society, China Audio-Video Copyright Association.

\(^{31}\) Art. 9 Patent Law.

\(^{32}\) Art. 42 Patent Law.


\(^{34}\) Art. 69 no. 5 Patent Law.

\(^{35}\) (计算机软件保护条例), Regulations on the Protection of Computer Software, promulgated by the State Council on December 20, 2001, effective on January 1, 2002.

\(^{36}\) Art. 21 Copyright Law.
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4. Trade Secrets

24 Under Chinese Law, trade secrets are protected mainly through art. 10 of the Law against Unfair Competition,\(^37\) which is complemented by the “Judicial Interpretation of the SPC concerning the Application of Law in the Trial of Unfair competition Disputes”\(^38\). Trade secrets are legally defined as technical information or business information that is neither available in the public domain nor readily ascertainable, may create business interests or profit for its legal owners and is kept secret through reasonable efforts.

25 Product formulations, manufacturing processes, supplier information, marketing strategies and bidding documents usually qualify as trade secrets. Following Information are not considered as trade secrets\(^39\): (1) Information generally known in a particular industry; (2) Information can be obtained from the product itself, such as product’s size, structure, materials and composition of product’s parts; (3) Information which has been publicly disclosed in publications, lectures or exhibitions; and (4) Information which can be obtained through public channels or without extra charge. Customers’ lists including names, addresses, contact information, and convention, content and intent of trade of the customers, which distinguishes itself from common information, are considered as trade secrets\(^40\); However, if the customer chooses to deal with a former employee based on personal trust and there is no bad faith soliciting on the side of the former employee, then such loss of the customer is not deemed as infringement of trade secrets.

26 In order to establish reasonable secret-keeping measures having already been taken, the secret holder has to show \textit{inter alia} that he limits the scope of persons having access to the information, locks the information, labels the information as confidential, uses password protecting the information, signs confidentiality agreements with information recipient or restricts machines, factory buildings, workshops and other places involved with secret information from visitors or requires visitors to keep secret.\(^41\)

27 The appropriation of trade secrets by theft, inducement, duress or other illegal means is prohibited. So are the unauthorized disclosure, use and allowing others to use a trade secret that is obtained by misappropriation or breach of secrecy agreement. Reverse engineering as a method to discover a trade secret by analyzing a legally obtained product is allowed.\(^42\) A third party is liable for the acquisition and use of a trade secret only in the case that he has actual or constructive knowledge. Criminal liability of up to seven years imprisonment may be imposed for infringement of trade secret according to Art. 219 Criminal Law.

28 It is advisable to either have a secrecy clause in the standard employment contract or to sign a secrecy agreement and non-compete covenant with employees.

\(^{37}\) (反不正当竞争法), promulgated by the SCNPC on September 2, 1993, effective on December 31, 1993.

\(^{38}\) Judicial Interpretation of the SPC concerning Some Issues on the Application of Law in the Trial of Civil Disputes over Unfair Competition (最高人民法院关于审理不正当竞争民事案件应用法律若干问题的解释) (hereinafter: Judicial Interpretation of the Law against Unfair Competition), promulgated on January 12, 2007, effective on February 1, 2007.

\(^{39}\) Art. 9 para. 2 Judicial Interpretation of the Law against Unfair Competition.

\(^{40}\) Art. 13 Judicial Interpretation of the Law against Unfair Competition.

\(^{41}\) Art. 11 para. 3 Judicial Interpretation of the Law against Unfair Competition.

\(^{42}\) Art. 12 Judicial Interpretation of the Law against Unfair Competition.
who have access to trade secret. A secrecy contract can provide a high contractual penalty in favor of the employer. In a dispute, the employee may ask the court to adjust the contractual penalty, however, in such a situation, the employee bears the duty to prove that the penalty is unreasonably high. The signing of a separate secrecy agreement can demonstrate that the employer has taken strong measures to maintain the secrecy of the trade secret, and can support the employer’s claim that the trade secret is of high business importance and value.

The non-compete covenant is important due to the fact that it is hard for the employer to prove the infringement of trade secrets and avail himself of the corresponding legal protection. Non-compete covenants may be included into employment contracts with senior management staff, senior technicians and other staff with a confidentiality obligation. For details of non-compete covenant (supra Chapter 9 at 60–62).

5. Domain Name

The main legal basis for the protection of domain names in China is the “Judicial Interpretation of the SPC on the Application of Law in the Trial of Civil Disputes involving Internet Domain Names” issued in 2001. According to art. 4 of this interpretation, cyber squatting can be established if following requirements are met: (1) the plaintiff has a legitimate right or interest to claim legal protection for the domain name; (2) the domain name of the defendant or its main part is a duplication, imitation or translation or phonetic translation of an unregistered well-known or are identical or similar to a registered trademark or domain name, which results in a confusion in the relevant public; (3) the defendant is neither entitled to nor has real interest in the domain name or its main part, nor good reason for the registration and use of the domain name; (4) the defendant registered the domain name in bad faith. The bad faith can be assumed if a well-known trademark is registered by a third party for commercial purpose or the defendant intends to cause consumer confusion or offers the domain name at unreasonably high price or the main purpose of the registration is to block the use by the plaintiff. The plaintiff is entitled to file the suit either with an Intermediate Court at the place of infringement or at the domicile of the defendant. If these two places cannot be identified, the plaintiff may theoretically sue at any Intermediate Court.

Within two years from the registration, the plaintiff is also able to seek protection through arbitration with one of the two arbitration centers designated by China Internet Network Information Center (CNNIC), namely the China International Economic and Trade Arbitration Center (CIETAC) and Hong Kong International Arbitration Center (HKIAC). However, these two arbitration centers have jurisdiction only over top level domain names “cn” and domain names in Chinese characters.

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43 Judicial Interpretation of the SPC on the Application of Law in the Trial of Civil Disputes Involving Internet Domain Names (最高人民法院关于审理涉及计算机网络域名民事纠纷案件适用法律若干问题的解释), promulgated on July 17, 2001 and effective on July 24, 2001.

44 Art. 2 Judicial Interpretation of the SPC on the Application of Law in the Trial of Civil Disputes Involving Internet Domain Names.
6. Enforcement

a) Administrative and Criminal Enforcement, Customs Protection

A distinctive feature of redressing infringement of IP rights in China is the dual track system. In China, IPR owners may seek protection both from the court and also from local AIC, patent or copyright administration agency. If not damages, but suppressing infringement is the main goal of the right holder, administrative remedies, which are efficient and inexpensive, may be the appropriate one. Right holders are able to obtain an injunction as well. Although in academic circle voices favoring the abolition of administrative remedies, which are indeed not so readily available in developed countries and claimed to having been misused by foreign investors in China, are becoming louder, the official policy remains unchanged. Apart from administrative and civil remedies, Chinese law also provides for criminal and customs protection for IPR.

b) Litigation

One handicap of administrative enforcement is the incapability to claim compensation, which is available only in civil actions. Litigation is also needed if the infringement is not obvious, e.g. the alleged infringement is not a literal duplication, but imitation of a patent, in which case the IP administrations tend to refuse to intervene. In terms of the substantive law, it has been the subject of much discussion in China, whether damages can be awarded only in case of fault, i.e. intent or negligence, on the part of the infringer, although in most cases the fault will be simply assumed by virtue of the fact that anyone is presumed to take notice of the trademark and patent registrations. Now it seems that the prevailing view considers fault a prerequisite for a damage claim. Also statutory damages and account of profits may not be awarded in China where the infringer did not knowingly, or with reasonable grounds to know, engage in infringement activities. At this point, Chinese law differs from art. 45 TRIPs, which allows recovery of profits and/or payment of pre-established damages independent of negligence. According to partial statistics, statutory damages are used quite frequently in court practice, which has caused certain concern, because due to the broad discretion of the court and difficulties in deciding whether a requested royalty is reasonable, the amounts awarded so far appear rather arbitrary and in most cases rarely exceed RMB 300,000. In light of the complexity of IP rights, right holders are often recommended to sue before courts with strong IP expertise in Beijing or Shanghai. For this purpose, the right holder usually has to sue the distributor and manufacturer as joint defendants.

c) Arbitration

In recent years there has been some discussion about the question of whether IP arbitration has the potential to develop into an alternative to substitute IP litigation.

45 Liao, 92; Zhang Yumin (2003), 24 et seq.; Yang Lixin, 294 et seq.
46 Zhou Huiguo, 9; The Third Civil Law Chamber of Jinan Intermediate Court, 18; disputed by Li Ying, 83; Zeng, 78.
47 The Third Civil Law Chamber of Beijing High Court, 42; Liu Tieguang, 53.
48 Liu Tieguang, 54.
II. Main Issues

1. Protection of Unregistered Trademarks

Although China follows the first-to-file principle, unregistered trademarks are not fully unprotected. It is possible to claim protection based on the provisions regarding well-known trademarks, agency trademarks, preemptive registration in bad faith and under the Law against Unfair Competition art. 5 (2). However, if the identical or similar sign has already been registered by a third party, the owner of an unregistered trademark may only claim legal protection through annulment of such a third party’s trademark. As long as the third party’s trademark still exists, its owner may bar the use of the unregistered trademark.

a) Well-Known Marks

(1) Extended Scope of Protection. A well-known mark is protected against the unauthorized duplication, imitation or translation in its entirety or of its major part on identical or similar goods or services, which causes confusion among the relevant public, even without registration. This is the reason why the establishment of well-known trademarks is often crucial in cases involving unregistered marks.

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49 Art. 2 Arbitration Law: “Contract disputes and other property disputes between equal legal subjects of citizens, legal persons and other organizations may be submitted to arbitration”.

50 However, the losing party is entitled to appeal against the decision of the PRAB or TRAB before the Beijing Intermediate Court No. 1 within three months upon receipt of the decision and further to Beijing High Court, which acts the final instance in the matter.

51 Not a single IP case has been solved by arbitration to date, see Xu Shu, 61.

52 Liu Xiaohai, 61–62.

53 “Cause confusion” means that the trademark of the defendant is suitable to cause the relevant public to mistaken the origin of the plaintiff’s and the defendant’s products or cause the relevant public to believe that there be certain such as licensing or affiliate relationship between the business using the plaintiff’s trademark and the trademark of the defendant. Art. 9 of the Judicial Interpretation of the SPC concerning Some Issues on the Application of Law in the Trial of Civil Disputes Involving Well-known Trademarks (最高人民法院关于审理涉及驰名商标保护的民事纠纷案件应用法律若干问题的解释) (hereinafter: Judicial Interpretation on Well-Known Trademarks), promulgated on April 23, 2009, effective on May 1, 2009.

54 Art. 13 para. 1 Trademark Law.
38 If a trademark is recognized as well-known and has also been registered in China, it enjoys an expanded legal protection than ordinary registered trademarks. The trademark owner may prevent the use of the trademark on non-similar goods/services or as a trade name (previously also as a domain name), if it is misleading for the public and, as a result, may cause damage to the trademark owner. “Misleading” means that the use of the trademark on a third party’s product makes the relevant public assume that certain association exists between the trademark owner and the third party. “Cause damage to the trademark owner” means that the distinctiveness of the trademark may be diminished or the reputation of the trademark may be undermined or the third party unjustifiably takes advantage of the reputation of the trademark.

39 The regulations regarding well-known trademarks in the Trademark Law are modeled after art. 6bis Paris Convention, art. 16 para. 2 TRIPs and the Joint Recommendation of WIPO concerning Provisions on the Protection of Well-Known Marks issued in September 1999.

40 (2) Criteria of Well-Known Trademarks. Whether a trademark is regarded as well-known depends on the perception of the relevant public and the reputation of the trademark in China. The scope of the relevant public is defined as consumers of the type of the goods/services using the trademark at issue and businesses and sales personnel dealing with the type of the goods/services. In determining whether a mark is well-known, following factors are to be considered: the extent of knowledge of the relevant public, the duration of the use of the mark, advertising or publicity and the record of the mark being determined as well-known in China and other jurisdictions as well as the turnover and the geographical area of the distribution of the products. It is not required that these factors are cumulatively present. For particularly famous trademarks which are known not only to the relevant public, but the general public, the requirements on the evidence can be reduced.

41 It is nonetheless difficult to overcome the high threshold of the establishment of the well-known status and the court practice was blamed to be unpredictable in the past. With the increase of the number of judicially recognized well-known trademarks, the judiciary is gaining more expertise in this area. In April 2009, the SPC promulgated a judicial interpretation on well-known trademarks, which aims to enhance the consistency and transparency of court practice in this regard.

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56 Ikea vs. Beijing Guowang Information Ltd. (荷兰英特艾基系统有限公司诉北京国网信息有限责任公司不正当竞争纠纷案), Judgment of Beijing High Court dated November 15, 2001 ((2000)高知终字第76号); E I Du Pont De Nemours and Company vs. Beijing Guowang Information Ltd. (美国杜邦公司诉北京国网信息有限公司计算机网络域名侵权纠纷案), Judgment of Beijing High Court dated November 15, 2001 ((2001)高知终字第47号). This protection is currently not restricted to well-known trademarks, but available to ordinary trademarks, infra at 43.
57 Art. 13 para. 2 Trademark Law; Art. 1 Judicial Interpretation on Trademark Disputes.
58 Art. 9 para. 2 Judicial Interpretation on Well-Known Trademarks.
59 Art. 2 Provisions of Determination and Protection of Well-known Trademarks (驰名商标认定和保护规定), promulgated by the SAIC on April 17, 2003, effective on June 1, 2003.
60 Art. 14 Trademark Law; Art. 3 Provisions of Determination and Protection of Well-known Trademarks.
61 Art. 4 Judicial Interpretation on Well-Known Trademarks.
62 Art. 8 Judicial Interpretation on Well-Known Trademarks.
(3) Authorities and Proceedings for the Recognition. In China, not only the court, but the TMB and the TRAB may also determine well-known trademark, depending on in which proceeding the trademark owner makes such a request. In civil litigations, the court is responsible for the establishment. As to unregistered trademarks, there is certain doubt concerning whether the court has competence in this respect despite a number of countervailing court practice. In any case, the court is not allowed to establish an unregistered mark as well-known if it is a generic term or descriptive or a common three-dimensional shape. This provision is supposed to prevent a trademark, which is under normal circumstances not registrable for reasons such as lack of distinctiveness, from being protected through the back door of well-known trademark like the controversial case “sour sour milk”. In administrative infringement proceedings (supra at 32) before a local AIC, the application for the recognition as well-known trademark will be forwarded to the TMB for final decision if the local and provincial AIC are in favor of the recognition. In opposition proceedings, the TMB may examine whether a trademark is well-known. In annulment proceedings, it is the TRAB that is responsible for the establishment of well-known trademarks. Well-known trademarks that are established by the TMB and TRAB are regularly published. Until April 2009, 1,624 trademarks have been recognized by the TMB and TRAB as well-known, among them 98 trademarks belong to foreign right holders.

In the past, it used to be possible to apply for the recognition of the well-known status of a trademark even in the absence of real disputes. Through this way, a number of trademarks were established as well-known and it became a trend for trademark owners to follow this strategy to enhance the publicity of their trademarks. After this possibility has been abandoned in 2003, there is still considerable incentive to acquire the well-known status by filing lawsuits based on fabricated legal disputes. The recent counteraction to the risk of abuse are the following measures adopted by the SPC in 2009: (1) the court is allowed to examine whether a trademark is well-known only if this question determines the outcome of the case. If an trademark infringement or unfair competition can be identified regardless whether the trademark is well-known, the court has to refrain from adjudicating the issue of the publicity of a trademark; A typical example is the use of a mark identical with or similar to a prior registered trademark in a domain name and thereby causes confusion, which constitutes a trademark infringement even the trademark is not well-known. (2) The normal evidence rule that an allegation is deemed proven if the other party does not raise objection does not apply to the establishment of well-known trademarks; (3) The SPC confirmed the principle

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63 Art. 22 para. 1 Judicial Interpretation on Trademark Disputes and art. 6 Judicial Interpretation on Domain Name Disputes.
64 Zhong Hongbo, 71 et seqq.
65 So far most unregistered trademarks recogized as well-known are Chinese translations of foreign trademarks: 艾富比 (Sotheby’s), 星巴客 (Starbucks).
66 Art. 12 Judicial Interpretation on Well-Known Trademarks.
69 Art. 2 and 3 Judicial Interpretation on Well-Known Trademarks.
70 Art. 7 para. 2 Judicial Interpretation on Well-Known Trademarks.
established by the SAIC in 2003 that the recognition of a well-known mark is generally only binding in a particular case. The court’s finding as to whether a trademark is well-known is to be excluded from the disposition in the judgment.\footnote{Art. 13 Judicial Interpretation on Well-Known Trademarks.} In a later case, if the defendant raises objection against the prior establishment conducted by a court or the TMB and TRAB, the court must carry out a new examination.\footnote{Art. 22 para. 3 Judicial Interpretation on Trademark Disputes.} (4) Only certain Intermediate Courts have jurisdiction over the establishment of well-known trademarks. Other Intermediate Courts are allowed to adjudicate this type of cases only with the SPC’s authorization.\footnote{Notice of the SPC concerning the Jurisdiction over Civil Disputes Involving the Establishment of Well-Known Trademarks (最高人民法院关于涉及驰名商标认定的民事纠纷案件管辖问题的通知), promulgated and effective on January 5, 2009.}

\textit{(4) Foreign Trademark Owners.} With respect to foreign trademark owners, the disputes mainly focus on Chinese translations or transliterations of their trademarks, which often constitute the genuine association with the product origin for Chinese consumers, but are not registered timely by oversight. To determine the merits of a foreign trademark owner’s action against the use of a Chinese translation of his trademark, following factors are to be considered:

\begin{enumerate}
\item Has the Chinese trademark already been registered? If this is the case, the plaintiff may require an annulment and permanent injunction against the use only if he is able to establish that his unregistered trademark is deemed already well-known \textbf{back to the time of the filing of the defendant’s trademark application}. In the case \textit{Dell vs. De Er}, the Beijing Intermediate Court No. 1 ruled against Dell’s claim of annulment of the trademark “德尔” (DE ER) on the ground that Dell failed to prove the trademark “Dell” was already well-known in 1997, in which year the defendant’s trademark application was filed. It is to note that a registered trademark may be cancelled or annulled only by the TMB and TRAB.\footnote{The TMB has jurisdiction over the cancellation and annulment in following circumstances: (1) the trademark is not registrable due to lack of distinctiveness or unauthorized use of a sovereignty sign (\textit{supra} at 6), or the trademark is registered in bad faith or by unfair means, art. 41 para. 1 Trademark Law; (2) the trademark itself, the address, name of the trademark owner is altered unilaterally by the trademark owner, the trademark is assigned unilaterally by the trademark owner or non-use, art. 44 Trademark Law. The TRAB has concurrent jurisdiction in the first scenario and additional jurisdiction in the case that a well-known trademark, agency trademark, geographic indication or preemptive registration is at issue, art. 41 para. 2 Trademark Law.} By contrast, the court has no original jurisdiction over the validity of a registered trademark. From 1 May, 2009 onwards the court may prohibit the use of a \textit{registered} trademark if a duplication or imitation of a well-known trademark has been identified, which used to be impossible before the promulgation of the Judicial Interpretation on Well-Known Trademarks. For instance, in the case “WAL-MART”, the registered trademark of the defendant was held confusingly similar to the plaintiff’s registered mark, the court nonetheless did not issue an injunction order.\footnote{Zhu Jianjun (祝建军)/Wang Hong (汪洪), On Dispute over Infringement of Wal-Mart’s Well-Known Trademark (评沃尔玛驰名商标侵权纠纷案), available at http://case.ipr.gov.cn/ipr/case/info/Article.jsp?a_no=123701&col_no=1000&dir=200709.} In fact, the court was even not allowed to take up a case in which two registered trademarks in their originally registered forms collide with each other.\footnote{According to art. 1 para. 2 Provisions of the SPC concerning Some Issues in the Trial of Civil Disputes over the Conflict between Registered Trademark or Enterprise Name with Prior Right (最
II. Main Issues

(2) Apart from this, it is possible to apply for the annulment of the defendant’s registered mark only within five years from the registration of the defendant’s trademark unless the plaintiff can prove that the application was filed in bad faith.

(3) If the defendant’s mark has been filed for registration, but not yet approved by the TMB, the plaintiff may challenge the application in an opposition proceeding. In this case, it is crucial to show that the plaintiff has used the Chinese translation prior to the date of filing of the defendant’s application. As in most cases, the plaintiff’s trademark is registered in the form of its original Latin letters in China, theoretically it would also be possible to claim protection on the ground that, according to art. 13 Trademark Law, registration and use of a trademark that is the imitation or translation of a registered well-known trademark on same or similar goods or services are prohibited. However, this approach is usually not feasible due to two practical hurdles. First, a foreign trademark can be translated into Chinese with different characters in almost unlimited variations. It goes without saying that the trademark owner is not entitled to prevent the use of all possible variations, the majority of which has either no or only very weak link to the original trademark in western language. This is why the trademark owner, even following the second approach, has anyway to establish that the Chinese translation used by a third party is perceived by the relevant public as the (by the foreign trademark owner intended) Chinese form of the original foreign trademark. Second, the plaintiff has to establish that the foreign trademark in its original form is in China well-known, which is often even harder to be proved than the reputation of the Chinese translation, because most Chinese have difficulties in recognizing foreign brands which they are familiar with, when the brands are written in Latin letters.

In 2008 the Beijing Higher People’s Court upheld the decision of the Beijing Intermediate Court no. 1 that the Chinese translation of “Viagra” – “伟哥” – does not constitute a well-known trademark, although it is now commonly linked to “Viagra” in China, with the argument that Pfizer has never used this translation prior to the time of the defendant’s filing for the mark “伟哥”. The fact that Pfizer has used the mark “伟哥” in Taiwan and Hong Kong prior to the filing is in the opinion of the court irrelevant.

(4) The defendant registered a Chinese translation of the plaintiff’s mark as a trade name, but used it in a trademark sense (infra at 58). In this case, if the registration of the trade name occurs later than the filing of the Chinese translation as a trademark, then the plaintiff may prevent both the use of such a trade name as a trademark and apply for the annulment of the trade name itself, if the Chinese translation is recognized as well-known at the time of registration of the defendant’s trade name. If the court denies the well-known status of the Chinese translation of the original trademark, the trademark owner is not entitled to annul the trade name and can only prohibit the use of such a trade name as a trademark once his trademark is approved and registered by the TMB. In this respect, the “Bloomberg” and “Starbucks” cases
are the examples representing these two scenarios. In the former case, the plaintiff’s attempt to have the trademark “Bloomberg” recognized as well-known back to the time of the registration of defendant’s trade name failed, therefore, the defendants who also operate in financial consulting business are allowed to continue using “澎博”, similar to the Chinese translation of Bloomberg “彭博” in their trade names, but banned from using this mark stand-alone for their services.79

49 In the Starbucks case, where the defendant used in its trade name the Chinese translation of “Starbucks” – “星巴克” – after this trademark has been filed for registration, but not yet been registered in class 42 for restaurants, café shops and bars etc, the court held that the unregistered mark “星巴克” constitutes a well-known trademark at the time of registration of the defendant’s trade name.80 Therefore, the defendant is ruled to change his trade name and cease applying the mark to his services.

b) Agency Marks

50 Agency mark refers to a trademark originally owned by the principle or the represented person, but registered by an agent or representative in his own name without proper authorization. The provision of art. 15 Trademark law is an imitation of art. 6bis Paris Convention. The Trademark Examination Guidelines expand the circle of agents to the extent that distributors are also deemed as agents. Representatives are legal representatives of legal persons, board members, supervision board members, managers and executive partners in partnerships.

51 The agent is barred from circumventing this provision through a dummy or by using a non-identical but similar mark on similar goods. According to the Trademark Examination Guidelines, the agent is bound by this requirement even after the termination of the agency relationship. The duration of such post-contractual ban is not specified. If the trademark has not been used by the principal before, but first put into use by the agent and is perceived as a trademark of the principle by the relevant public as a result of publicity campaign financed by the principle, the trademark is still regarded as owned by the principle. The principal may raise opposition against a trademark application filed by the agent or apply for annulment within five years from registration if such an agency trademark has already been registered.82 Under the Trademark Law, the principle is only entitled to oppose or annul an improper agency trademark, but not to claim the assignment of the trademark to the principle. Therefore, the principle has to register the trademark again in its own name after the former registration of the agent has been successfully challenged.

79 Bloomberg LLP vs. Shanghai Peng Bo Financial Information Co. Ltd. (彭博有限合伙公司诉上海澎博财经资讯有限公司等商标侵权纠纷案), et al., Judgment of Shanghai Pudong District Court dated of November 24, 2006 ((2005)浦民三(知)初字第97号).

80 Lu Guoqiang, 80.

81 In the case OBO Bettermann vs. Huang the defendant who filed the application for “OBO” trademark is the owner of a company, which has been the distributor of the plaintiff in China. In the opposition proceeding initiated by the plaintiff, the TRAB held that the trademark application of the defendant is regarded as a filing originated from the agent of the plaintiff. See TRAB [Shang Ping Zi] (2005) No. 0242 "Decision re Trademark No. 1578392 ‘OBO and picture’", (国家工商行政管理总局商标评审委员会商评字(2005)第0242号《关于第1578392号“OBO及图”商标争议裁定书》).

82 Art. 15 and 41 para. 2 Trademark Law.
c) Other Types of Preemptive Registrations

A registered trademark that infringes a prior right of a third party or is a preemptive registration of another unregistered mark that has been used by a third party before and gained considerable reputation, through unfair means, may be annulled by the TRAB within five years from the registration date. The same grounds can be used to initiate an opposition proceeding against a trademark application. Prior rights include prior trademark, copyright, design patent and trade name on the trademark at issue. With respect to preemptive registration the preconditions are still subject to discussion, although a number of trademarks were invalidated on this ground.

Basically, the considerable reputation of the unregistered mark has to be present in mainland China, but it suffices if the mark is well-known in a particular region. In the case "MUJI", Ryohin Keikaku Co. Ltd filed application for the trademark “MUJI” in Britain and Hong Kong in 1991 for goods of class 25 including clothes, shoes and hats. In 1994, a Hong Kong based company filed the same trademark in mainland China for the same class of goods. The Beijing High Court held the use outside mainland China is also deemed as a use for the purpose of the prohibition of preemptive registration. The prerequisite of “unfair means” is also met due to the fact that the defendant was in the same business branch and should have been able to take notice of this trademark. However, the question of geographical scope of the reputation of plaintiff’s mark was left open.

In the case where the plaintiff fails to prove that the unregistered trademark has gained considerable reputation, the catch-all clause of art. 41 para. 1 Trademark Law “preemptive registration by deceit or other unfair means” still allows annulment of a preemptive registered trademark if forged documents were submitted. Until recently, a registration that filed in bad faith could also be annulled based on art. 41 para. 1 Trademark Law. For this purpose, bad faith means that the defendant has actual or constructive knowledge of the existence of the prior mark either through business relationship or legal disputes or employment relationship or due to the distinctiveness of the prior mark. However, according to a recent judgment rendered by the SPC, art. 41 para. 1 Trademark Law seems to be no longer available as a legal ground for annulment of a preemptively registered trademark.

A recent high profile case involving an OTC painkiller “Saridon” adjudicated by the SPC shows that there exists considerable uncertainty with respect to the preemptive trademark registrations. In this case, the Southwest Pharma AG registered a Chinese trademark “San Lie Tong” (散列通), which closely resembles the Hoffman-La Roche AG’s Chinese trademark “San Li Tong” (散利痛) – the Chinese translation of Roche’s original trademark “Saridon”, both were licensed to Southwest Pharma for three years prior to Southwest Pharma’s registration of its trademark “San Lie Tong”. The SPC ruled that the trademark “San Lie Tong” was registered prior to the

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83 Art. 31 and 41 para. 2 Trademark Law.
85 Part II, Section 5, 2.2 of the Trademark Examination and Adjudication Guidelines.
86 Changzhou Chengliang vs. TRAB et al. (常州诚联电源制造有限公司诉国家工商行政管理总局商标评审委员会常州市创联电源有限公司商标撤销行政纠纷再审), Judgment of the SPC dated September 24, 2008 (2006)行监字第1181号.)
trademark “San Li Tong” and Roche may only challenge the registration if it has a legitimate prior right to the term “San Li Tong”. Such a prior right is denied by the SPC on the ground that the use of the “San Li Tong” by Roche prior to the registration of the trademark “San Lie Tong” does not constitute the use of an unregistered trademark, but the use of the term as generic merchandize name, while the preceding two instances are of the opinion that such use is undoubtedly a use in a trademark sense.

**d) Protection under Anti-Unfair Competition Law**

If a product is recognized as well-known merchandize in China, it is protected against passing-off according to art. 5 No. 2 Anti-Unfair Competition Law. Unauthorized use of name, package or decoration that is identical with or similar to the name, package or decoration peculiar to a well-known merchandize, which causes consumer confusion, is prohibited. The use of the name, package or decoration or trade name on goods, package and other business correspondence or in advertisement, exhibition, or other business activities constitute a use in the sense of art. 5 No. 2 Anti-Unfair Competition Law. The factors for the establishment of a well-known merchandize are comparable to those with respect to well-known trademarks.

**2. Conflicts between Trademark and Trade Name**

**a) Trade Name**

A trade name is the distinctive part of an enterprise name, which in China consists of “administrative region + trade name + business branch + organization type”. The registration of trade names (字号) is conducted by local AICs. Therefore, the registration is normally reviewed and protected locally. That means, in the administration region of an AIC, an enterprise is prohibited from using a trade name that is identical with or similar to another existing trade name for identical or similar business branch. To prevent a third party from registering the same trade name in the same business branch in another administration region, it is advisable to register the trade name as a trademark.

**b) Use of Trade Name as Trademark**

(1) Terminologies. In terms of conflicts between a trademark and a trade name, it is crucial to first distinguish the ordinary use of a trade name as a part of an enterprise name to identify the producer or the service provider from the use of a trade name in a trademark sense, because the former scenario is judged based on Anti-unfair Competition Law and the latter primarily based on the Trademark Law. Using the trade name on the product/service stand-alone or particular highlighting the trade name constitute such use of the trade name in a trademark sense (作为商标使用). In addition, it is also important to analyze whether the use of trademark or trade name on identical or similar goods/services or on non-identical

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88 Art. 7 Judicial Interpretation of the Law against Unfair Competition.
89 Art. 1 Judicial Interpretation of the Law against Unfair Competition.
or dissimilar goods/services, because the latter is normally allowed even if the trademark and the trade name are identical or similar.

A registered trademark owner may in principle enjoin the use of an identical or similar trade name on identical or similar goods/services in a trademark sense by virtue of art. 52 no. 1 Trademark, even in cases where the trade name is registered earlier than the trademark.\textsuperscript{90} The trade name owner may avert this challenge either in a judicial proceeding or by way of annulment of the trademark by the TRAB, if it can establish that (i) the registration and use of the trademark are in bad faith and may cause confusion in the relevant public, regardless of geographical limitation of the trade name registration,\textsuperscript{91} and (ii) the trade name was registered earlier than the trademark.

(2) Special Problem in China – Trademark for Retail and Wholesale Services. The issue of using trade name in a trademark sense sometimes involves the question of service mark in trading activities. China is one of the jurisdictions which do not recognize trademarks for retail and wholesale service. In the explanation to Class 35 (for business services) in the Classification of Similar Goods and Services (类似商品和服务区分表) issued by the TMB and a reply of the TMB dated August 13, 2004\textsuperscript{92}, retail and wholesale are explicitly excluded from the scope of Class 35. This restriction brings about following problems in practice:

First, retailers and wholesalers are forced to register trademarks in the subcategory of Class 35 – distributing (for others) (为他人推销) – in order to circumvent this restriction. After being registered, such trademarks are then used in retail and wholesale services. However, if such trademarks are used together with the sign ® or otherwise indicated as registered trademarks, it constitutes an improper use of registered trademarks, as a registered trademark is only allowed to be used in the class for which protection is claimed at the time of registration.\textsuperscript{93} If such trademarks are used without the sign ®, they are treated as unregistered marks in the field of retail and wholesale. Whether unregistered trademarks are allowed for retail and wholesale services is also questionable. In the same vein, it is also arguable whether well-known trademarks may be recognized with respect to retail and wholesale services, although as a matter of fact no one doubts the publicity of many supermarkets, department or convenient stores. The court practice so far seems to give an affirmative answer to this question and has indirectly recognized the validity of trademark for trading activities.\textsuperscript{94}

Second, in case that a trading company has registered trade name that is identical to a registered trademark, it is doubtful whether the trademark owner may prevent such a use. The precondition for such an injunction would be that the use of the

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\textsuperscript{90} Wenzhou Aopo Furniture Co. Ltd. vs. Foshan Aopo Furniture Co. Ltd. (温州澳珀家俱有限公司诉佛山市澳珀家具有限公司等商标侵权及不正当竞争纠纷案), Judgment of Foshan Changan District Court dated of August 17, 2006 ((2006)佛禅法民四知初字第43号).

\textsuperscript{91} Wu Lichao, 39.

\textsuperscript{92} Reply of the TMB to the Question whether Class 35 of the International Classification Includes Department Stores and Supermarkets (国家工商管理总局商标局关于国际分类第35类是否包括商场超市服务问题的批复).

\textsuperscript{93} Art. 44 Trademark Law.

\textsuperscript{94} Beijing Guomei Eletronic Appliance Co. Ltd. vs. Wenzhou Guomei Machinery Engineering Co. Ltd. (北京国美电器有限公司与温州国美机械制造有限公司商标侵权及不正当竞争纠纷上诉案), Judgment of Zhejiang High Court dated of December 19, 2005 ((2005)浙民三终字第244号); Li Changbao (2006), 58.
identical sign in the trade name constitutes a use in a trademark sense on identical and similar goods/services according to art. 52 no. 1 Trademark Law. As the trading company uses the sign in retail or wholesale business and no trademark is allowed to be registered in these two areas, the trademark owner would encounter certain difficulties in proving the similarity of the goods/services. If the trademark owner fails to establish a case of trademark infringement, he may still try to seek protection over the general clause of unfair competition law, which is however less predictable due to the burden of proof regarding bad faith of the trade name owner.

c) Conflict between Trademark and Trade Name in its Ordinary Use

To solve conflicts between a trademark and a trade name in its ordinary use, following rules are applicable:

(1) Trade Name is Registered Prior to the Trademark. If a trade name that is identical with or similar to a trademark has been registered by a company in the same or similar branch prior to the filing date of that trademark, the rule is that the trademark owner is unable to prevent the trade name being ordinarily used as a trade name, even the trade name owner has failed to contest the validity of the trademark in a judicial proceeding or before the TRAB.95

A caveat to this rule: if a trade name is registered earlier than the filing date of the trademark or the trademark is not yet registered, the trademark owner may nonetheless prohibit the use of the trade name in its ordinary use if the trademark is recognized as a well-known trademark back to the time of the registration of the trade name and the use is regarded as an infringement of the expanded protection for well-known trademarks (supra at 37 et seqq.).

(2) Trade Name is Registered after the Trademark. Conversely, the owner of a trademark that is filed for registration earlier than an identical or similar trade name by a company in the same or similar branch may enjoin ordinary use of the trade name according to the catch-all clause in the Anti-unfair Competition Law (art. 2), if the trade name was registered in bad faith and the use of the trade name may cause confusion in the relevant public.96 It is to note that the bad faith may not be derived from the mere fact of the registration of the trade name itself, but is to be established in connection with the reputation and distinctiveness of the trademark. The more reputable and distinctive a trademark is, the easier it is for the trademark owner to prove bad faith of the trade name owner. If the trademark owner is unable to discharge this burden of proof, then he is not entitled to prevent the ordinary use of the trade name.

d) Two Conflicting Trade Names

In the case that two trade names registered in different geographical regions are identical or similar, the earlier registered one may stop the use of the later registered one according to art. 5 no. 3 Anti-Unfair Competition Law, if the later trade name was registered in bad faith and the use may cause confusion in the relevant public. Even trade names of foreign corporations, which are not registered in China, qualify

95 Gao Da, 54.
96 Yuan Xiuting, 51; Art. 2 Provisions of the SPC concerning Some Issues in the Trial of Civil Disputes over the Conflict between Registered Trademark or Enterprise Name with Prior Right.
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for the protection afforded by art. 5 no. 3 Anti-Unfair Competition Law. In the case Sotheby’s Auction House vs. Sichuan Sufubi Auction Company Limited, the plaintiff successfully enjoined the use of the trade name of the defendant that is the Chinese translation of Sotheby’s trade name, although the plaintiff is a British corporation and does not use the Chinese translation in its own trade name.

e) Offshore Shadow Companies

In cases where an offshore company registered outside the jurisdiction of mainland China an enterprise name containing a trade name that is similar to a registered Chinese trademark or trade name without the respective owner’s authorization, the use of the whole enterprise name in China to indicate the producer/service provider is usually allowed. Using the trade name alone to highlight the product/service may be seen as an infringement of the registered trademark or unfair competition. However, it is still controversial whether in this situation a domestic company is allowed to raise the defense that he has acquired a license to use the enterprise name from the shadow offshore company. To answer this rather complex question, following factors have to be considered:

First, an enterprise name in its entirety is supposed to distinguish a legal entity in business transactions and is therefore excluded from licensing.

Second, the distinctive part of an enterprise name, namely the trade name might be licensed to a third party. In practice, such trade name licenses are frequently used, particularly in franchising business. However, the black letter law in this regard is inconsistent: the SAIC prohibits trade name licensing explicitly in several regulations, while the art. 3 of the “Administrative Regulations on Commercial Franchising” promulgated by the MOFCOM implies the permissibility of a trade name license. The SPC apparently supports the MOFCOM’s approach.

97 Art. 6 para. 1 Judicial Interpretation of the Law against Unfair Competition.
98 Sotheby’s Auction vs. Sichuan Sufubi Auction Company Limited (四川苏富比拍卖有限公司与(英国)苏富比拍卖行(SOTHEBY’S)擅自使用他人企业名称和虚假宣传纠纷上诉案), Judgment of Beijing High Court dated of August 7, 2008 ((2008)高民终字第324号).
99 Gao Da, 52; Jiang/Kong/Xia, 52; Wu Lichao, 39–40. In the case Yamaha Corporation vs. Zhejiang Huatian adjudicated by the SPC, the defendant used “Japan Yamaha Co. Ltd.” on its products and package of its products and asserted that a third party “Japan Yamaha Co. Ltd.” has granted the defendant a license to use this trade name. This third party and the defendant turned out to have the same person as chairman of the board of directors. During the course of litigation, the trade name of the shadow company “Japan Yamaha Co. Ltd.” was annulled in Japan. Partially based on this fact the SPC ruled that, the defendant, who is a major competitor to Yamaha in China must have known the Yamaha brand and nonetheless used this brand by acquiring a license on the trade name “Japan Yamaha Co. Ltd.” from an obviously unauthorized party, has acted in bad faith. See Yamaha Corporation vs. Zhejiang Huatian (雅马哈发动机株式会社与浙江华田工业有限公司台州华田摩托车销售有限公司等商标侵权纠纷案), Judgment of the SPC dated April 25, 2007 ((2006)民三终字第1号).
100 Art. 26 no. 3 of the Regulations on the Administration of the Registration of Enterprise Names (企业名称登记管理规定), promulgated by the SAIC on July 22, 1991, effective on September 1, 1991; Reply of the SAIC to the Relevant Questions regarding the Enterprise Name Licensing (国家工商行政管理总局关于对企业名称许可使用有关问题的答复), issued on February 7, 2002.
101 (商业特许经营管理条例), promulgated on February 6, 2007, effective on May 1, 2007.
102 In the case mentioned in supra at n. 99, the SPC did not rule out the validity of the defense on the ground of a trade name license, but held the trade name at issue was not registered in China.
Third, even a trade name is available for licensing, the problem exists that two legal entities in the same administrative region must have different enterprise names. In franchising business, even the chain stores in the same administrative region acquire trade name licenses, they are still barred from using the same trade name in their enterprise names, which would otherwise be very likely identical, because other components such as administrative region, business branch and company form (supra at 57) are usually the same. This raises the question why the franchisor chooses this legally cumbersome solution, instead of registering the trade name as a trademark, the licensing of which is straightforward.

One function of trade name license is to identify franchise relationship in shop signs by indicating itself as chain store of “xy brand”. In this case, the trade name is not used as a part of the enterprise name, but stand-alone in a trademark sense. Therefore, under certain circumstances, a trade name license can be used to avoid restrictions in trademark licensing. For instance, as no trademark is registrable for retail service in China (supra at 60 et seq.), the franchisees of chain department stores, supermarkets and convenience stores are able to identify themselves as a chain only by trade name licenses. The essence of such arrangement is, however, not a genuine trade name license, but a disguised trademark license in that the franchisor grants the franchisees a license to use its trade name in a trademark sense such as in shop signs or stand-alone in advertisement.

Fifth, even trade name license is tolerated in practice, it is unclear whether the trade name to be licensed must have been registered in China. Should an offshore shadow company grant a trade name license to a Chinese domestic company, the use of the trade name stand-alone in association with the same or similar product constitutes a use in a trademark sense, which may be enjoined by the trademark owner. The registration of the trade name as part of the enterprise name of the Chinese domestic company may be challenged if it is established that such registration was conducted in bad faith and may cause public confusion (supra at 66).

f) Remedy

If the court finds that the use of a trade name constitutes unfair competition or infringement of a trademark, it may order damages in the case of fault of the defendant, and order the defendant to cease using the trade name or using the trade name in a trademark sense, it may also order the defendant to change its trade name.\textsuperscript{104}

\textsuperscript{104} Jiang/Kong/Xia, 51; Zhou Xiaobing, 49.
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3. (Multiple) Assignment and Bona Fide Acquisition

a) Trademark

The assignment of an IPR, namely the complete transfer of title to an IPR, is subject to different rules in China depending on the underlying right. A trademark can be assigned independently by concluding an assignment agreement, for which the written form is not explicitly proscribed. The assignment of a part of the business is not required for the transfer of a trademark. However, the assignee is obligated to guarantee the quality of the underlying goods attached with the registered trademark, which is not to be construed that the assignee has to be in

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105 Art. 39 Trademark Law.
106 Art. 39 Trademark Law.
the same industry. Although the assignment contract becomes legally binding upon conclusion, the assignee acquires the trademark only after the assignment is approved by the TMB and published in the trademark gazette. That means, the publication brings about the effectiveness of the assignment between the parties and against a third party. To initiate the approval procedure, a joint application of the assignee and assignor has to be submitted to the TMB. If not agreed otherwise, it is the assignee who is responsible for the completion of the assignment procedure. Normally, acquiring the TMB’s approval for the assignment is rather a routine work. However, it is not entirely risk free. The TMB may reject an assignment if there is a possibility of confusion or other negative impact. A partial assignment, namely the assignment of a registered trademark for part of its designated goods on the same or similar goods/services, is not allowed under Chinese Law.

As the assignment becomes effective only upon publication by the TMB, it is impossible for an assignee to transfer the trademark further to a third party prior to the publication of the first assignment. The TMB requires that in the assignment procedure the assignor has to be the registered trademark owner and if the assignee of the first assignment has not yet been publicly announced as the new registered trademark owner, he is not deemed as a qualified assignor in the second assignment. In practice, court will exceptionally acknowledges the standing of the assignee to sue in an infringement proceeding even prior to the publication by the TMB if the assignor has granted the assignee the right to use the trademark and to sue infringer upon conclusion of the assignment contract. In the case that a trademark owner concludes two assignment contracts, the assignee to the benefit of whom the assignment contract is published first acquires the trademark. The other acquirer may only seek damages from the original trademark owner. A minority view believes that the second contract is voidable, because the assignee is deceived, and the assignee may opt for validity, then seek damages for breach of contract.

The bona fide acquisition of trademarks is so far denied in court practice. The underlying transactions involving this question normally have a similar fact pattern: a trademark had been first assigned by a person pretending to be the trademark owner by showing forged trademark owner’s signature or company stamp to an assignee who further assigned the trademark to a third party. At a later point of time when the original trademark owner finds out the unauthorized assignment, he then in the trademark register registered owner asserts that he had no knowledge about the illegal assignment and he has acquired the trademark in reliance of the trademark register. Under these circumstances, the courts com-

108 Art. 25 para. 1 Implementation Rules of Trademark Law.
109 Art. 25 para. 2 Implementation Rules of Trademark Law.
110 Huang Hu, 193.
111 Art. 35 of the Replies of Beijing High Court to Several Questions In Adjudicating Trademark Civil Disputes (北京市高级人民法院关于印发《北京市高级人民法院关于审理商标民事纠纷案件若干问题的解答》的通知), published on March 7, 2006.
112 Zhang Yazhou, 70–71.
113 For general concept of bona fide acquisition supra Chapter 7 at 54–59.
114 It was confirmed in art. 40 Replies of Beijing High Court (n. 111); Fan, 10 f.
115 In the case Taiwan Huamao Co. Ltd. vs. TMB the trademark of the plaintiff was first assigned by an a third party to Huabang Sujiao Co. Ltd., which further transferred it to Huamao Industry and Trade Co. Ltd. The assignments were published by the TMB in February 2002 and in June 2005
monly rule that the actual registered owner cannot effectively acquire the disputed trademark, if this trademark was in the chain of title once assigned by a person without the necessary entitlement. It is irrelevant whether the acquirer relied on the entry of the trademark register, paid reasonable consideration and there was no indication suggesting such lack of entitlement. In other words, the reliance of an acquirer on the content of the trademark register is not legally protected. This holding has, of course, significant impact on trademark transactions and implicates that basically a trademark buyer has always to take into account that the trademark he acquired might have to be returned to the original owner. It is unclear whether in this case the trademark buyer may claim compensation from the TMB. In the author’s view, such a damage claim has merits if the TMB, by exercising due care, should have identified the forgery of the signature. Although the TMB has taken measures to curb the illegal assignments, the new regulations apparently would not change the situation significantly.\textsuperscript{116}

In practice, the original trademark owner may choose to sue the TMB or the last assignee in the title chain. The TRAB has no jurisdiction in this regard.\textsuperscript{117} The court is bound to accept a proceeding against the assignee even the original trademark owner lost the lawsuit against the TMB. In one case the trademark had been assigned by the board chairman of the plaintiff to himself, the plaintiff lost the case against the TMB on the ground that the chairman is authorized to sign on behalf of the plaintiff and it is not the duty of the TMB to examine whether the signature is not binding for the plaintiff due to self-dealing of the chairman. The court nevertheless accepted the lawsuit filed by the plaintiff against the assignee in the aftermath of the first action.\textsuperscript{118}

In several cases the trademark agents handling the assignment procedure were also held liable based on the finding that they failed to discharge their duty of care and submitted the assignment application on behalf of their clients despite evidence indicating the assignment might lack a proper legal basis. This ruling is challenged in the practice\textsuperscript{119} on the ground that an agent is jointly liable for damages only if he knew or had reason to know the business he was entrusted with was illegal.\textsuperscript{120} One may argue it is fair to impose higher degree of care on trademark agents who are supposed to possess professional expertise in dealing with trademark assignment issues, however, it certainly goes too far to require trademark agents to inquire into the authenticity of the underlying assignment transactions.

respectively. The plaintiff was able to establish that the first assignments was conducted without his knowledge and authorization and demanded the restoration of the original registration. Both the court of the first instance and the appellate court ruled in favor of the plaintiff and thereby rejected the bona fide acquisition of trademarks. Chen Yong, Some Thoughts on Illegal Assignments of Registered Trademarks (非法转让注册商标纠纷的若干思考), available at http://www.zwmscp.com/list.asp?unid=8699. A comparable case Guangzhou Kangbai vs. Shanghai Jinma, in Wang Zhengqing, 184–192. See Taiwan Huamao Co. Ltd. vs. TMB (桦懋国际贸易有限公司诉国家工商行政管理总局商标局商标核准转让纠纷案), Judgment Beijing Intermediate Court No. 1 dated of December 26, 2006 ((2006)一中行初字第267号).

\textsuperscript{116} Provisions of the TMB on Issues relating to Application for Assignment of Trademarks (国家工商行政管理总局商标局关于申请转让商标有关问题的规定), promulgated on August 6, 2009, effective on August 10, 2009.

\textsuperscript{117} Li Xiangzhang, 42.

\textsuperscript{118} Zhu/Wang (2007a), 35–37.

\textsuperscript{119} Dai, 31–32.

\textsuperscript{120} Art. 67 GPCL.
b) Patent

The assignment of a patent or the right to apply for a patent requires a written agreement. The assignment is to be published in the patent gazette, but it becomes effective upon the registration with the SIPO. Therefore, the assignment agreement concerning future or existing patents may only create a contractual obligation, the assignment occurs between the parties and against a third party only upon registration. If the patent owner assigns the patent to more than one person, the same rule regarding trademarks (supra at 76) applies here as well, – the one who first completed the registration acquires the patent. Whether the bona fide acquisition of a patent is possible is rarely discussed in China to date.

c) Copyright

Moral rights on a work are not assignable. Copyright owner may only assign the economic rights to a third party. Written form is required for the assignment contract. An oral agreement is also valid, if the form failure can be cured according to the general rule of contract law. By contrast, registration is only optional, as a result, the assignment usually becomes effective upon signing of the assignment agreement, unless agreed by the parties otherwise. Absent an explicit provision, it can be assumed that the registration will not grant the registered assignee priority over an unregistered assignee. Thus, if the copyright owner assigns the same economic right to two or more persons, the one to whom the right is first assigned acquires the right, regardless whether he registered the assignment. The registration of copyright in China is voluntary, consequently, the copyright register is neither complete nor always accurate, which is the reason why it is impossible to acquire a copyright from an unauthorized person by virtue of good faith. Assignment of economic rights on a future work is possible.

4. Licensing

As the same case with the assignment of IPR, the licensing rules are also different with respect to patents, trademarks and copyrights. Like other jurisdictions, licenses can be divided into three types under Chinese Law: exclusive (排他), sole (独占) and non-exclusive (普通) license.

a) Trademark License

(1) Recordal of License. Art. 40 Trademark law does not explicitly require the written form for trademark licenses. The written form and the subsequent registration with the TMB are essentially voluntary despite the opposite wording of the specific regulation on license recordal. Failure to register the licensing agreement

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121 Art. 10 para. 3 Patent Law.
122 Art. 25 Copyright Law.
123 Art. 22 Judicial Interpretations of the SPC concerning Some Issues on the Application of Law in the Trial of Civil Disputes over Copyright, promulgated on October 12, 2002, effective on October 15, 2002.
125 Zhang Yazhou, 70.
126 Art. 4 Measures for Recordal of Trademark License Contracts, promulgated by the SAIC and entered into force on August 1, 1997.
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with the TMB does not result in invalidity of the agreement, unless the parties agreed so. However, lack of recordal still bears certain drawbacks for the licensee. Art. 19 Judicial Interpretation on Trademark Disputes (hereinafter: art. 19 Trademark Interpretation) provides that “a trademark license is not effective against a bona fide third party (opposabilité aux tiers) without the recordal with the TMB.” The construction of this provision is rather controversial and has caused certain confusion in practice.

(2) Third Party in Good Faith. The first question to be solved in this context is the scope of the bona fide third party in the sense of art. 19 Trademark Interpretation. It is important to note that not anyone who did not know nor had reason to know the existence of said licensing agreement qualifies as a “bona fide third party”. “Bona fide third party” includes only those who acted in good faith and have a direct legal right on the said trademark, i.e. assignee (supra at 75) and pledgee of a trademark and registered licensees. Trademark infringers and normal creditors of the licensor are not included.127 Without recordal the licensee may still sue infringer by showing the license contract to the court to prove its standing.128

(3) Multiple Licensing. In the author’s view, art. 19 Trademark Interpretation is not only applicable to licensing contracts, but has also established a rule, according to which a registered license always has priority over an unregistered license, what the conflicting part of the two licenses is concerned, regardless which license is granted first, provided that the registered licensee was in good faith. If the licensee of the registered license was in bad faith, he is to be treated as a non-registered licensee. That means:

(A) In cases where the registered licensee was in good faith:
(1) If the trademark owner has first granted a non-exclusive license that is registered and then granted an exclusive license that is not registered, the licensee of the second license has to tolerate the existence of the first license, which virtually converts the exclusive license into a non-exclusive license. The second licensee may also register its (now non-exclusive) license.
(2) Should the first registered license be an exclusive one, no second license may effectively be granted. For this reason, the recordal of the second license at a later point of time is also impossible.
(3) In the case that a non-exclusive or exclusive license previously granted has not been registered and an exclusive license later granted was registered, the first license becomes invalid at the point of time of the second license being registered.
(4) In the case where an exclusive license previously granted has not been registered and a non-exclusive license later granted was registered, the first licensee has to tolerate the second registered one.
(B) In cases where the registered licensee was in bad faith, because he knew nor had reason to know the existence of the prior unregistered license:
(1) If the prior license is a non-exclusive one and the second license is an exclusive license, the registered licensee has to tolerate the first license.
(2) If the prior license is an exclusive one, the second license is invalid regardless whether it is exclusive or non-exclusive.

127 Zhang Cheng, 40.
128 Art. 4 no. 1 Interpretation of the SPC on the Application of Law for Stopping the Infringement upon the Right to the Exclusive Use of a Registered Trademark and Preserving Evidence before Filing a Lawsuit (最高人民法院关于诉前停止侵犯注册商标专用权行为和保全证据适用法律问题的解释), promulgated on January 9, 2002, effective on January 22, 2002.
(C) In cases where no license has been registered, a parallel existence of the conflicting licenses is to be assumed. If both licensees now apply for recordal, the TMB has to register the application first submitted, unless the first applicant is acting in bad faith.

By contrast, the majority scholars have developed a different view from a contract law perspective: for instance, in the above mentioned case of (A) (3), the first exclusive license should remain valid, since its recordal is not a precondition for its validity. The second exclusive license is invalid, because A has lost its right to dispose of his trademark after granting the first exclusive license. According to art. 51 Contract Law a contract is invalid if a contract party lacks the right of disposal over the contract item and fails to obtain this right or consent afterwards from the person who has such a right. The recordal of the contract cannot cure this flaw. Furthermore, the first unrecorded licensee is even entitled to cancel the recordal of the second license which may be seen as conducted through deceit or by other unfair means, since only the licensor is entitled to apply for the recordal and he has knowledge of the previously existing license.

To avoid this dilemma, it has been put forward to make the recordal mandatory for exclusive license contract following the example of Japan and Korea.

In summary, in the author’s view, the recordal of a trademark licensing agreement can protect the licensee from losing the license due to multiple licensing to a bona fide third party. Although lack of recordal will not affect licensee’s standing to sue the infringer, the recordal is a prima facie evidence of the licensee’s standing to apply for injunction or bring a civil action. In addition, without recordal it is impossible to remit licensing fee to licensor abroad. Therefore, it is recommended to submit a licensing agreement to the TMB for recordal, as the costs are moderate.

(4) Recordal Procedure. The application for recordal of a licensing contract has to be signed by both parties. If the licensor refuses to cooperate, the licensee may seek a court judgment compelling the licensor to give his consent as part of his obligations under the licensing contract. If the licensor refuses to fulfill the judgment, the licensee can require the TMB to undertake the recordal based on the judgment.

The licensor has to submit a duplicate of the licensing contract and a copy of the trademark registration certificate besides the application for recordal within three months upon conclusion of the license contract. The TMB will undertake a substantive review of the contract clauses and may reject the application if the contract lacks minimum contents which include registration number of the trademark, the goods covered by the license, duration of the license, the way how the trademark signs will be delivered to the licensee, the quality guarantee measures taken by the licensor and the obligation of the licensee to indicate the name and address of the licensor on the goods manufactured by the licensee, or if the licensor failed to demonstrate his authorization to grant license or the licensed trademark is not the same one indicated in the trademark certificate. The duration of the

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129 Chi (2005), 35; Chi (2007), 90–91; Huang/Sun, 34, is in favor of a parallel existence of both licenses; Li Changbao (2005), 42, is of the opinion that the first contract is valid, but impossible to be fulfilled.

130 Art. 16 Measures for Recordal of Trademark License Contracts; He, 45.

131 Yang Yiping, 14.


133 Art. 6 and 11 Measures for Recordal of Trademark License Contracts.
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The recordal of the license may not exceed the validity period of the trademark registration, meaning maximum 10 years. If the license term is longer than 10 years or an unspecified period of time, the parties have to renew the license recordal once the original registration period expires.\footnote{134}{He, 44.}

Upon approval by the TMB, the recordal will be published in the trademark gazette.\footnote{135}{Art. 12 Measures for Recordal of Trademark License Contracts.} Changes of the name of the licensee or the licensor and the early termination of the license are to be reported to the TMB. The licensor may deregister a license by delivering a court judgment or other document certifying the termination of the licensing contract. For instance, if the license contract contains a change of control clause, the recordal of the license may be removed by submitting relevant evidence that such a clause has been triggered, instead of a separate termination notice.\footnote{136}{He, 46.} The registered license contracts are available to attorneys and state organs in the event of a dispute involving the license, although the relevant provision seems to grant anyone such a right of access.\footnote{137}{Art. 17 Measures for Recordal of Trademark License Contracts.}

**b) Patent License and Technology Transfer**

(1) **Domestic Licensing vs. Cross-Border Technology Transfer.** In China domestic licensing agreements and cross-border technology transfer agreements are subject to different sets of rules with the former being governed primarily by Contract Law\footnote{138}{Contract Law (合同法), promulgated by the NPC on March 15, 1999, effective on October 1, 1999.} and the latter additionally by special provisions on technology import and export. Such provisions may be found in the Foreign Trade Law\footnote{139}{Foreign Trade Law, (对外贸易法), promulgated by the SCNPC on April 6, 2004, effective on July 1, 2004.} and Regulations on the Administration of Technology Import and Export.\footnote{140}{Regulations on Administration of Import and Export of Technologies (技术进 出口 管 理 条 例), promulgated by the State Council on December 10, 2001, effective on January 1, 2002.} Cross-border technology transfer is legally defined as transfer of technology from the PRC to abroad or from abroad to the PRC in form of trade, investment or economic or technical cooperation, which includes the assignment of patent, assignment of patent application right, licensing of patent, transfer of know-how, delivery of technology service and other form of technology transfer.\footnote{141}{Art. 2 Regulations on Technology Import and Export Administration.} Such technology transfer may have either registered IPR such as patents, and non-registered IPR such as software, know-how, operating instructions, procedures and formulas as subject matter.

(2) **Formation, Approval and Recordal.** What domestic patent licenses are concerned, the recordal is optional and the legal effect of such recordal is not even mentioned in the relevant provisions.\footnote{142}{According to art. 5 Administrative Measures for Recordal of Patent Licenses (专利实施许可合同备案管理办法), promulgated by the SIPO on December 17, 2001, effective on January 1, 2002, the licensing agreement is to be registered within three months from the effective date of the licensing agreement.} Like trademark licenses, the recordal of the license does not constitute a prerequisite for the application for preliminary measures...
prior to initiating judicial proceeding.\textsuperscript{143} Licensing future patents is possible and if the invention has already been filed for patent, a license granted on such an invention may also be recorded with the SIPO.

Cross-border transfer of technologies is subject to government control in China. To this end, technologies are divided into three categories: prohibited, restricted and free transferable technologies. If a technology falls under the “restricted” category, the parties have to seek prior approval from competent authorities, for exports the Ministry of Science and Technology (MOST) and for imports MOFCOM and MOST respectively. The license contract becomes effective upon approval issued after the content of the contract being substantively scrutinized. “Restricted” and “prohibited” technologies are listed in the Catalogue of Technologies Prohibited and Restricted for Import to China\textsuperscript{144} and Catalogue of Technologies Prohibited and Restricted for Export from China\textsuperscript{145} which are updated from time to time. With respect to free transferable technologies, the recordal is required, though it has only declaratory effect.

\textbf{(3) Warranty and Disclaimers of Warranty.} The issue of warranties in patent license agreements is a delicate question in China. According to art. 349 Contract Law, the licensor has to warrant that (1) he is the rightful owner or duly authorized to license the technology and (2) the technology is complete, effective and suitable for achieving the technical aims. A breach of the first part of the statutory warranties is assumed in cases where the patent is encumbered with a pledge or the patent infringes third-party rights. It is the same in case of the existence of another conflicting license or statutory prior use right with respect to exclusive licenses.\textsuperscript{146}

If the patent does not belong to the licensor or not the licensor alone, the license is deemed void absent the consent of the proper owner or the co-owner according to art. 329 Contract Law. This provision differs from the relevant one regarding know-how license: If a bona fide licensee of know-how who neither knew nor had reason to know the licensor’s lack of right to grant license, he may continue using the license against the payment of licensing fee.\textsuperscript{147}

Absent explicit agreement, the licensor is not liable in the case that the patent is invalidated after the conclusion of the licensing contract and consequently is entitled to retain the licensing fee already paid. This rule is subject to two exceptions: the licensee may recover the licensing fee if the licensor has acted in bad faith or the rejection of such recovery would violate the principle of fairness, for instance, in the event that the entire licensing fee or a major portion of the licensing fee has already been paid although the licensee just began to employ the license.\textsuperscript{148}

The interpretation of the warranty for the technology being complete, effective and suitable for achieving the technical aims is still subject to uncertainty. With

\textsuperscript{143} Art. 4 no. 1 Several Provisions of the SPC on the Application of the Law concerning Injunctions against Patent Infringement before Filing a Lawsuit (最高人民法院关于对诉前停止侵犯专利权行为适用法律问题的若干规定), promulgated on June 7, 2001, effective on July 1, 2001.

\textsuperscript{144} (中国禁止进口限制进口技术目录), promulgated by the MOST/MOFCOM on October 23, 2007, effective on November 23, 2007.

\textsuperscript{145} Catalogue of Technologies Prohibited and Restricted for Import to China (中国禁止出口限制出口技术目录), promulgated by the MOST/MOFCOM on September 16, 2008, effective on November 1, 2008.

\textsuperscript{146} For details Xu Zhongqiang, 54–58.

\textsuperscript{147} Arts. 12, 13 Judicial Interpretation on Technology Contract Disputes.

\textsuperscript{148} Yang/Yang, 9.
respect to domestic licensing contracts, courts in China tend to construe this requirement as fitness of the technology for commercialization.\footnote{Cheng, 527 et seq.}

The statutory warranties may be excluded to the extent that the allocation of rights and obligations stipulated in the contract is not deemed substantially unfair. With respect to cross-border patent licensing contracts, the exclusion of the non-infringement warranty is void. This provision aims to protect Chinese parties who are usually licensees in cross-border technology transfer. For the same reason, the licensor may not validly restrict the amount of indemnification to the licensee in the case that the licensed patent infringes a third party’s right and the licensee has to pay damages to the third party.\footnote{Opposite view: Chi (2002), 36.}

In addition, art. 53 Contract Law prohibits limitations of liability for willful act and gross negligence as well as limitations of liability regarding bodily injury.

\footnote{Zhang Xiaodu, 48 et seq.}

(4) Obligation to Exploit. In licensing practice it is not uncommon to agree upon a duty to exploit the licensed patent. According to art. 346 Contract Law such an obligation to exploit is even mandatorily stipulated. However, the exact scope of this obligation is to be determined based on the principle of good faith. In jurisprudence and literature, a breach of this duty may be assumed in the case where the licensing fee of an exclusive license is dependent on the turnover of the licensee and the licensor has not yet been able to recoup the value of the license.\footnote{Art. 26 Judicial Interpretation on Technology Contract Disputes.}

(5) Obligation to Maintenance of the Patent. The jurisprudence of patent licensing contracts construes maintenance of the validity of the underlying patent as one of the major obligations of the licensor.\footnote{Art. 61 of the Notice of the SPC on the Reprint and Circulation of the Minutes of the National Judicial Working Meeting of IP Trial concerning the Adjudication of Disputes over Technology Contracts (最高人民法院关于印发全国法院知识产权审判工作会议关于审理技术合同纠纷案件若干问题的纪要的通知), promulgated and effective on June 19, 2001.}

Consequently, absent express agreement, the licensor bears the duty to pay the annual maintenance fee and defend the patent in invalidation proceedings. A breach of this duty may give rise to a claim of the other party to damages and termination of the contract.\footnote{Art. 61 of the Notice of the SPC on the Reprint and Circulation of the Minutes of the National Judicial Working Meeting of IP Trial concerning the Adjudication of Disputes over Technology Contracts (最高人民法院关于印发全国法院知识产权审判工作会议关于审理技术合同纠纷案件若干问题的纪要的通知), promulgated and effective on June 19, 2001.}

However, there is no settled case law as to whether the licensor has a statutory obligation to sue an infringer in the case where the underlying patent is infringed. With respect to an exclusive license, considering the exclusivity is infringed if another person uses the patent without the patentee’s consent, it is fair to demand the licensor to cure this flaw even without explicit agreement. On the other hand, an exclusive licensee may directly sue the infringer in his own name without acquiring approval from the licensor, which speaks against the presumption of such a statutory duty. The key question that is not clarified so far is actually about who is to bear the costs for litigations.

As far as a non-exclusive license is concerned, one may either argue against a statutory duty in that a non-exclusive licensee has to reckon with other non-exclusive licenses which an infringement may also constitute, if the toleration of an infringement is viewed as the grant of a free license, or may favor such a statutory duty because a non-exclusive licensee should enjoy a most-favored treatment and the toleration of an infringement is a breach of such obligation.
(6) Anti-monopoly Requirements on Licensing Agreement. The anti-monopoly aspects of licensing agreements have drawn Chinese legislator's attention from very early on. The relevant provisions are stipulated in the Contract Law, Regulations on Administration of Technology Import and Export, and from August 1, 2008 may also be derived from Anti-monopoly Law (supra Chapter 6 at 1). The Chinese legal framework is still rudimentary compared to EU regulations and, in particular, neither makes differentiation between competitors and non-competitors nor provides for self-executing block exemptions. Following restrictions are regarded as unfair restrictive practice and thus void:

- Tying, namely the requirement on the licensee to purchase unnecessary facilities, technologies, raw materials, parts, products, accessories or to acquire unnecessary service.
- Requirement of paying royalties even in the case of expiration or invalidation of the patent.
- Restrictions of improvements: The title on the improvements belongs to the party accomplishing it, unless the parties agreed otherwise which is permissible with respect to domestic licensing agreement and barred with respect to cross-border patent licensing agreement.
- Non-Compete, namely the restriction of licensee's right to acquire similar or competing technologies.
- Non-Attack, namely the restriction of licensee’s right to attack the validity of the patent. With respect to cross-border patent licensing agreement, a non-attack clause is not per se illegal, and is forbidden only in the case that fair competition is restricted.
- Grant-Back under unreasonable conditions, namely the imposition of unequal conditions on the use of improvements.
- Unreasonable restrictions on sourcing of the licensee or the sales price, output, variety of licensee's products, distribution or export channels.

c) Copyright License

Copyright law does not provide for detailed regulations on copyright licensing contracts. In practice, the conclusion of a licensing contract concerning a future work is accepted. As to the form requirement, neither the written form nor the recordal is mandatory except for exclusive publishing contract of books, which has to take the written form. The recordal of copyright license contracts is only possible with respect to computer software. Unlike other jurisdictions, the duration of copyright licensing contracts is not subject to any statutory limitation.

d) General Terms

(1) Choice of Law. Choices of law are allowed in foreign-related licensing contracts. According to art. 126 Contract Law, parties to a foreign-related contract are entirely free to choose the law of any jurisdiction governing their agreement. A
II. Main Issues

A choice of law clause is not enforceable to the extent that mandatory requirements are circumvented. If the parties fail to expressly make a choice of law in their license contract, the law of the jurisdiction with the closest connection to the contract should apply by virtue of art. 126 Contract Law. The closest connection is to be decided based on the venu of the conclusion and fulfillment of the contract and the domicile of the parties. In China, with respect to patent licensing contract, scholars tend to assume that the country of the licensee’s domicile has such closest connection. According to the SAIC, the jurisdiction in which the trademark is registered, is the place with the closest connection for trademark license contracts.158

(2) Right to Sublicense. Lacking clear rules, the issue of licensee’s right to sublicense is subject to contractual agreements. Absent agreement, it is to conclude that even an exclusive licensee of a trademark license is not entitled to grant sublicense by operation of law. Art. 8 Measures of Recordal of Trademark License Contracts suggests that the TMB recognizes and registers sublicenses granted by a licensee only when he is expressly authorized by the trademark owner to do so. In practice so far, if the right owner knows the grant of sublicense and raises no objection, an implied consent is deemed having been given under such circumstances.159

Patent licenses are generally perceived as being built on personal trust between the licensee and the licensor, thus, the licensee of (even an exclusive) patent license is not entitled to grant a sublicense to a third party without prior consent of the licensor either. The only exception to this rule exists with respect to patent: in the case that the licensee does not possess the necessary conditions to make use of the license and thus entrusts a third party to implement the patent, the grant of a sublicense is allowed.160

(3) Assignability of License. The assignability of license is to be distinguished from the assigability of the license contract, which refers to the transfer of the entire contractual position including all rights and obligations under a license contract. Under Chinese law, a license contract may not be unilaterally assigned by the licensee or the licensor to a third party, because the transfer of obligations is subject to the other party’s consent according to art. 84 Contract Law. Although IPR license as a contractual right would have basically been freely transferable without the other party’s approval by virtue of Art. 79 Contract law, the personal nature of the license denies such free assignability.

(4) License in Bankruptcy. Chinese bankruptcy regulations lack elaborate rules on the survival of contracts in bankruptcy proceedings. According to art. 18 Bankruptcy Law (supra Chapter 8 at 75), the bankruptcy administrator may rescind the

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157 Art. 304 Opinions of the SPC on Some Questions regarding the Application of Civil Procedure Law (最高人民法院关于适用《民事诉讼法》若干问题的意见), promulgated and effective on July 14, 1992.
158 Reply of the TMB on the Application of Law concerning Foreign-Related Trademark Licenses (国家工商行政管理局商标局关于涉外商标使用许可合同适用法律问题的复函), issued and effective on November 16, 1989.
160 Art. 27 Judicial Interpretation on Technology Contract Disputes.
licensing contract that is fulfilled by neither party completely in the case of licensor or licensee’s bankruptcy without any restriction. If the bankruptcy administrator chooses to continue the contract, the other party has no right to object and may only request guarantee for the fulfillment of the contract (supra Chapter 8 at 75). Under Chinese law, the ability of the licensee to retain the license through contractual arrangement in the case of bankruptcy of the licensor is also limited.

(5) Termination. Absent an explicit agreement, a license contract may be terminated based on the statutory termination grounds provided in art. 94 Contract Law, which include inter alia (1) impossibility of fulfillment due to force majeure (2) the express or implied showing of refusal to fulfill the principal obligation prior to the performance date (3) delay of fulfillment and non-performance despite the grant of a grace period (4) impossibility of fulfillment due to delay of performance or other breach of contract.

e) Exhaustion and Parallel Import

The amended Patent Law (art. 69) has expressly adopted the international exhaustion of patent rights. As a result, an IPR owner is not entitled to prevent a third party from importing products that are protected by a Chinese patent and have been first marketed outside China with the consent of the right owner, a practice commonly called “parallel import”. The application of the same principle is still subject to debate in China in terms of trademarks and copyrights.161

f) Original Equipment Manufacturer (OEM)

Due to low labor costs, China is one of the most attractive places for outsourcing, which may often involve OEMs. An OEM makes products or components that are marketed by its clients under the client’s trademark. Questions arise in cases where the trademark attached to the product is registered in China and the client is neither the owner nor authorized by the owner to use the registered Chinese trademark. In one case, a Spanish corporation, Cidesport, placed an order for garments bearing the trademark “Nike”, which were to be exported to Spain. Although Cidesport owns “Nike” brand for garments in Spain, the American Nike successfully sought an injunction against the Chinese OEM based on its in China registered trademark “Nike”. In literature some authors expressed certain doubts about the appropriateness of the court judgment and argued that the manufacturing of goods to which a in China registered trademark is affixed does not constitute a trademark infringement even if neither the client nor the OEM has the right to use such trademark, because there is no risk of public confusion in China since the products are exclusively designated for export.162

Art. 52 no. 1 Trademark Law forbids the manufacturing of goods furnished with the relevant trademark without the trademark owner’s consent, regardless whether the products are sold in China or not. Public confusion does not constitute a precondition for trademark infringement either. To this extent, the previously mentioned scholarly opinion clearly contradicts the black letter law. In the absence of an explicit statutory exception, the use of trademarks by OEM is not exempted

161 In favor of parallel imports: Yu Xiang, 112; Oppose it: Huang Hui, 180.
162 Du, 10–11; Hu, 72–73; Zhang Yumin (2008), 72; Opposite views: Jiang Zhipei, 14–16; Research Group of Zhejiang High Court, 69.
from normal liability for trademark infringements. In judicial practice, the subcontractor may excuse himself from compensation if he was unaware of the infringement and was able to produce evidence showing the authorization provided by the client to use the trademark.

However, this case is to be distinguished from the case where the client has a license from the trademark owner to use the trademark, but no right to grant sublicense and he nevertheless engages a subcontractor. In this situation, the relationship between the subcontractor and its client can be viewed as that of a construction contract, not that of a licensing contract, because the main obligation of the OEM is the delivery of products which meet the agreed quality standard to a person who is allowed to use the attached trademark. Therefore, even the subcontractor is not authorized by the trademark owner, his conduct should not be deemed a trademark infringement.

g) Survival of License in the Event of Assignment

It is to note that the assignment of a trademark or a patent does not affect prior granted licenses, which is an equivalent to the doctrine of “previous license protection” (Sukzessionsschutz) in German law, consequently, the assignee assumes the assignor’s entire legal position in the license contract without the licensee’s consent by operation of law. However, the licensor is allowed to abrogate this statutory protection for the licensee by contractual agreement. Although not explicitly mentioned, the same principle should be applicable to copyright licenses as well. According to the pertinent provisions, a non-recorded license may also survive the assignment of the underlying right, which, in terms of trademark, could contradict the provision regarding the legal effect of the recordal.

To illustrate it with an example: Trademark owner A signed an exclusive licensing contract with B and this contract is not recorded; then A assigned the same mark to C, who did not know the existence of the contract between A and B. By virtue of the principle of the “previous license protection”, the validity of the contract between A and B will not be affected by the assignment. However, A is liable to C for the breach of contract by delivering a contract item which is not free from flaws. Applying art. 19 Trademark Interpretation (supra at 85) to the case, at least according to the interpretation developed by the author, it could lead to another result: the contract between A and B is not effective against C, because it is not recorded, as a result of which C is not entitled to assert a claim for breach of contract against A.

In order to protect the interest of the assignee, who has no possibility to find out the existence of such non-registered licenses through public channels, and to ensure the safety of business transactions, it is proposed to make the registration a mandatory requirement for license contract, as mentioned above (supra at 89).
However, the same result could also be achieved if the ambiguity in the construction of the current rule is clarified, so that a licensee is aware of the risk of losing his license if it is not registered, and the assignee may be sure that the IPR he acquires is not encumbered if the register is clean. Compared to the other approach, this approach allows broader party autonomy in licensing practice and deserves in the author’s view endorsement.

122 In connection with the survival of licenses in the event of assignment, a question arises as to whether a creditor, who intends to enforce the debtor’s trademark to realize his claim, may prevent the debtor from either granting license or assigning the IPR to a third party. According to the SPC, it is possible to apply for a seizure of the trademark which may bring about a registry ban.168 This measure is increasingly gaining popularity: in 2007 the TMB conduct seizures on ca. 3000 trademarks.169 If the debtor concludes a license agreement with a third party despite the seizure and then the trademark or patent is sold at an auction to a third party, that third party is not obligated to tolerate the license.170 However, the creditor is well advised to apply for a comprehensive registry ban covering assignment, licensing, serving as collateral, cancellation and change of entry. Should the seizure not cover licensing, it is to assume that the license agreement signed despite the seizure, if properly recorded, is effective against the creditor and the assignee.171

5. Security Interest in Intellectual Property

a) Status Quo

123 Following the international trend of using IP assets in secured transactions, this new security right is attracting greater interest and state support in China as well,172 although currently the practical value of IP collateral is still limited. Statistic shows that from 1996–2007 on an annual average only ca. 60 patent pledge contracts are registered with the SIPO and in most cases, IP assets constitute merely a part (up to 40 %) of the whole security package.173 Commercial banks are still sceptical about this new form of collateral and tend to involve specialized security firms to reduce the risk imminent to the IP security system,174 such as difficulties of assessing the value of the IP assets, instability of the IP rights, risk of invalidation and infringing a

168 Reply of the SPC to Questions concerning Seizure and Enforcement in Registered Trademarks (最高人民法院关于对注册商标专用权进行财产保全和执行等问题的复函), issued and effective on January 9, 2002; Interpretation of the SPC concerning Seizure of Registered Trademarks by People’s Courts (最高人民法院关于人民法院对注册商标权进行财产保全的解释), issued on January 2, 2001, effective on January 21, 2001.
170 Art. 26 para. 1 of the Provisions of the SPC for the People’s Courts to Seal up, Distrain and Freeze Properties in Civil Enforcement (最高人民法院关于人民法院民事执行中查封扣押冻结财产的规定), promulgated on November 4, 2004, effective on January 1 2005, last revision effective on December 31, 2008; Tan, 47.
171 Art. 26 para. 3 of the Provisions of the SPC for the People’s Courts to Seal up, Distrain and Freeze Properties in Civil Enforcement (supra n. 170).
173 Lu Zhiying, 46.
174 Lu Zhiying, 46.
third party’s rights, depreciation of value of a patent or trademark as a result of technology innovation of the competitors or mismanagement of its own business, and limitations in realization of the security right. There are also many open questions as to the practical operation of IP collateral. At current stage, the only security interest which may be created in IP assets such as trademarks, patents and copyrights is pledge.\(^{175}\) However, unregistered trademarks, collective and certificate trademarks and the right to apply for patent are excluded from the eligibility as security. Pledge on future rights is unavailable, because it is impossible to register such collateral with the competent authority before the formation of the relevant IP right, which is the precondition for the creation of the security right. Licenses that are assignable may theoretically also be used to establish collateral.\(^{176}\) Under Chinese law, IP licenses are generally not transferable without the consent of the licensor (\textit{supra} at 112), thus are unsuitable to serve as collateral. The licensor’s right to royalty payment is regarded as a kind of account receivables, which is explicitly set out as eligible for the establishment of collateral (\textit{supra} Chapter 7 at 104).

b) Creation of Security Interest in IP assets

A pledge becomes effective both between the parties and against a third party ("perfected") upon registration of the relevant written pledge contract with the respective authority TMB, SIPO or NCA.\(^{177}\) That means the registration is not only necessary for the perfection, but already for the attachment of the IP asset. If the pledgee is a foreign person, the registration of a pledge on copyrights on computer software has to be approved by the responsible department of the State Council. After the establishment of the pledge, the pledger is not allowed to assign or grant license on the right without the creditor’s permission.\(^{178}\) Therefore, it is impossible to create several pledges on the same right without the prior pledgee’s consent. The assignment or licenses granted on the IP right without the pledgee’s consent is invalid and the pledger is liable for the damage suffered by the third party.\(^{179}\)

The eligibility of an IP right to the creation of a pledge is not affected by licenses previously granted. However, the question of whether the security interest is extended to the proceeds of the collateral (licensing fee) is still disputed. Some endorse such an expansion or propose to put the proceeds and the profit of the pledger derived from the exploitation of the right in an escrow, if the pledger is at the same time the debtor.\(^{180}\)

c) Enforcement of Security Interest in IP assets

In the case that the debtor fails to fulfill his obligation, the secured creditor may enforce the IPR by either selling it by public or private sale or offsetting it with the

\(^{175}\) Art. 223 No. 5 Property Law.

\(^{176}\) \textit{Wang Chun}, 55.

\(^{177}\) Art. 227 para. 1 Property Law; Interim Administrative Measures of of the Registration of Pledge Contract regarding Patent (专利质押合同登记管理暂行办法), issued on September 19, 1996, effective on October 1, 1996; Measures for Registration of Pledge Contract regarding Copyright (著作权质押合同登记办法), issued and effective on September 23, 1996.

\(^{178}\) Art. 80 Security Law; art. 227 para. 2 Property Law.

\(^{179}\) Art. 105 of the "Judicial Interpretation of the SPC on Some Issues regarding the Application of Security Law", promulgated on December 8, 2000, effective on December 13, 2000 (\textit{supra} Chapter 7 at 2).

\(^{180}\) \textit{Wang Chun}, 56.
debt, which will result in an assignment of the underlying IPR. Therefore, the rules on the assignment of trademark, patent and copyright shall apply. If the pledger goes bankrupt, the administrator may get the IPR back against the early repayment of the debt or deliver other acceptable security.\(^{181}\)

6. IPR as Contribution in Kind and R&D Center in China

IPR as contribution in kind is in China a more complicated issue, because the contribution form and the appraisal of IPR are subject to official review and approval if a foreign party is involved. For instance, although an IPR may be contributed to the new company by assignment or licensing and for the right holder the assignment bears the drawback of losing the control over the IP assets irrevocably, the authorities usually demonstrates strong preference for the first form on the ground that the value of a license is hard to determine. The ratio of the IPR in the total registered capital is capped by 70%.\(^ {182}\)

The liability of a shareholder contributing IPR in the case of invalidation of the IPR at a later point of time is basically subject to contractual agreement. Absent agreement, following factors are to be considered in establishing the contributing shareholder’s liability such as, whether the risk of invalidation has been taken into consideration in the value appraisal of the IPR at the time of the incorporation and whether the contributed IPR has been able to generate benefits for the corporation.\(^ {183}\)

By the end of 2004, more than 700 R&D Centers in China have been set up in China, most notably in the greater area of Beijing and Shanghai.\(^ {184}\) The majority of these centers are conducting research in IT, telecommunications, pharmaceuticals, automobiles, chemicals, biotechnology and agriculture with a focus on adaptive innovations.\(^ {185}\) As pointed out in literature, there are three points to be paid attention to.\(^ {186}\) (1) the R&D center has to make sure that the employee assigns his right on potential invention according to the work for hire regulations under Chinese law (infra at 130–133); (2) The assignment of patent rights and the right to apply for patents to foreigners needs to report to the SIPO first; (3) As the assignment of patent rights and the right to apply for patents to foreigners qualify as technology transfer, the relevant regulations may apply as well (supra at 96). Therefore, an approval of the MOFCOM and the MOST has to be acquired if the technology to be assigned falls within the limited category in the relevant catalogue.

7. IPR in Employment Contracts

The issue of work for hire is addressed both in the Patent Law and in the Copyright Law. According to art. 6 no. 1 Patent Law, an invention is deemed work for hire if it is made either to fulfill a work assignment or by substantially using of the material and technological conditions which include capital, equipment, parts and raw materials or know-how of the employer.\(^ {187}\) Absent contractual agreement,

\(^{181}\) Art. 37 para. 1 Bankruptcy Law.

\(^{182}\) Art. 27 para. 3 Company Law (supra Chapter 2 at 26).

\(^{183}\) Cao Jianjun, 37–38.

\(^{184}\) UNCTAD, 140.

\(^{185}\) UNCTAD, 137.

\(^{186}\) Ordish/Adcock, 258 et seq.

an invention for hire is owned by the employer. The employee is entitled to be indicated as the inventor in the patent application and certain remuneration.\textsuperscript{188} Arts. 74–75 Implementation Rules of Patent Law specify the approximate ranges of such remuneration in case that state enterprises and organizations are employers.

The rules on work for hire are more complex with respect to copyright. A work created in the fulfillment of a work assignment is usually a work for hire, the copyright of which is owned by the author. The employer has priority to use it within his business scope. Within two years, the author may not allow anyone to use the work in the same way as the employer without the employer’s permission.\textsuperscript{189} In terms of certain special type of works such as engineering blue prints, product design, maps, computer software, which are developed by using the material and technological conditions and for which the employer bears the responsibility, the employee is only entitled to be recognized as the author and certain remuneration.\textsuperscript{190}

To avoid potential dispute, it is essential for employees and employers to make contractual arrangement regarding work created during the employment relationship.

\section*{III. Relevant Laws & Regulations}

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\textsuperscript{188} Arts. 16, 17 Patent Law.
\textsuperscript{189} Art. 16 para. 1 Copyright Law.
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<td>Notice of the SPC concerning the Jurisdiction over Civil Disputes Involving the Establishment of Well-Known Trademarks (最高人民法院关于涉及驰名商标认定的民事纠纷案件管辖问题的通知)</td>
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Chapter 11. Outbound Investment from China*

I. Overview

1. Recent Development

In recent years, China has accumulated vast foreign exchange reserves, which are currently the world’s largest1, and many Chinese enterprises have become eager to explore overseas markets. As a result, the volume of outbound investments made by Chinese enterprises has increased significantly.2 Regulations relating to outbound investments have followed the same trend, and as a result legal requirements for Chinese entrepreneurs to make overseas investments have been gradually relaxed. In contrast to inbound foreign investment to China, outbound investment from China still lacks a centralized regulatory system. The relevant regulations are complex and rapidly evolving. There are both general legal requirements, which are applicable to most outbound investments, and special regulations and rules, which are relevant depending on the nature of the investment and the type of investors involved.

2. Types of Outbound Investors

It is important to understand the classification of different outbound investors because certain kinds of investors are subject to special review and approval requirements that others are not. Typical outbound investors include:

a) State-Owned Enterprises (SOEs)

Currently in China, SOEs still dominate in certain industries such as electricity, transportation, and telecommunications. In 2008, the aggregate annual revenues of all SOEs (excluding financial enterprises) reached RMB 21,050 billion (USD 3,095 billion).3 SOEs are generally subject to supervision by the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) or its local counterparts. Those SOEs under direct control of the SASAC are referred to as “Central Enterprises”. By the end of 2007, the amount of outbound direct investment made by Central Enterprises accounted for 78.5 percent of China’s outbound direct investment in non-financial industries4.

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1 The authors would like to thank Mr. Zhongda Wu for his contribution to this article. Mr. Wu is currently a legal counsel at Covanta Energy Asia Pacific.

2 In February 2006, China’s foreign exchange reserves finally exceeded those of Japan to become the world’s largest, increasing to USD 853.7 billion. In January 2009, that figure rose to USD 1,946 billion. Available at http://business.timesonline.co.uk/tol/business/markets/china/article698289.ece and http://www.ft.com/cms/s/0/e1a81054-e32b-11dd-a5cf-0000779f2d2.html.

3 According to the latest statistics announced by the Ministry of Commerce, China outbound direct investment in non-financial industries recorded a 64 percent annual growth in 2008, reaching USD 46.2 billion. Available at http://cfen.mof.gov.cn/web/meyw/2009-01/16/content_485663.htm.


The SASAC and its local counterparts represent the state as the shareholder of SOEs in non-financial industries, while the Ministry of Finance (MOF) and Central Huijin Investment Ltd. (HUIJIN) are shareholders of major state-owned financial enterprises at the central level. Therefore, those major state-owned financial enterprises including commercial banks, securities companies, insurance companies, and financial holding companies with the MOF and HUIJIN as their shareholders are all subject to the supervision of the MOF and HUIJIN. Financial enterprises are also supervised by the relevant financial regulators, including the People’s Bank of China (PBOC), the MOF, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC) (each a Financial Regulator and together the Financial Regulators). As a result, a state-owned financial enterprise’s outbound investment also has to be approved by the relevant Financial Regulators.

b) Private Companies and Foreign Invested Enterprises (FIEs)

Private companies and FIEs have both emerged as important players in the Chinese economy and are generally subject to the same regulations on outbound investment.

c) Individuals

With the advent of a growing middle class and increasingly wealthy entrepreneurs in China, individuals have also become a significant source of investment capital, but they face greater restrictions than corporate investors when making outbound investments.

d) Qualified Domestic Institutional Investors (QDIIs)

The QDII scheme was launched in 2006 to allow financial institutions, such as commercial banks, trust companies, securities companies, fund management companies, and insurance institutions, to raise funds from domestic companies and individuals (with the exception of insurance institutions, which can only utilize their own funds) for investing in overseas securities and other investment products.

e) Sovereign Funds

Currently, there are three entities which can be described as Chinese sovereign funds.

(1) China Investment Corporation (CIC). CIC is a wholly state-owned investment company, established in September 2007, in accordance with the Company Law of the People’s Republic of China, and funded by the MOF through the

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5 HUIJIN was established in December 2003, and became a wholly-owned subsidiary of China Investment Corporation in 2007.
6 In theory, private companies should include FIEs. However, due to historical reasons, it is generally accepted that FIEs themselves constitute a separate type of enterprise in China.
7 See the PBOC’s Announcement No. 5 of 2006 (中国人民银行公告[2006]第5号), issued on April 13, 2006 and came into effect on April 13, 2006.
8 Arts. 4–6 of the PBOC’s Announcement No 5 of 2006.
issuing of special treasury bonds worth RMB 1.55 trillion. At present, CIC is managing USD 200 billion and reports directly to the State Council. Approximately USD 110 billion is allocated for outbound investment, and the remaining have been or would be used to assist state-owned financial enterprises.

(2) The State Administration of Foreign Exchange (SAFE). The SAFE, under the supervision of the PBOC, is the governmental authority responsible for managing China’s foreign exchange reserves. The SAFE has traditionally preferred passive reserve management, and therefore has usually invested in low-risk fixed-income products, such as U.S. treasury bonds. In November 2008, China held U.S. treasury bonds worth a total of USD 681.9 billion, and is currently the largest holder of U.S. treasury bonds. However, the SAFE has recently started to make overseas equity investments to diversify its investment portfolio. An example of this came in mid-2008, when it invested USD 2.5 billion in one of TPG Capital’s funds.

(3) The National Council for Social Security Fund (NCSSF). The NCSSF was set up by the State Council in 2000 and is a governmental agency at the ministerial level managing China’s strategic reserves for social security. In accordance with art. 2 of the Interim Measures on the Administration of the Investment of the National Social Security Fund (hereinafter: NSSF Rules), the funding capital of the National Social Security Fund (NSSF) consists of the proceeds garnered from selling state-owned shares, fiscal funds allocated by the state treasury, capital raised by other means as approved by the State Council, and other investment proceeds. By the end of 2008, the NCSSF managed assets worth around RMB 562 billion (USD 82 billion). Furthermore, due to the Interim Rules on the Administration of Outbound Investment by the National Social Security Fund (hereinafter: NSSF Outbound Investment Rules) that came into effect in May 2006, the NCSSF is authorized to make outbound investments that are capped at 20 percent of the NSSF’s total assets. In accordance with art. 4 of the NSSF Outbound Investment Rules, outbound investment made by the NCSSF is under the direct supervision of the MOF, the SAFE, and the Ministry of Human Resources and Social Security. Both the CSRC and the CBRC are also authorized to monitor the NCSSF’s outbound investment in accordance with their respective jurisdictions.

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10 Which were used to acquire USD 200 billion of China’s foreign exchange reserves and formed the foundation of CIC’s registered equity capital. Available at http://www.china-inv.cn/cicen/about_cic/aboutcic_overview.html (visited on February 17, 2009).
11 The CIC’s first outbound investment was to acquire a USD 3 billion stake in the Blackstone Group in June 2007.
13 Available at http://www.treas.gov/tic/mfh.txt.
15 (全国社会保障基金投资管理暂行办法), issued on December 13, 2001, by the MOF and the Ministry of Labour and Social Security and came into effect on December 13, 2001.
17 (全国社会保障基金境外投资管理暂行规定), issued on May 1, 2006 and came into effect on May 1, 2006.
II. Main Issues

According to the relevant administrative interpretation, an outbound direct investment refers to a Chinese domestic investor investing abroad by way of establishing a new wholly-owned, joint venture, or co-operative enterprise overseas, or by acquiring an existing overseas enterprise (including purchasing shares or voting rights) with the intention to own, control, or manage that enterprise or project. Before an outbound direct investment is actually made by a Chinese domestic investor, the investor is obligated to go through a number of general governmental reviews and approval processes. Some investors may also abide by the applicable industry’s specific rules.

In contrast with outbound direct investments, investments in overseas securities or other financial products usually focus on short-term profits and do not provide a domestic investor with direct control over the relevant overseas company. The securities investments also require frequent trading, which makes it impractical to follow a lengthy approval process similar to the one applicable to outbound direct investments. As a result, under Chinese law, outbound securities investments are not generally treated as a type of outbound direct investments and are instead subject to a different approval regime.

1. General Approval Requirements for Outbound Direct Investment

a) State Council/National Development and Reform Commission (NDRC) Rules

In July 2004, the State Council issued its Decision on Reforming the Investment System (hereinafter: Circular 20 [2004]), which sets out new principles encouraging all types of investment activities and relaxing the relevant regulatory requirements. Art. 13 of the Index of Investment Projects Requiring Governmental Approval specifies that the NDRC, China’s central planning authority, is responsible for approving certain outbound investment transactions. In October 2004, the NDRC issued the Interim Administrative Measures on Approval of Outbound Investment Projects (hereinafter: NDRC Rules), which together with Circular 20 [2004], replaced the previous regulations relating to outbound investment made by the State Council and the NDRC (the National Development and Planning Commission at that time) in 1991.

According to the NDRC Rules, a domestic investor must first submit the approval application to a provincial branch of the NDRC for its proposed overseas investment. The NDRC’s provincial branch is authorized to approve the outbound investment if the estimated amount of investment is less than (i) USD 30 million for natural resource projects and (ii) USD 10 million for other projects.
a natural resource project or (ii) USD 10 million for other projects.\textsuperscript{24} However, if the estimated amount of investment is greater than or equal to (i) USD 30 million for a natural resource project or (ii) USD 10 million for other projects, after the preliminary review, the relevant provincial branch of the NDRC should submit the application to the NDRC for review and approval.\textsuperscript{25} In the event that the estimated investment amount reaches or exceeds (i) USD 200 million for a natural resource project or (ii) USD 50 million for other projects, the NDRC then has to submit the application to the State Council to obtain final approval.\textsuperscript{26} If a domestic investor plans to invest in Taiwan or a country which does not have diplomatic relations with China, then, regardless of the estimated investment amount, that domestic investor must first obtain approval from the NDRC or the State Council for the proposed investment.

Nevertheless, the NDRC has granted the Central Enterprises exemption from obtaining approval if the estimated outbound investment amount is less than (i) USD 30 million for a natural resource project or (ii) USD 10 million for other projects.\textsuperscript{27} For other outbound investment, a Central Enterprise is entitled to apply directly to the NDRC.\textsuperscript{28}

It is worth noting that the conditions for obtaining approval from the NDRC/State Council are set out in art. 18 of the NDRC Rules, which include: (i) whether the domestic investor has suitable investing capacity and (ii) whether the proposed investment is in compliance with (A) the relevant Chinese law and industry policy, public policy, and applicable international law; (B) the requirement that the project contributes to sustainable development, exploration of strategic resources, exporting Chinese products, technologies, or labors, or importing foreign advanced technologies, and (C) the relevant regulations on foreign exchange.

In addition, art. 20 of the NDRC Rules prohibits a domestic investor from signing any legally binding documents relating to its outbound investment until NDRC/State Council approval has been granted. In June 2009, the NDRC issued a new Circular on Relevant Issues in Improving Outbound Investment Project Administration\textsuperscript{29} (hereinafter: NDRC 2009 Circular). The NDRC 2009 Circular establishes additional rules for outbound acquisition projects and outbound bidding projects that need to be approved by the NDRC or the State Council in accordance with the Index of Investment Projects Requiring Governmental Approval\textsuperscript{30}. Before starting any material work abroad for those outbound investing projects\textsuperscript{31}, the relevant domestic investor is required to first submit a project information report to the NDRC.\textsuperscript{32} If the content of the information report complies with the requirements set out in art. 4 of the NDRC 2009 Circular, the NDRC will issue a confirmation letter which is a

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\textsuperscript{24} Art. 5 of the NDRC Rules.
\textsuperscript{25} Arts. 4 and 8 of the NDRC Rules.
\textsuperscript{26} Art. 4 of the NDRC Rules.
\textsuperscript{27} Art. 6 of the NDRC Rules.
\textsuperscript{28} Art. 8 of the NDRC Rules.
\textsuperscript{29} (国家发展改革委关于完善境外投资项目管理有关问题的通知), issued on June 8, 2009 and came into effect on June 8, 2009.
\textsuperscript{30} The Index of Investment Projects Requiring Governmental Approval has not been revised since it was issued in 2004.
\textsuperscript{31} Which exceeds (i) USD 30 million for natural resources projects; or (ii) USD 10 million for other projects.
\textsuperscript{32} Art. 3 of the NDRC 2009 Circular.
requisite document for applying for NDRC/State Council approval thereafter.\textsuperscript{33} If a proposed investment project involves material negative factors, the NDRC will add a risk reminder in the confirmation letter and that project will be subject to a more stringent review by the NDRC at the later project approval stage.\textsuperscript{34} The requirement to submit a preliminary information report illustrates a desire by the State Council and the NDRC to become more involved in those strategic outbound investments from an early stage in an effort to improve the potential success rate.

b) Ministry of Commerce (MOFCOM) Rules

In March 2009, the MOFCOM issued the Administrative Provisions on Outbound Investment\textsuperscript{35} (MOFCOM Rules). The MOFCOM Rules replaced (i) the Provisions on the Approval of Investing in or Establishing Overseas Enterprises, issued by the MOFCOM in October 2004\textsuperscript{36} (hereinafter: 2004 MOFCOM Rules), and (ii) the Provisions on the Approval of Investing in or Establishing Enterprises in Hong Kong and Macao by Domestic Enterprises in August 2004\textsuperscript{37} (MOFCOM HK/Macao Rules, together with the 2004 MOFCOM Rules as the Old MOFCOM Rules). The MOFCOM Rules set out detailed provisions on how to seek approval from the MOFCOM for a proposed outbound investment. If a domestic enterprise plans to invest abroad, obtaining approval from either the MOFCOM or its provincial counterpart is a prerequisite for completing the relevant foreign exchange registration and customs clearance procedures.

Generally, a domestic investor should first apply to a provincial branch of the MOFCOM for review and approval of its proposed outbound investment.\textsuperscript{38} The MOFCOM’s provincial branches are authorized by the MOFCOM to approve a non-Central Enterprise’s outbound investment of less than USD 100 million but greater than or equal to USD 10 million, made in the energy or mineral resources industries, or involving domestic investment.\textsuperscript{39} MOFCOM’s approval is required for an outbound investment if (i) it takes place in a country that does not have diplomatic relations with China or has a special investment environment\textsuperscript{40}; (ii) it reaches USD 100 million or above; (iii) it relates to the interests of multiple countries or areas; or (iv) it is for establishing an overseas special purpose vehicle (SPV) for the purpose of overseas listing\textsuperscript{41}\textsuperscript{42}. Other types of outbound investments made by Central Enterprises and non-Central Enterprises still need to be approved by the MOFCOM and the MOFCOM’s provincial branches respectively, but they are subject to less strict documentation requirements and a shorter time frame for approval.\textsuperscript{43}

\textsuperscript{33} Arts. 6 and 9 of the NDRC 2009 Circular.
\textsuperscript{34} Art. 7 of the NDRC 2009 Circular.
\textsuperscript{35} (境外投资管理办法), issued on March 16, 2009, and came into effect on May 1, 2009.
\textsuperscript{36} (关于境外投资开办企业核准事项的规定), issued on October 1, 2004 and came into effect on October 1, 2004.
\textsuperscript{37} (关于内地企业赴香港澳门特别行政区投资开办企业核准事项的规定), issued on August 31, 2004 and came into effect on August 31, 2004.
\textsuperscript{38} A Central Enterprise should apply directly to the MOFCOM (Art. 13 of the MOFCOM Rules).
\textsuperscript{39} Art. 7 of the MOFCOM Rules.
\textsuperscript{40} The list of those countries is decided jointed by the MOFCOM and the Ministry of Foreign Affairs.
\textsuperscript{41} Art. 37 of the MOFCOM Rules.
\textsuperscript{42} Art. 6 of the MOFCOM Rules.
\textsuperscript{43} Arts. 8 and 16 of the MOFCOM Rules.
Art. 9 of the MOFCOM Rules expressly prohibits the MOFCOM or its provincial branches from permitting an outbound investment transaction if it (i) impairs state sovereignty, security, or public interests; (ii) violates any domestic law or regulation; (iii) is likely to cause the Chinese government to breach any international treaty; or (iv) involves any technology or products restricted from export.

In addition, the MOFCOM, together with the SAFE, requires preliminary reports to be submitted by domestic investors on their proposed acquisition of assets or controlling equity interests in overseas enterprises. That report is also a required document for the relevant MOFCOM approval.

However, outbound investments in the financial industry do not need to be approved by the MOFCOM. Art. 2 of the MOFCOM Rules clearly states that the MOFCOM Rules only pertain to the establishment or acquisition of an overseas non-financial enterprise.

Compared with the Old MOFCOM Rules, the MOFCOM Rules illustrate both (i) an expanded scope of outbound investments that specifically require MOFCOM approval, rather than approval from its provincial branches, evidencing caution in response to the recent market turmoil caused by the global financial crisis; and (ii) more efficient approval procedures for small outbound investments (less than USD 10 million), which, on the other hand, shows a desire to reduce government involvement in small investment projects.

c) SAFE Rules

The SAFE is the governmental authority responsible for supervising and monitoring foreign exchange transactions. Although at present, China still imposes strict foreign exchange controls on capital account transactions, foreign exchange rules on outbound investment have been gradually relaxed over the past 20 years. The revised Regulations on Foreign Exchange Administration promulgated by the State Council in August 2008 (hereinafter: FX Regulation), abolished most foreign exchange-related approval requirements for outbound investment which previously needed to be obtained from the SAFE in accordance with the Rules for Foreign Exchange Administration on Outbound Investment (hereinafter: Old FX Rules).

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44 See the Preliminary Reporting Rules for Overseas Mergers and Acquisitions by Enterprises (企业境外并购事项前期报告制度), issued by the MOFCOM and the SAFE on March 31, 2005, and came into effect on May 1, 2005.

45 Art. 12 of the MOFCOM Rules.

46 Which, together with the current account, are the two primary components of a country’s balance of payments. Outbound investment is one type of capital account transaction.


48 Which was approved by the State Council on February 5, 1989, and issued by the SAFE on March 6, 1989 (境外投资外汇管理办法). The Old FX Rules initially established the main requirements and procedures for governmental approval with respect to foreign exchange controls on outbound investment. Under the Old FX Rules, a domestic investor is obliged to (i) provide information on the target country for the SAFE to use in its evaluation of relevant investment risks; (ii) submit relevant documentation on funding sources for the SAFE to review and issue its opinion thereof; (iii) before remitting any foreign currency funds overseas, deposit 5 percent of the total proposed investment amount in a bank designated by the SAFE as a guaranteed deposit which will not be released until the profits transferred back to China resulting from the outbound investment have reached the original investment amount; (iv) register the outbound investment and complete relevant procedures for remitting foreign currency out of China with the SAFE; and (v) file annual
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Under art. 17 of the FX Regulation, a domestic investor is currently only required to register its outbound investment with the SAFE, rather than obtain prior approval from the SAFE. Instead of granting its separate approval\(^59\), the SAFE now only needs to check whether other required governmental approval has been obtained before allowing an outbound investment to be registered with the SAFE.

In July 2009, the SAFE issued the Provisions on the Administration of Foreign Exchange for Outbound Direct Investment by Domestic Entities\(^50\) (hereinafter: 2009 FX Provisions). The 2009 FX Provisions consolidated various previous rules issued by the SAFE on outbound direct investment. Under the 2009 FX Provisions, a domestic entity is allowed to invest abroad by using its own foreign exchange funds, domestic foreign currency loans, RMB-purchased foreign exchange funds, tangible or intangible assets, or other kinds of SAFE-permitted foreign exchange funding sources.\(^51\) Compared with the previous legislation, the 2009 FX Provisions have further broadened the permitted funding sources for outbound investment.\(^52\)

The 2009 FX Provisions have also confirmed that, in general, an outbound direct investment, which is carried out by a domestic entity, only needs to register with the SAFE instead of obtaining the SAFE’s prior approval, and the SAFE’s local branches are responsible for the relevant registration and the issuance of the foreign exchange registration certificate for outbound direct investment.\(^53\)

However, a domestic investor is still obliged to apply to the SAFE if it plans to provide a guarantee for the benefit of an overseas enterprise.\(^54\) If a domestic enterprise wants to lend money to its overseas subsidiary, the aggregate lending quota also needs to be approved by the SAFE, although the relevant criteria and procedures have been relaxed by the SAFE’s Circular on Relevant Issues in Foreign Exchange Administration of Domestic Enterprises Granting Loans Overseas.\(^55\)

\(^{50}\) (境内机构境外直接投资外汇管理规定), issued on July 13, 2009, and came into effect on August 1, 2009.

\(^{51}\) Art. 4 of the 2009 FX Provisions.

\(^{52}\) In accordance with the Supplemental Notice to the Old FX Rules (关于境外投资外汇管理办法的补充通知) issued by the SAFE in September 1995, a domestic investor is required to use its own funding to invest abroad, and is only entitled to apply for a special purpose loan if the target industry or country is one encouraged by the Chinese government. In June 2006, the SAFE issued the Circular to Adjust Certain Foreign Exchange Administrative Policies on Outbound Investment (国家外汇管理局关于调整部分境外投资外汇管理政策的通知) to permit a domestic investor to use RMB-purchased funds or foreign currency loans borrowed from domestic banks to invest in an overseas enterprise.

\(^{53}\) Arts. 6 and 7 of the 2009 FX Provisions.

\(^{54}\) Art. 19 of the FX Regulation.

\(^{55}\) (国家外汇管理局关于境内企业境外放款外汇管理有关问题的通知), issued on June 9, 2009, and came into effect on August 1, 2009.
addition, the SAFE’s approval is required if certain preliminary expenses for outbound investment need to be remitted out of China before the relevant governmental approvals have been obtained.\textsuperscript{56}

In practice, the SAFE plays a key role in the governmental approval process for an outbound investment. The SAFE is acting like a “goalkeeper” and will not permit a domestic investor to remit foreign currency funds out of China for direct investment purposes until all the required governmental approval, mainly from the NDRC and the MOFCOM, has been granted for such a transaction. In addition, the FX Regulation authorizes the SAFE to monitor and check whether the foreign currency funds relating to a capital account transaction have indeed been used for the specific purpose that the relevant governmental authority approved of.\textsuperscript{57} The 2009 FX Provisions require a domestic investor to notify and register with the relevant SAFE’s local branch upon the occurrence of certain material events relating to the outbound investment.\textsuperscript{58} This implies that the SAFE will also focus on post-investment supervision.

d) SASAC Rules

In accordance with arts. 2 and 6 of the Interim Regulations on the Supervision and Administration of State-owned Assets of Enterprises\textsuperscript{59} promulgated by the State Council in 2003, the SASAC and its local counterparts are acting as investors on behalf of the state and are responsible for supervising the operation of non-financial SOEs. The SASAC’s authority is reinforced by art. 11 of the Law on the State-owned Assets of Enterprises\textsuperscript{60} enacted in 2008. As a result, any outbound investment made by a non-financial SOE needs to be approved by either the SASAC or its local counterparts.

In 2006, the SASAC issued the Interim Measures for the Supervision and Administration of Investment by Central Enterprises\textsuperscript{61} (hereinafter: SASAC Interim Measures), which set out the relevant supervisory procedures for domestic investment made by Central Enterprises. Art. 16 of the SASAC Interim Measures provides that the SASAC will make a separate set of rules for managing outbound investment. However, the Circular on Further Standardizing the Administration of Investment by Central Enterprises\textsuperscript{62} issued by the SASAC in 2007 includes outbound investment as a type of significant investment that requires the relevant Central Enterprise to first serve advance notice to and obtain approval from the SASAC\textsuperscript{63}. This means that, before separate regulations regarding outbound investment by Central Enterprises are issued by the SASAC, a Central Enterprise which plans to invest abroad has to follow the same reporting procedures applicable to a domestic investment. Under the SASAC Interim Measures, a Central Enterprise is obligated to first report a significant

\textsuperscript{56} Art. 14 of the 2009 FX Provisions.
\textsuperscript{57} Art. 23 of the FX Regulation.
\textsuperscript{58} Arts. 9, 10 and 19 of the 2009 FX Provisions.
\textsuperscript{59} (企业国有资产监督管理暂行条例), issued on May 13, 2003, and came into effect on May 27, 2003.
\textsuperscript{60} (企业国有资产法), issued on October 28, 2008, and came into effect on May 1, 2009.
\textsuperscript{61} (中央企业投资监督管理暂行办法), issued on June 28, 2006, and came into effect on July 1, 2006.
\textsuperscript{62} (关于进一步规范中央企业投资管理的通知), issued on June 27, 2007 and came into effect on June 27, 2007.
\textsuperscript{63} Art. 1 of the Circular.
investment to the SASAC, and then the SASAC will, within 20 working days, notify the applicant in writing of its decision to either approve, veto, or warn of the problems involved and request revision.64

e) Rules on Outbound Direct Investment by Individuals

Whether or not a PRC individual is allowed to make outbound direct investment is currently a controversial issue in China. The NDRC Rules permit an individual to apply for approval regarding his/her proposed outbound investment in accordance with the same provisions that are applicable to investors with “legal person” status.65 Furthermore, art. 16 of the Rules of the Administration of Individual Foreign Exchange66 issued by the PBOC in 2006 states that a domestic individual whose foreign direct investment is in compliance with relevant regulations is entitled to purchase foreign currency or remit self-owned foreign currency funds abroad upon the SAFE’s approval and should register such overseas investment with the SAFE. Similarly, art. 16 of the FX Regulation requires an individual to register with the SAFE after the relevant government approval has been obtained for its outbound direct investment. Nevertheless, the MOFCOM Rules do not include individuals in its definition of an investor. Based on the above rules, it may appear that, in theory, a domestic individual is entitled to carry out outbound direct investment, and there is no need to obtain approval from the MOFCOM. In reality, however, the answer to this question is far more complicated. In practice, the most common type of outbound direct investment carried out by PRC individuals is a “round-trip investment” (infra Chapter 12 at 1 et seqq.). In accordance with the Circular of Relevant Issues on Fund Raising and Round-Trip Investment by Domestic Residents through Overseas SPVs (hereinafter: Circular 75 [2005])67, the use of an offshore SPV in a round-trip investment is allowed, provided that foreign exchange registrations have been made with the SAFE’s local branch. Furthermore, under art. 42 of the Regulations on the Acquisition of Domestic Enterprise by Foreign Investors68 which was jointly issued in 2006 by six government ministries, the setting up of an offshore SPV69 requires advance approval from the MOFCOM, which is a prerequisite to register with the SAFE’s local branch. Nevertheless, there have not been any reported new approvals granted by the MOFCOM on round-trip investment since 2006.

2. Industry-Specific Rules for Outbound Direct Investment

As discussed above, financial enterprises are subject to the supervision of the relevant Financial Regulators. However, among the Financial Regulators, only the

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64 Art. 8 of the Implementation Rules of the SASAC Interim Measures (中央企业投资监督管理暂行办法实施细则), issued on July 18, 2006 and came into effect on July 18, 2006.
65 Art. 26 of the NDRC Rules.
66 (个人外汇管理办法), issued on November 30, 2006, and came into effect on February 1, 2007.
67 国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知, issued on October 21, 2005, and came into effect on November 1, 2005.
68 (关于外国投资者并购境内企业的规定), issued on August 8, 2006, and came into effect on September 8, 2006; revised on June 22, 2009.
69 A SPV is defined in art. 39 of the regulations as a foreign company directly or indirectly controlled by a Chinese domestic company or national person for the purposes of getting listed on an offshore exchange of its rights and interests of a domestic company actually owned by the same company or natural person.
CIRC has officially issued the following detailed rules in this respect: (i) the Measures for the Administration of the Establishment of Overseas Insurance Institutions by Insurance Companies\textsuperscript{70}, which outline the CIRC’s approval procedures for a domestic insurance company to either set up its branch or a new insurance company abroad, or acquire more than 20 percent (or a controlling equity interest) of an overseas insurance institution; and (ii) the Measures for the Administration of the Investment in Overseas Insurance Enterprises by Non-insurance Institutions\textsuperscript{71}, which set out how a domestic non-insurance company obtains approval from the CIRC for setting up an overseas insurance institution, or the acquisition of more than 20 percent of equity interest of an existing overseas insurance institution. Under both Measures, the CIRC is required to notify the relevant domestic investor of its decisions in writing within 20 days of receiving the application.\textsuperscript{72} Other Financial Regulators approve the relevant outbound direct investment in accordance with their internal policies and procedures.

Chinese financial enterprises have illustrated great interest in investing overseas but have also incurred enormous losses in 2007–2008 due to the global financial crisis. For example, in October 2008, Ping An Insurance (Group) Company forecasted a book-value loss of USD 2.3 billion for its investment in Fortis, a Belgian-Dutch financial services company.\textsuperscript{73} In recognition of the risks involved in overseas acquisition of financial institutions and the difficulties in regulating such activities by separate Financial Regulators, a draft of the Measures for the Administration of Overseas Acquisitions by Financial Institutions was jointly prepared by the MOF, the PBOC, the CBRC, the CSRC, and the CIRC, and was circulated among the Financial Regulators and major domestic financial institutions for comments in mid-2008.\textsuperscript{74} Under the draft rules, with respect to a significant acquisition proposed by a state-owned financial institution (which includes an acquisition of over 20 percent equity interest in the target overseas financial institution or an estimated investment amount exceeding USD 1 billion), the relevant Financial Regulator should consult with the MOF before granting approval. In the event that more than one domestic financial institution intends to bid for the same overseas financial institution, the Financial Regulators are authorized to coordinate and either allow only one domestic investor to bid or permit a few domestic bidders to jointly bid for that target. In addition, the relevant Financial Regulators may reject an outbound investment if the target foreign institution incurs significant losses during the approval procedure.

In some other industries, the domestic investors may also be required to comply with certain industry-specific rules on outbound investment (if any). For example, the additional procedures required for a domestic entity that is directly supervised by the Ministry of Construction to establish or invest in an overseas enterprise are set out by the Interim Measures for the Administration of Overseas Enterprises under the

\textsuperscript{70} (保险公司设立境外保险类机构管理办法), issued on March 13, 2006, and came into effect on September 1, 2006.

\textsuperscript{71} (非保险机构投资境外保险类企业管理办法), issued on March 13, 2006, and came into effect on September 1, 2006.

\textsuperscript{72} See art. 14 of the Measures for Insurance Companies and art. 6 of the Measures for Non-insurance Companies.

\textsuperscript{73} Available at http://english.peopledaily.com.cn/90001/90776/90884/6517348.html.

\textsuperscript{74} Available at http://business.sohu.com/20080721/n258279083.shtml.
Supervision of the Ministry of Construction and the Detailed Rules Issued by the Ministry of Construction on Establishing Overseas Enterprises or Institutions.

### 3. Outbound Securities Investment

Under current Chinese law, outbound securities investments are generally not treated as a type of outbound direct investment and are subject to a different approval procedure. For example, art. 17 of the FX Regulation requires a domestic investor to register with the SAFE both its (i) outbound direct investment or (ii) issuing or trading of overseas securities.

In response to the growing needs of domestic investors to have diversified investment options, the “Qualified Domestic Institutional Investors” investment scheme was introduced by the PBOC in 2006. It is a scheme under which authorized domestic institutional investors are entitled to invest in overseas capital markets. In addition, a pilot plan for PRC individuals to directly trade securities on the Hong Kong Stock Exchange was announced by the SAFE in 2007, but the pilot plan has not yet been implemented because of opposing opinions from other Financial Regulators.

**a) Rules on QDIIs**

The QDII scheme allows qualified domestic commercial banks and securities companies to raise funds from domestic investors (including both institutional investors and individuals) for investing in overseas financial products as approved by the relevant Financial Regulators and within the permitted foreign exchange quota pre-set by the SAFE. However, qualified insurance companies are only allowed to invest their own funds in overseas capital markets.

In April 2006, the PBOC issued the PBOC Announcement No. 5 of 2006 which marked the commencement of the QDII scheme. Various Financial Regulators have thereafter issued detailed rules applicable to different financial enterprises for conducting QDII transactions. In April 2006, the CBRC, together with the PBOC and the SAFE, promulgated the Interim Rules on Administration of Commercial Banks Providing Overseas Wealth Management Services, which were later supplemented by a CBRC Notice in June 2006 that set out detailed approval procedures and another CBRC Notice in May 2007 that expanded the permitted scope of invest-

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75 (建设部所属境外企业管理暂行办法), issued on June 28, 1996 and came into effect on June 28, 1996.
76 (建设部关于在境外设立企业机构审批细则), issued on June 28, 1996 and came into effect on June 28, 1996.
77 In practice, it is possible to carry out an outbound direct investment through a securities investment, such as acquiring a public company’s listed shares on a stock exchange with the intention to eventually take over that company. In that case, the domestic investor is required to follow the relevant review and approval procedures for an outbound direct investment.
78 中国人民银行公告[2006]第5号), issued on April 13, 2006 and came into effect on April 13, 2006.
79 (商业银行开办代客境外理财业务管理暂行办法), issued on April 17, 2006 and came into effect on April 17, 2006.
ment to include publicly traded shares. In March 2007, the CBRC and the SAFE also issued the Interim Rules for the Administration of Trust Companies’ Overseas Financial Management Business. In June 2007, the CIRC, together with the PBOC and the SAFE, issued the Interim Rules on Outbound Investment Using Insurance Funds which replaced the previous interim rules and set out the relevant criteria and application procedures for a domestic insurance company to seek approval from the CIRC and the SAFE for outbound investment. The CSRC also issued the Trial Rules for the Administration of Overseas Securities Investment by Qualified Domestic Institutional Investors in June 2007, which are applicable to domestic securities companies and fund management companies.

The above rules established: (i) the qualifications required for conducting QDII transactions; (ii) the application procedure for seeking approval from the relevant Financial Regulator and the SAFE; (iii) the selection criteria for an investment advisor who is responsible for managing overseas investment and a custodian who supervises that investment; (iv) the permitted scope of investment and restrictions on investment allocation; (v) the restrictions on the design and sale of QDII products; and (vi) a risk control mechanism.

According to figures announced by the SAFE, by the end of 2007, 50 QDIIs had been approved and the total permitted foreign exchange investment quota was approximately USD 64.5 billion. However, due to the global financial crisis, many QDIIs reported huge losses, and since then the development of QDIIs has significantly slowed down.

b) Rules on Outbound Securities Investment by Individuals

Regarding an individual’s direct investment in overseas securities, in August 2007 the SAFE approved its Tianjin branch’s application to commence a pilot plan that would allow PRC individuals to directly invest in securities traded on the Hong Kong Stock Exchange. This plan was intended to provide domestic residents with direct access to securities investment in Hong Kong and was called by the public the “Direct Train to Hong Kong Stock”. However, owing to debates among govern-
mental officials and scholars on its potential impact on China’s domestic capital market, this plan was suspended shortly after the SAFE’s announcement.

At present, in accordance with Chinese law, there is only one expressly permitted way that a domestic individual can invest directly in overseas securities – by means of a global employee program. Under art. 18 of the Detailed Implementation Measures for the Rules of the Administration of Individual Foreign Exchange issued by the SAFE in 2007, if a domestic individual participates in an employee stock plan or stock option plan of a company listed overseas and its employer has already obtained the relevant approval from the SAFE for the stock plan, then that individual will be allowed to invest in the employee stock plan. Nevertheless, because of the stringent requirements, the number of domestic individuals eligible to invest in an employee stock plan is very limited.

Art. 23 of the Detailed Implementation Measures for the Rules of the Administration of Individual Foreign Exchange also states that the SAFE will issue separate detailed rules to gradually permit domestic individuals to borrow foreign debts, provide overseas lending or guarantees, and directly participate in the overseas commodity futures market and other financial derivative trading.

In addition, it is generally acknowledged that a domestic individual is entitled to carry out overseas securities investments indirectly through the QDII scheme, i.e., by purchasing financial products from the QDIIs.

III. Concluding Remarks

In response to China’s economic boom and Chinese entrepreneurs’ growing ambition to enter into the global market, the Chinese government and its legislators have established a comprehensive and complicated legal framework to both facilitate and supervise outbound investment by domestic investors.

The requirements of seeking prior approval from different governmental authorities will inevitably delay the process of an outbound investment, and in many circumstances such delay may result in losing a valuable business opportunity. In this respect, it is vital to simplify or abolish as many approval requirements as possible. On the other hand, China has not yet liberalized capital account transactions. The enormous losses suffered by Chinese companies in some recent overseas acquisitions also have caused the Chinese government to reconsider its strategy. The usual approach adopted by the Chinese government when dealing with a new and difficult issue is often described as a policy of “groping for stones to cross the river.” This means that a gradual reforming process is preferred over a sudden change in order to avoid potential destructive effects. It is clear that the Chinese government is using this same approach in the development of the legal procedures for outbound investment. The abolishment of the SAFE’s pre-approval requirement for an outbound direct investment and the delegation of approval authority to local governments to speed up the approval process illustrate the government’s intention.

90 (个人外汇管理办法实施细则), issued on January 5, 2007, and came into effect on February 1, 2007.


92 This phrase was referred to frequently by Deng Xiaoping, a prominent Chinese politician and reformer.
to encourage Chinese domestic enterprises to invest abroad. Nevertheless, the suspension of the pilot plan to allow domestic individuals to directly purchase overseas securities and the restriction on “round-trip investment” have shown the government’s caution regarding potential capital flight.

It will be interesting to observe further development of relevant legislation, particularly with respect to the following questions: (i) when the consolidated Measures for Administration of Overseas Acquisitions by Financial Institutions will be enacted and whether there are any further amendments; (ii) when the “Direct Train to Hong Kong Stock” pilot plan will be implemented; and (iii) whether there will be a piece of comprehensive legislation governing all types of outbound investments issued in future.

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Chapter 12. Offshore Investment Vehicles

I. Overview

Offshore investment vehicles have been widely used by both Chinese and international investors, particularly venture capital and private equity funds. For international investors, structuring investments in China through offshore vehicles offers the following benefits: (i) shares of offshore vehicles are generally freely transferable, while sale of an onshore FIE’s interest is subject to the Chinese government’s review or approvals (supra Chapter 3 at 33); (ii) offshore vehicles are usually incorporated in jurisdictions which have preferential tax regimes and transparent legal systems; and (iii) there are less political and commercial risks involved in setting up the holding company at the offshore SPV level rather than at the onshore Chinese operating company level. For Chinese investors, offshore vehicles primarily serve two purposes: firstly, to acquire the FIE-status and associated preferential treatments for the domestic operating company whose shares are held by an offshore vehicle (supra Chapter 3 at 45); and secondly, to circumvent strict domestic regulations on raising funds from capital markets, in particular, to seek overseas listing. Such investments made by Chinese investors are commonly called “round-trip investments”, as the “foreign” capital, which is invested in a Chinese domestic company through an offshore vehicle, originates from China. In other words, the capital makes a trip from China back to China. As such, the economic substance of the establishment of an offshore SPV in roundtrip investment is not a real outbound investment as discussed in Chapter 11 of this book.

In the case where an offshore vehicle in a round-trip investment scheme lists its shares on an overseas stock exchange, the listing is referred to as “red-chip listing”. The whole red-chip listing procedure is a special form of round-trip investments and accomplished by the following steps: (i) firstly, shareholders of a PRC domestic company establish an offshore SPV; (ii) then the SPV purchases either the majority equity interest or the key assets of the abovementioned domestic company; (iii) after this inbound acquisition is completed, the SPV may apply to be listed on an overseas stock exchange (normally in HK or New York) or engage in other kinds of offshore financing. Since the SPV is incorporated outside of mainland China but has its main profit-generating business located in mainland China, the stocks of that SPV are commonly called “red-chip stocks”.

Since it is usually quite easy to set up an SPV in a tax-friendly jurisdiction such as the Cayman Islands, Bermuda, or the British Virgin Islands, many successful Chinese entrepreneurs have set up offshore SPVs and then used these SPVs to apply for overseas listing without obtaining any approval from the Chinese government.\(^1\)

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\(^1\) In accordance with the China Securities Regulatory Commission (CSRC)’s Notice on Overseas Shares Issuing and Public Listing of Overseas Companies Which Have Domestic Interest (中国证券监督管理委员会关于涉及境内权益的境外公司在境外发行股票和上市有关问题的通知), which was issued on June 9, 2000 and entered into force on June 9, 2000, a “no comment letter”
The situation was further complicated by the issuance of the Regulations on Fund Raising and Round-Trip Investment by Domestic Residents through Offshore SPVs (《境内居民个人境外投资登记及外资并购外汇登记有关问题的通知》), which was issued by SAFE on October 21, 2005 and entered into force on the same day. This Circular was repealed by Circular 75 on November 1, 2005.

5 The Circular of Relevant Issues on Registration of Overseas Investment by Domestic Residents and Foreign Exchange Registration for Merger and Acquisition by Foreign Investors (关于境内居民个人境外投资登记及外资并购外汇登记有关问题的通知), which was issued by SAFE on April 8, 2005 and entered into force on the same day. This Circular was appealed by Circular 75 on November 1, 2005.

6 The Circular of Relevant Issues on Fund Raising and Round-Trip Investment by Domestic Residents through Offshore SPVs (关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知), which was issued by SAFE on October 21, 2005 and entered into force on November 1, 2005.

7 The Circular on the Distribution of Operational Guidelines for Circular of Relevant Issues on Fund Raising and Round-Trip Investment by Domestic Residents through Offshore SPVs (关于印发《国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知》操作规程的通知), which was issued by SAFE on May 29, 2007 and entered into force on June 22, 2009. Through the amendments, the relevant rules of merger control in the M&A Regulations have been replaced by those set forth in Antimonopoly Law (反垄断法) and the State Council’s Provisions on Thresholds for Prior Notification of Concentrations of Undertakings (国务院关于经营者集中申报标准的规定).

8 (关于外国投资者并购境内企业的规定), jointly promulgated by the Ministry of Commerce (MOFCOM), the State-Owned Assets Supervision and Administration Commission (SASAC), CSRC, the State Tax Administration (SAT), the State Administration for Industry and Commerce (SAIC) and SAFE on August 8, 2006 and entered into force on September 8, 2006. The M&A Regulations was later amended by MOFCOM Decree No. 6 [2009] (商务部令第6号), which was issued and entered into force on June 22, 2009. Through the amendments, the relevant rules of merger control in the M&A Regulations have been replaced by those set forth in Antimonopoly Law (反垄断法) and the State Council’s Provisions on Thresholds for Prior Notification of Concentrations of Undertakings (国务院关于经营者集中申报标准的规定).
an offshore SPV required advance approval from the MOFCOM and this MOFCOM’s approval became one prerequisite for SAFE registration. This was the first time that MOFCOM’s approval was required for red-chip listings. Although M&A Regulations have provided a process for legally setting up offshore SPVs for round-trip investment, there has not been any reported new approval granted by the MOFCOM on round-trip investments since 2006.

II. Main Issues

1. General Procedure

There are broadly two types of round-trip investments: one is to use an offshore SPV to acquire the domestic operating company for a red-chip listing and the other is to complete the inbound investment purely for the purpose of obtaining the preferential treatment for an FIE.

All round-trip investments are subject to general rules set out in M&A Regulations with respect to a normal inbound acquisition (supra Chapter 5 at 26 et seqq.)\(^8\). However, in relation to special rules regarding SPVs provided in Section 3 of Chapter 4 of M&A Regulations, art. 39 M&A Regulations seems to suggest that only those SPVs which are set up for seeking red-chip listing are covered by those special rules. In practice, based on a number of consultations with the MOFCOM, many MOFCOM officials hold the view that since the legislative intent of those SPV rules in M&A Regulations is to control the inbound investment which is actually made by domestic investors, in theory, the same rules should be applicable to all kinds of round-trip investments regardless of whether the purpose of the investment is for a red-chip listing.

Set forth below is a flow chart showing the procedure to obtain necessary government approval and registration for a red-chip listing together with a brief analysis of each step in accordance with M&A Regulations:

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\(^7\) The approval here refers to the approval of MOFCOM rather than the approval of a local branch of MOFCOM.

\(^8\) Art. 2 M&A Regulations.
Step 1: MOFCOM’s approval of overseas investment by a domestic company

At this stage, the domestic company must apply to the MOFCOM for a “certificate of approval for overseas investment by a Chinese enterprise” (Overseas Investment COA) to set up an offshore SPV.9

Step 2: SAFE registration for overseas investment by a domestic company

After having obtained the Overseas Investment COA, the founder or controlling person of that offshore SPV needs to apply to the local branch of SAFE for overseas investment foreign exchange registration.10

Step 3: MOFCOM principle approval of equity swap

Following Step 2 and the set-up of the offshore SPV is the principle approval of the MOFCOM for an equity swap between the domestic company and the SPV. Although when the equity swap takes place the relevant SPV is not an overseas listed company yet, the general domestic equity swap procedures are still applicable to that equity swap (supra Chapter 5 at 60–70). In addition, arts. 44 and 45 M&A Regulations have imposed certain extra document submission requirements on the

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9 Art. 42 para. 1 M&A Regulations.
10 Art. 42 para. 2 M&A Regulations.
II. Main Issues

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The additional documents include (i) the Overseas Investment COA and other government approval document or certificate to set up the offshore SPV; (ii) the SPV’s foreign exchange registration document; (iii) the SPV’s business licenses, articles of association and the actual controlling person’s identity certificate; (iv) the business plan for the SPV’s overseas listing; (v) the merger consultant’s valuation report of the potential issuing price of the SPV’s shares in a future IPO. If the listing company is another overseas entity which holds the SPV’s equity interest, the domestic target company is also required to submit (A) that entity’s business licenses and articles of association; and (B) the trading and valuation arrangement between that entity and the SPV in relation to the domestic target company’s equity interest.

11 The additional documents include (i) the Overseas Investment COA and other government approval document or certificate to set up the offshore SPV; (ii) the SPV’s foreign exchange registration document; (iii) the SPV’s business licenses, articles of association and the actual controlling person’s identity certificate; (iv) the business plan for the SPV’s overseas listing; (v) the merger consultant’s valuation report of the potential issuing price of the SPV’s shares in a future IPO. If the listing company is another overseas entity which holds the SPV’s equity interest, the domestic target company is also required to submit (A) that entity’s business licenses and articles of association; and (B) the trading and valuation arrangement between that entity and the SPV in relation to the domestic target company’s equity interest.

12 Arts. 32, 44 and 45 M&A Regulations. It is not entirely clear from M&A Regulations whether other types of inbound acquisition, such as cash injection, should also be approved by MOFCOM.

13 Art. 45 para. 1 M&A Regulations.

14 As defined in Step 6 (infra at 14).

15 Art. 45 para. 2 M&A Regulations.

16 Art. 46 M&A Regulations.

17 Ibid.

18 The total value of the SPV’s shares issued in the IPO should be no less than the value of the domestic company’s equity interest as assessed by the relevant asset appraisal institutions. Art. 43 M&A Regulations.
COA). However, it is important to note that if the domestic company fails to report to the MOFCOM within the 30 day time limit, the previously issued Remarked Foreign Investment COA automatically becomes invalid and the domestic company’s previous equity structure before the occurrence of the SPV’s inbound acquisition will be restored.

**Step 8: Non-Remarked FIE registration with the SAIC and SAFE**

Within 30 days of receipt of the Non-Remarked Foreign Investment COA, the domestic company shall apply to the SAIC and SAFE or their authorized local branches for issuance of a non-remarked FIE business license and a non-remarked FIE foreign exchange certificate, respectively. In addition, art. 48 M&A Regulations requires all proceeds received from the overseas IPO to be remitted to the PRC in accordance with the repatriation plan previously submitted to SAFE and the relevant foreign exchange control regulations.

**Step 9: Restoration of a domestic company’s equity structure (if the overseas listing of the SPV does not take place within 1 year)**

Under art. 49 M&A Regulations, if a domestic company fails to obtain its Non-Remarked Foreign Investment COA within 1 year from the issuance date of the Remarked FIE Business License, its Remarked Foreign Investment COA will automatically cease to be valid, and the domestic company’s previous equity structure will be restored. However, art. 47 M&A Regulations only allows the domestic company to apply to the MOFCOM for the Non-Remarked Foreign Investment COA after the overseas listing is completed. As a result, in the event that the overseas IPO does not occur within 1 year of the issuance of the Remarked FIE Business License, it is inevitable that the former shareholding structure of the domestic company will be restored. In addition, under art. 49 even if the overseas IPO is completed within 1 year but the domestic company fails to obtain the Non-Remarked Foreign Investment COA within the 1 year time limit, the domestic company’s equity structure will also be restored.

2. **SPV**

The offshore SPV plays a key role in round-trip investment. In particular, in case of a red-chip listing, the SPV serves as a two-way channel for economic value transfer between the domestic company and international investors.

**a) SPV in General**

According to art. 2 Circular 75, a domestic resident is required to apply to SAFE’s local branch for overseas investment foreign exchange registration before the offshore SPV is established. However, an SPV is defined differently by Circular 75, Circular 106, M&A Regulations, and the “Administrative Provisions on Outbound Investment” (MOFCOM Rules). According to Circular 75, an SPV means “an offshore enterprise which is directly established or indirectly controlled by PRC...
domestic legal persons or individuals for the purpose of overseas equity financing (including convertible debt financing) by injecting into the SPV the economic value of the assets or equity interests that the domestic residents hold in domestic enterprises.”24 That definition has then been further clarified by Circular 106 as “an overseas enterprise which is directly established or indirectly controlled by domestic residents for the purpose of financing (including public offering, private placement or bridge loans) and by the operation of which the cross-border capital injection or equity swap trading is carried out.”25

Under art. 39 M&A Regulations, an SPV refers to “an overseas enterprise directly or indirectly controlled by a Chinese domestic company or natural person for the purpose of overseas listing of its rights and interests of a domestic company that is actually controlled by the same company or natural person.” In MOFCOM Rules, the SPV is defined in a similar way as in M&A Regulations.26 As a result, it is not entirely clear whether any of the MOFCOM’s approval set out in art. 42 M&A Regulations or art. 6 MOFCOM Rules is applicable to the set-up of an SPV for non listing purpose.

b) SPV for Red-Chip Listing

While an SPV is defined in Circular 75 and Circular 106 as an instrument for financing which includes not only overseas listing but also convertible debt, private placement, bridge loans and so on, it is narrowly defined in M&A Regulations and MOFCOM Rules solely as an instrument for overseas listing.27 Therefore, an SPV for the purpose of red-chip listing could be called as “Narrowly-Defined SPV”. It seems clear under M&A Regulations that if in a red-chip listing the domestic target company is going to be acquired by the offshore SPV by means of an equity swap (Round-trip Investment via Equity Swap), the MOFCOM’s approval should be a prerequisite for the set-up of the offshore SPV.28 However, where the SPV purchases the equity interests of the domestic target company by means of cash payment instead of equity swap (Round-trip Investment via Cash Payment), there is no express provision under M&A Regulations stating that the SPV can only be established after the MOFCOM’s approval has been obtained. In contrast, under MOFCOM Rules, there is no provision that links the MOFCOM’s approval only with the SPV which intends to acquire the domestic company by equity swap, and therefore it is clear that the MOFCOM’s approval required under MOFCOM Rules should be also applicable to Round-trip Investment via Cash Payment. In practice, based on consultations with MOFCOM officials, the common view seems to be that M&A Regulations should in theory apply to Round-trip Investment via Cash Payment as well.

24 Art. 1 Circular 75.
25 Table 1 Circular 106.
26 Under art. 37 MOFCOM Rules, an SPV refers to “an overseas enterprise directly or indirectly controlled by domestic enterprises for the purpose of overseas listing of its rights and interests of a domestic company that is actually controlled by the same enterprise”.
27 Art. 39 M&A Regulations and art. 37 MOFCOM Rules.
28 Art. 42 of Section 3 of Chapter 4 of M&A Regulations requires MOFCOM’s approval for the establishment of SPVs by domestic company and in accordance with art. 39 para. 2 of M&A Regulations, Section 3 of Chapter 4 (special provisions about SPVs) is applicable to Red-Chip Listing via Equity Swap.
3. Inbound Acquisition

a) FIE Status

22 The Chinese government used to grant FIEs super-national treatment in the PRC to attract foreign investment. For example, the then corporate tax rates applicable to FIEs were significantly lower than the normal tax rates for domestic companies. Although the latest Law on Enterprise Income Tax\(^\text{29}\) has unified the enterprise income tax rates for domestic enterprises and FIEs to 25 percent,\(^\text{30}\) according to art. 57 of Law on Enterprise Income Tax, FIEs which were established before the promulgation of the law have a five-year buffer period (i.e. until January 1, 2013) before their income tax rates are raised to 25 percent. In addition, at present, in order to keep attracting foreign investment, PRC local governments in practice still try to grant certain kinds of super-national treatment to FIEs. As a result, the FIE status currently remains appealing to some foreign investors.

23 In accordance with art. 9 M&A Regulations, in general, domestic companies acquired under a round-trip investment scheme are not entitled to FIEs treatments unless either (i) the overseas SPV subscribes to any increased capital of the domestic company or contributes additional capital to the enterprise newly formed after the inbound acquisition, and (ii) the amount of the increased/additional capital exceeds 25 percent of the domestic enterprise’s registered capital; or apart from the actual PRC controlling party of the domestic company that has made a round-trip investment, the other foreign investors contribute more than 25 percent of the domestic company’s registered capital. Those conditions demonstrate the Chinese government’s desire to differentiate an FIE established for round-trip investment from an FIE established for traditional foreign direct investment (FDI).\(^\text{31}\) As a result, if the above conditions are not satisfied, a domestic company acquired under a round-trip investment arrangement will not qualify for any super-national treatment granted to FIEs and that domestic company is often referred to as a “quasi-FIE”.\(^\text{32}\)

b) Disclosure Rules

24 To supervise the inbound acquisition of the domestic operating company and ascertain whether the transaction is carried out between related overseas and domestic entities, apart from the general requirement to obtain MOFCOM’s approval for the acquisition,\(^\text{33}\) M&A Regulations also require the transaction parties to clarify whether there is any connection between them.\(^\text{34}\) If both parties are controlled by the same person, the transaction parties are obliged to disclose to the MOFCOM the identity of the real controlling person, explain the purpose of the acquisition and whether the valuation result complies with the fair market value.\(^\text{35}\)

\(^{29}\) (企业所得税法), which was promulgated by the National People’s Congress on March 16, 2007 and entered into force on January 1, 2008.

\(^{30}\) Art. 4 Law on Enterprise Income Tax.

\(^{31}\) According to art. 9 M&A Regulations, a normal foreign invested enterprise is entitled to enjoy the FIE treatment provided that the foreign equity investment in that domestic enterprise accounts for more than 25 percent of the total registered capital of that enterprise.

\(^{32}\) In that case, a note “foreign investment proportion is less than 25 percent” needs to be added to the relevant government approval or registration documents. Art. 9 M&A Regulations.

\(^{33}\) Art. 11 M&A Regulations.

\(^{34}\) Art. 15 M&A Regulations.

\(^{35}\) Ibid.
The transaction parties are also prohibited from circumventing such disclosure obligations by means of trusteeship, custodianship or other arrangements. In practice, shareholders of the domestic operating company sometimes try to use the following two approaches to avoid the abovementioned disclosure requirements. The first method is to incorporate other offshore SPVs as subsidiaries of the holding SPV which is directly established by the domestic company’s shareholders and then use the terminal subsidiary SPV to acquire the domestic company’s equity interest. As a result, the MOFCOM, SAIC, SAFE and other regulatory authorities may not be able to track down the ultimate affiliation between the founder of the holding SPV and the terminal subsidiary SPV. The second approach is to change the nationality of the domestic company’s shareholders and then try to convert the domestic company to an FIE.

Although those two approaches have been used and are still being used in round-trip investments, M&A Regulations, Circular 75 and Circular 106 have express provisions prohibiting such behavior. Under the first approach, failure to disclose the real connection between the domestic company and the overseas SPV is a clear violation of law. With respect to the second approach, art. 55 M&A Regulations has specified that a domestic company does not change its status just because its shareholder has changed his nationality; and Circular 106 has further clarified that in round-trip investment even if a domestic shareholder of the domestic company has changed his Chinese nationality, he is still treated as a domestic resident and subject to the relevant obligations.

4. CSRC Approval

Among all the required governmental approval and registration for round-trip investments, the CSRC’s approval in relation to the overseas listing is the most controversial one.

a) Scope of Authority

Arts. 40 and 45 M&A Regulations state that the overseas listing of an SPV is subject to CSRC’s approval; and art. 39, Section 3 of Chapter 4 of M&A Regulations clearly provides that the whole Section 3 (including arts. 40 and 45) is applicable to Red-Chip Listing via Equity Swap. However, it is not entirely clear under M&A Regulations whether the wording of “overseas listing” also includes Red-Chip Listing via Cash Payment. Since arts. 40 and 45 are set out in Chapter 4 of M&A Regulations and the title of Chapter 4 is “acquisition of a domestic company by a foreign investor through payment of equity interests”, it seems reasonable to suggest that arts. 40 and 45 do not apply to Red-Chip Listing via Cash Payment.

Nevertheless, in accordance with art. 238 of the Securities Law, CSRC’s approval is a prerequisite for all overseas listing activities carried out directly or indirectly by domestic enterprises. On September 21, 2006, the CSRC issued

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36 Ibid.
37 Art. 11 M&A Regulations.
38 Arts. 2(i), 3(i) and 12 Circular 75.
39 Tables 4 and 5 Circular 106.
40 Table 1 Circular 106.
41 (中华人民共和国证券法), which was issued on December 29, 1998, entered into force on July 1, 1999, and was amended by the SCNPs on October 27, 2005.

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“Guidelines Relating to the Review and Approval of PRC Enterprises’ Indirect Overseas Issuance or Listing of Securities” (CSRC Guidelines), which not only summarizes the relevant legislations that grant the CSRC the authority to approve all indirect overseas listing activities but also sets out 26 documents which need to be submitted to the CSRC for obtaining such approval. By issuing the CSRC Guidelines, the CSRC officially reemphasized its authority in this area.

b) Nature of Approval

The issue of whether the CSRC approval of an offshore SPV’s overseas listing is a substantive review has not yet been officially clarified. The amount of documents that need to be provided for CSRC’s review under the CSRS Guidelines seems to imply CSRC’s intention to carry out a substantive review. However, there are also some good arguments that CSRC’s approval does not need to be a substantive one: (i) the regulatory authority of an overseas stock market will determine by itself whether the relevant offshore SPV meets the applicable listing requirements; (ii) under art. 40 M&A Regulations, the red-chip stocks can only be listed in a country or region which has a well developed legal and regulatory system; and (iii) the relevant overseas regulatory authority should have already established cooperative relationship with the CSRC as required by art. 40 M&A Regulations.

III. Concluding Remarks

Since the issuance of M&A Regulations in 2006, the PRC round-trip investment & red-chip listing legal regime has experienced significant changes. The Chinese government wants to encourage domestic companies to seek onshore listing, and therefore has set out various restrictions on offshore red-chip listing. Although the equity swap as a type of transaction is expressly recognized by M&A Regulations, the attached stringent conditions and tight timetable make it less appealing to both domestic and international investors in round-trip investments.

During the same period, international investors have continued to seek appropriate investment structures to benefit from China’s outstanding economic performance; and domestic companies and individuals have also tried to obtain access to international capital markets. Under this yet to mature legal regime, the further development and clarification of the relevant government procedures and rules in relation to an offshore SPV being used as an offshore investment vehicle remains a key legal issue for all stakeholders.

### IV. Relevant Laws & Regulations

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