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China: Trends and Developments

Steven Yu and Evan Sun
Global Law Office

Trends and Developments

Contributed by:
Steven Yu and Evan Sun
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Authors

Steven Yu is a partner of Global Law Office based in Shanghai. With 20 years of experience in leading international and Chinese firms, Steven has focused his practice on private equity/venture capital, M&A, fund formation and capital market transactions across a wide spectrum of industries, including the manufacturing, auto, chemical, clean energy, logistics, TMT, fintech, consumer staple, pharmaceutical/healthcare, commercial property, entertainment and sports, and education sectors. Steven has long been recognised as a leading or highly ranked/recommended lawyer in the private equity/venture capital areas by Chambers, among several other legal directories.

Evan Sun is a partner of Global Law Office based in Shanghai with extensive experience in foreign direct investment, general corporate law, M&A, private equity fund formation and investment, and capital markets. Evan has advised leading VC/private equity institutions such as Morningside Ventures, Trustbridge Partners, CICC Capital, Tencent, ByteDance, SenseTime and Qiming Venture Partners, as well as many start-up companies, on legal issues in their daily operations, financings, and employee stock ownership plan design and implementation. Evan's practice covers a variety of industries, including life sciences, renewable energy, automobiles, education, food, chemicals, manufacturing, finance, telecommunications, the internet, culture and entertainment.

Global Law Office

35 & 36/F Shanghai One ICC
No. 999 Middle Huai Hai Road
Xuhui District Shanghai
200031
China

Tel: +86 21 2310 8288
Fax: +86 21 2310 8299
Email: global@glo.com.cn
Web: www.glo.com.cn

China's New Company Law is Significantly Impacting Private Equity Transactions Involving Chinese Companies

The Standing Committee of the PRC National People's Congress adopted the amended Company Law of the People's Republic of China ("New Company Law") on 29 December 2023. The New Company Law, which came into force on 1 July 2024, has substantive changes relative to the previous version (the "2018 Company Law", last amended in 2018) in areas such as capital contribution, equity transfer, capital reduction and corporate governance rules. These changes are having, and will continue to have, a significant impact on private equity transactions involving Chinese companies.

Capital Contribution

One of the major changes introduced by the New Company Law is a strengthening of the capital contribution obligations of shareholders, with a view to protecting the company and its creditors from the abusive use of the previous capital contribution scheme.

Time limit for capital contribution

The PRC Company Law (2028 Revision) ("2018 Company Law") had no statutory timeline for shareholders to pay their committed capital contributions to a company in full. As a result, many companies were established with a large amount of registered capital, while the actual paid-in capital was minimal or nil throughout the lifespan of these companies. In contrast, the New Company Law now requires shareholders of a limited liability company to make capital contributions in full within five years from the establishment of the company.

Grace period

Companies established before 1 July 2024 have a three-year transition period to adjust their capital contribution schedules to meet the new timeline requirement. This grace period is granted by the Provisions of the State Council on the Implementation of the Company Law of the People's Republic of China on the Registration of Registered Capital Management System, promogulated on 1 July 2024.

Consequences of failure to pay on time

Shareholders of a company can agree on a more detailed capital contribution schedule in the articles of association ("AoA") of the company, provided that the time schedule is within the statutory time limit for capital contribution. If a shareholder fails to pay its subscribed capital pursuant to the New Company Law or the time schedule set out in the AoA, then the shareholder in default may be required to:

- indemnify the company against losses caused by such failure; and
- forfeit its right to the portion of the unpaid equity interest upon board resolution after the lapse of a grace period provided by the company.

If the forfeited equity has not been transferred or cancelled within six months from the forfeiture, then other shareholders of the company will be required to make up the outstanding capital contribution in full in proportion to their respective capital contributions to the company. If a shareholder fails to pay its subscribed capital within the statutory time limit, then the shareholder in violation may also be subject to a fine by the government authority of up to CNY200,000, and in more serious cases, a fine of up to 15% of the unpaid amount.

Joint and several liability for outstanding capital

The New Company Law provides that if a founding shareholder of a company (ie, a shareholder upon the establishment of the company) fails to pay the capital contribution according to the AoA of the company, or where the founding shareholder makes its capital contribution in kind and the actual value of the in-kind capital contribution is significantly lower than the capital contribution subscribed to by this founding shareholder, then the other founding shareholders of the company are jointly and severally liable for the outstanding capital contribution.

In light of the above, founders of start-up companies and early-stage investors should carefully consider and determine the amount of registered capital of a company to ensure that all shareholders are able to fulfil their capital commitments to the company on time. In addition, parties to a private equity investment transaction may also wish to clarify in the transaction documents their rights and obligations when a forfeiture of equity interest or a default in capital contribution by a shareholder occurs. For example, the parties may wish to set out in the transaction documents provisions relating to investor's right of first refusal to purchase the forfeited equity, and the defaulting shareholder's liability to indemnify the other shareholders if the latter are forced to make up the underpaid capital as required by law.

Equity Transfer

The New Company Law has several key changes that may affect equity transfer transactions, as follows.

Buyer and seller's joint and several liability

Under the 2018 Company Law, because there was no statutory time limit for capital contributions, unpaid equity was generally not a serious concern to the parties when negotiating an equity transfer transaction. The New Company Law, however, provides that if a shareholder of a limited liability company delays a capital contribution in violation of the AoA and transfers its unpaid equity interest after its capital contribution obligation falls due, then the buyer and the seller are jointly and severally liable for the outstanding capital. The buyer can be exempted from this liability only if it is able to prove that it was not aware, and should not have been aware, that the transferred equity was unpaid when the transaction occurred. As such, the buyer in an equity transfer transaction should perform a thorough investigation of the capital contribution status of the target company, in addition to requiring the seller to make full representations and warranties with respect to the same. If the equity to be transferred is unpaid, the buyer may require the seller to either complete the capital contribution before the transfer or deduct the unpaid amount from the equity transfer price.

Simplified process

Under the 2018 Company Law, the transfer of equity interest by a shareholder to a non-shareholder third party is subject to the approval of a majority of the other shareholders of the company and the other shareholders' right of first refusal. The New Company Law no longer has this requirement for approval. Under the New Company Law, the seller is required to serve a written notice on the other shareholders of the key terms and conditions of the intended transfer, such as the quantity, price, payment method and period of time for the transfer, and the other shareholders have the right of first refusal to purchase the equity under the same terms and conditions. Shareholders who fail to respond within 30 days from the receipt of the written notice will lose their right of first refusal.

Capital Reduction

Redemption right is a key preference right of investors in private equity transactions, and capital reduction is one of the major ways for companies to fulfil their redemption obligations.

The 2018 Company Law was silent on whether a company may reduce its capital disproportionately amongst its shareholders. In contrast, the New Company Law provides that a company should reduce the capital contribution in proportion to the capital contributions made by its shareholders, except when:

- provided by law;
- agreed upon by all the shareholders of a limited liability company; or
- provided by the AoA of a joint stock company.

As such, although the New Company Law confirms that capital reductions can be made disproportionately amongst its shareholders, such reduction is subject to the following restrictions/requirements:

- for a limited liability company, the redemption right of investors needs to be reflected in a shareholders' agreement entered into by all shareholders of the company;
- and for a joint stock company, investors should make sure that redemption rights are set out in the AoA of the company.

Corporate Governance

Corporate governance structure

The New Company Law makes some significant adjustments to the structure and powers of a company's corporate governance bodies.

I) Company without supervisor

The 2018 Company Law required a company to have a board of supervisors, or one to two supervisors, to supervise the financials of the company and the performance of duties of the directors and senior management. The New Company Law provides that, if unanimously approved by its shareholders, a limited liability company of small scale or with a small number of shareholders may operate without a supervisor.

II) Audit committee

The New Company Law provides that a company may set up an audit committee under the board of directors to function in lieu of a supervisor or the board of supervisors. The audit committee introduced by the New Company Law may vest supervisory powers in the directors. As such, an investor may wish to have to right to nominate a member of the audit committee in its portfolio companies.

III) Employee director

The 2018 Company Law only required state-owned companies to have an employee director on the board of directors. In contrast, the New Company Law provides that any company with more than 300 employees needs to have employee representation on its board of directors unless the company already has an employee representative(s) as a supervisor. The employee director must be elected by the company's employees through employees' meetings or another democratic process.

IV) Legal representative

The 2018 Company Law provided that the chairperson of the board of directors, executive director or general manager of a company may act as the company's legal representative. In contrast, the New Company Law provides that a director or general manager who carries out the businesses of the company may act as the legal representative. The 2018 Company Law was silent on the duties and powers of the legal representative. The New Company Law provides that a company bears the legal consequences of its legal representative acting on the company's behalf, and that the company may request compensation from its legal representative for losses incurred due to acts of the legal representative in violation of laws or the AoA of the company. In light of the importance of the position of legal representative, investors and founders of companies should carefully consider and determine the candidate for this position and design a proper governance structure to strike a balance between:

- allowing a legal representative to perform his or her duties and exercise his or her powers; and
- reducing risk to the company relating to any unauthorised acts of the legal representative.

Duties and liabilities of directors, supervisors and senior management

In comparison with the 2018 Company Law, the New Company Law further elaborates on the fiduciary duty of directors, supervisors and senior managers.

I) Fiduciary duties

The New Company Law provides that directors, supervisors and senior management personnel:

- owe fiduciary duties to the company;
- should take measures to avoid conflicts between their own interests and those of the company; and
- should not use their powers to seek improper benefits.

The New Company Law further requires directors to report to the board of directors or to a shareholders' meeting, and to obtain a resolution in accordance with the company's AoA, before they can directly or indirectly engage in businesses similar to that of the company.

II) Duties of diligence

The New Company Law also provides that directors, supervisors and senior management personnel owe duties of diligence to the company, and must exercise the reasonable care normally expected of management personnel in the best interests of the company when performing their duties.

In light of these changes, directors, supervisors and senior management personnel nominated by investors or founders need to familiarise themselves with these enhanced requirements regarding their duties and obligations. In addition to performing their duties in a faithful and diligent manner as legally required, investors and their nominated directors, supervisors and senior management personnel may wish to take other measures to protect themselves from potential liabilities, such as:

- requiring the company to purchase director and officer liability insurance, entering into a director indemnification agreement with the company; and
- keeping full records of board meeting minutes and other communication materials as evidence for his/her due performance of duties and obligations.

China's New Regulations for Overseas Listing Filing – the First Anniversary Review and Outlook

It has been over one year since 31 March 2023, when the China Securities Regulatory Commission (CSRC) promulgated the Trial Measures for the Administration of Overseas Securities Offering and Listing of Domestic Enterprises (the "Trial Measures"), and five supporting rules for regulatory guidance (collectively, the "New Filing Regulations") came into effect. Based on market observations, the New Filing Regulations have reshaped China's regulatory landscape with respect to the offering and listing of overseas securities by domestic enterprises in the short-to-medium run and are expected to have a profound influence on China's private equity and VC market.

Overview of implementation practice of the New Filing Regulations

According to information publicised by the CSRC, during the period from 31 March 2023 to 30 June 2024, 272 applicants (excluding those issuers who applied for "full circulation" of their existing non-tradable shares in overseas capital markets) were known to submit filing applications to the CSRC. Among these applicants, 158 have obtained the filing notice from the CSRC, accounting for nearly 60% of the total applicants. During the first half of 2024, about 100 applicants obtained filing notices from the CSRC (the number of passing applicants was 57 in 2023), indicating that the CSRC has expedited its steps towards giving the green light to applicants.

According to GLO's rough calculation based on publicly available information from the CSRC, during the period from 31 March 2023 to 30 June 2024:

- about 170 applicants chose the Hong Kong Stock Exchange as the listing exchange, and about 100 applicants chose to list on US capital markets (including Nasdaq, the New York Stock Exchange and other US exchanges not specifically disclosed);
- about 68 applicants chose overseas direct listing as the listing model, and about 204 applicants chose overseas indirect listing as the listing model; and
- among the 204 applicants who chose indirect listing, 55 are issuers operating with a variable interest entity (VIE) structure, and a total

of 20 applicants with the VIE structure have obtained filing notices from the CSRC.

Based on GLO's rough estimate, among applicants who have received a filing notice from the CSRC since the implementation of the New Filing Regulations, the average time from receipt of the filing application by the CSRC to the issuance of the filing notice is approximately five months, with the minimum and maximum review period being less than three months and more than ten months, respectively. Applications for overseas direct listing appear to have a prominent advantage over applications for overseas indirect listing in terms of the average length of time required (four months and six months, respectively). In addition, although the CSRC relaxed its scrutiny of filings by applicants with the VIE structure in the first half of 2024, compared with the filing time of applicants without the VIE structure, it would take on average twice as long for those applicants with the VIE structure (four-and-a-half months and nine months, respectively).

Given the above observations, it can be seen that CSRC filing under the New Filing Regulations has been running smoothly as a routine procedure for more than one year, and that domestic and overseas regulatory processes have been effectively connected to each other, improving the transparency available to applicants and potential applicants. Key elements that may influence the speed of the CSRC's review process include, among others, whether an issuer has adopted or used the VIE structure for overseas listing.

Scope of Domestic Enterprises Subject to Filing Requirement Under the New Filing Regulations

Statutory criteria under the Trial Measures

Article 15 of the Trial Measures provides that, if an issuer simultaneously meets the following criteria, it shall be identified as a domestic enterprise indirectly offering securities and listing overseas:

- in terms of the operating income, total profits, total assets or net assets of domestic enterprise(s) in the most recent fiscal year, any indicator thereof accounts for more than 50% of the relevant data in the audited consolidated financial statements of the issuer in the same period; and
- the main links regarding the business activities are in China, the business activities are mainly carried out in China, or most of the senior management personnel responsible for business management are Chinese citizens or have their main residence in China.

Furthermore, the Trial Measures emphasise applying the "substance over form" principle in particular cases.

Despite the test being stipulated in the Trial Measures, there still remains some ambiguity regarding its interpretation or the discretional application of the "substance over form" principle by the CSRC (eg, how to identify the main links regarding the business activities of an issuer).

Observation of market practice

GLO notes that different issuers with high similarity in terms of the proportions of domestic enterprises' financial (and other) indicators made different choices in their application for the CSRC filing.

In one case, an issuer disclosed in its filing materials for public listing that, although its revenue in the last two fiscal years accounted for more than 50% of its revenue from overseas, since most of its assets and business activities are located in mainland China, it took the initiative to submit an application to the CSRC, and shortly thereafter it was informed in writing by the CSRC that it was not currently covered by the filing requirement. In contrast, another issuer with no essential differences from the above-mentioned issuer believes that it did not need to file with the CSRC (as disclosed in its publicly listed filing materials), and GLO's follow-up public search indicated that this issuer has completed its IPO and listing in the relevant securities market.

Compared with the above two cases, some issuers with business and operations (eg, R&D centre, purchasing and/or marketing staff) in mainland China adopted a more conservative strategy to address the risks of CSRC filing, although strictly speaking their financial and other key indicators do not meet the statutory thresholds. To reduce regulatory uncertainty, such issuers conducted several rounds of communications with the CSRC prior to submitting a formal application and/or voluntarily submitted a filing application to the CSRC, and they each have been granted a "not applicable" clearance or successfully obtained a filing notice.

One more noteworthy case, occurring in May 2024, has come to GLO's attention and merits caution for all market players. As publicly disclosed by the issuer in this case, it received a written notice from the CSRC requiring it to perform the CSRC filing within one week after its receipt of the Notice of Effectiveness of the US Securities and Exchange Commission (SEC) on its share-registration documents. However, it was previously advised by its PRC counsel that, since the issuer generated over 50% of its revenue, net income, total assets and net assets from outside mainland China for the relevant fiscal years, the offering and listing of this issuer are "unlikely" to trigger the filing requirement.

In view of the above-mentioned cases, it is suggested that consideration should be given to whether there are strong connections between the issuers and mainland China by applying the "substance over form" principle, in addition to the statutory indicators. Also, precautionary measures such as pre-application communications with the CSRC would be necessary to avoid or reduce the risk of being unexpectedly prevented from making steps towards overseas securities offering and listing.

Issuers With the VIE Structure

Overview

As of the end of June 2024, a total of 20 issuers using the VIE structure have successfully obtained filing notices from the CSRC; 18 of these were obtained in 2024, accounting for about 13% of the total of 158 issuers who have completed filing with the CSRC.

Issuers who adopt the VIE structure usually use contractual arrangements to hold interests in industrial sectors/areas restricted for foreign investors. However, so far, there have been no specific PRC laws and regulations clarifying the legality of the VIE structure, and the stability and potential risks of the structure have been hotly debated in the market. With the implementation of the New Filing Regulations, the 20 cases passing the filing indicate that the CSRC is becoming increasingly positive and tolerant towards the VIE structure, as long as the red line set by law is not crossed.

Based on GLO's observation, issuers with the VIE structure that have completed the CSRC filing are mainly concentrated in the internet, insurance, travel, education, logistics and medical industries, among others. The main business areas that may involve foreign capital prohibition or restriction include value-added telecommunications, network culture, network publishing, radio and television programme production and operation, surveying and mapping, medical institutions and domestic mail delivery.

Focus on examining issuers with the VIE structure

The New Filing Regulations require applicants with the VIE structure to disclose and clarify the following in the filing documents:

- the reasons for using and detailed composition of the VIE structure;
- legal and compliance risks associated with the VIE structure, as well as risk treatment measures;
- whether foreign investors are participating in the operation and management of the issuer;
- whether there are PRC laws and regulations explicitly prohibiting an issuer in the involved industries/business areas from using the VIE structure; and
- whether foreign participation in the involved industries/business areas is subject to national security review, and whether the issuer is involved in industries/business areas in which foreign investment is restricted or prohibited.

According to the supplementary material requirements for certain issuers publicised by the CSRC, the CSRC's concerns about the VIE structure mainly focus on:

- the overall compliance of the VIE structure (including but not limited to foreign exchange management, overseas investment, foreign investment and tax payment);
- information relevant to the signing of the VIE agreements, in particular decision-making procedures pertaining to the internal performance of the signatories; and
- the transaction arrangements between entities under the VIE structure, including fund transfer between domestic and foreign entities, profit transfer and other aspects of capital flow arrangements.

In view of the above, market players should consider the following reminders:

- at present, there is still lack of clear industry-specific guidelines regarding the extent to which the VIE structure is permitted for issuers with operations in a particular industry/business area in which foreign investment is restricted;
- issuers who intend to use the VIE structure for overseas securities offering and listing should be more cautious when analysing their business necessity and legal viability to adopt the VIE structure, taking into account the examination focus and concerns of the CSRC in relation to reviewing the filing applications, and where there is an existing VIE structure – if the VIE structure is not workable – unwinding or dismantling it might be a possible solution for passing the filing; and
- for issuers who intend to use the VIE structure for overseas securities offering and listing, historical compliance issues that remain unresolved in connection with or arising out of the VIE structure should be given full attention and be solved in a timely manner (before the issuance of the filing notice by the CSRC at the latest).

Conclusion

The introduction and implementation of the New Filing Regulations by the CSRC is an important measure that has reshaped China's regulatory landscape for overseas securities offering and listing by domestic enterprises. After more than a year of exploration and implementation, the filing mechanism has become more mature and transparent, and is more compatible with the practice of overseas listing in Hong Kong SAR, the United States and other jurisdictions. Even the VIE structure, which is generally considered more "difficult" by the market, has been given the green light in successful cases. Market players (domestic enterprises and global investors in the PE/VC areas) should adhere to the compliance-based principle by keeping a close eye on China's latest regulatory trends, so that they can formulate the most suitable investment/financing and divestment/listing strategy and action plans.

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