



## RECENT IMPORTANT PRC LAW CHANGES AFFECTING VENTURE CAPITAL AND PRIVATE EQUITY INVESTMENT INTO CHINA

Venture capital and private equity funds that are investing into China enterprises should be aware of recent changes in Chinese law that will affect the structure of these investments, the degree of control that a foreign shareholder can exert over operations and the liability associated with such investments.

### *Tax Law Changes Affecting Use of Offshore Special Purpose Vehicles (“SPVs”)*

Recent changes to the Chinese Income Tax Law that take effect on January 1, 2008 will affect the withholding tax rate for dividends, interest and royalties paid to an offshore shareholder of a Chinese enterprise. If the offshore shareholder is a SPV that is incorporated in a jurisdiction that does not have a double taxation agreement with China (such as the British Virgin Islands or Cayman Islands), the withholding tax rates for dividends, interest and royalties will be 20%, 10% and 10%, respectively. However, if the SPV is incorporated in a jurisdiction that has a double taxation agreement with China (such as Hong Kong, Mauritius or Barbados), those tax rates would be lower, depending on the terms of the double tax agreement. It is important to get proper tax advice when structuring new investments or restructuring existing investments into China.

### *Using Share Swaps to Conduct M&A Transactions*

Venture capital and private equity investors often use offshore SPVs to invest into Chinese enterprises. Some structures anticipate an exchange of shares for consideration as part of the investment, causing existing Chinese shareholders to subscribe for or exchange their shares for shares in the offshore SPV. This practice is now subject to the stringent and time consuming procedures set forth in recent merger and acquisition regulations. Examination and approval by the Ministry of Commerce is needed to approve share swap transactions. Certain exceptions apply, and investors should seek counsel when structuring such transactions.

### *Approvals Required for Offshore Listing of Securities of SPVs*

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When a SPV, over which a Chinese domestic enterprise has obtained control through share swaps, seeks to list its securities on a stock exchange outside of China, recent regulations require that approval be obtained from the China Securities Regulatory Commission. Venture capital and private equity investors should seek advice when structuring deals with Chinese domestic enterprises, and should also carefully prepare their exit strategy.

***Shareholder Agreements Might Trigger Anti-Monopoly Laws.***

The recently enacted Anti-Monopoly Law may negatively impact common provisions of shareholder agreements or investor rights agreements aimed at securing management control over the invested company because it regulates controlling rights or the ability to exercise decisive influence over another party by contract or other means. This law has many provisions that are problematic and unclear. Many of these provisions, when the implementing regulations are issued, may unfairly protect control issues in state owned enterprises as well as selected industries. Many problematic protectionist provisions may trigger a review by the Anti-Monopoly enforcement authority. Therefore, the way these different issues are handled in the transaction documents should also be assessed in advance.

***Liability of Officers and Directors of Chinese Enterprises***

Recent changes to the Company Law now specifically create fiduciary duties and liabilities of directors and officers of Chinese enterprises and subject them to potential shareholder actions. Venture capital and private equity investors are advised to assess risks when taking on such positions in portfolio companies. The new provisions also allow for the “piercing of the corporate veil” in case controlling shareholders abuse the company to evade liabilities and debts. Therefore, corporate governance practices should also be carefully assessed.

***Expansion of Property Subject to Security Interests.***

Venture capital and private equity investors will now be able to take advantage of the recent expansion in the types of property that can be used to secure debt pursuant to the revised Property Law. Security interests may now be created on any kind of property, including raw materials, unfinished goods not yet in existence, accounts receivables, intellectual property rights and much more. Investors will now have more flexibility when securing debt transactions.