China

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I. Introduction

The year 2006 was a very busy year in the development of the People's Republic of China's (China or PRC) legal system. In the limited space available, this Year in Review will examine ten legal developments that occurred between January 1 and December 1, 2006. On January 1, 2006, China's new Company Law and new Securities Law came into effect, fundamentally changing company and securities regulation in China. In August, the Chinese government changed the regulation affecting qualified foreign institutional investors in an attempt to attract medium and long-term investment in China. The Chinese government released new regulations that fundamentally changed how foreign-invested mergers and acquisitions would be regulated. The government also issued revised regulations aimed at cooling off foreign investment in real estate ventures. For the first time, the National People's Congress issued a comprehensive bankruptcy code. The Chinese government also changed how personal income taxes are assessed. Further, many Chinese court cases have begun to appear online. Finally, certain aspects of China's enforcement of arbitration clauses and awards were changed.

II. Revised Company Law

China's new, revised Company Law (Revised Company Law) became effective on January 1, 2006, and fundamentally changed several areas of business regulation in China.[1] The Revised Company Law enables PRC residents, for the first time, to form a single-member limited liability company and lowers the number of promoters needed to form a company limited by shares to two.[2] Further, the revised law lowers the minimum registered capital requirement to form a limited liability company to RMB¥30,000 and lowers the minimum registered capital requirement to form a company limited by shares to

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1. Company Law (promulgated by Presidential Order No. 42, Oct. 27, 2005, effective Jan. 1, 2006), *translated in* CHINA L. & PRAC., Dec. 1, 2005, at 21.

2. *Id.* at arts. 24 (limited liability companies), 79 (companies limited by shares).

RMB¥500,000.[3] For the first time, the Revised Company Law allows up to 70 percent of a limited liability company's registered capital to be in the form of non-cash contributions.[4]

The Revised Company Law enables, for the first time, companies (limited liability companies and companies limited by shares) to invest in other companies, provided that the investing company does not assume any liability for the invested entity's debts.[5] In addition, the revised law allows a company to provide security for a shareholder's or a third party's debts if the security is approved by the company's board and a majority of the company's disinterested shareholders.[6]

Mirroring changes in the Securities Law, discussed below, the Revised Company Law allows private (non-government) limited liability companies to issue bonds.[7] Further, the new law enables publicly-listed companies to issue bonds that are, at the option of the holder, convertible into shares of the issuing company.[8] In addition, the Revised Company Law shortens the period during which company founders may not transfer any part of their interest in the company to one year.[9]

Perhaps the most notable change wrought by the Revised Company Law is the increased power it confers on shareholders over the operations of their company. For the first time in Chinese law, pursuant to the Revised Company Law, shareholders have the right to view and copy a company's articles of association, financial reports, and board meeting minutes, as well as view the company's accounting books.[10] Also, under the revised law, shareholders in a limited liability company may object to an equity transfer from another shareholder to a third party but must do so within thirty days of receiving notice from the transferring shareholder of the proposed transfer.[11] In addition, shareholders holding 3 percent or more of a company's shares may make proposals before the company's board of directors, while shareholders holding 10 percent or more of a company's shares may request a shareholder's meeting.[12] The Revised Company Law gives shareholders a put option whereby they could force the company to repurchase the shareholder's shares when, for example, the shareholder opposes a company merger or disposition of company assets or when the company does not distribute a dividend for five consecutive years despite being profitable during that time.[13] Further, the Revised Company Law enables weighted voting systems, cumulative voting, and preferred stock.[14]

Shareholders, under the Revised Company Law, have expanded rights to bring actions against officers and directors of a company. Shareholders holding 10 percent or more of a company's shares may petition the People's Court to liquidate the company if managerial

3. *Id.* at arts. 26 (limited liability companies), 81 (companies limited by shares).
4. *Id.* at art. 27.
5. *Id.* at art. 15.
6. *Id.* at art. 16.
7. *Id.* at arts. 154-63.
8. *Id.* at art. 162.
9. *Id.* at art. 142.
10. *Id.* at arts. 34 (limited liability companies), 98 (companies limited by shares).
11. *Id.* at art. 72.
12. *Id.* at arts. 41 (limited liability companies), 101-03 (companies limited by shares).
13. *Id.* at art. 75.
14. *Id.* at art. 106.

problems threaten to damage shareholders' interests.[15] Under Article 21, officers, directors, and controlling shareholders of a company may be liable to pay compensation for losses they cause to the company by abusing their shareholder rights or utilizing any relationships they may have in order to expropriate company interests.

For the first time in Chinese law, the Revised Company Law specifies the fiduciary duties owed by management to the company. Officers, directors, and supervisors owe duties of loyalty and diligence to their companies. Article 149 specifies that officers and directors of companies may not (a) misappropriate funds; (b) deposit company funds in bank accounts opened in their own names or in the names of others; (c) lend company funds directly to others or pledge company assets as security for the debts of others, in violation of the company's articles of association or without approval by shareholders or by the board of directors; (d) enter into any contract or transaction with the company in violation of the company's articles of association or without approval by the shareholders; (e) take advantage of their positions to obtain for their own benefit or the benefit of others any business opportunities belonging to the company or engage in the same type of business as the company for their own account or for the account of others without approval by the shareholders; (f) accept commissions on transactions between others and the company and keep such commissions as their own; (g) disclose any company secrets without authorization; and (h) commit any other act that is in violation of their duty of loyalty to the company. Shareholders may enforce such duties, and, under the revised law, the company is entitled to any gains made by a director or senior officer who breaches a fiduciary duty owed the company. It is important to note that the fiduciary duties specified in the Revised Company Law are not imposed on the company's controlling shareholders.

Article 152 of the Revised Company Law allows derivative lawsuits, for the first time under Chinese law, in response to the commission of any act proscribed by Article 150 of the Revised Company Law. Potential defendants of such derivative actions include officers, directors, and supervisors who violate any laws or administrative regulations or the company's articles of association.

In addition to the foregoing, the Revised Company Law enables the piercing of the corporate veil where a controlling shareholder abuses the company form to evade liabilities and debts.[16] If the corporate veil is pierced, such shareholders might be held liable for the company's debts. Company directors are ineligible to vote on matters in which they have a financial, or other, interest.

III. Revised Securities Law

The most significant development affecting securities regulation in China in several years is the implementation, as of January 1, 2006, of China's revised Securities Law (Revised Securities Law).[17] At over 200 articles, the Revised Securities Law fundamentally changes securities regulation in China. The Revised Securities Law for the first time defines "securities" and "public offering" and also enables some form of derivatives trading and enhances investor protection.

15. *Id.* at art. 183.

16. *Id.* at arts. 21 (controlling shareholders), 113 (directors).

17. Securities Law (promulgated by Presidential Order No. 43, Oct. 27, 2005, effective Jan. 1, 2006), *translated in* CHINA L. & PRAC., Feb. 2, 2006, at 31.

Unlike the previous edition, the Revised Securities Law, at Article 2, defines "securities" to include company shares and bonds, government bonds, units in securities investment funds, and derivatives.[18] Article 2 of the Revised Securities Law empowers the State Council to, in the future, define items as "securities."[19] Further, Article 2 of the Revised Securities Law provides that the State Council will adopt, at a point in the future, regulations governing the issuance and trading of derivatives.[20]

Article ten of the Revised Securities Law defines "public offering" as (a) issuing securities to an undefined group of offerees; (b) issuing securities to more than 200 identified offerees; or (c) engaging in other activities classified as "public offering" by other laws or regulations.[21] The China Securities Regulatory Commission (CSRC) is expected to issue implementing rules defining "undefined offerees" and how to calculate the 200-person limit. The Revised Securities Law also states that private placements may not be made through public announcements, although that term is undefined in the statute.

The Revised Securities Law provides for the creation of a Securities Investor Protection Fund intended to compensate creditors of securities companies and other persons.[22] The Securities Investor Protection Fund will be subject to revised implementing regulations to be issued by the State Council. Additionally, the Revised Securities Law imposes new liabilities on the directors and senior management of listed companies and requires that such persons certify the periodic disclosures made by such companies.[23]

IV. Qualified Foreign Institutional Investors Regulations

On August 24, 2006, the CSRC, the People's Bank of China (PBOC), and the State Administration of Foreign Exchange (SAFE) jointly issued new Measures for the Administration of Securities Investments in China by Qualified Foreign Institutional Investors, amending the rules that govern how qualified foreign institutional investors (QFIIs) operate in China.[24] Related thereto, the CSRC issued the Circular on Issues Relevant to the Implementation of the Measures for the Administration of Securities Investments in China by Qualified Foreign Institutional Investors on August 24, 2006, which is effective as of September 1, 2006. Collectively, these releases are referred to herein as the QFII Rules.

Under the QFII Rules, applications from pension funds, insurance funds, mutual funds, charitable funds, and other long-term asset management institutions will be given priority in terms of review and approval. The QFII Rules lower the amount of assets-under-

18. *Id.* at art. 2.
19. *Id.*
20. *Id.*
21. *Id.* at art. 10.
22. *Id.* at art. 134.
23. *Id.* at art. 68.
24. Measures for the Administration of Securities Investments in China by Qualified Foreign Institutional Investors (promulgated by the China Sec. Regulatory Comm'n, People's Bank of China, and State Admin. of Foreign Exch., Aug. 24, 2006, effective Sept. 1 2006), *translated in* CHINA LAW & PRAC., Nov. 1, 2006, at 1 [hereinafter Measures]; Circular on Issues Relevant to the Implementation of the (Measures for the Administration of Securities Investments in China by Qualified Foreign Institutional Investors) (issued by the China Sec. Regulatory Comm'n, Aug. 24, 2006, effective Sept. 1, 2006), *translated in* CHINA L. & PRAC., Nov. 1, 2006, at 1 [hereinafter Circular].

management a fund management institution or insurance company must have in the most recent fiscal year in order to qualify as a QFII to US$5 billion.[25] The QFII Rules do not change the five-year operational history requirement of the previous regulations.[26] Also, the QFII Rules do not change the qualifying criteria for securities companies and commercial banks.[27] In an implementing regulation related to the QFII Rules, other institutional investors such as pension funds, charitable funds, donation funds, trust companies, and government investment companies may qualify for QFII status if (a) they had at least US$5 billion in assets under management in the previous fiscal year; or (b) they have been in operation for at least five years.[28]

The QFII Rules allow QFIIs to establish multiple securities sub-accounts corresponding to multiple renminbi accounts with a Chinese clearing house.[29] Further, the QFII Rules specify, unlike the previous rules, that any assets in such sub-account belong to the fund in question and not the QFII, itself.[30] In addition, the QFII may use a broader range of permissible securities held in the account of one customer to settle trades entered into by the QFII's other customers.[31] Further, under the new rules, QFIIs may appoint their actual investors to exercise shareholder rights attached to the QFII's underlying investments.[32]

The QFII Rules end the previous regulation's rules on lock-up periods attached to QFII investments as well as repatriation limits. Further, the QFII Rules clarify that (a) each underlying non-PRC investor investing through QFII may not hold more than 10 percent of the total outstanding shares in any one listed company; and (b) in the aggregate, all offshore investors may not hold more than 20 percent of the total outstanding shares in one listed company.[33] Also, the QFII Rules now permit QFIIs to invest in securities investment funds and warrants, in addition to PRC-listed securities and bonds.[34]

V. Foreign Invested Mergers and Acquisitions

On September 8, 2006, the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors (the New M&A Provisions), issued by China's Ministry of Commerce (MOFCOM) and other agencies, became effective, replacing 2003's Provisional Rule on Acquisitions of Domestic Enterprises by Foreign Investors.[35] The New M&A Provisions are a significant development in the regulation of mergers and acquisitions (M&A) in China.

25. Circular, *supra* note 24.
26. *Id.*
27. *Id.* ¶¶ 1(3), 1(4).
28. *Id.* ¶ 1(5).
29. *Id.* ¶¶ 6-9.
30. *Id.*
31. *Id.* ¶ 9.
32. *Id.* ¶¶ 12-13.
33. *Id.* ¶ 10.
34. *Id.* ¶¶ 9-10.
35. Provisions for the Acquisition of Domestic Enterprises by Foreign Investors (promulgated by the Ministry of Commerce, State-owned Assets Supervision and Admin. Comm'n of the State Council, State Admin. of Taxation, State Admin. for Indus. and Commerce, China Sec. Regulatory Comm'n, and State Admin. of Foreign Exch., Aug. 8, 2006, effective Sept. 8, 2006), *translated in* CHINA L. & PRAC., Oct. 1, 2006, at 69.

Under the New M&A Provisions, a purchaser may use its own equity (provided it is listed on a foreign stock exchange) to acquire equity interests in a domestic Chinese company.[36] A Chinese-registered advisor must conduct specific due diligence into the purchaser's financial condition and submit a required report to MOFCOM.

In certain circumstances, the equity in a Special Purpose Vehicle (SPV) (an offshore company directly or indirectly controlled by domestic Chinese companies or residents) may be listed on a foreign stock exchange.[37] Proceeds from such listing must be used only for authorized purposes, including establishing a new foreign-invested enterprise (FIE).[38] Such equity, subject to certain conditions, may be used as consideration in an M&A transaction.

The New M&A Provisions reiterate that the foreign-owned equity interests in a target *after* a foreign-invested M&A transaction must exceed 25 percent of its registered capital for such FIE to be able to avail itself of any FIE-related incentives or preferences.[39] In addition, the New M&A Provisions clarify the treatment of FIEs established by offshore entities that, in turn, are controlled by domestic Chinese persons or enterprises.[40]

The burdensome antitrust review process created by the 2003 M&A regulations remains in the new M&A Provisions.[41] This process relies in part on vague and undefined terms to determine which M&A transactions should receive antitrust review.

If an M&A transaction would (a) result in any change in control of any domestic company in a key industry; (b) involve the holder of a well-known Chinese mark or brand; or (c) have potential or actual impact on national or economic security, such transaction must be approved by MOFCOM.[42] This approval process is independent of the usual approval processes imposed on all foreign investment in China, including M&A transactions. Note that the New M&A Provisions do not define terms such as "key industry" or "well-known trademark" and do not specify the approval procedures or timeline applicable in this context.

The New M&A Provisions are the Chinese government's latest effort to regulate foreign-invested M&A transactions. In some measure the New M&A Provisions reflect the Chinese government's concerns over asset stripping of state-owned enterprises and potential abuse of FIE incentives. They also reflect the government's efforts to enable more forms of M&A transactions in China. The New M&A Provisions likely will be supplemented with implementing rules in the near future, meaning that China's M&A regime will continue to evolve.

VI. Labor Litigation

On August 14, 2006, the Supreme People's Court issued the Interpretation on Several Issues Concerning the Application of the Law in the Trial of Labour Disputes (the Interpretation), effective October 1, 2006, which provides detailed rules to determine the date

36. *Id.* at arts. 27-38.
37. *Id.* at arts. 39-50.
38. *Id.*
39. *Id.* at arts. 9, 16.
40. *Id.* at art. 16.
41. *Id.* at arts. 51-54.
42. *Id.* at art. 12.

when an employment dispute arises.[43] For disputes involving the payment of wages and salary, the Interpretation provides that the effective date of such refusal is the date on which an employer provides written notice to the employee indicating a refusal to pay the disputed wages or salary or the date on which the employee asserts his or her rights.[44] The Interpretation also provides that the effective date of the termination of an employment relationship is the date on which the employer provides written notice concerning the relationship's termination or the date on which the employee asserts his or her rights.[45] This is a change from the existing Labor Law in that it seems to require an employer to provide some sort of written notice to an employee concerning the expiration or termination of an employment relationship. For disputes involving payments after the termination of the employment relationship, the Interpretation provides that the effective date is the date on which the employer promised payment of such amounts to the terminated employee.[46]

Under China's existing Labor Law, the effective dates described in the previous paragraph start a sixty-day "clock," the expiration of which signals the start of the statute of limitations for such claim. Pursuant to Article 12 of the Interpretation, the sixty-day period will be tolled for events outside either parties' control or other specified events that prevent the filing of an arbitration claim. Further, the sixty-day period may be paused when one party (a) demands that the other party perform its obligations; (b) seeks relief from an administrative agency; or (c) agrees to perform its obligations.[47] Article 3 of the Interpretation provides that, as a variance to the Labor Law, the People's Courts must accept cases directly filed by employees for payment of late wages or salary as ordinary civil claims, provided that employees submit written notices provided by employers promising payment of the delayed wages or salary. The Interpretation allows for the attachment of employer's assets in certain circumstances.

The Interpretation makes other changes to Chinese law. If there is a conflict between an employment contract and a company's internal rules and regulations, the terms of the contract are to prevail.[48] For seconded employees, the Interpretation allows the employer to whom they are seconded to be listed as a co-defendant with such person's original employer in labor actions.[49]

VII. Real Estate

MOFCOM and five other government entities, on July 11, 2006, issued Opinions on Regulating the Entry of Foreign Investment into the Real Property Market and the Administration Thereof (Real Estate Measures), changing the regulation of foreign real es-

43. Interpretation on Several Issues Concerning the Application of the Law in the Trial of Labour Disputes (issued by the Sup. People's Ct., Aug. 14, 2006, effective Oct. 1, 2006), *translated in* CHINA L. & PRAC., Nov. 1, 2006, at 1.

44. *Id.* at art. 1(1).

45. *Id.* at art. 1(2).

46. *Id.* at art. 1(3).

47. *Id.* at art. 2.

48. *Id.* at art. 16.

49. *Id.* at art. 10.

tate investors operating in China.[50] The Real Estate Measures end the option for foreign investors to hold their real estate investments through an offshore entity. With the exception of real estate investments for the investor's own use, foreign investors will have to form a foreign-invested enterprise in China to hold their Chinese real estate investments.[51] Further, the Real Estate Measures introduce new procedures and requirements for business license applications and land use rights.

Under the Real Estate Measures, the registered capital requirement for foreign-invested real estate enterprises is increased to 50 percent of the total investment, with the total investment threshold triggering such requirement lowered to US$10 million.[52] Foreign-invested real estate enterprises may not obtain onshore or offshore credit financing, and the State Administration of Foreign Exchange will not permit foreign-denominated loans to be converted to Renminbi until the foreign-invested real estate enterprise's registered capital has been paid up, it has obtained appropriate land-use rights, and 35 percent of the capital for the project has been expended.[53]

In addition, any merger and acquisition involving a PRC real estate enterprise and a foreign-invested real estate enterprise will be subject, under the Real Estate Measures, to strict regulatory scrutiny.[54] In any such transaction, the foreign investor must pay the entire transaction consideration in one up-front payment.[55]

VIII. Bankruptcy Law

After a long gestation, China's new Enterprise Bankruptcy Law (Bankruptcy Law) will become effective on June 1, 2007.[56] The Bankruptcy Law was adopted by the Standing Committee of the Tenth National People's Congress on August 27, 2006, and will significantly change how Chinese and foreign entities analyze bankruptcy issues. The old law, the State Enterprise Bankruptcy Law (Trial Implementation), issued in 1986, regulated the bankruptcy process only for State-Owned Enterprises (SOEs) and, by the mid-1990s, was seen to be in serious need of amendment.

The Bankruptcy Law is the first standardized bankruptcy law in China. It replaces the old law and myriad other regulations and removes some of the administrative uncertainty that existed under the former sets of regulations. The Bankruptcy Law applies to all enterprises with legal person status, including SOEs, private companies, limited liability companies, companies limited by shares, and FIEs.[57] Individuals and partnerships are not subject to the new Bankruptcy Law.[58]

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50. Opinions on Regulating the Entry of Foreign Investment into the Real Property Market and the Administration Thereof (issued by the Ministry of Constr., Ministry of Commerce, Nat'l Dev. and Reform Comm'n, People's Bank of China, State Admin. for Indus. and Commerce, and State Admin. of Foreign Exch., July 11 2006), *translated in* CHINA L. & PRAC., Sept. 1, 2006, at 35.

51. *Id.* ¶ 1(1).

52. *Id.* ¶ 1(2).

53. *Id.* ¶ 2(7).

54. *Id.* ¶ 1(4).

55. *Id.* ¶ 1(5).

56. Enterprise Bankruptcy Law (promulgated by Presidential Order No. 54, Aug. 27, 2006, effective June 1 2007), *translated in* CHINA L. & PRAC., Oct. 1, 2006, at 39.

57. *Id.* at art. 2.

58. *Id.*

The scope of the Bankruptcy Law is limited in two circumstances: (a) financial institutions whose bankruptcy could harm China's economy may have their bankruptcy directly administered by relevant Chinese government authorities; and (b) SOEs that announce their bankruptcy prior to June 1, 2007, may receive assistance in the bankruptcy process from the Chinese government and must pay employment-related claims before any secured or unsecured creditor, a continuation of policy bankruptcies.[59]

Under the Bankruptcy Law, either a debtor or a creditor can file a bankruptcy application with the relevant People's Court. A debtor may make an application if it is (a) cash-flow insolvent; (b) balance-sheet insolvent; or (c) "obviously" insolvent. A creditor may make an application only if its debtor is cash-flow insolvent.[60]

The People's Court must decide within fifteen days of receipt whether to accept such application.[61] Debtors may contest an application made against them, and either a creditor or debtor may contest the rejection of a bankruptcy application.[62] If accepted, the People's Court is to (a) notify the debtor and all of its known creditors of such acceptance; and (b) appoint a bankruptcy administrator, as discussed below.[63] An acceptance of a bankruptcy application begins a stay of actions against the debtor.

The bankruptcy administrator is a new concept in Chinese Law and is appointed by a People's Court when it accepts a bankruptcy application.[64] Creditors may apply to have the administrator replaced for failing to perform his or her duties while the administrator may only resign with 'cause' and with the permission of the appointing People's Court.[65] The administrator has broad powers to operate the debtor company during the pendency of bankruptcy proceedings and other powers specified in the Bankruptcy Law. For example, the administrator may review a request by a creditor to set-off a debt owed by the creditor to the debtor (if the debt incurred prior to the bankruptcy application acceptance date) against amounts owed by the debtor to the creditor.[66]

An administrator may elect to have the company perform or rescind a contract that has not been fully performed as of the date the bankruptcy application was accepted.[67] Note, however, that a contract is deemed rescinded if the administrator files to respond to the contract's counterparty within two months of the bankruptcy application acceptance date.[68] Also, a contract is deemed rescinded if an administrator fails to provide security requested by the contract counterparty after the administrator informs such counterparty that the contract in question is to be performed. The administrator reports to the People's Court and the creditors committee.[69]

The Bankruptcy Law sets forth new avoidance provisions. Under these, (a) acts outside the ordinary course of business may be voidable if they occur within one year of the bankruptcy application acceptance date; (b) payments made to creditors, while the debtor is

59. *Id.* at arts. 133-34.
60. *Id.* at arts. 2, 7.
61. *Id.* at arts. 10-21.
62. *Id.* at art. 10.
63. *Id.* at art. 14.
64. *Id.* at arts. 22-29.
65. *Id.* at arts. 28-29 (resignation).
66. *Id.* at art. 25.
67. *Id.*
68. *Id.* at art. 18.
69. *Id.* at art. 22.

insolvent, within six months of the bankruptcy application acceptance date are voidable; and (c) concealing or diverting the bankrupted company's assets to avoid liabilities is void.[70] The administrator may recover any assets lost through a void or voidable act, and, in certain circumstances, the debtor's legal representative and other responsible personnel may have to indemnify the debtor for resulting losses.[71]

Under the Bankruptcy Law, a debtor may be declared bankrupt, may apply for reorganization, or may apply for conciliation. If a debtor is declared bankrupt, all of its assets must be sold by auction, unless the creditor's meeting decides otherwise.[72] Unlike the previous bankruptcy regime in China, the Bankruptcy Law provides that secured creditors have payment priority to the extent of the value of the secured property, with any shortfall classified as unsecured debt.[73] After payment of secured debt, the payment priority in a liquidation is: (a) bankruptcy expenses; (b) unpaid employee's salaries and social insurance premiums; (c) outstanding tax liabilities; and (d) unsecured debt.[74] Note, however, that any employment-related claims that accrue prior to August 27, 2006, the Bankruptcy Law's issuance date, rank higher than secured claims.

The Bankruptcy Law enables the debtor or creditor to apply to the People's Court for reorganization of the debtor, a new concept in Chinese law.[75] If a creditor applies to bankrupt a debtor, either the debtor or investors holding more than one-third of the debtor's registered capital may apply to reorganize the debtor.[76] Generally, the administrator manages the entity in bankruptcy, although the debtor's management can petition the court to continue managing the debtor's operations.[77]

Within six months of the start of the reorganization period, which period could be extended to nine months with court approval, the debtor or administrator must submit a reorganization plan, including plans for the repayment of the debtor's debt and/or restructuring of its debt.[78] Upon receiving the reorganization plan, the court is to convene a meeting of the debtor's creditors.[79] At such meeting, creditors are divided into classes (secured, unsecured, etc.), and the reorganization plan must receive approval from a majority of the creditors in each class, representing at least two-thirds of the total confirmed claims in each such class.[80] If approved, the plan is submitted to the court for approval before implementation.[81] Secured creditors are restricted from enforcing their secured rights during the reorganization period, and secured creditors may not vote on a reorganization plan that involves the sale of company assets until such secured creditors terminate their security interests.[82]

70. *Id.* at art. 31.
71. *Id.* at arts. 32-34.
72. *Id.* at art. 112.
73. *Id.* at art 113.
74. *Id.*
75. *Id.* at art. 70.
76. *Id.*
77. *Id.* at arts. 73-74.
78. *Id.* at art. 79.
79. *Id.* at art. 84.
80. *Id.* at art. 85.
81. *Id.* at art. 86.
82. *Id.* at art. 87.

Conciliation, similar to Chapter 11 in the U.S. bankruptcy code, is another new concept introduced by the Bankruptcy Law and allows a debtor to propose a settlement of its debts with its creditors.[83] If the court accepts a debtor's conciliation offer, it will convene a meeting of the debtor's creditors.[84] A conciliation settlement must be approved by a majority of the creditors attending such meeting, holding more than two-thirds of the total amount of conformed claims, except secured claims, against the debtor.[85] If a conciliation settlement is rejected, the court must declare the debtor bankrupt.[86]

While China has not adopted the U.N. Commission on International Trade Law Model Law on Cross-Border Insolvency (UNCITRAL Model Law) or that law's framework for cooperation in cross-border insolvency, the Bankruptcy Law does, for the first time, address cross-border insolvency issues. Article five of the Bankruptcy Law provides an avenue to effect Chinese bankruptcy procedures against debtor's assets located outside of China, provided that China is established as the center of main interests of the debtor. From this it appears as though the United States and other jurisdictions that have adopted the UNCITRAL Model Law would treat China, at least insofar as enforcement of Chinese bankruptcy procedures overseas, as if China had adopted the UNCITRAL Model Law.

The Bankruptcy Law also provides that, in certain situations, a foreign bankruptcy proceeding may be binding within China against the debtor's assets located in China. In order to be enforced in China, the foreign judgment must: (a) be from a jurisdiction that has relevant treaties or reciprocal relations with China; (b) not violate Chinese State sovereignty, national security, or social public interest; or (c) not harm the lawful rights of creditors inside China.[87]

The Bankruptcy Law introduces to Chinese law management liability concepts found in other jurisdictions' bankruptcy codes. The debtor's directors and officers may be subject to civil liability if the debtor's bankruptcy is the result of a breach by the directors or officers of their duties of loyalty and diligence to the debtor. Directors and officers of a bankrupt enterprise are barred from assuming an officer or director position in another enterprise for a period of three years, starting on the date the bankruptcy concluded.[88] A bankruptcy administrator may recover any of the debtor's assets improperly taken by the debtor's managers.[89]

The Bankruptcy Law is a significant new step in China's legal development and is an improvement over the previous bankruptcy regime in China. The Bankruptcy Law is the first unified law on the subject in China and brings China's bankruptcy system closer to international standards. The more streamlined rules in the Bankruptcy Law will improve the transparency and certainty of China's bankruptcy system, but challenges still remain. Provincial courts might resist applying the new bankruptcy rules to important local enterprises. Future implementing regulations will flesh out the ambiguous areas of the Bankruptcy Law, but this law is a significant step forward.

83. *Id.* at art. 95.
84. *Id.* at art. 96.
85. *Id.* at art. 97.
86. *Id.* at art. 104.
87. *Id.* at art. 5.
88. *Id.* at art. 125.
89. *Id.* at arts. 127, 128.

IX. Personal Income Tax

China's Personal Income Tax Law was amended on October 27, 2005, and the revised statute took effect on January 1, 2006.[90] Therefore, Chinese law on the personal income tax (PIT) has witnessed momentous changes since last year's Year in Review.[91] Perhaps unique among all areas of law, PIT law directly affects almost all businesses operating or individuals living in China, be they Chinese or foreign, and as each year goes by, it does so to a greater extent. This review summarizes major statutory and regulatory developments in the twelve-month period preceding November 30, 2006.

For readers unfamiliar with the Chinese PIT, it may be useful first to note a few background facts. Despite its high marginal rates, the PIT is still only the fourth largest tax in China in terms of revenue: it collected about 7 percent of total tax revenue in 2005 and is dwarfed by the value added tax (VAT), the business tax, and the domestic enterprise income tax. The PIT is primarily a *local* tax: except for the tax on individuals' interest income (which is collected by the central government and represented 17.4 percent of all PIT revenue in 2005),[92] PIT revenue is collected by local tax bureaus. This fact has many important implications, foremost that local policies in regard to both substantive PIT rules and their enforcement vary significantly. For example, the PIT imposes a 20 percent tax on capital gains from the transfer of real property.[93] Even after an emphatic push in 2006 (discussed below) by the central government to enforce this rule, however, local levels of enforcement still appear uneven. At the same time, because law and regulation-making powers with respect to the PIT are centralized, as most PIT regulations are issued by the State Administration of Taxation (SAT), large gaps between written law and settled practice can be found. For example, the law applies high marginal rates to a partner's profit in a partnership (such as a law firm),[94] but local tax bureaus are known to apply low rates to partnership revenue (and not profit) as a substitute, often resulting in dramatic reductions in partners' tax burden. When written law changes, however, there can be great uncertainty as to whether settled practice may still be followed. Partners in Chinese partnerships now face this uncertainty due to the new annual return-filing obligation discussed below.

A. Statutory Changes

The amended PIT statute contains three new elements: certain taxpayers will be required to file annual tax returns for the first time;[95] persons responsible for withholding

90. The Personal Income Tax Law of the People's Republic of China (promulgated under Presidential Decree No. 44, Oct. 27, 2005, effective Jan. 1, 2006), *available at* http://www.tdctrade.com/report/reg/reg_051203.htm [hereinafter PITL].

91. *See* Qiang Bjornbak et al., *International Legal Developments in Review: 2005: China*, 40 INT'L LAW. 547 (2006).

92. State Admin. of Taxation (SAT), Notice Regarding Personal Income Tax Revenue in 2005, GUOSHUIHAN [2006] No. 221 (Feb. 24, 2006).

93. PITL, *supra* note 90, at art. 3(5).

94. PITL, *supra* note 90, at art. 3(2); Ministry of Finance and SAT, Notice Regarding Applying the Personal Income Tax to Investors in Single-Member Companies and Partnerships, CAISHUI [2000] No. 91 (Sept. 19, 2005).

95. PITL, *supra* note 90, at art. 8.

face new information reporting obligations;[96] and the personal allowance against employment income was increased.[97]

1. *Annual Return*

Before the amendment of the statute, taxpayers who were required to file tax returns included (1) several types of self-employed individuals; (2) those who have taxable income from overseas; (3) those who hold more than one job; (4) those who receive certain types of installment payments; and (5) those who receive payments on which tax was not properly withheld.[98] In addition, local tax bureaus were authorized to impose their own return-filing requirements.[99] This authorization was removed by the SAT's regulation (issued November 6, 2006) under the new statute, as were categories (4) and (5).[100] But an additional category of return filers was added: taxpayers with annual income exceeding RMB120,000 are required to report their income during the first three months of the subsequent year, regardless of whether tax has already been fully withheld on such income.[101]

Given Chinese tax agencies' poor prior record in enforcing return-filing obligations and in processing returns that were filed, the RMB120,000 threshold is surprisingly low: in cities like Beijing and Shanghai, monthly income of RMB10,000 or more is now quite common. In light of the potential size of the filer population, it is even more remarkable that the SAT waited over ten months after the announcement of the new return-filing requirement—and until just two months before the 2007 filing season—to publish detailed rules. All evidence suggests that both taxpayers and local tax bureaus are unprepared for the new filing requirement, although since taxpayers act faster than tax agencies, an outcome quite different from what the government intends can be expected. Many dormant legal issues in the PIT may also become exposed as a result. For example, should partners now report their share of partnership profit and self-assess tax at the statutory rates, even though previously local tax bureaus only required the partnerships to file returns for PIT purposes, and apply rates much lower than those that appear in the statute?[102]

2. *Withholding and Information Reporting*

Under the new statute and related regulation, potentially taxable income (other than several types of self-employment income for which there is no withholding agent) are

96. *Id.*

97. *Id.* at art. 6(1).

98. The Personal Income Tax Law of the People's Republic of China (promulgated by the Nat'l People's Cong., Aug. 30, 1999 (now supplanted by the PITL)), art. 9; SAT, Provisional Rules Regarding the Filing of Personal Income Tax Returns, GUISHUIFA [1995] No. 77 (Apr. 28, 1995), art. 2.

99. The Personal Income Tax Law of the People's Republic of China, *supra* note 98.

100. SAT, Rules Regarding the Filing of Personal Income Tax Return (Trial Version), GUISHUIFA [2006] No. 162 (Nov. 6, 2006), art. 2.

101. *Id.* at arts. 3, 15.

102. *See, e.g.*, Beijing Local Tax Bureau, Notice Regarding Changes to the Collection of the Personal Income Tax from Investors in Law Firms, JINGDISHUIGE [2005] No. 69 (Feb. 1, 2005).

subject not only to withholding but also to information reporting.[103] On the basis of information received, tax agencies are to issue "certificates of tax payment" to individual taxpayers.[104] In American terms, these certificates can be understood as similar to IRS Forms W-2 and 1099. Moreover, for Chinese taxpayers who do not need to file returns, the certificates can be used like tax returns in the United States, for example in providing proof of income.

3. *Increased Personal Allowance*

The monthly personal allowance against wage income was raised from RMB800 to RMB1,600 (for foreigners, from RMB4,000 to RMB4,800).[105] The same increase was extended by regulation to allowances available to sole proprietors, partners, and owners of single-owner enterprises.[106] Nationally, this has halved the growth rate of PIT revenue from the affected categories of income, although that has still meant a 10.5 percent year-to-year increase during the first three quarters.[107]

B. Policy-Oriented Regulations

The government aimed to advance several major tax and nontax policies through tax regulations during 2006. Most significantly, subject to certain qualifications, employer payments and contributions on behalf of employees for basic pension insurance, basic health insurance, unemployment insurance, and to collective housing funds are excluded from income, as are an employee's own payments and contributions for such purposes. Moreover, benefits and withdrawals from such insurance policies and funds are excluded from income.[108]

More controversial was the government's pursuit of its policy towards the urban real estate market. The SAT participated in a multi-ministry initiative aimed in part at combating market speculation and stalling the rapid rise in housing prices in some cities.[109] One measure the SAT adopted was the enforcement of the previously-rarely-enforced 20 percent tax on capital gains from the sale of real property.[110] Property in which the owner has resided for five years prior to sale and which constitutes the owner's only residence is

103. PITL, *supra* note 90, at art. 8; State Council of the P.R.C., Implementation Rules for the Personal Income Tax Law, Order No. 452 (Dec. 19, 2005), art. 37 [hereinafter Implementation Rules].

104. SAT and the State Post Office, Notice Regarding the Issuance and Delivery by Mail of Certificates of Tax Payment, Guoshuifa [2006] No. 30 (Feb. 20, 2006).

105. PITL, *supra* note 90, at art. 6(1); Implementation Rules, *supra* note 103, at art. 27, 29.

106. Ministry of Finance and SAT, Notice on Adjusting the Amount of Personal Allowance to Industrial and Commercial Households and Investors in Single-Member Companies and Partnerships, Caishui [2006] No. 44 (Apr. 10, 2006).

107. *The Personal Income Tax Increasingly Targets High-Income Earners*, China Taxation News, Nov. 1, 2006, at 5.

108. Ministry of Finance and SAT, Notice on Personal Income Tax Policies Regarding Basic Pension Insurance, Basic Health Insurance, Unemployment Insurance and Collective Housing Funds, Caishui [2006] No. 10 (June 6, 2006).

109. *See* State Council Admin. Office, Notice Forwarding Proposals by the Ministry of Construction and Other Ministries for Adjusting the Structure of Housing Supply and Stablizing Housing Price, Guobanfa [2006] No. 37 (May 24, 2006).

110. SAT, Notice on Certain Issues in the Collection of the Personal Income Tax from Transfers of Personal Residences, Guoshuifa [2006] No. 108 (July 18, 2006).

exempt from the tax.[111] SAT regulations also provided detailed rules for determining the original purchase price and other amounts that may be deducted from the sales price to compute capital gain.[112] But viewed as an exercise in PIT administration, the SAT's initiative achieved only mixed results. Many local tax bureaus, out of real or alleged difficulty in ascertaining original purchase price, have opted to collect a 1 to 3 percent tax on gross sales price instead, which frequently reduces the tax payable on the sale.[113] Viewed as economic policy, the initiative's impact on housing price has been equally questionable.

C. Law-Clarifying Regulations

Some of the year's more specialized tax notices and rulings produced laudable clarifications of PIT law. For example, the SAT issued notices clarifying (1) what types of transportation subsidies should be treated as wages;[114] and (2) what constitutes re-employment on the part of retirees.[115] Relative to the thin base of legal authority on the concepts of employment and wages, these notices are notable additions. Similarly, the SAT further developed its positions on the taxation of stock options in an October 2006 notice; treatments of tradable options and stock appreciation rights are discussed for the first time, and the character, timing, and source of income from stock options are clarified.[116]

As underdeveloped as Chinese PIT law may appear (particularly in comparison with U.S. law), it already has plenty of quirks, and more are emerging from the games played by the central government, local tax agencies, and taxpayers. Further, as China's per capita income continues to rise and as traditional taxes such as the production-type VAT are reformed, the PIT is bound to gain in significance.

X. Chinese Cases Online

One of the major complaints of lawyers trying to understand the Chinese legal system in the past has been the absence of any case reporting system in China. China is a civil law jurisdiction, and cases do not have precedential weight, even if they are occasionally submitted as evidence to support the legal argument that a lawyer is making.

In this regard China is not unlike other civil law jurisdictions such as Germany and France, which provide very limited access to cases and where practitioners collect copies of important cases. In Germany, even these copies will usually have the names of the parties obscured.

But as courts in China are setting up websites, they are now posting their decisions online. This is dramatically changing access to the Chinese legal system. Russia has started a project to have all courts put their decisions online in order to improve the

111. *Id.*
112. *Id.*
113. *Beijing, Guangzhou and Hangzhou Adopt 1% Rule*, China Taxation News, Aug. 4, 2006, at 1.
114. SAT, Notice on Personal Income Tax Issues Relating to Subsidies Received as a Result of Reforms to Employer-Provided Transportation, Guoshuihan [2006] No. 245 (Mar. 6, 2006).
115. SAT, Advice on the Issue of Determining Whether Retirees Have Been Re-Employed, Guoshuihan [2006] No. 52 (June 5, 2006).
116. SAT, Supplemental Notice on Issues in Applying the Personal Income Tax to Income from Stock Options Held by Individuals, Guoshuihan [2006] No. 902 (Sept. 30, 2006).

transparency of the system. It is hoped that this will reduce corruption and improve trust in the courts.[117]

In China, it appears that posting decisions online may not be directly related to such a policy or even to WTO requirements. Previously, as part of Chinese civil procedure, the decisions of Chinese courts have been posted outside the courthouse.[118] This is in contrast to some European civil law systems where a copy of a decision cannot be obtained by a party's lawyer without first showing identification and authorization from the client.[119] Once the Chinese courts started setting up websites, the posting of the decisions online was apparently the next logical step. This has mainly occurred in the last year or two.

In any event, the Supreme People's Court has its own website at www.court.gov.cn. Copies of the decisions of this court can be obtained by clicking on the button labeled "cai pan wen shu." Alternatively, by clicking on "xiang guan lian jie" or "links," access can be obtained to www.chinacourt.org. On the Chinese version only, the button "fa yuan zai xian" will produce a page of links to the websites of Higher People's Courts, Intermediate People's Courts, and Basic People's Courts across China.

Many such sites have a search function, such as the Beijing Court System web site at http://bjgy.chinacourt.org. If appropriate key characters are entered, decisions and news releases will be listed. Alternatively, using key legal terms in characters in Google will produce not only decisions from these web sites but also commentaries and statements of claim posted online by Chinese lawyers.

Alternatively, those seeking intellectual property decisions can go from the China Court web site noted above to http://ipr.chinacourt.org, a web site that had at the time of writing well over 4,000 decisions accessible online listed in date order. This web site also has a search function.

The availability of the cases, even if they do not carry the same weight in court as common law decisions, greatly increases the transparency of the Chinese legal system and should contribute significantly to its development.

XI. Arbitration Proceedings

On August 23, 2006, the Supreme People's Court issued the Interpretation on Selected Issues Relating to the Application of the PRC Arbitration Law (Arbitration Interpretation), effective as of September 8, 2006.[120] Article one of the Arbitration Interpretation makes the definition of a written arbitration agreement consistent with the definition of

117. Nabi Abdullaev, *Supreme Court Touts Automated Justice*, MOSCOW TIMES, Apr. 11, 2006. The web site for the project is www.sudrf.ru.

118. Interview with Tao Kaiyuan, Senior Vice President and Judge of the Guangdong Higher People's Court, and Wang Zhiqiong, who formerly practiced law in Beijing, in Guangzhou (Nov. 13, 2006).

119. Bulgaria is an example of a jurisdiction where authorization is required. European civil law jurisdictions are slowly changing. In France, a limited selection of cases is available on Legifrance, http://www.legifrance.gouv.fr/html/. In Germany, the decisions of the intellectual property and competition tribunals can be found online. Arbitration cases are available at www.dis-arb.de. For both countries, there are fee-based services such as http://rsw.beck.de/bib/default.asp and http://www.lexisnexis.fr/. Fee-based services also exist in China.

120. Interpretation on Several Issues Concerning the Application of the (PRC Arbitration Law) (promulgated by the Sup. People's Ct., Aug. 23, 2006, effective Sept. 8, 2006) *translated in* CHINA LAW & PRAC., Oct. 1, 2006, at 91.

written agreements by specifying that electronic documents may satisfy the 'writing' requirement for an arbitration agreement. The Arbitration Interpretation also expands the number of disputes that may be arbitrated. Further, as a change to previous regulation, the new interpretation provides that failure to specify an arbitration institution is not, itself. sufficient grounds to invalidate an arbitration agreement, provided that some arbitration institution could specified under applicable rules.[121] Also, per the Arbitration Interpretation, an agreement that allows a dispute to be referred to arbitration or litigation is invalid.[122]

The Arbitration Interpretation provides that once an arbitration institution has decided on the validity of an arbitration agreement, a People's Court may not hear any challenges to such decision.[123] Further, the validity of the arbitration agreement will be determined based on the law of the place of arbitration.

Article nineteen of the Arbitration Interpretation clarifies that the People's Court may set aside the relevant part of an arbitral award that is outside the scope of the arbitration agreement. The Arbitration Interpretation specifies that a People's Court must suspend enforcement proceedings on an arbitral award if one party applies to set aside that award.[124] Note, however, that once an application to set aside an arbitral award has been dismissed, an application on substantially similar grounds may not be entertained by a People's Court. Further, if a party does not raise the argument that the arbitration award is invalid during the course of the proceedings, it waives the right to raise the issue when it attempts to set aside the award.[125]

XII. Conclusion

As this article indicates, 2006 saw developments in ten important legal areas: revisions to China's Company Law; amendments to China's Securities Law; modifications to regulations affecting QFIIs; new regulations covering foreign-invested mergers and acquisitions; changes to labor litigation rules; amendments affecting the operation of foreign-invested real estate companies; the new Bankruptcy Law; modifications to China's personal income tax system; the placing of legal cases online; and changes to the interpretation of arbitration clauses. In 2007, we expect that China will release new versions of its Patent Law and other intellectual property regulations, issue a new Partnership Law, and continue the speedy development of its legal system.

121. *Id.* at arts. 4-6.

122. *Id.* at art. 7.

123. *Id.* at art. 27.

124. *Id.* at art. 19.

125. *Id.* at art. 27.