Newsletter

10th Edition of 2016

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Legal Updates

1. Foreign Invested Enterprise Record-filing System Implemented (Author: Han Kun Corporate Team)

On September 3, 2016, the Standing Committee of the National People's Congress promulgated the *Decision of the Standing Committee of the National People's Congress on Amending Four Laws Including the Law of the People's Republic of China on Wholly Foreign-owned Enterprises* (the "**Decision**"). The Decision provides for record-filing in lieu of administrative approval in the case of foreign invested enterprise establishment and alterations for foreign invested enterprises ("**FIE**s") not subject to special administrative measures. On October 8, 2016, the Ministry of Commerce ("**MOFCOM**") issued the *Interim Measures for Record-filing for the Establishment and Alteration of Foreign-invested Enterprises* (the "**Interim Measures**"). On the same day, MOFCOM and the National Development and Reform Commission ("**NDRC**") jointly issued a statement (the "**Joint Statement**"), which clarified that the special administrative measures to be implemented in this case are the restricted and prohibited industry category provisions as well as encouraged industry categories having shareholding and executive management requirements prescribed in the *Catalogue for the Guidance of Foreign Investment Industries (2015 Edition)* (the "**Catalogue**"). The Joint Statement also stated that the relevant provisions currently in force will apply in the case of establishment and alterations resulting from foreign mergers and acquisitions. Based on the foregoing, the Decision-mandated record-filing system now has a clear package of supporting measures, thus making official the implementing of the "pre-access national treatment plus negative list" administrative regime.

Overview

The Interim Measures consist of five chapters and 37 articles and basically follow the foreign investment record-filing administrative framework in China's free trade zones, and carry out the state policies of "streamlining administration," "contained deregulation" and "collaborative supervision." The main content of the Interim Measures includes:

a. Record-filing Administration for FIEs outside of the Negative List

The record-filing process applies to the establishment and alterations of FIEs not subject to special administrative measures for foreign investment. Based upon MOFCOM's interpretation of the Interim Measures, record-filing administration is a notice filing and the filing receipt is not a prerequisite for enterprises to apply for other procedures. FIEs and their investors are responsible for the authenticity, accuracy and completeness of the filing information. The record-filing authorities will only examine the form of the filing information, and collection of the filing receipt after the completion of record-filing is not mandatory. Of particular note is that, for establishment filing, the

Interim Measures currently only apply to FIEs resulted from greenfield investment. Foreign investors will continue to be subject to the approval system under the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (MOFCOM, 2009 Order No. 6) in the case of foreign mergers and acquisitions that result in establishing FIEs or transforming existing enterprises into FIEs, regardless of whether or not such FIEs are subject to special administrative measures.

b. Scope of Application

The Interim Measures apply to enterprises that include the three traditional forms of FIEs (WFOE, EJV and CJV), and also include PRC enterprises set up by investment-type FIEs (holding companies and venture capital enterprises) within China. Hong Kong, Macau and Taiwan investors are also subject by reference to the Interim Measures (except that Hong Kong and Macau service providers that establish service trade enterprises under the CEPA will continue to comply with the *Provisions for Hong Kong and Macao Service Provider Mainland Investment Record-filings* (for Trial Implementation)). The types of filing enterprises include limited liability companies and companies limited by shares. The Interim Measures apply nationally, and the *Administrative Measures for Pilot Free Trade Zone Foreign Investment Record-filings* (for Trial Implementation) (MOFCOM, 2015 Order No. 12) is thus repealed.

c. Matters Subject to Record-filing

The Interim Measures stipulate that the events subject to record-filing include all applicable FIEs' establishments and alterations. The Interim Measures cover most of the alterations that previously required MOFCOM approval to implement, including increases and decreases to registered capital, changes to equity, entity conversions, changes to business scope, consolidations, separations and terminations. It is worth noting that the Interim Measures do not include FIE equity pledges, which differs from the earlier comment draft version. We understand this to mean that MOFCOM will no longer regulate equity pledges, either by way of record-filing or approval. In addition, for FIES publicly listed or traded over the National Equities Exchange and Quotations, only when the cumulative shareholding ratio of the foreign investor changes greater than 5% or the foreign investor experiences a change of control position in the FIE, the filing for basic information of the foreign investor or the shareholding change will be needed, further reducing administrative burden on the enterprises.

d. Timing of Record-filing

The Interim Measures stipulate that all record-filing can be undertaken on a post-event basis. Establishment record-filings can be undertaken before establishment (upon pre-approval of the enterprise name and before issuance of the business license), or within 30 days of the issuance of the business license. Enterprise alterations are to be filed within 30 days following occurrence of the event. If laws or regulations have requirements for the effectiveness of an enterprise alteration, the alteration is deemed to have occurred when such legal or regulatory requirements are satisfied.

For other alterations that involve a resolution of the highest authority of an FIE, the time the resolution is adopted is when the alteration occurs.

e. Record-filing Procedures

All filings are to be made online. Filers complete and submit forms and supporting documents through the comprehensive foreign investment management system. The record-filing authorities can provide online feedback in case any record-filing information is incomplete or inaccurate, or if additional information is required. The results of the filing information are published through the filing system.

f. Administrative Oversight and Legal Liability

While the pre-event approval system is abolished, MOFCOM has strengthened the oversight and administration of record-filing. The competent MOFCOM department may carry out oversight and examinations through conducting random inspections, based on tips, and upon their own initiative, etc. The competent MOFCOM departments will share information with other administrative departments and timely inform such departments of illegal conduct for which the departments are responsible. Information regarding the integrity of the FIE and its investors will be entered into the foreign investment credit file system. The Interim Measures provide that FIEs and their investors who violate filing obligations, invest in restricted or prohibited areas, or refuse to cooperate with inspections will be subject to legal liability, and filers who do not cooperate with inspections or who refuse to comply with punishment decisions will be publicized.

Commentary

The issuance of the Interim Measures marks the beginning of the formal implementation of the negative list system on a national basis. Since that time, FIE establishments and alterations that are not subject to special administrative measures have been changed from an "case-by-case approval" to a more standardized and convenient filing process. FIEs covered under the record-filing system can undertake business activities upon obtaining a business license and no longer require authorization from the competent MOFCOM department. The FIE approval certificate that has been in place for many years will also be replaced by a FIE establishment filing receipt and a FIE alteration filing receipt.

Specifically, the Interim Measures greatly reduce the information and documents required to be submitted compared to the previous approval system. At the establishment filing stage, investors or promoters need only to complete basic information for the enterprise to be established. The documents required to be submitted at this stage also include only the name pre-approval documents or the business license, the letter of undertaking executed by all investors (or promoters), the investors (or promoters) qualifications or personal identifications, and the relevant entrustment documents. For alterations, the filing enterprise needs only to complete a form to reflect the changed item, submit the filing enterprise's business license, the filing enterprise's signed letter of

undertaking, and the qualifications or personal identifications of the investors or legal representative involved in the change. The record-filing authority will only conduct a non-substantive examination of the record information. The documents required under the previous approval system are no longer required, such as the articles of association, joint venture contracts, equity transfer agreements, capital increases and reduction agreements, consolidation or separation agreements, etc. This change is undoubtedly positive for foreign investors in order to more flexibly arrange investment and business transactions, since they will no longer need to be concerned about the attitude of the relevant approval department. At the same time, eliminating the review and approval of articles of association and contracts means that approval will no longer constitute a condition for such documents to be legally effective. This development will help to eliminate uncertainties in practice regarding the validity of contracts when the documents have not been approved, promoting the security and predictability of transactions.

The current negative list system, however, remains at a transitional stage. Special administrative measures, a key to the negative list system, have not been separately introduced. The special administrative measures in this case have been implemented by referencing the Catalogue, and thus areas accessible to foreign investment have not been substantially broadened. At the same time, the Catalogue, as a guide to industry access, is relatively general. Specific regulatory measures to be adopted for restricted industries are unclear and the possible reforms to the examination and approval system under the new regulatory regime have not yet been addressed. Also, in terms of investment projects, FIEs engaging in investment projects must still obtain approval or conduct filings, based on their industry and the project size, pursuant to the *Administrative Measures for Foreign Investment Project Approvals and Record-filings* (NDRC, 2014 Order No. 20).

Despite the foregoing, the implementation of the negative list is a very important milestone in remolding the administration of foreign investment in China. This reform is linked to the ongoing reform of the market access negative list system which is applicable to all types of enterprises in China. After reforms are completed, foreign investment will be subject to the foreign investment negative list system and, subsequently, FIEs will be subject to the market entry negative list system the same as all other types of market players (including state-owned enterprises and private enterprises). The full implementation of the negative list system will greatly reduce the government's administrative intervention, release market vitality, and promote the function of the market in playing a decisive role in resource allocation. At present, the basic laws for FIEs have been revised and the procedural process of the record-filing has been established. However, the legacy of the examination and approval system that has lasted for nearly three decades is still present in a large number of administrative regulations, department regulations, and normative documents. A thorough implementation of the negative list system will require the relevant departments to actively engage in a complete review and update of the laws and regulations in light of the changed regulatory framework.

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2. **Statistory Circumstances for Shareholders to Undertake Liability for Company Debts and Related Judicial Practices (Authors: Andy LIAO, Ruochen CHEN, Mo CHEN)**

The independence of the corporate form and the limited liability of shareholders are two fundamental principles stipulated in the PRC Company Law (hereinafter referred to as "**Company Law**"). Article 3 of the Company Law reflects such principles by stating that a company shall be an enterprise legal person who possesses independent legal person property and enjoys legal person property rights, a company shall be liable for its debts to the extent of all of its assets, the shareholders of a limited liability company are liable to the company to the extent of its respective subscribed capital contribution, and the shareholders of a company limited by shares bear the liabilities of the company to the extent of their respective subscribed shares. Given this, the general understanding is that a company is liable for its debts only to the extent of its own assets, and the shareholders shall not be liable for the company's debts.

However, in practice some shareholders or de facto controllers of certain companies deliberately co-mingle company assets with their own or that of their associated companies, through a number of methods, such as related party transactions, creating false debts, transferring of company assets, concealing company assets, etc., thus maliciously infringing upon the rights and interests of the company and eventually leading to the company's insolvency, making any favorable judgment essentially unenforceable. In other words, creditors who win in such judicial proceedings are not able to recover due to the debtor's insufficient corporate assets. In practice, such behaviors have become increasingly common and many debtors are using these tactics to circumvent their financial obligations owed to creditors, thereby not only seriously infringing upon the interests of creditors, but also ruining the social credit and the business environment as a whole.

The Company Law and several related judicial interpretations provide a variety of legal remedies for creditors with respect to shareholders or de facto controllers that seek to evade the debts of their debtor companies. By looking at the relevant laws and regulations, researching the underlying legislative background and legal theory, and by citing recent court decisions, this article summarizes particular circumstances where creditors have been able to directly claim against the shareholders or de facto controllers for the debts owed by the debtor companies.

I. Piercing the Corporate Veil

According to Article 20 of the Company Law, the shareholders of a company shall abide by laws, administrative regulations and articles of association and exercise shareholders' rights in accordance with the law, and shall neither damage the interests of the company or other shareholders by abusing

shareholders' rights nor damage the interests of any creditor of the company by abusing the company's independent status as a legal person or the limited liability of shareholders. The same Article also stipulates that shareholders who evade the payment of debts by abusing a company's independent legal person status or the limited liability of shareholders shall be held jointly and severally liable for the debts of the company.

The aforesaid provisions not only prevent the shareholder from abusing the independence of the company's legal status and the limited liability of shareholders, but also describes the legal liability for those who have breached obligations, also known as the theory of "Disregarding the Corporate Entity" or "Piercing the Corporate Veil" under the Company Law. However, no clear judicial interpretations have been established to clarify what kind of conduct constitutes an abuse of the independent legal status and the limited liability of shareholders as the basis for applying this provision, and this has created fierce controversy in scholarly circles and judicial practice.

In 2009, the Shanghai High People's Court promulgated Guidelines of Civil Adjudication Tribunal No. 2 of Shanghai Higher People's Court on Several Issues of the Trial of cases concerning Disregarding the Company Personality (hereinafter referred to as the "**High Court Guidelines**") aiming to provide detailed guidance on the issue. According to the High Court Guidelines, when a company is significantly lacking company capital, or is difficult to distinguish from its shareholders, or a shareholder improperly dominates or controls the company, it is possible for the court to determine these situations to be forms of abuse of the independent legal status of a company and the limited liability of shareholders. The High Court Guidelines further stipulate standards for the determination of these three circumstances. Where any shareholder fails to fulfill or fully fulfill its capital contribution obligations, or withdraws subscribed capital after the establishment of the company, the company capital shall be deemed to be insufficient. Where continuous and widespread commingling of property, businesses, personnel and premises between shareholders and the company is found, it can be concluded as a serious mixing of personal and company identity. Where any shareholder illegally conceals or transfers company property through related-party transactions, it may be concluded that the shareholder illegally dominates or controls the company.

The Supreme People's Court holds a similar opinion in judicial practice. In the case regarding a loan agreement dispute between Hebei Jixing Freeway Co., Ltd. ("**Jixing Company**") and Jingyu Freeway Co., Ltd. ("**Jingyu Company**") ([2011] Min Shen Zi No. 289), the retrial applicant, Jixing Company, claimed that He Yuhua had abused his shareholder rights as the de facto controller of Jingyu Company, Kangyong Company and eight other companies. In fact, Jingyu Company directly exercised the shareholder rights of Kangyong Company and the eight other companies, causing a severe mixing of the establishment, capital contribution, registered address, finance and personnel between Jingyu Company, Kangyong Company and the eight other companies, thus gravely infringing upon the interests of creditors. Therefore, Jixing Company contended, Kangyong Company and the eight other companies should bear joint and several liability for the debts of Jingyu Company. The Supreme People's Court found that, according to Article 3 of the Company Law, the

independence of property is foundational to the independence of corporate entity status. Therefore, in order to successfully prove a mixing of identity has occurred between a shareholder and a company, the first step is to determine the independent status of the company property, namely whether the company property has been comingled with its shareholders. Additionally, the registered address, organization of personnel, and the distribution of company profits shall also be taken into consideration. Although the Supreme People's Court rejected the claim of the retrial applicant on the grounds of insufficient evidence, its analysis clearly set out the criteria for determining the mixing of corporate identity between a shareholder and a company.

It is worth noting that the theory of "Disregarding the Corporate Entity" is generally believed to be confined to Vertical Disregard (i.e., only applicable to shareholders of the company) but excludes Horizontal Disregard (i.e., cannot be applied to the company or the affiliated companies de facto controlled by shareholders). Nonetheless, in the aforementioned case ([2011] Min Shen Zi No. 289), the Supreme People's Court appears to have tacitly approved the Horizontal Disregard of Personality, because the court only rejected the retrial applicant's claim on the grounds of insufficient evidence rather than from the aspect of application of law. Besides this, it seems that the Supreme People's Court clearly stands for the Horizontal Disregard of Corporate Entity in its later judicial practice. In the 15th Guiding Case, Xugong Group Engineering Machinery Co., Ltd V. Chengdu Chuanjiao Industry and Trade Co., Ltd and Other Respondents on Dispute over Purchase and Sales Contracts, the court confirmed the mixing of corporate identity between the debtor and two affiliated companies. The two affiliated companies were found to be subject to joint and several liability for the repayment of the debts to the creditor under the provisions under Article 20 of the Company Law.

Another crucial procedural issue that needs to be mentioned is whether a creditor must first have a disputed debt judicially confirmed and fail to resolve the debt before invoking Article 20 paragraph 3 of the Company Law in order to initiate a lawsuit on the theory of piercing the corporate veil. In other words, is the creditor entitled to directly file a lawsuit against the debtor company and its shareholders claiming repayment of debt? No clear provision regarding this question has been found in relevant statutes. Analyzing from a legal principle perspective, the basis for a lawsuit based on piercing the corporate veil is the joint tortious act by the debtor company and its shareholders. The losses suffered by creditor are due to the debtor company's inability to repay the debt, and are thus triable in the lawsuit as a factual issue. As a result, it is not inappropriate for a creditor to sue a debtor company and its shareholder jointly in a single lawsuit. The High Court Guidelines shares the same opinion toward this matter. Article 3 paragraph 3 of the High Court Guidelines stipulates "When the debt between a company and its creditor, either arising from contract or tort liability, has not been confirmed by effective judicial documents, and the company creditor has filed a piercing corporate veil suit claiming liability of a company shareholder, the court shall explain to the creditor, and join the company in the lawsuit as a co-defendant upon application of the creditor." Article 4 also provides that "when the company creditor has filed lawsuit based on contract or tort liability against the company and subsequently claims for joint and several liability of the company shareholders for their

abuse of independent corporate entity status or limited liability of shareholders, the court may grant the creditor, prior to the deadline of adducing evidence, the right to add new claims or new defendants to the lawsuit."

II. Shareholders Fail to Fulfill Capital Contribution Obligations

Article 13 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (III) (hereinafter referred to as "**Company Law Judicial Interpretation (III)**") provides that the People's Courts shall uphold supplemental compensatory liability claims of any company creditor against a shareholder who has not fulfilled or fully fulfilled its capital contribution obligations to the extent of the capital not so contributed and interest for the part of any company debts that the company is unable to repay. Such claims shall not be upheld in the event that the shareholder has already borne this liability.

According to the abovementioned provision, the controversial issue in judicial practice is whether creditors have the right to claim against shareholders to bear supplemental compensatory liability before the maturity of their capital contribution obligations. In 2015, Civil Adjudication Tribunal No. 2 of the Supreme People's Court expressed its view of this issue through Provisions on Several Issues Concerning the Current Trials of Commercial Cases. The court held that a shareholder would not be forced to perform its capital contribution obligation prior to maturity because the company's inability to repay a single creditor's debts must necessarily mean that the company is unable to pay off its debts as they come due, its assets are not sufficient to pay off all its debts, or that the company is insolvent. Therefore, the court reasoned, the company met the conditions for bankruptcy as stipulated in Article 2 of the Enterprise Bankruptcy Law of the People's Republic of China (hereinafter referred to as the "**Bankruptcy Law**"). In such case, the court reasoned, the interests of all the creditors shall prevail, and to allow for a single lawsuit filed by one creditor is not in conformity with the legislative spirit of Articles 31 and 32 of the Bankruptcy Law. Under such circumstances, creditors shall submit a bankruptcy application and request the shareholders to perform their capital contribution obligations in advance in accordance with Article 35 of the Bankruptcy Law, so as to protect the interests of all the creditors. The above opinion of the Civil Adjudication Tribunal No. 2 of the Supreme People's Court has legal basis and represents the dominant view in judicial practice.

No. 1 Intermediate People's Court of Shanghai held the same opinion in a case concerning a loan agreement dispute between Shanghai Jinlang Spray Technology Co., Ltd. ("**Jinlang Company**") and Honghuo (Shanghai) International Trade Co., Ltd. ("**Honghuo Company**") ([2016] Hu Yi Min Zhong Zi No. 2471). According to Article 35 of the Bankruptcy Law, the advance performance of the capital contribution obligations is premised upon the acceptance of a bankruptcy application by the People's Court, and Article 22 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (II) (hereinafter referred to as "**Company Law Judicial Interpretation (II)**") stipulates that capital contributions not paid by any shareholder of the company shall be treated as liquidation property only in the process of dissolution

of the company. Based on the above regulations, if any creditor plans to urge a shareholder that is not fully paid-in to perform its capital contribution obligations in advance, there should be a statutory requirement or mutual agreement. In this case, the appellant had not reached an agreement with any shareholder of Honghuo Company, and Honghuo Company had not entered into a bankruptcy or dissolution procedure. Therefore, the creditors had neither legal merit nor factual basis to require the shareholders to perform their capital contribution obligations prior to the maturity. Meanwhile, this court deemed that it contradicts the independence of the corporate entity and the limited liability of shareholders to request the shareholders to perform their capital contribution obligations in advance once the company has failed to repay its debts.

However, some courts have held the opposite point of view. In the case Hangzhou Dingzheng Packaging Material Co., Ltd. V. Tang Huaizhong Company on Dispute over the Responsibility for the Damages of the Creditors ([2016] Zhe 0111 Min Chu No. 1150), Hangzhou Fuyang District People's Court ruled that the debtor company was unable to repay its debts and thus the shareholder had lost its privilege to withhold capital contributions until the contribution term date stipulated in the company's articles of association, and that the shareholder must therefore make advance capital contributions to the company. In other words, the shareholder is granted the privilege to time the making of its capital contributions, but that privilege cannot be used to endanger the legitimate rights and interests of creditors by taking advantage of the company's independent legal status to shift business risk. In the event that the capital contribution obligation has not reached maturity but the debtor company is already unable to repay its debts, the creditor the shall have the right to claim against the shareholders to bear supplemental compensatory liability to the extent of the non-contributed capital for the portion of the debt that the company was unable to pay off.

Moreover, it is worth noting that, according to Article 18 of the Company Law Judicial Interpretation (III), Where any shareholder of a limited liability company transfers its equity without fulfilling its capital contribution obligations and the transferee is aware of or should have been aware of such fact, creditors of the company may sue the shareholder in accordance with Article 13 of the Company Law Judicial Interpretation (III) and request the transferee to bear joint and several liability for the company's debts. This provision could further prevent shareholders who have not fully fulfilled their capital contribution obligations from effectively escaping the debts of the company by transferring equity ownership.

III. Shareholders Withdraw Contributed Capital

Article 14 of the Company Law Judicial Interpretation (III) states that "where any creditor of the company claims against the shareholder who withdraws contributed capital to bear supplemental compensatory liability to the extent of capital withdrawn and the interest thereon for the part of the company's debts that the company is unable to repay, and against other shareholders, directors, senior managers or de facto controllers who assist said shareholder to withdraw capital to bear joint and several liability therefor, the People's Court shall sustain; in the event that the shareholder who

withdraws capital has borne foregoing liability, and other creditors file same claims, the People's Court shall not sustain."

There is no explicit or clear provision in relation to the definition and specific form of what conduct constitutes withdrawal of a company's registered capital. According to Article 12 of the Company Law Judicial Interpretation (III), the following actions of shareholders or de facto controllers may be considered as withdrawals of company capital: (i) preparation of false financial statements to increase non-existent profits and distribute the same; (ii) payments of contributed capital by fabricating credit-debt relationships; (iii) payments of contributed capital through related-party transactions; and (iv) any other acts of withdrawing capital without legal procedures.

Based on the aforesaid provisions, if any creditor can prove that any shareholder or de facto controller has committed the behavior of withdrawing capital from the company, the creditor may bring a lawsuit against the shareholder or de facto controller to claim for supplemental compensatory liability for the debts that the company is unable to repay.

IV. Shareholders Violate Their Statutory Obligations during the Liquidation Process

Article 183 of the Company Law stipulates that the liquidation group of a limited liability company shall be comprised of its shareholders, while a joint stock limited company shall be comprised of its directors or any other individuals appointed by the general meeting. Article 189 of the same law stipulates that the members of a liquidation group shall, during the course of liquidation, carry out their duties and perform their obligations in accordance with the law. Any member of a liquidation group who causes any loss to the company or to any of its creditors either intentionally or due to his gross negligence shall be liable to compensate the affected party.

In light of the above regulations, where any shareholder acts as a member of the liquidation group but fails to perform its obligations in accordance with the laws and regulations and causes losses to any creditors of the company, that shareholder shall bear tort liability for the losses. Company Law Judicial Interpretation (II) provides detailed explanations of and rules for this issue as follows:

Provisions of Law	Illegal Act	Accountable Party	Liability
Article 11 paragraph 2 of the Company Law Judicial Interpretation (II)	Failure to perform notification and public announcement obligations by a liquidation group for a company will prevent creditors from promptly declaring and resolving their interests	**Members of the liquidation group**	Bear liability for any creditor losses arising therefrom
Article 15 paragraph 2 of the Company Law Judicial Interpretation (II)	The implementation of an unconfirmed liquidation proposal	Members of the liquidation group	Bear liability for any creditor losses arising therefrom
Article 18 paragraph 1 of the Company Law Judicial Interpretation (II)	Failure to establish a liquidation group within the statutory time limit and to commence the relevant liquidation work by shareholders of a limited liability company or directors or the controlling shareholder of a company limited by shares results in any impairment, drain, or the destruction or loss of company property.	The shareholders, directors or the controlling shareholder of the limited liability company	Bear liability for any loss of the creditors arising therefrom
Article 18 paragraph 2 of the Company Law Judicial Interpretation (II)	Delay in the performance of obligations by shareholders of a limited liability company or directors or the controlling shareholder of a joint stock limited company results in the loss of the main assets, account books, material documents or other items of the company which cause the liquidation of the company to become impossible.	The shareholders, directors or the controlling shareholder of the company	Bear joint and several liability for the debts of the company
Article 18 paragraph 2 of the Company Law Judicial Interpretation (II)	The circumstances described above in Art. 18, paras.1 and 2 are caused by the *de facto* controller of the company	*De facto* controller of the company	Bear corresponding civil liability for the debts of the company
Article 19 of the Company Law Judicial Interpretation (II)	Where shareholders of a limited liability company, directors or the controlling shareholder of a joint stock limited company, or the *de facto* controller of the company cause any loss to	The shareholders, directors, controlling shareholder or *de*	Bear corresponding liability for the debts of

	the creditors of the company as a result of any malicious disposals of company property upon the dissolution of the company or instead of carrying out the relevant liquidation work in accordance with the law, the company goes through the registration formalities for legal person cancellation by deceiving a company registration authority with a false liquidation report.	*facto* controller of the company	the company
Article 20 paragraph 2 of the Company Law Judicial Interpretation (II)	Where shareholders of a limited liability company, directors or the controlling shareholder of a joint stock limited company, or the *de facto* controller of the company make a cancellation registration for the company without going through the relevant liquidation procedures, making it impossible to commence the liquidation process.	shareholders, directors, controlling shareholder, or *de facto* controller of the company	Bear liability for repaying the debts of the company
Article 23 paragraph 2 of the Company Law Judicial Interpretation (II)	Where a violation of laws, administrative regulations or the articles of association committed by any member of a liquidation group of a company in carrying out the relevant liquidation work causes any loss to the company or any creditor of the company	Members of the liquidation group	Bear liability for compensation

Civil liability as described under the foregoing regulations can be seen as taking two forms. One form is liability for damages, namely to compensate for the loss caused by the illegal conduct or to repay the debts of the company. Theoretically, the scope of the liability is determined after the liquidation of the company is finalized. While in judicial practice, the People's Courts tend to direct shareholders to assume the liability for the debts which the company is unable to repay without considering the causation between the illegal conduct of shareholders and the resulting injury to the creditors. The second form is joint and several liability for the debts of the company, which usually applies to situations where any responsible person commits illegal conduct and which results in the liquidation of the company becoming impossible. In addition, no matter what kind of liability shareholders bear, all relevant shareholders shall bear joint and several liability for the external debts of the company. In terms of shareholder liability internally, the shareholders may be held liable to the extent of their respective faults in accordance with Article 21 of the Company Law Judicial Interpretation (II).

V. Shareholder Promises to Assume Company Debt

Article 20 of the Company Law Judicial Interpretation (II) provides that where any shareholder of a company or any third party promises to assume debts of the company when the company makes a cancellation registration with a company registration authority without going through the liquidation procedures, the People's Courts shall support the claims of any creditor of the company for civil liability against the shareholder or third party in accordance with the law.

In accordance with the aforesaid regulation, parties liable for the liquidation shall resolve debts of the company in accordance with laws during the liquidation proceeding. Creditors are entitled to request shareholders to undertake liability for debts of the company in the event of an unlawful liquidation and the shareholders had made a commitment to be liable for debts of the company when carrying out deregistration formalities. The issue is what kind of shareholder commitments constitute promises to assume the debts of the company under this regulation. Below are some cases that provide guidance in this regard.

In the dispute on compensation for property damage between Dandong Hongyun Estate Management Limited Company ("**Hongyun Company**") and Guan Shuping [(2015) Dan Shen Min Zai Zi No. 00022], since Hongyun Company failed to perform routine public utility maintenance responsibilities, a water pipe eventually burst and resulted in property damage to Guan Shuping and others. Hongyun Company was found to be liable for those damages. During the retrial procedure in Dandong Intermediate People's Court, Hongyun Company completed liquidation and deregistration formalities. However, the court finally ruled that the shareholders Qu Shouming and Li Li, as successors of the rights and obligations of Hongyun Company, should undertake liability to compensate Guan Shuping since Qu Shouming and Li Li had committed in the liquidation plan that "should there be any other matters not mentioned herein, all shareholders should undertake responsibility."

In the dispute on liquidation liability between Guangdong Energy Engineering Bureau of China Energy Engineering Group ("Energy China GEEB") and Shantou Jian'an (Group) Company [(2015) Zhu Fa Min Er Zhong Zi No.356], the court found that Energy China GEEB made no public announcements and did not notify its creditors as required by law during the liquidation procedure of its subsidiary Zhuhai Company. However, as Energy China GEEB had made a commitment in the liquidation plan that if related debts need to be repaid in the future, the investor will continue to undertake the repayment obligations. The court found this commitment to be legally binding, and thus Energy China GEEB bore liability in accordance with the judgment of the court.

VI. Conclusion

All of the above circumstances discussed in this article are special provisions set forth in the Company Law to protect creditors of companies, and which act to provide creditors with powerful legal tools. When dealing with debt disputes, creditors may find themselves overwhelmed by debtors' attempts to evade repayment if they only seek remedies under the Contract Law and focus on the assets and solvency of the debtors alone. Certain provisions in the Company Law grant creditors not only the legal right to claim against shareholders and de facto controllers but also provide actionable guidance on how to file a direct lawsuit against the responsible shareholders, affiliates or de facto controllers as parties in civil proceedings and to take relevant property or evidence preservation action, thereby providing creditors with better and broader solutions for handling debt disputes.

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3. Study on Foreign-Invested Medical Institutions (II): Case Studies (Authors: Huanhao HE, Yaohua HU)

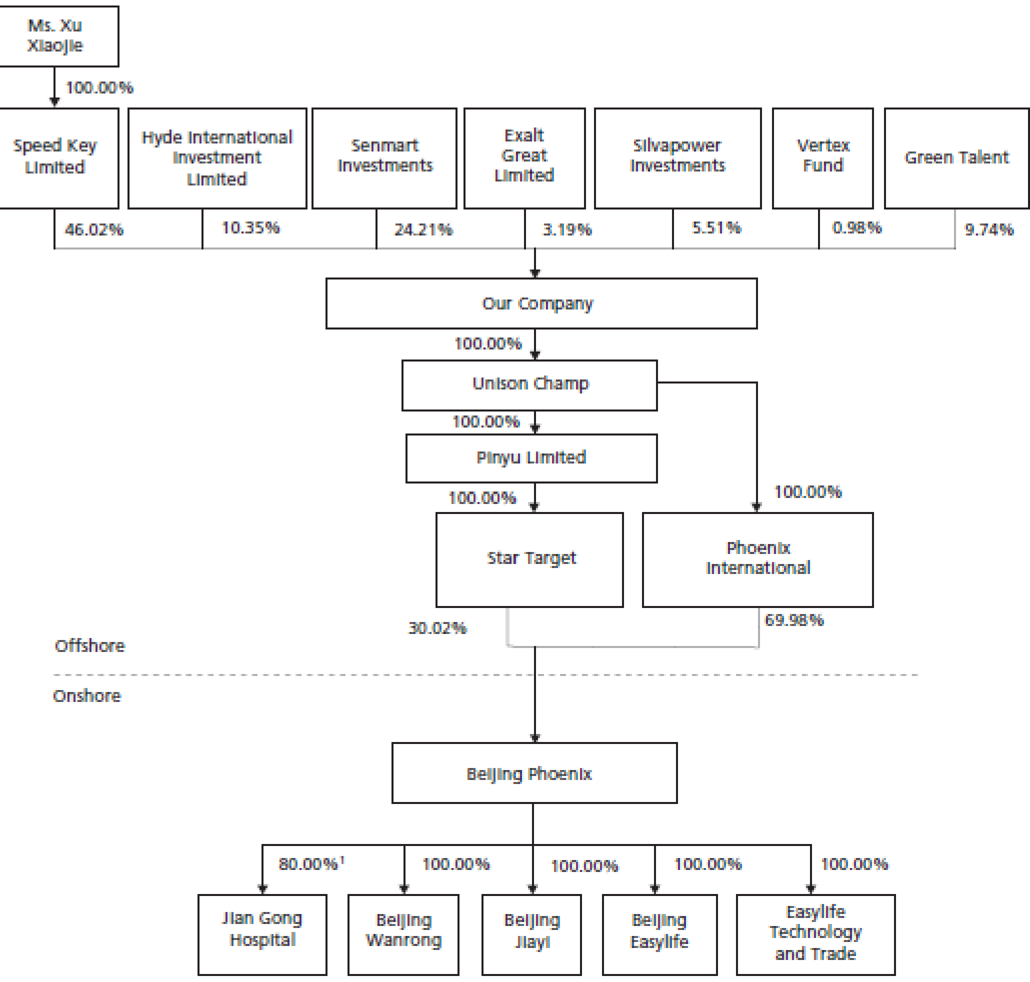
As mentioned in *Study on Foreign-Invested Medical Institutions (I)* (Click to Read), although China had at one time implemented a pilot program for establishing wholly foreign-owned hospitals, current policies prohibit full ownership. Currently, foreign ownership of medical institutions is limited to 70% as stipulated by the *Interim Measures for the Administration of Sino-foreign Equity Joint and Cooperative Joint Medical Institutions* (order of Ministry of Health and Ministry of Foreign Trade and Economic Cooperation, [2000] No. 11, hereinafter referred to as the "**Interim Measures**"), without reference to qualified Taiwan, Hong Kong and Macao investors.

We have noted, however, certain instances in which this foreign equity limitation was exceeded. How exactly did these foreign investors successfully break the 70% limitation? Is it due to previously applicable laws and policies, sophisticated ownership structures or some other coincidence? What

lessons can potential foreign investors learn from these cases? In this article, we will attempt to answer these questions by analyzing three cases involving Phoenix Medical, Harmonicare, and Artemed in Shanghai pilot free trade zone.

Phoenix Medical

On November 29, 2013, Phoenix Medical (01515.HK) completed an IPO and was listed on the Hong Kong Stock Exchange Main Board as the first hospital concept stock. Phoenix Medical Group Co., Ltd. ("**Phoenix Medical**"), as the foreign listed company, was founded on February 28, 2013, and was the largest private hospital group in China. At the time of the IPO, all Phoenix Medical member medical institutions were located in Beijing, including some large general hospitals and community health care institutions. The ownership structure of Phoenix Medical immediately after the pre-IPO restructuring and before the IPO is shown below:



As shown in the chart above, prior to listing, Beijing Phoenix United Hospital Management Consulting Co., Ltd. ("**Beijing Phoenix**") was a wholly foreign-owned enterprise and directly held 80% of the equity of Beijing Jiangong Hospital ("**Jiangong Hospital**"). The remaining 20% of the equity was held by an independent third party, Beijing Construction Engineering Group Co., Ltd. The issue with

this ownership structure is whether it violates the 70% foreign investment limit.

Review of Regulations from Article (I): Policies

- When the restructuring was taking place, the General Office of the State Council had proposed to launch a pilot program for establishing wholly foreign-owned medical institutions and *the Catalogue for the Guidance of Foreign Investment Industries (revised in 2011),* effective as of January 30, 2012, had categorized medical institutions as permitted to foreign investment. However, the applicable law should continue to have been the *Interim Measures*, since the *Circular on Carrying out the Pilot Program of the Establishment of Wholly Foreign-Owned Hospitals* (of which Beijing is one of seven pilot municipalities/provinces) by the National Health and Family Planning Commission and the Ministry of Commerce had not yet been officially promulgated.
- On the other hand, the *Tentative Measures for Administration of Foundation of Wholly-Controlled Hospitals in Mainland China by Hong Kong and Macao Service Providers* and the *Foundation of Wholly-Controlled Hospitals in Mainland China by Taiwan Service Providers* were put into force on January 1, 2011, according to which, since April 1, 2012, the permitted regions for Hong Kong service providers to establish wholly foreign-owned hospitals shall expand from the initial five cities to all direct-controlled municipalities and provincial capital cities (including Beijing).

The answer to this issue involves a restructuring of Jiangong Hospital which took place between April and August 2013, prior to which Beijing Phoenix was a wholly domestic-owned enterprise.

The main steps of the restructuring are as below:

Beijing Phoenix, after seeking the advice of its PRC counsel, chose to transfer its 10% equity interest in Jiangong Hospital to Beijing Wantong on April 19, 2013. However, it was expressly stipulated in the equity transfer agreement that Beijing Phoenix would retain voting rights, the right to appoint directors and the right to receive dividends in relation to the 10% transferred interest, and that Beijing

2013.04.19	2013.05.22	2013.06.17	2013.08.27
• Beijing Phoenix transfers a 10% equity interest in Jiangong Hospital to Beijing Wantong and retains a 70% equity interest.	• Beijing Municipal Committee of Commerce approves the transfer of a 30.02% equity interest in Beijing Phoenix to Xintong (Hong Kong). After that, Beijing Phoenix became a joint venture enterprise.	• Beijing Municipal Committee of Commerce approves the transfer of the remaining 69.98% equity interest in Beijing Phoenix to Phoenix International. After that, Beijing Phoenix became a wholly foreign-owned enterprise.	• Beijing Wantong sells its 10% equity interest in Jiangong Hospital back to Beijing Phoenix at the orginal purchase price, so Beijing Phoenix again held 80% of the equity in Jiangong Hospital.

Phoenix would have the right to request Beijing Wantong to sell the transferred equity back to Beijing Phoenix at the original purchase price. After completion of the transfer, Beijing Phoenix officially held a 70% interest in Jiangong Hospital. We understand Beijing Phoenix took this seemingly redundant step because of concern that the Beijing Municipal Committee of Commerce ("**BMCC**") could decide that the Interim Measures also applied to medical institutions jointly established by a joint venture enterprise and wholly domestic-owned enterprise.

As stated in the prospectus, in spite of the above arrangements, in relation to the 30.02% Beijing Phoenix equity transfer, BMCC still believed it needed to consult with the Beijing Municipal Health Bureau ("**BMHB**") to confirm the interpretation of the Interim Measures. According to a reply from BMHB on May 13, 2013, BMHB believed that completion of the equity transfer would cause Beijing Phoenix to change from a wholly domestic-owned enterprise to a joint venture enterprise. This would in turn cause Jiangong Hospital's status to change from a wholly domestic enterprise to a "foreign-invested enterprise re-invested enterprise," rather than a foreign invested enterprise, which would not be subject to BMHB approval. BMCC approved the equity transfer based upon the BMHB reply.

Subsequently, the transfer of the remaining 69.98% equity interest in Beijing Phoenix was also approved based upon the same reasoning. After the second equity transfer, Beijing Phoenix became a wholly foreign-owned enterprise and subsequently repurchased the 10% equity interest in Jiangong Hospital from Beijing Wantong. Upon completion of the equity repurchase, Beijing Phoenix owned 80% equity in Jiangong Hospital. So, does this case mean that foreign investors may exceed the 70% equity limit without any concerns? If yes, this would undoubtedly be good news for foreign investors who intend to establish wholly foreign-owned hospitals in China.

However, we recommend investors hold a modestly positive attitude towards this result, mainly for the following reasons:

a. The *Interim Provisions on the Investment of Foreign-invested Companies in China* (Order of Ministry of Foreign Trade and Economic Cooperation, the State Administration for Commerce and Industry [2000] No. 6) expressly stipulates that the *Catalogue for the Guidance of Foreign Investment Industries* shall apply by reference to domestic investments made by foreign-invested enterprises. In other words, in principle, domestic re-investments made by foreign-invested enterprises must also comply with foreign investment admission policies.

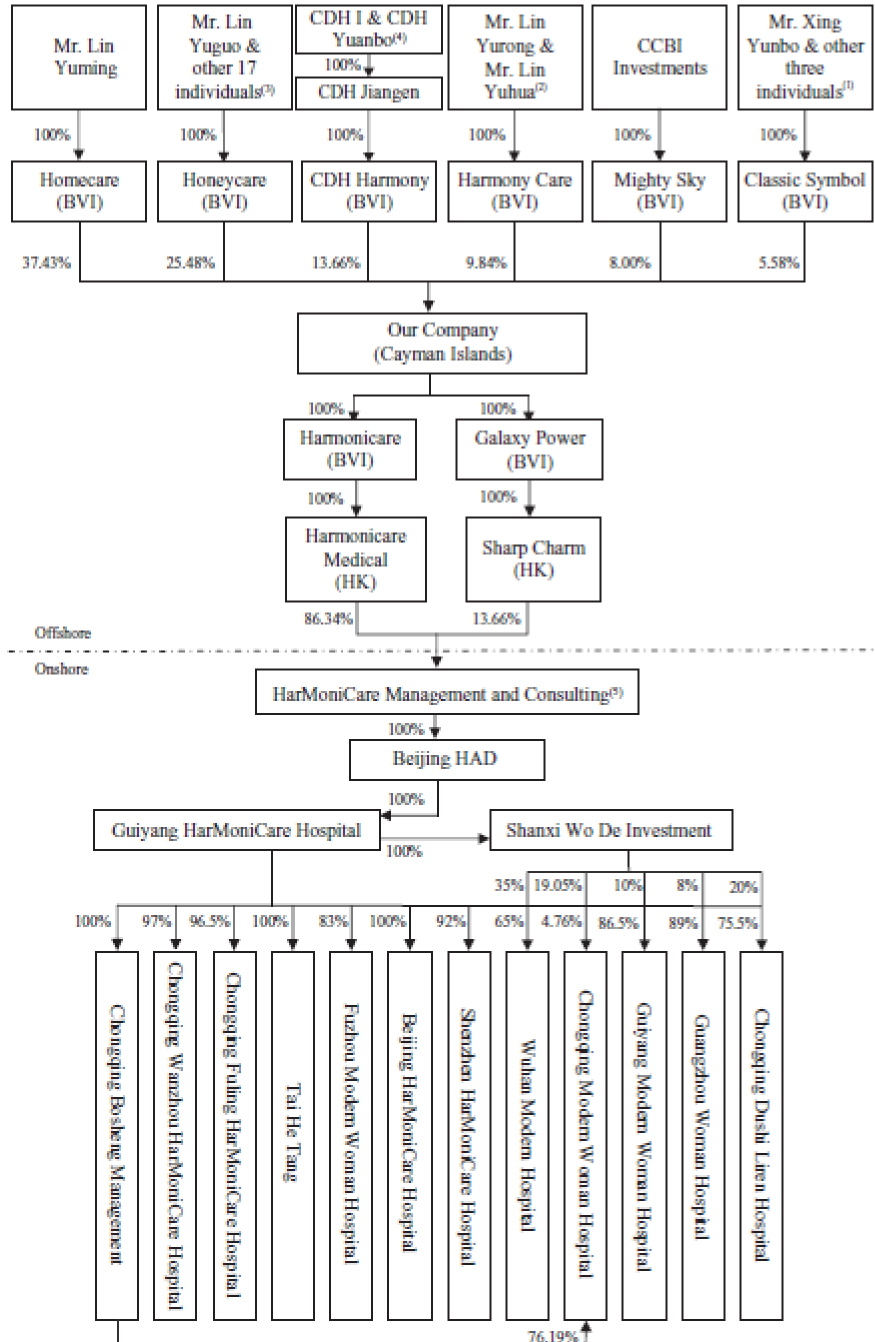
b. As shown in the prospectus for Phoenix Medical, the BMHB reply is critical for BMCC to approve the restructuring. Without a definite reply from the local health department, the commerce department may not use the same interpretation.

c. At the time of the Phoenix Medical restructuring, although the Circular on Carrying out the Pilot Program of the Establishment of Wholly Foreign-Owned Hospitals had not yet been promulgated, the Circular of the General Office of the State Council on Forwarding the Opinions of the National Development and Reform Commission and the Ministry of Health and Other Departments on

Further Encouraging and Guiding Non-government Funding for Medical Institutions (Guo Ban Fa [2010] No. 58) and the Catalogue for the Guidance of Foreign Investment Industries (revised in 2011) indicated that the tone of macroeconomic policy at that time was to encourage foreign investors to set up wholly foreign-owned medical institutions in China. In this regard, BMHB was likely to interpret the Interim Measures more liberally. However, since April 2015, the policy has again become re-tightened, and no longer permits the establishment of wholly foreign-owned medical institutions. Based on this development, it is difficult to say whether BMHB will continue with its favorable attitude towards foreign investment.

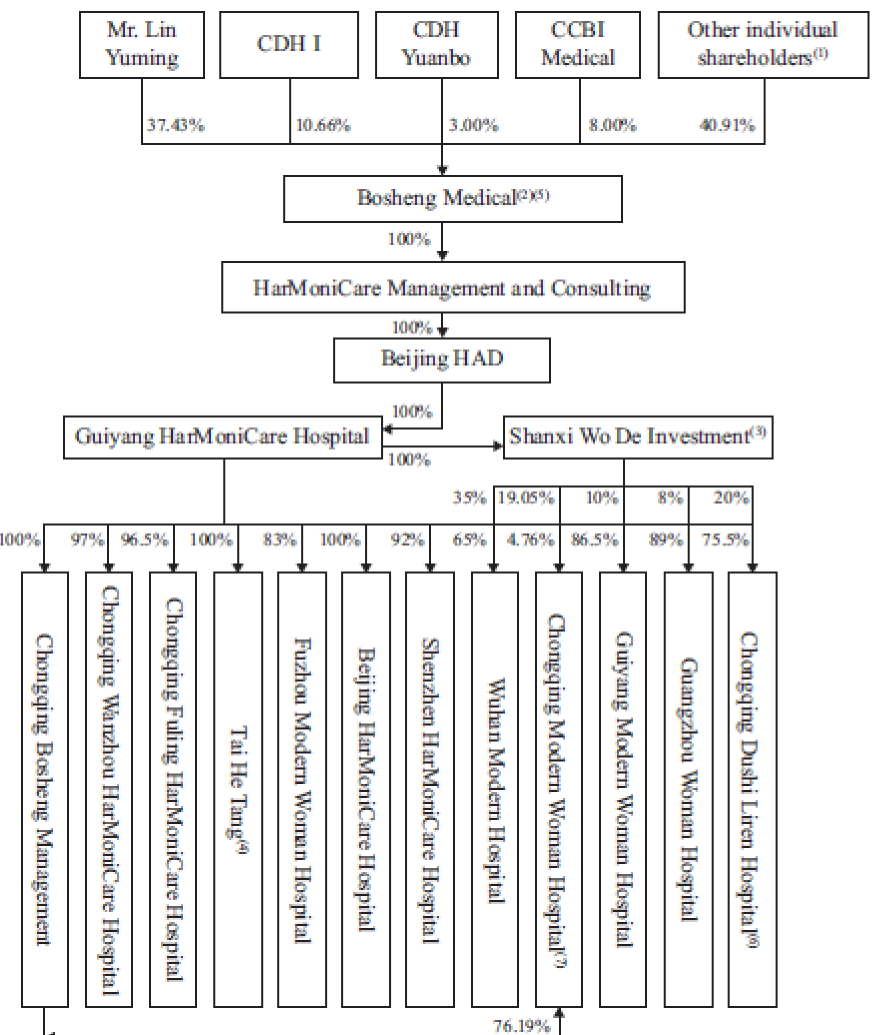
Harmonicare

In June 2015, following Phoenix Medical, Harmonicare (01509.HK) was listed on the Hong Kong Stock Exchange as the second domestic hospital concept stock. Harmonicare Holdings Limited ("**Harmonicare**"), as the foreign listed company, was founded on August 26, 2014 and is the largest maternity hospital group in China. Its member medical institutions are located in Beijing, Guangzhou, Shenzhen, Chongqing, Guiyang, Wuhan, and Fuzhou, etc., most of which specialize in obstetrics and gynecology. The ownership structure of Harmonicare immediately after the pre-IPO restructuring and before the IPO is as below:



As shown in the chart above, prior to listing, Harmonicare Management Consulting Co., Ltd. ("**Harmonicare Consulting**") was a wholly foreign-owned enterprise and held a 100% equity interest in Beijing Heanda Management Consulting Co., Ltd. ("**Beijing Heanda**"). Beijing Heanda held a 100% equity interest in Guiyang Harmonicare Maternity Hospital ("**Guiyang Harmonicare**"), which actually held more than an 80% equity interest in a majority of the domestic hospitals associated with Harmonicare. The issue here is whether this ownership structure violates the 70% equity limitation as stipulated in the *Interim Measures*?

After the restructuring, the ownership structure of Harmonicare before establishing the overseas red-chip structure is shown below:



The restructuring took place in December 2014 and resulted in a change in the nature of the owners of Guiyang Harmonicare. Before establishing the overseas red-chip structure, Harmonicare Consulting was a wholly domestic-invested enterprise.

Review of Regulations from Article (I): Policies

- when the above reorganization occurred, the *Circular on Carrying out the Pilot Program of the Establishment of Wholly Foreign-Owned Hospitals* (Guo Wei Yi Han [2014] No. 244, hereinafter referred to as"**Circular 244**") had already been promulgated by the National Health and Family Planning Commission and the Ministry of Commerce on July 25, 2014.
- On the other hand, the *Catalogue for the Guidance of Foreign Investment Industries (Revised in 2015)* had not yet been formally promulgated. The *Catalogue* was released on March 10, 2015 and put into force on April 10, 2015.

The main steps to establish the overseas red chip structure are as follows:

- December 11, 2014
  BMCC approves the transfer of a 13.66% equity interest in Harmonicare Consulting held by Boshengyl Medical to Sharp Charm. After that, Harmonicare Consulting became a joint venture enterprise.

- December 30, 2014
  BMCC approves the transfer of Boshengyl Medical's remaining 86.34% equity interest in Harmonicare Consulting to Harmonicare Hong Kong, resulting in Harmonicare Consulting becoming a wholly foreign-owned enterprise.

Harmonicare also noted the issue regarding the legality of its indirect holding of more than a 70% equity interest in PRC hospitals. As a result, Harmonicare presented the following comments in its prospectus:

a. Harmonicare has held a greater than 70% equity interest in its affiliated PRC hospitals since January 2015. The *Catalogue for the Guidance of Foreign Investment Industries (Revised in 2011),* which was effective during that period, had no restriction on the foreign ownership of medical institutions. Harmonicare completed the restructuring before the implementation of the *Catalogue for the Guidance of Foreign Investment Industries (Revised in 2015)*.

b. Prior to, at the time of and after the restructuring, the direct owners of the affiliated PRC hospitals, as well as the hospitals themselves were not foreign-invested entities. Therefore, the PRC hospitals associated with Harmonicare are not "Sino-foreign joint venture medical institutions" as defined in the *Interim Measures*.

c. The *Interim Measures* have no limitation on the ownership ratio of foreign enterprises in medical institutions through intermediate PRC affiliates.

In addition, Harmonicare has also committed that it would ensure its compliance with PRC laws and regulations related to foreign investment when establishing or acquiring new hospitals in the future, particularly for plans to introduce minority owners to such new hospitals (including senior management staff and other potential domestic business partners).

Compared with Phoenix Medical, the biggest difference in this case was that the Harmonicare restructuring occurred in December 2014, at the time when the foreign investment policy was at its most open and relaxed stage. However, we understand that there is still room for discussion about this most important comment. In fact, Harmonicare had several affiliated PRC hospitals located in Chongqing, Wuhan and Guiyang, which are not among the seven pilot provinces/municipalities under Circular 244. Strictly speaking, regions other than the seven pilot provinces/municipalities should still have been subject to the *Interim Measures*. This is one reason why Harmonicare added the two other comments.

Furthermore, both Phoenix Medical and Harmonicare raise the same critical question - what is a

"Sino-foreign joint venture medical institution"? According to Article 2 of the *Interim Measures*, "Sino-foreign joint venture medical institutions and cooperative medical institutions refer to medical institutions established in the form of a joint venture or cooperation by foreign medical institutions, companies, enterprises or other economic organizations (hereinafter referred to as foreign joint venturers or foreign cooperators) with Chinese medical institutions, companies, enterprises or other economic organizations (hereinafter referred to as Chinese joint venturers or cooperators) within the territory of China (excluding Hong Kong, Macao and Taiwan) on the basis of the principle of equality and mutual benefit and on the approval of the Chinese government." Taken literally, since wholly foreign-owned enterprises and Sino-foreign joint venture enterprises are not foreign medical institutions, companies, enterprises or other economic organizations, the medical institutions that such entities jointly establish with Chinese joint venturers or cooperators are certainly not Sino-foreign joint venture medical institutions or cooperative medical institutions. However, we wish to ask whether this interpretation truly reflects legislative intent. We recommend that investors fully consult with the competent health department and commerce department before carrying out similar transactions, in order to reduce the risk of being found to have deliberately evaded mandatory legal provisions. In addition, investors may also refer to the example of Harmonicare and introduce domestic minority owners.

Artemed Hospital in the Shanghai Pilot Free Trade Zone

Different from the previous two cases involving public listings, the Artemed Hospital case is notable because the hospital is known as being the first wholly foreign-owned hospital in mainland China (excluding those wholly owned by Taiwan, Hong Kong or Macao investors).

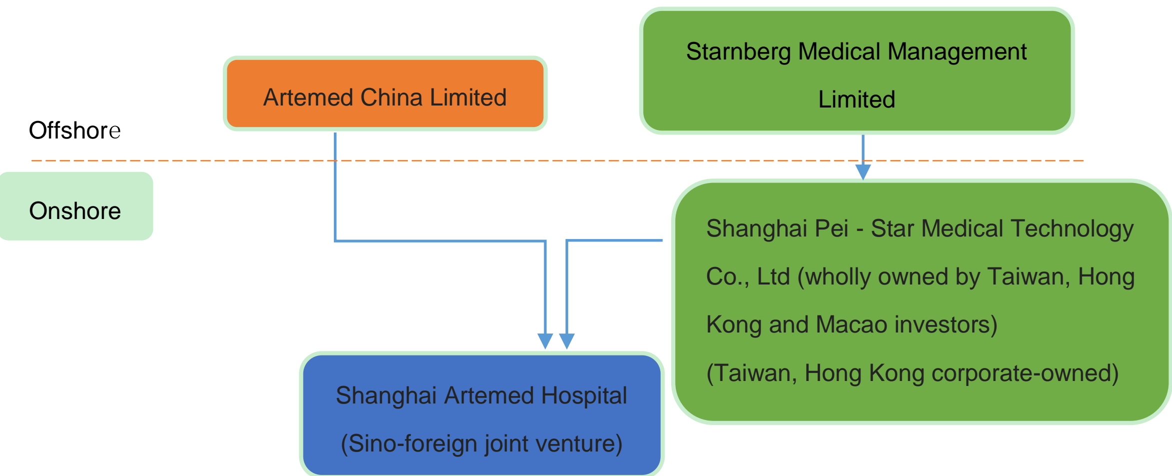
According to public reports, on July 22, 2014, Artemed Group, Silver Mountain Capital and Shanghai Waigaoqiao Bonded Area Sanlian Development Co., Ltd. and Waigaoqiao Medical Insurance Center signed a strategic cooperation framework agreement with respect to the establishment of Artemed Shanghai Hospital ("**Shanghai Artemed Hospital**"), which, after completion, is to become the first wholly foreign-owned hospital (excluding Taiwan, Hong Kong and Macao) in the Shanghai pilot free trade zone and across the nation.

According to the information shown on the official Artemed website and inquiry results from the National Enterprise Credit Information Publicity System, the schedule for the Shanghai Atmed Hospital project is as shown in the table below:

Date	Event	Source
2014.07.22	Executed the Strategic Cooperation Framework Agreement with respect to establishment of a wholly foreign-owned hospital	Artemed website
2015.11.24	Obtained the approval to set up medical institution	Artemed website
2015.12.11	Obtained investment approval for investors from	Artemed website

	Taiwan, Hong Kong and Macao	
2015.12.14	Obtained a business license with a scope of business for "hospital construction"	National Enterprise Credit Information Publicity System
At present	Engineering design stage, plans to break ground by the end of 2016	Artemed website

However, as the project progressed, things did not proceed exactly as expected. According to the information shown in the National Enterprise Credit Information Publicity System, Shanghai Artemed Hospital is a limited liability company (Sino-foreign joint venture), whose equity structure is shown as below:



As shown in the above chart, Shanghai Artemed Hospital eventually adopted the form of a Sino-foreign joint venture, with investment from an enterprise wholly-owned by Taiwan, Hong Kong and Macao investors and foreign investors. And the foreign investors referred to in this case may also mean entities incorporated in Taiwan, Hong Kong or Macao (due to limited public information, it is difficult to determine whether they meet relevant conditions to be Taiwan, Hong Kong or Macao service providers). But from this point of view, all of the investors are foreign entities.

The question is why did the company abandon the original wholly foreign-owned structure? Was it because of the re-tightened foreign investment admission policy for medical institutions which was put into force since April 10, 2015? If yes, does Artemed's Sino-foreign joint venture structure, which is wholly-foreign owned when looking through the structure, raise suspicions of evading the 70% foreign equity limitation? If both Artemed China Limited and Starnberg Medical Management satisfy the conditions to be Taiwan, Hong Kong and Macao service providers, can the two entities directly establish a hospital wholly owned by Taiwan, Hong Kong and Macao investors, rather than through

the intermediate Shanghai Pei-Star Medical Technology Co., Ltd. (established on August 19, 2015)?

Review of Regulations in Article (I): Policies

- The Strategic Cooperation Framework Agreement was signed on July 22, 2014. However, the *Provisional Measures on the Administration of Wholly Foreign-Owned Medical Institutions in the China (Shanghai) Pilot Free Trade Zone* was already released and put into practice since November 13, 2013.
- The approval to establish medical institutions was obtained on November 24, 2015. However, *Catalogue for the Guidance of Foreign Investment Industries (Revised in 2015)* had already been promulgated since April 10, 2015.

Due to the limited public information available about non-listed companies, we only make above analysis from a legal perspective. In any event, the Artemed Hospital case also touches on the difficult question of "what is a Sino-foreign joint medical institution"? Business practices are constantly changing, we shall see how the legislators and competent authorities respond to this question in the future.

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