HAN KUN
汉坤律师事务所
Han Kun Law Offices

HAN KUN 2023 VC/PE DATA ANALYSIS

2024.07

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Part 1 Introduction

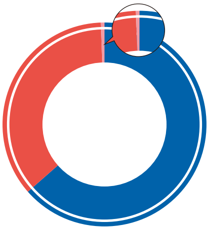
Han Kun Law Offices is a full-service law firm in China. Over the years we have been a leader in the venture capital and private equity (VC/PE) practice area representing clients in the full range of VC/PE transactions from angel/seed to pre-IPO rounds of investments. These transactions may be structured either onshore or offshore with investment proceeds denominated either in RMB or U.S. dollars to accommodate specific needs of the transactions. Our clients epitomize the entire investment community consisting of the most prolific domestic and international investors on the one hand and, on the other, household name corporations, start-ups and unicorns positioned on the cutting edge of leading industries.

In 2023, we helped clients close nearly 400 VC/PE transactions. In this report, we analyze the investment structures and key legal terms commonly used in such transactions. In addition, we horizontally compare the data from the nearly 3,900 transactions we worked on in the previous seven years to illustrate the evolving trends and changes of the investment structures and key legal terms. Much of the comparison and analysis is anchored on an examination of the following legal terms: (i) preemptive right, (ii) right of first refusal and co-sale right, (iii) redemption right, (iv) anti-dilution right, (v) drag-along right, (vi) dividend preference, (vii) control right (protective provisions and board composition), (viii) employee equity incentive plans, (ix) liquidation preference, (x) restrictions on founders, (xi) share transfer by founders, (xii) information right and inspection right, (xiii) survival period of representations and warranties, (xiv) indemnification and founders' personal liability, (xv) restrictions on investors, (xvi) most-favored nation clause, (xvii) valuation adjustment mechanism and (xviii) dispute resolution.

Unless otherwise defined, the transactions and investments referred to in this report relate to the VC/PE transactions that we worked on over the specific years.

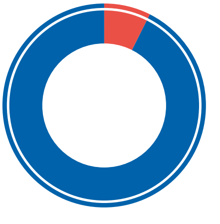
We publish this report annually in the hope that readers may find it useful to track the evolution and development of China's VC/PE industry.

2023 VC/PE Transactions — Investment Currency and Investor Type



Investment Currency

- RMB 63.53%
- USD 35.90%
- HKD 0.57%



Investor Type

- Financial investors 92.59%
- Strategic investors 7.41%

In the VC/PE transactions we worked on in 2023, the following trends transpired:

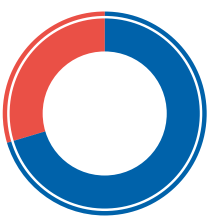
Both the number of transactions and the deal value declined while early-stage investments defied the slide. The VC/PE market registered a noticeable slowdown in 2023. The increasing geopolitical tensions and the economic paradigm shift suppressed the global investment demand and hampered the post-Covid recovery of the world economy. Compared to the recent past, the number of VC/PE transactions completed in 2023, the total amount of investment and the average deal value of such transactions all registered a significant decline. Among the transactions completed in 2023, the early-stage investments (such as seed, angel and Pre-A rounds) accounted for 36.47%, the highest percentage recorded in the past seven years. By contrast, Series B and subsequent rounds of investments and their share in the total transactions continued to languish for the year.

Onshore transactions continued their upward trend while VIE structure lost luster for offshore transactions. In the VC/PE parlance, the onshore transaction (or onshore structure) refers to a situation where the investee company (the "company" or the "investee company") uses an entity registered in China as its financing vehicle and investments are made directly into such vehicle. By contrast, in an offshore transaction (or offshore structure), the investee company uses an entity registered outside of China (i.e., the Cayman Islands) to receive investments while the company's principal business operations remain in China.

Onshore transactions are further divided into (i) those using a pure domestic structure, where the company is 100% domestic company without any foreign investment; and (ii) those using a FIE structure, where the company is partially owned by foreign investors and registered under PRC law as a foreign-invested enterprise. In 2023, onshore transactions accounted for 70.37% of the total, the highest percentage recorded in the past seven years. Of the onshore transactions completed in 2023, those using the pure domestic structure accounted for 67.61%, showing a slight increase from 64.80% recorded in 2022, and those using the FIE structure accounted for 32.39%, which decreased slightly from 35.20% recorded in 2022.

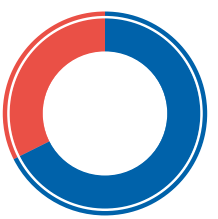
Offshore transactions are likewise further divided into (i) those using the VIE structure, where the offshore financing vehicle indirectly controls the onshore operating company through contractual arrangements; and (ii) those using the direct shareholding structure, where the offshore financing vehicle directly owns the equity interests in the onshore operating company. In 2023, the offshore transactions accounted for 29.63% of the total, the lowest percentage recorded in the past seven years and among them only 43.27% adopted the VIE structure, showing a significant decline as compared to a range of 99.32%—70.93% recorded in 2017 to 2022. Those using the direct shareholding structure, on the other hand, accounted for 56.73%, reflecting a growing popularity of this structure as compared to a range of 0.68%—29.07% recorded in 2017 to 2022. This is the first time that the direct shareholding structure outnumbered the VIE structure in offshore transactions.

2023 VC/PE Transactions — Structures



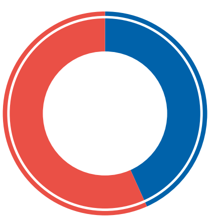
Transaction Structure

- Onshore structure 70.37%
- Offshore structure 29.63%



Onshore Structure

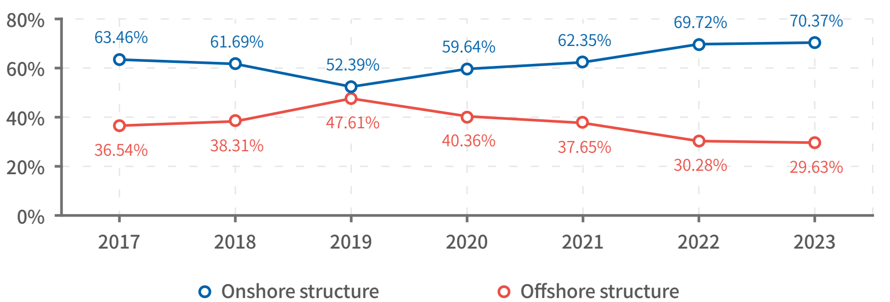
- Domestic structure 67.61%
- FIE structure 32.39%



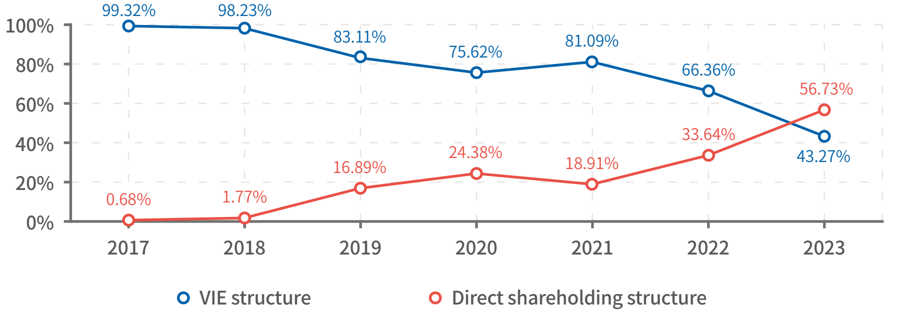
Offshore Structure

- VIE structure 43.27%
- Direct shareholding structure 56.73%

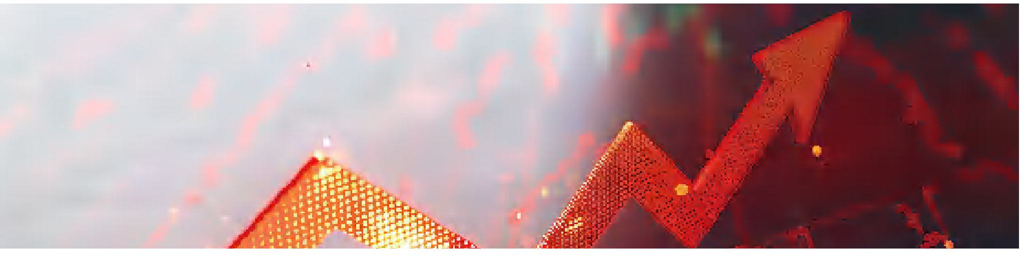
Changes in Transaction Structures over the Past Seven Years



Changes in Transaction Structures over the Past Seven Years — Offshore Structure



Shanghai, Beijing, Shenzhen, Hangzhou and Suzhou were the most popular cities in China for investee companies to base their principal operations. Among the transactions completed in 2023, 64.96% of the investee companies chose Shanghai, Beijing, Shenzhen, Hangzhou and Suzhou to base their principal operations. For many years as shown in our data, the thriving VC/PE market in Beijing, Shanghai and Shenzhen made them the home of choice for many start-ups. Since 2021, however, the popularity of Beijing and Shanghai as the principal business abode has gradually slid downward. This is particularly true of Beijing where in 2023 only 17.95% of the transactions had companies choosing the city to base their operations. This is a noticeable decline from 24.81% recorded in 2022. It also marked the first time that Beijing forfeited the honor to Shanghai as the choicest domicile for new investee companies. On the other hand, companies based in Suzhou continued to attract a growing share of VC/PE investments. In 2023, the number of investments placed into Suzhou-based companies accounted for 5.41% of the total, making Suzhou the fifth most favored Chinese city for VC/PE investments. It is worth noting that VC/PE investments placed with companies based in the United States and Singapore has been on the rise. In 2023, such investments accounted for 6.55% and 1.71% of the total, respectively, representing a solid growth from the year before.



Biomedical, new materials, semiconductor, smart hardware, automobiles and transportation were the top draws for VC/PE investments. The biomedical sector has attracted the largest share of VC/PE investments over the past seven years, as is shown in our data. In 2023, 22.79% of the transactions involved companies engaged in biotechnology, medical and pharmaceutical business, the highest percentage in the past seven years. The next four top sectors for VC/PE investments were new materials and new energy products (excluding new energy vehicles), 12.25%; semiconductor, integrated circuit and chip, 11.11%; smart hardware (e.g., artificial intelligence, augmented reality), 10.83%; and automobiles and transportation (including new energy vehicles), 3.99%. Corporate services, e-commerce and food catering sectors, which used to command top five positions for investment in the past, all fell from the pedestal in 2023 and garnered the lowest level of VC/PE investments recorded in the past seven years.

Transactions originated by financial investors trended upward. In 2023, transactions initiated by financial investors accounted for 92.59% of the total, the highest level in the past seven years. As a corollary, transactions driven by strategic investors fell to 7.41% of the total, as compared to the range of 8.10%—16.44% in the previous years.

Term sheet transactions reached a new low. Among the transactions completed in 2023, only 38.75% were initiated with the execution of a term sheet/letter of intent between investors and target companies, the lowest level in the past seven years. Such transactions peaked in 2018 commanding 66.44% of the total. Since then, they have been on a continuous decline.

Part 2 Analysis of Specific Terms

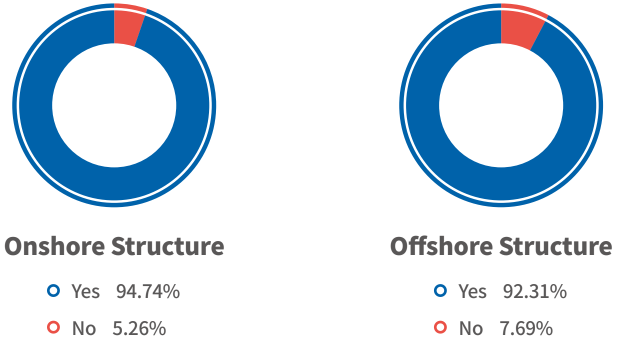
Preemptive Right

The preemptive right is a priority right commonly granted to investors. It accords to certain shareholders (typically investors[1]) a priority right over other shareholders and third parties to subscribe for any new shares (or new registered capital) to be issued by the company. It is designed to preserve the shareholding of investors from being diluted by the company's future capital raisings. According to our data, in each of the past seven years around 94%—97% of the transactions adopted the preemptive right. In 2023, it was 94.02%.

[1] In VC/PE transactions, investors usually hold preferred shares of the company (also called the preferred shareholders), founders usually hold common shares of the company (also called the common shareholders). The preferred shares carry a series of preferred rights and privileges.

The following chart presents how the preemptive right was adopted in onshore and offshore transactions in 2023.

Preemptive Right



It should be noted that under the PRC Company Law, shareholders of a limited liability company enjoy the right as a matter of law to subscribe for any new capital of the company in an amount corresponding to their current paid-up capital in the company's registered capital. Thus, in the absence of an express agreement to the contrary, even if the preemptive right is not expressly provided for in an onshore transaction, the existing shareholders are entitled to nothing less.

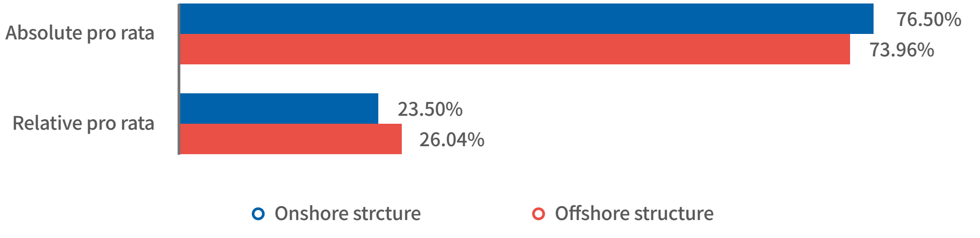
The preemptive right is divided into "absolute pro rata" and "relative pro rata". Under the absolute pro rata scenario, the number of newly issued shares that an existing investor is entitled to subscribe for is calculated based on its current shareholding[2] in the company. As a result, the existing investors cannot collectively exhaust all the newly issued shares of the company. Under the relative pro rata scenario, on the other hand, the number of newly issued shares that an existing investor is allowed to subscribe for is calculated based on its shareholding relative to the shares held by all existing investors. Thus, the existing investors can collectively exhaust all the newly issued shares of the company. Since the main purpose of the preemptive right is to prevent dilution and not to seek an increase in the shareholding of the existing investors, the absolute pro rata is used more often to calculate the number of newly issued shares that an existing investor is allowed to subscribe for.

[2] In offshore transactions, an investor's pro rata share (or shareholding) in a company is usually determined based on the number of common shares deliverable to it upon conversion of its preferred shares (or on an as-converted basis). Under onshore and offshore transactions, parties may further specify the formular for calculating shareholding percentage (e.g., based on the paid-up capital and fully diluted basis).

Our data of the past seven years show that about 70%—80% of the transactions that provided for the preemptive right adopted the absolute pro rata approach. In 2023, this percentage was 75.76%.

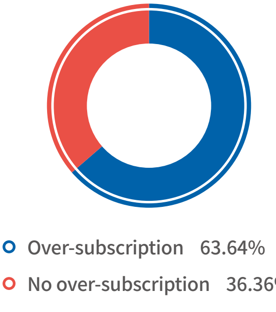
The chart below shows how the two categories of preemptive right were adopted in onshore and offshore transactions in 2023.

Preemptive Right — Absolute Pro Rata vs. Relative Pro Rata



The over-subscription right is a key companion to the preemptive right. It allows a holder of the preemptive right who has fully exercised its preemptive right to subscribe for additional newly issued shares if another preemptive right holder decides not to fully exercise its own right. According to our 2023 data, about 63.64% of the transactions that provided for the preemptive right also provided for the over-subscription right.

Preemptive Right — Over-subscription Right

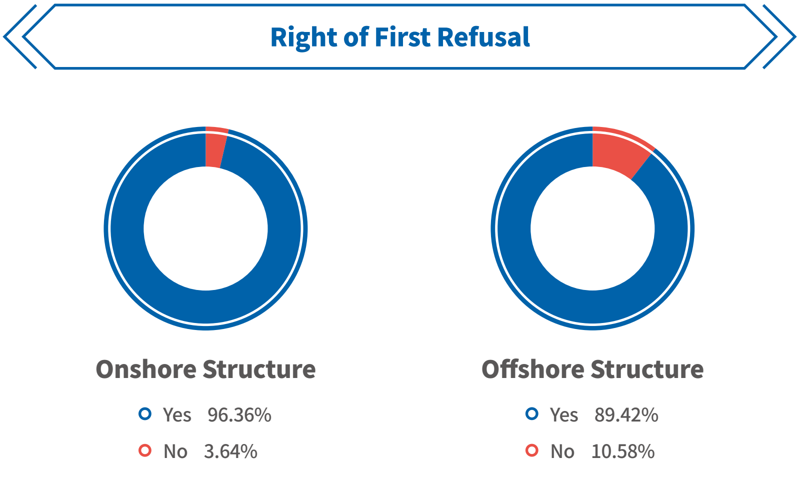


Right of First Refusal and Co-sale Right

Right of First Refusal

In the context of VC/PE transactions, when a shareholder intends to sell its shares, the right of first refusal ("ROFR") allows the right holders (typically investors, the "ROFR holders") to purchase the offered shares prior to any prospective buyer on terms and conditions that are at least equal to those offered by the prospective buyer. This ROFR is designed to restrict share transfers by specific shareholders and, when exercised, to increase the shareholding of the ROFR holders.

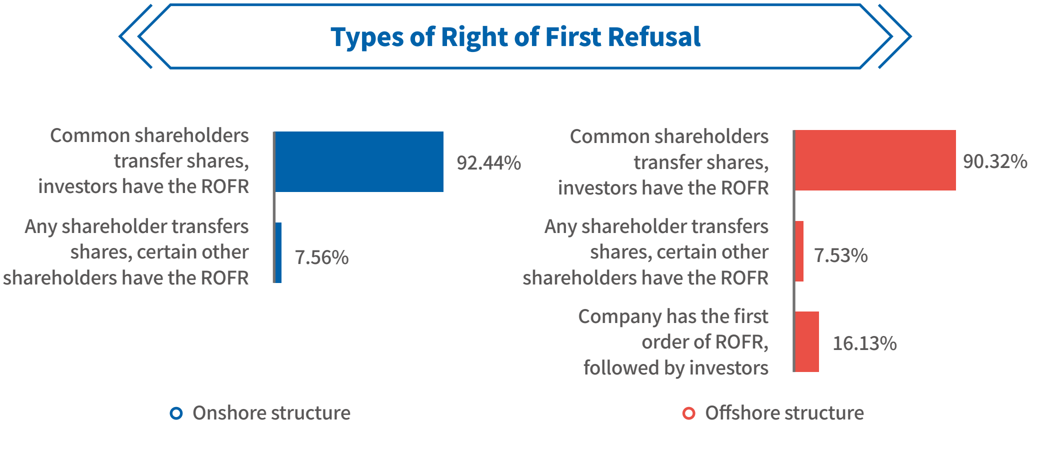
The figure below shows how the ROFR was adopted in the 2023 transactions.



For the few transactions that did not provide for the ROFR, it is worth noting that the PRC Company Law contains specific provisions governing the transfer of company shares. Accordingly, even if the ROFR is not expressly provided for in transactions governed by the PRC law, the right is statutorily available to shareholders of a limited liability company.

In most transactions, the ROFR is used to restrict share transfers by common shareholders (typically the founders). Our data over the past seven years indicate that in about 90% of the transactions that provided for the ROFR, deal documents provided that when common shareholders proposed to sell their shares, the preferred shareholders had the ROFR to purchase such shares (known as the "common shareholders transfer shares, investors have the ROFR"). In some offshore transactions, the ROFR is granted to the company to purchase the offered shares ahead of the preferred shareholders. In this case, only when the company elected not to fully exercise the ROFR may the preferred shareholders purchase any remaining shares proposed to be sold by the common shareholders (known as the "company has the first order of ROFR"). Based on our 2023 data, among the offshore transactions that provided for the ROFR, 16.13% adopted the "company has the first order of right of first refusal" approach. Furthermore, there have always been a small number of transactions where certain other shareholders will have the ROFR if any shareholder proposes to sell its shares. Such other shareholders may include all investors or all non-selling shareholders. This is known as "any shareholder transfers shares, certain other shareholders have the ROFR". As per this approach, shares to be sold by investors are also subject to the ROFR.

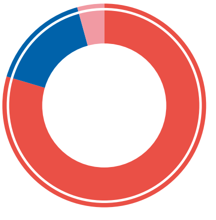
The following chart shows how different types of ROFR were adopted in 2023 transactions.



Note: The data include cases where multiple types of the right of first refusal are used simultaneously.

Like the preemptive right, the ROFR may also be exercised on an absolute pro rata or relative pro rata basis. Unlike the preemptive right, however, the ROFR is exercised predominantly on the relative pro rata basis. According to our 2023 data, the relative pro rata approach was used in 79.60% of the transactions that adopted the "common shareholders transfer shares, investors have the ROFR" model. The rationale is that the relative pro rata approach maximizes the ability of investors to purchase all the offered shares and maximally restricts founders from selling their shares to third parties.

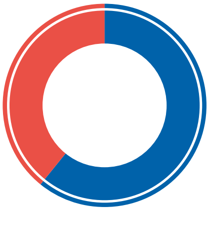
Right of First Refusal — Absolute Pro Rata vs. Relative Pro Rata



- Absolute pro rata 16.12%
- Relative pro rata 79.60%
- Others 4.28%

The overallotment right is designed to enhance the ROFR to further restrict share transfers by restricted shareholders and to allow the ROFR holders to purchase additional shares. Thus, if a ROFR holder does not exercise its ROFR with respect to all or part of the offered shares, each other ROFR holder who has fully exercised its ROFR will be entitled to purchase any offered shares still remaining. Based on our 2023 data, the overallotment right was provided for in 60.82% of the transactions that adopted the "common shareholders transfer shares, investors have the ROFR", which represented a significant decline from 70.34% as recorded in 2022.

Right of First Refusal — Overallotment Right



- Overallotment 60.82%
- No overallotment 39.18%

Co-sale Right

When a common shareholder proposes to sell its shares, the co-sale right allows an investor (who has not exercised its ROFR) to sell its own shares alongside the selling common shareholder at a pre-agreed ratio. The co-sale right is a common feature in VC/PE transactions which allows investors to simultaneously exit with the founders. It also functions as a restriction on the founders' freedom to transfer shares. Based on our data in 2023, 93.16% of the transactions provided for the co-sale right.

The key to the co-sale right is the formula for calculating the maximum number of shares an investor can co-sell. The table below sets out the various formulas and how they were adopted in the 2023 transactions. The first formula, which maximizes the number of shares an investor can sell, was the most popular for both onshore and offshore transactions.

Co-sale Ratio Calculation Formula	Onshore Structure	Offshore Structure
Shares held by the investor / (shares held by all investors exercising co-sale right + shares held by the transferor)	66.25%	63.33%
Shares held by the investor / (shares held by all investors entitled to exercise co-sale right + shares held by the transferor)	18.14%	26.67%
Shares held by the investor / (shares held by all investors + shares held by the transferor)	4.64%	2.22%
Shares held by the investor / all issued and outstanding shares	3.80%	2.22%
None of the above	7.17%	5.56%

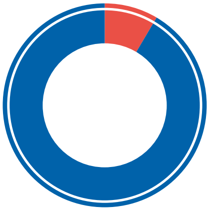
Finally, in the 2023 transactions that provided for the co-sale right, 15.95% adopted "special co-sale right under change of control". Thus, if the transfer by a common shareholder would lead to a change of control of the company, the investors may co-sell the whole of their own shares. According to our 2023 data, the "special co-sale right under change of control" provision was more common in onshore transactions than in offshore ones.

Redemption Right

The redemption right (also known as the repurchase right) provides investors with a mechanism to divest their investment in the company. In VC/PE transactions, investors are usually given the right to require the company and/or for the founders to redeem their shares at a pre-agreed price upon the occurrence of one or more the following trigger events (the "redemption trigger events"): (i) failure of the company to consummate a qualified IPO or a trade sale within a set time limit or (ii) a material default or non-compliance attributable to the company and/or the founders. Based on our data over the past seven years, the redemption right was overwhelmingly adopted in transactions (either onshore or offshore) sponsored by Chinese investors. This demonstrates that the redemption right is the preferred exit strategy for Chinese investors. However, in 2023 the percentage of offshore transactions that did not provide for the redemption right increased notably as compared to 2022. Particularly, the redemption right was seldom accorded to investors in transactions involving the biomedical and Web3 sectors and those involving investee companies based in the United States.

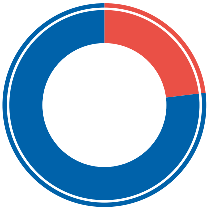
The following chart shows the use of redemption right in onshore and offshore transactions in 2023.

Redemption Right



Onshore Structure

- Yes 91.50%
- No 8.50%



Offshore Structure

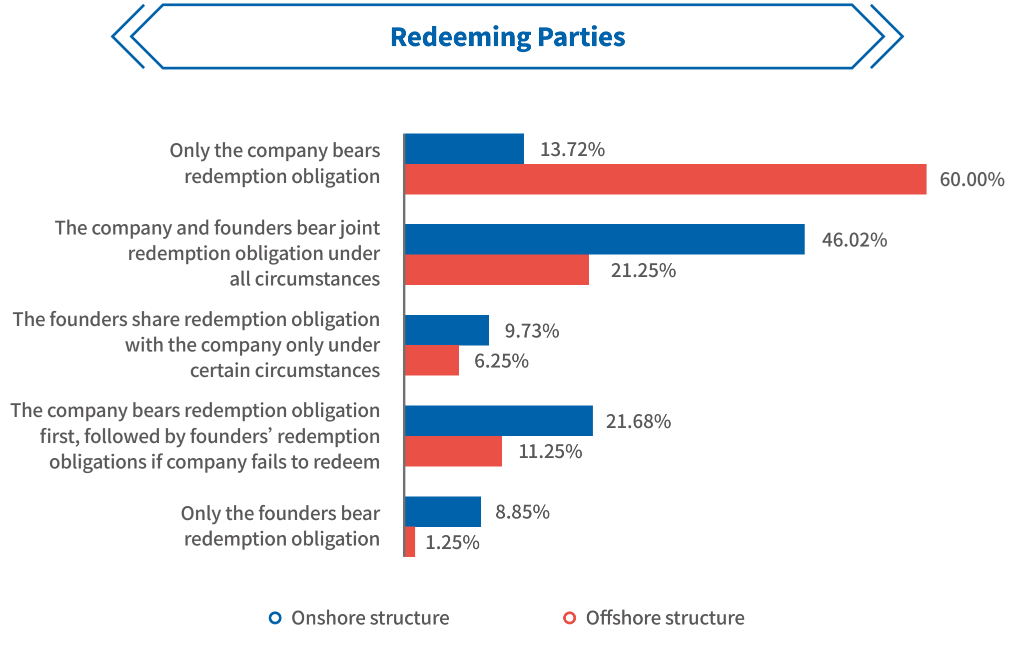
- Yes 76.92%
- No 23.08%

The onshore and offshore transactions differ substantially as to which parties to bear the redemption obligation. In most offshore transactions, the obligation falls solely upon the company. In onshore transactions, by contrast, founders and the company are usually bound together to discharge the redemption obligation, or in some cases, the founders alone are responsible for the redemption. This divergence comes mainly from the differences in law and judicial practice of the jurisdictions where the financing vehicles of investee companies are established. Given the complexity of the share redemption procedures under the PRC law, investors in onshore transactions usually require that the founders and companies be jointly and severally liable for the redemption to minimize any uncertainty for the investors to exercise their right. In this context, it is noteworthy that even in offshore transactions it has become increasing rare for the companies alone to shoulder the redemption obligation. In the 2023 offshore transactions that had the redemption right, 60% of them provided that the companies alone should be responsible for the redemption obligation. Although the number was slightly higher than 56.76% in 2022, it is still a relatively low percentage in the past four years. This shows that investors in offshore transactions increasingly demand flexibility to divest their investment.

When required to bear the redemption obligation jointly with the company, founders often seek to limit their personal risk exposure by predicating their obligation on certain conditions, such that their obligation will only be triggered (i) under certain pre-agreed circumstances or (ii) when the company is unable to carry out the redemption obligation due to legal obstacles or the lack of funds. The following is a summary of the common variations as to which parties to bear the redemption obligation:

- the company alone bears the redemption obligation
- the company and founders jointly bear the redemption obligation under all circumstances
- the founders share the redemption obligation with the company only under certain circumstances
- the company bears the obligation first, and the founders' redemption obligation is triggered if the company fails to fulfill its redemption obligation
- the founders alone bear the redemption obligation

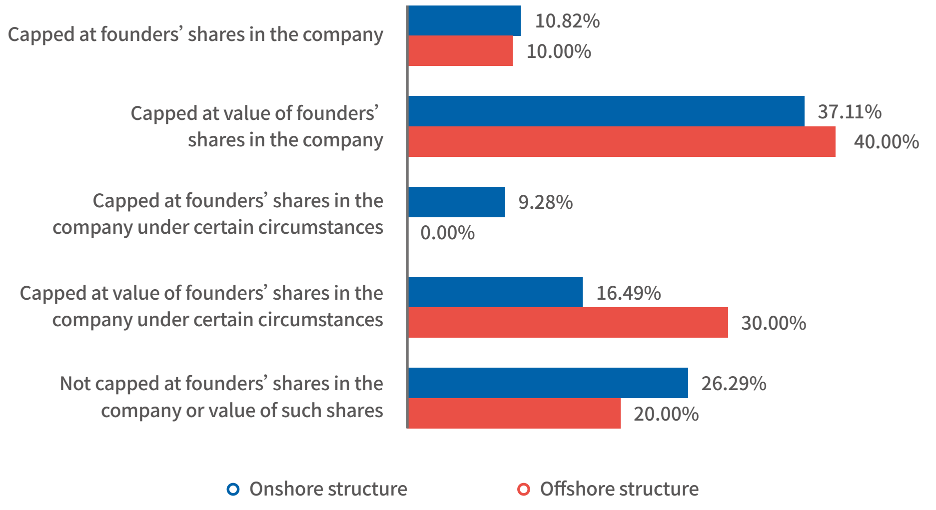
The chart below presents a breakdown of how the redemption obligations were allocated in onshore and offshore transactions in 2023.



Where they are obligated to redeem shares from investors either alone or together with the company, founders often seek to cap their obligation to the extent of their shares in the company or the value of such shares (under all or limited circumstances) so that their personal and family assets are protected from such obligation.

The chart below shows the various caps that founders used to limit their redemption obligation in the 2023 transactions where they assumed the redemption obligation.

Redeeming Parties — When Founders Assume the Redemption Obligation, the Capped Amount



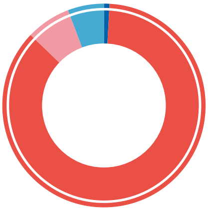
The redemption price is typically calculated based on the following formulas:

(a) the multiples of the investment principal,
(b) the investment principal (or certain multiples thereof) + simple or compound interest accrued thereon, or
(c) the higher of (i) the amount calculated as per (a) or (b) and (ii) certain other benchmarks such as the fair market value or audited net assets.

Our data over the past seven years show that formula (b) was the most popular for the calculation of the redemption price, regardless of whether the underlying transactions were structured onshore or offshore. According to our 2023 data, formula (b) was used in 85.62% of the transactions that had redemption right, the highest level in the past seven years. This seems to suggest that (i) investors and companies preferred a formula that could adjust the price by factoring in the timing of the exit and that (ii) investors wanted to reconcile the redemption price with the internal rate of return for their investment. By contrast, formula (a) was used in only 1.63% of the 2023 transactions that had redemption right, the lowest in the past seven years. Over the same time span, formula (c) accounted for 8.17%.

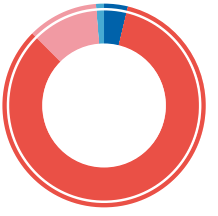
The chart below shows the formulas for calculating the redemption price used in the 2023 transactions.

Formulas for Calculation of Redemption Price



Onshore Structure

- Multiples of investment principal 0.88%
- Investment principal (including multiples thereof) + simple/compound interest 86.28%
- Higher of two or three models 7.08%
- Others 5.75%

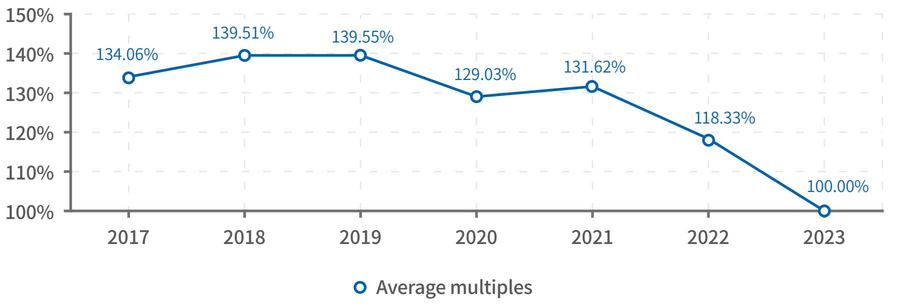


Offshore Structure

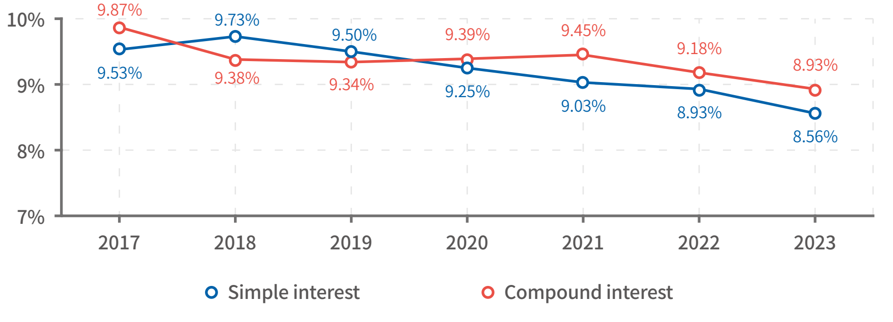
- Multiples of investment principal 3.75%
- Investment principal (including multiples thereof) + simple/compound interest 83.75%
- Higher of two or three models 11.25%
- Others 1.25%

Based on our 2023 data, (i) where the redemption price was calculated based on (a) above (the "multiples of the investment principal"), the average multiple was 100%, a significant drop as compared to 2022 and the lowest in the past seven years; (ii) where the redemption price was calculated based on (b) above (the "investment principal or certain multiples thereof + simple or compound interest accrued thereon"), the average interest rate was 8.56% annualized simple interest or 8.93% annualized compound interest, representing a slight drop as compared to the previous years. The drop seemed to correlate with the global economic slowdown in 2023 which apparently dampened the expectations about the internal rate of return of investee companies. Likewise, some companies and founders became increasingly sensitive to the redemption price as the economic uncertainties increased the likelihood that their redemption obligation would be triggered.

Redemption Price — Only Multiples of Investment Principal Average Multiples Trend over the Past Seven Years

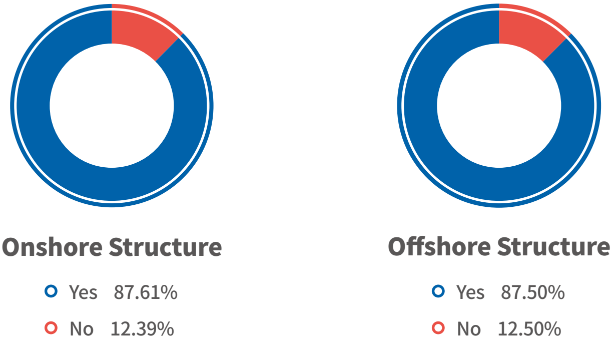


Redemption Price — Investment Principal (or certain multiples thereof) + Simple/Compound Interest Average Interest Trend over the Past Seven Years



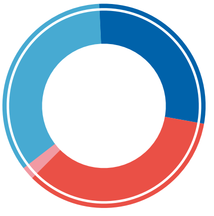
The right of investors to demand redemption can be exercised only upon the occurrence of one or more redemption trigger events. A very common trigger event is the company's failure to consummate a qualified IPO within a pre-agreed time limit. As shown in our data where the redemption right was accorded to investors, 87.58% of the transactions in 2023 provided that if the company failed to complete a qualified IPO within a time limit, the investors could enforce their redemption right. With respect to the IPO time limit, a range of 3—5 years was common, but it may vary depending on the specific expectations of investors. As shown in our 2023 data, about 2/3 of the early-stage investments (such as seed, angel and Pre-A rounds) indulged a time limit beyond five years, while nearly 50% of Series C and later rounds of investments typically demanded three years or less to complete the required IPO.

Redemption Trigger Event — Company's Failure to Complete Qualified IPO within Required Time Limit after the Closing Existence



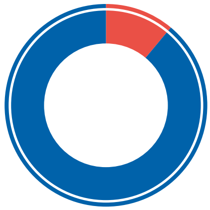
In each round of financing, the required time limit for a qualified IPO is typically set to run from the financial close of such round. In the case of multiple rounds of financing, the deadline for a qualified IPO specified in subsequent rounds of financing is usually later in time than those set in the preceding rounds. If so, the redemption obligation in a subsequent round of financing would be triggered later in time than those in the preceding rounds. Since subsequent investors do not want the company to exhaust its cash reserve to redeem earlier investors and suppress the company's valuation, they sometimes require the earlier investors to extend their IPO deadline so that all IPO deadlines would be synchronized. Companies often welcome such an extension as it eases the time pressure to accomplish the IPO. In 2023, in about 1/3 of Series B or later rounds of transactions, investors in earlier rounds agreed to extend the existing IPO deadlines. If the earlier investors insist on sticking to their original IPO deadline, subsequent investors often request a cross-trigger right so that they could enforce their redemption right simultaneously with the earlier investors.

Redemption Trigger Event — Company's Failure to Complete Qualified IPO within Required Time Limit after the Closing Whether Investors in Earlier Rounds Agree to Extend IPO Deadline in Subsequent Financing



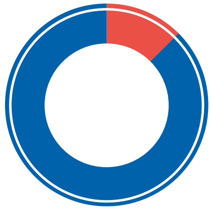
In addition to the qualified IPO time limit and the cross-trigger right discussed above, other common redemption trigger events include (i) failure of the founders or the company management to meet the integrity test; (ii) material breach by the company and/or founders of the transaction documents; (iii) illegality of the company's business operation due to the change of PRC legal environment; (iv) failure of the company to obtain or retain key licenses or intellectual property; and (v) invalidity of the VIE arrangement (mostly in offshore transactions). Among these trigger events, the material breach of transaction documents has been a top trigger event for investors to commence the redemption process. However, since the benchmark to measure materiality is often elusive and the underlying circumstances are difficult to ascertain, companies and founders often request a grace period to cure the breach so that the redemption will be initiated only if the breach is not cured within the grace period. In 2023, about 56.78% of the transactions provided for the grace period to deal with the material breach, representing a seven-year high.

Redemption Trigger Event — Material Breach of Transaction Documents by Company and/or Founders
Existence



Onshore Structure

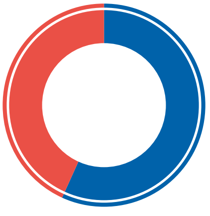
- Yes 88.94%
- No 11.06%



Offshore Structure

- Yes 87.50%
- No 12.50%

Redemption Trigger Event — Material Breach of Transaction Documents by Company and/or Founders
Use of Grace Period



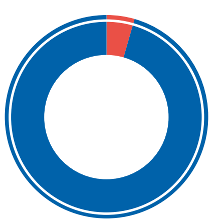
- With grace period 56.78%
- Without grace period 43.22%

Anti-dilution Right

When a company raises a new round of financing at a price lower than the previous round (a down round), the anti-dilution right allows the existing investors to adjust the price per share they paid in the previous round pursuant to a pre-agreed formula, so that they would be entitled to receive additional shares to compensate for the higher price they paid than the down round. In offshore transactions, the anti-dilution right is often effected by adjusting the conversion price between the preferred shares and common shares such that each preferred share may be converted into additional common shares. In onshore transactions where share conversion is not expressly permissible by law, the adjustment is often effected by (i) the company issuing additional shares to the affected investors at a nominal price, (ii) the founders transferring part of their shares to the affected investors at a nominal price or (iii) the company and/or founders providing cash compensation to the affected investors.

According to our data, in each of the past seven years, over 90% of the transactions provided for the anti-dilution right. In 2023, this percentage was 91.74%.

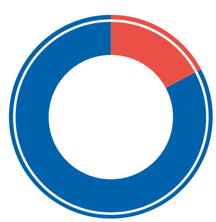
Anti-dilution Right



Onshore Structure

Yes 95.55%

No 4.45%



Offshore Structure

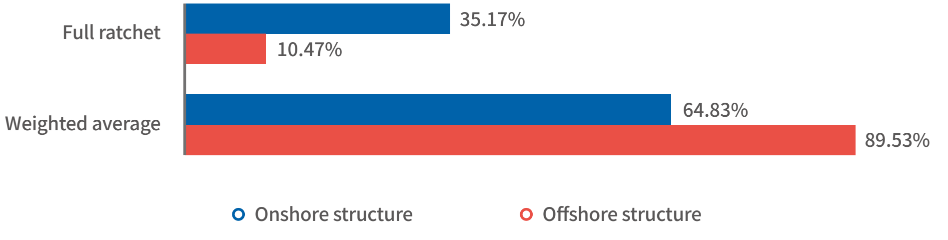
Yes 82.69%

No 17.31%

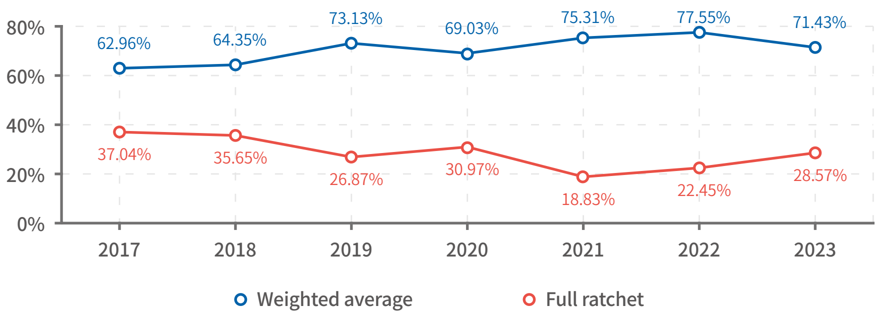
Depending on the calculation methodologies used to adjust the share price, the anti-dilution right is divided into the “full-ratchet” and the “weighted average” models. Although weighted average offers less robust protection to investors than the full-ratchet method, it is more acceptable to companies and more widely used in both the United States and China.

The chart below shows the use of these two formulas in the 2023 transactions. The weighted average model outnumbers the full-ratchet model by a large margin in both onshore and offshore transactions.

Anti-dilution Right — Full ratchet vs. Weighted average



Formulas for Calculation of Anti-dilution Right over the Past Seven Years

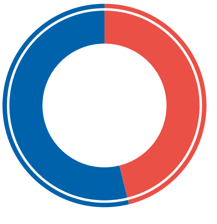


Drag-along Right

The drag-along right grants certain investors the right to require all other shareholders of the company to participate in a trade sale of the company when pre-agreed conditions materialize. A trade sale involves the sale to a third party the whole or substantially whole of the equity and/or assets of the company. When a prospective trade sale offers optimal price and/or conditions, investors may want to divest through the trade sale and realize a desirable return on their investment. However, if the investors are minority shareholders or not otherwise in control of the company, they may not be able to proceed with the trade sale without consent and cooperation of other shareholders. To break this impasse, such investors often demand the drag-along right so that when the right price and/or conditions occur, they can force all other shareholders to consent to and follow through with the trade sale.

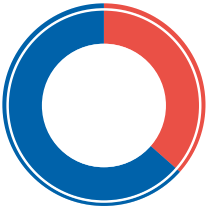
The drag-along right is more common in offshore transactions than in onshore ones. Its popularity, however, has lost some luster over the years. As is shown in our data, only 56.70% of the transactions provided for drag-along right in 2023, the lowest level in the past seven years.

Drag-along Right



Onshore Structure

- Yes 53.85%
- No 46.15%



Offshore Structure

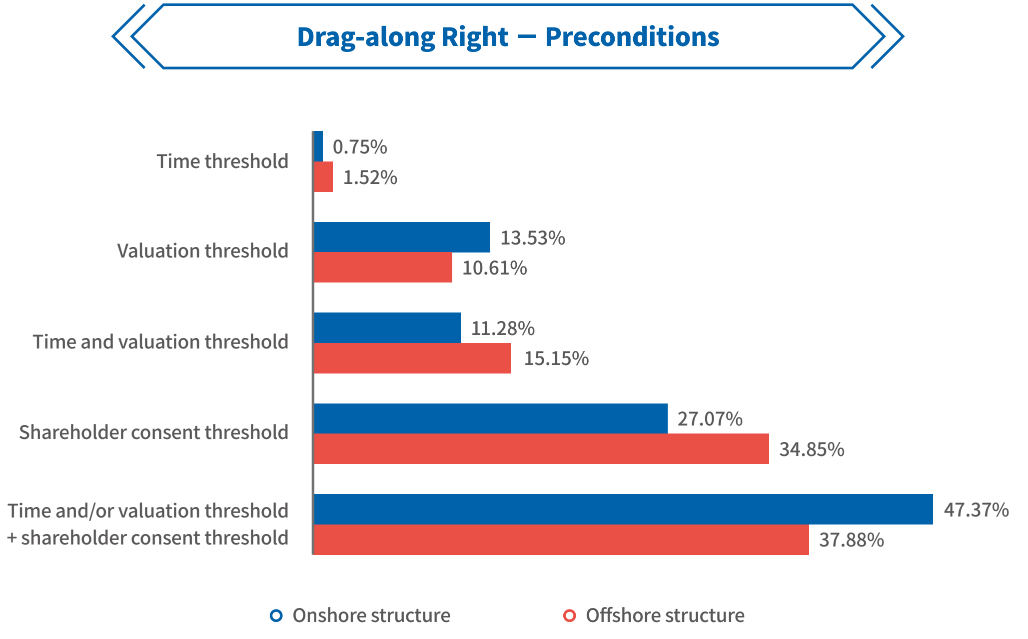
- Yes 63.46%
- No 36.54%

Since it could cause drastic changes to the equity and/or asset composition of the company, the drag-along right is usually subject to certain preconditions. The most common ones include the following:

(1) A period of time must have elapsed after the investment closing (the "time threshold"). This would allow the company to operate without interruption for this period of time,
(2) Valuation of the company in the trade sale must have reached a set target (the "valuation threshold"). This would allow both the investors holding the right and the other shareholders to obtain a satisfactory return on their investments and for the founders to cashout with desirable returns,
(3) Both the time threshold and valuation threshold must be met (the "time and valuation threshold"),
(4) The trade sale and its terms must have been consented by the shareholders holding certain percentage of the company's shares (the "shareholder consent threshold"), or
(5) Combination of (1), (2) and (4) above (the "time and/or valuation threshold + shareholder consent threshold").

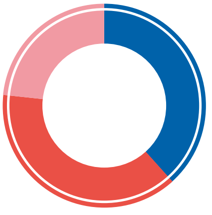
Over the past seven years, the lone use of the "time threshold" as a precondition has become less common, while the use of shareholder consent, such as (4) or (5) above, is increasingly popular. As is shown in our data, the lone use of the "time threshold" accounted for 1.01% of the transactions that provided for the drag-along right in 2023, the lowest level in the past seven years. The (4) and (5) above, on the other hand, were more popular than other preconditions, accounting for 29.65% and 44.22%, respectively, of the transactions in 2023 where the drag-along right was provided for. Both percentages were slightly higher than in 2022.

The chart below shows a breakdown of the preconditions in the 2023 transactions that provided for the drag-along right.



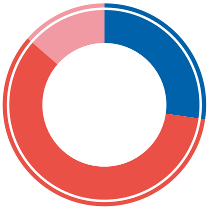
The parties entitled to the drag-along right are usually investors, including specified investor(s) or a group of investors holding a requisite percentage of shares. In some transactions, the founders may also insist on having this right to approve the trade sale such that the drag-along right would also be subject to approval of the founders or their appointed directors. Among the 2023 transactions that provided for the drag-along right, 34.67% required only the consent of the investors to effect the drag-along right. Transactions where the consent of the founders or their appointed directors was required accounted for 45.23%, and such cases were more popular in offshore transactions than in onshore ones.

Drag-along Right — Exercising Parties



Onshore Structure

- Require consent of investors only 38.35%
- Require consent of founders (or their appointed directors) 38.35%
- Other forms of exercising parties 23.31%



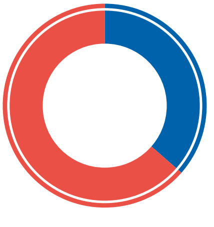
Offshore Structure

- Require consent of investors only 27.27%
- Require consent of founders (or their appointed directors) 59.09%
- Other forms of exercising parties 13.64%

Dividend Preference

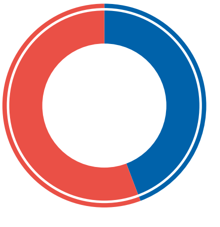
The dividend preference provides investors with a right to receive dividends ahead of common shareholders. In practice, many investors do not insist on having dividend preference because dividend income is not the primary motivation for their investment in the first place, especially investment in start-up companies that are not expected to become profitable in the immediate future. Our data validate this rationale. In 2023, 61.25% of the transactions did not provide for the dividend preference, akin to 2022. In addition, the onshore transactions without the dividend preference outnumbered the offshore ones.

Dividend Preference



Onshore Structure

- Yes 36.44%
- No 63.56%

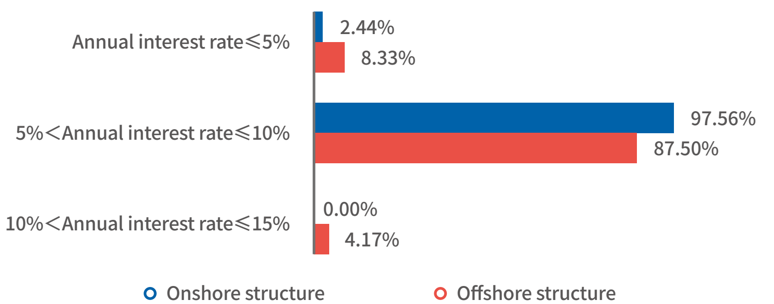


Offshore Structure

- Yes 44.23%
- No 55.77%

In transactions where dividend preference was provided for, investors sometimes required not only that their dividend payments rank ahead of all other shareholders, but also the dividend amount be benchmarked against the interest accrued on the principal of their investment. In most cases, the interest rate ranged between 5%—10% per annum. The dividend yields in 2023 are set out in the following chart.

Preferential Dividend Yields

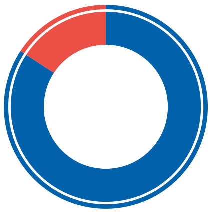


Control Right (Protective Provisions and Board Composition)

Protective Provisions

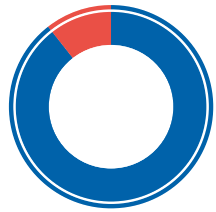
Protective provisions grant specific shareholder(s) or shareholders holding a certain percentage of voting rights (usually investors) or their appointed directors the veto right regarding certain important matters of the company. Matters subject to the veto right are called "reserved matters", which often relate to issues vital to the company such as the company's share structure, business operations, disposal of assets and the incurrence of debt. According to our data, 85.75% of the transactions in 2023 had the protective provisions.

Protective Provisions



Onshore Structure

- Yes 84.21%
- No 15.79%



Offshore Structure

- Yes 89.42%
- No 10.58%

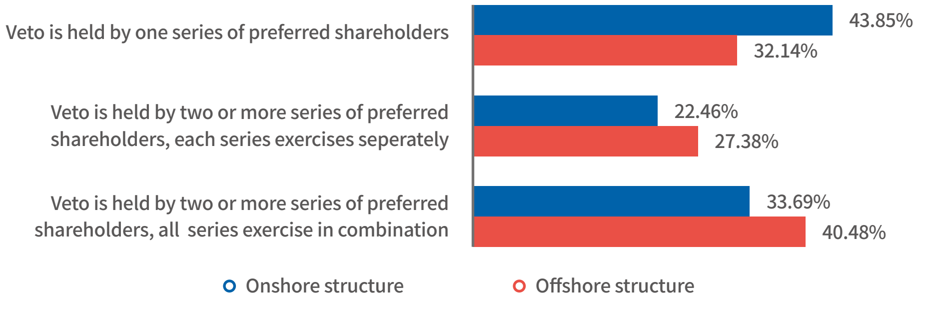
Since the protective provisions are designed to protect the interests of investors, the veto right is generally granted to the investors or their appointed directors. The veto right may be exercised at the shareholder level or at the board level, or partially at the shareholder level and partially at the board level. Reserved matters subject to the veto right at the shareholder level generally concern the share structure, shareholder rights, liquidation, dissolution of the company. Reserved matters subject to the veto right at the board level usually concern important business operations of the company.

At the shareholder level, the veto right is generally exercised (i) by only one series of preferred shareholders, including specific preferred shareholder(s), (ii) by holders of certain percentage of voting rights in each series of the preferred shares, exercising separately or (iii) by holders of certain percentage of voting rights in all series of the preferred shares, calculated in the aggregate.

At the board level, since founder-appointed directors tend to dominate the company board, the investors will counter by requiring that certain reserved matters be approved by each investor-appointed director or by a certain percentage of all investor-appointed directors.

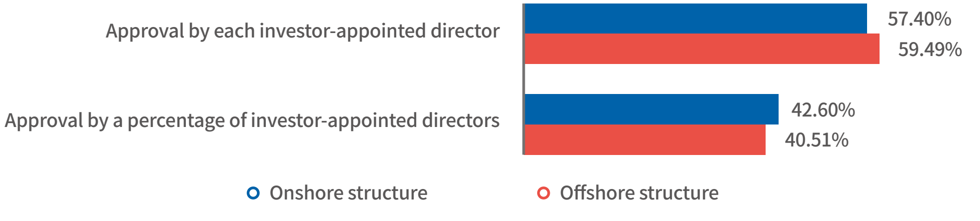
The chart below presents a breakdown of the veto right mechanisms at the shareholder level in the 2023 transactions.

Protective Provisions — Veto Right Mechanisms at Shareholder Level



The chart below presents a breakdown of the veto right mechanisms at the board level in the 2023 transactions.

Protective Provisions — Veto Right Mechanisms at Board Level



Two issues about the veto right warrant special attention:

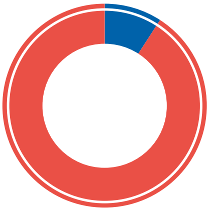
(1) Exclusive veto power. In early rounds of capital raising when investors are few and the investment risk is high, it is common that a single investor (or its appointed director) is given the exclusive veto right. As the rounds of capital raising increase, so does the number of investors. If every investor is accorded the veto right, it could paralyze the decision-making process and hamper corporate governance of the company. To deal with this potential deadlock some companies seek to design the veto right framework differently. Separately, as the Chinese government has tightened anti-trust regulations in recent years, if an investor (or its appointed director) is given the exclusive veto right over certain reserved matters, it may be deemed to have control over the company. This may trigger the obligation to file with the government a concentration report for the entire transaction if the revenues of such investor and/or the company exceed a certain benchmark. As a result, some investors may shy away from the exclusive veto right.

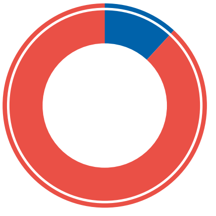
(2) Thresholds to the veto right. As investors grow in number, companies often seek to establish thresholds to restrict the veto right. For example, an investor (or its appointed director) may be entitled to the veto right only if the investor holds at least a certain number or percentage of shares of the company. The veto right will be relinquished if the number or percentage of the shares falls below the threshold either because of a share transfer or shareholding dilution. In the 2023 transactions which had protective provisions, 20.33% established similar thresholds to restrict investors' veto right.

Finally, after multiple rounds of capital raising, the ownership of the founders could be diluted up to a point when they lose control of the company. Therefore, while the veto right is accorded to the investors, in some transactions the founders also require a special veto right relating to matters vital to the company. Our data show that in each of the past seven years about 4%—10% of the transactions gave the founders (or their appointed directors) such special veto right. In 2023, this percentage was 9.97%.

The following chart shows whether the founders' enjoyed a special veto right in 2023.

Protective Provisions — Whether Founders (or their appointed directors) Have Veto Right for Certain Reserved Matters





Note: The data include cases where investors' veto right is used simultaneously.

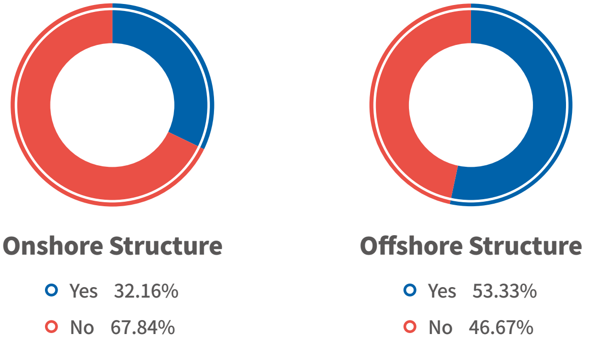
Board Composition

In most VC/PE transactions, directors appointed by founders tend to dominate the company board. For example, in each of the past seven years, there were only 2%—5% of the transactions in which the votes controlled by founder-appointed directors were less than or equal to those controlled by investor-appointed directors.

To counter the dominance of founder-appointed directors in the company board, investors usually demand the right to appoint directors so that they could partake in the decisions vital to the company. Despite their wishes, however, the percentage of transactions where investors secured the right to appoint directors slid downward in the past seven years from 93.83% in 2017 to 70.37% in 2023, as is shown in our record. As the number of investors grows, the company, too, wants to limit the investor-appointed directors. For example, the company may require investors to hold a minimum number or percentage of shares as a condition to appoint directors. This is akin to the restrictions on the veto right of investors discussed above. If the number or percentage of shares held by an investor falls below the minimum, its right to appoint directors will be relinquished. Our record of the past seven years shows that more and more transactions adopted this approach rising from 10.66% in 2017 to 38.62% in 2023, and it was more popular in offshore transactions than in onshore ones.

The chart below shows how the right to appoint directors was restricted in the 2023 transactions.

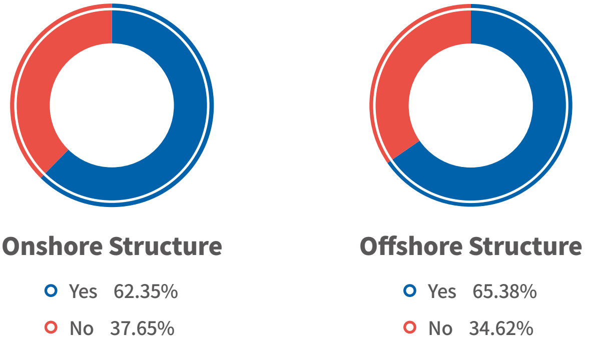
Investors Must Hold a Certain Percentage or Number of Shares to Appoint Directors



Employee Equity Incentive Plans

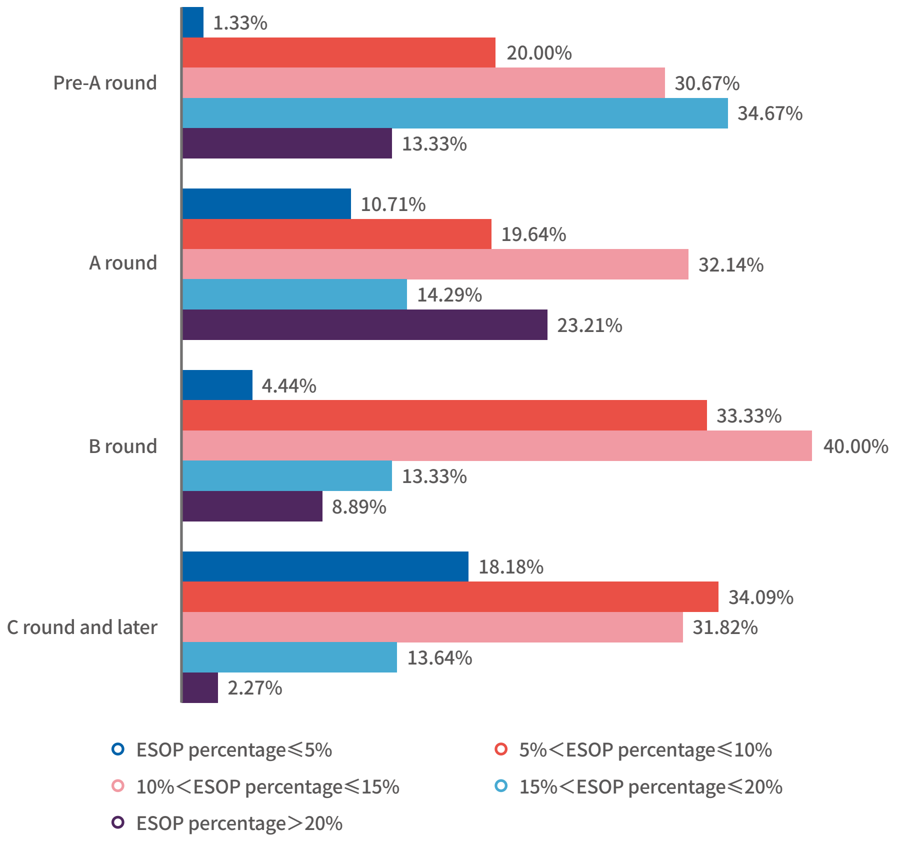
Employee equity incentive plans (known as "ESOPs") are a standard feature in most start-up companies. They are designed to motivate senior officers and key employees to serve and create value for the companies on a continuous basis. A company may adjust from time to time the amount of share capital allocated to ESOPs to meet the needs of the company and to accommodate multiple rounds of capital raising. According to our data, from 2017 to 2022, around 70%—82% of the companies in onshore transactions adopted ESOPs while 77%—94% of the companies in offshore transactions did the same. In 2023, however, the ESOP programs slid significantly downward to 62.35% and 65.38%, respectively, for onshore and offshore transactions, reaching a 7-year low.

ESOPs



Where ESOPs are set up, companies generally allocate an average of 5%—20% of share capital to support the ESOP program. The allocation of less than 5% or more than 20% is rare. The chart below shows the percentage of shares reserved for the ESOP program in each financing round of the 2023 transactions.

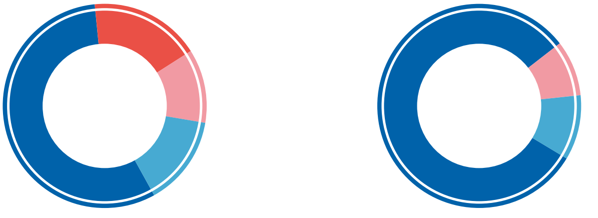
Percentage of Shares Reserved for ESOPs in Each Financing Round



Equity incentives under ESOPs may take on different forms, the most common being stock options and restricted shares. According to our 2023 data, among the transactions that had ESOP programs, 89.70% offshore companies and 68.68% onshore companies adopted stock options, while 8.82% offshore companies and 29.22% onshore companies adopted restricted shares to incentivize employees.[3] Each year, a small number of companies adopted other forms of incentive plans for employees.

[3] For stock options, the percentages include the case where only stock options were granted and the case where multiple forms of incentives (which include stock options) were granted concurrently. For restricted shares, the percentages include the case where only restricted shares were granted and the case where multiple forms of incentives (which include restricted shares) were granted concurrently.

Forms of Equity Incentives



Onshore Structure

- Options 56.49%
- Restricted Shares 17.53%
- Options + Restricted Shares 11.69%
- Others 14.29%

Offshore Structure

- Options 80.89%
- Options + Restricted Shares (+ Others) 8.82%
- Others 10.29%

The equity incentives are generally issued for the benefit of employees in one of the following manners:

(a) Direct issue of equity incentives to the employees (the "direct issue method"),
(b) Issue of equity incentives through an ESOP platform (the "platform issue method"),
(c) Holding of the equity incentives by founders in trust for the employees (the "trust method").

Due to differences in law, offshore transactions and their onshore counterparts use different methods to deploy the equity incentives.

(1) Offshore Structure

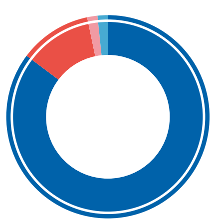
For either stock options or restricted shares, offshore companies often implement the ESOP program through the direct issue method, the platform issue method or a combination of the two. This is because in many foreign jurisdictions (e.g., the Cayman Islands) the procedures for direct issue of stock options or shares are easy to implement. One caveat: if the recipients of foreign stock options or shares are Chinese nationals, extra caution is warranted as the recipients may be required by the PRC law to undergo foreign exchange registration.

Based on our 2023 data, in offshore transactions with stock option arrangement, about 85.25% of the companies chose the direct issue method which is done as follows: The company reserves certain number of shares for the ESOP program (known as the “ESOP pool”) and then assigns stock options to the employees against the shares in the ESOP pool. When the employees exercise their stock options, the company will withdraw shares from the ESOP pool in an amount corresponding to the options and release the shares to the employees. Prior to exercise, the employees do not legally own the shares in the ESOP pool. The direct issue method is easy to effect and is commonly adopted in offshore transactions.

In 2023 where the restricted shares arrangement was adopted in offshore transactions, 33.33% of the companies chose the direct issue method, 33.33% chose the platform issue method, and 16.67% chose both methods concurrently to implement the ESOP program.

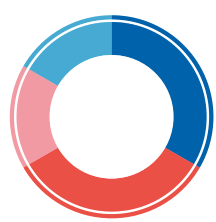
The platform issue method can be deployed for various types of equity incentives. When it is implemented, the company will have the founders or corporate officers directly or indirectly set up an ESOP platform to which the company will issue incentive shares. Eligible employees may hold stock options, restricted shares or other types of incentives at the platform level in an amount corresponding to their entitlement in the company under the ESOP program. This method is usually adopted for corporate management purposes.

ESOP — Offshore Structure — Issue Methods



Stock Options

- Direct issue method 85.24%
- Platform issue method 11.48%
- Direct issue method and platform issue method 1.64%
- Others 1.64%



Restricted Shares

- Direct issue method 33.33%
- Platform issue method 33.33%
- Direct issue method and platform issue method 16.67%
- Others 16.67%

(2) Onshore Structure

Under the PRC Company Law, the concept of reserved shares is not recognized and the number of shareholders of a limited liability company may not exceed 50. Thus, in onshore VC/PE transactions, companies often implement the ESOP program via the platform issue method, the trust method or a combination of the two.

Where the platform issue method is used, generally founders will set up an ESOP platform to hold incentive shares for the benefit of eligible employees. The employees may own the shares/units of interest kept at the platform either (i) outright or (ii) by virtue of contractual arrangement between them and the company without being registered as the owner.

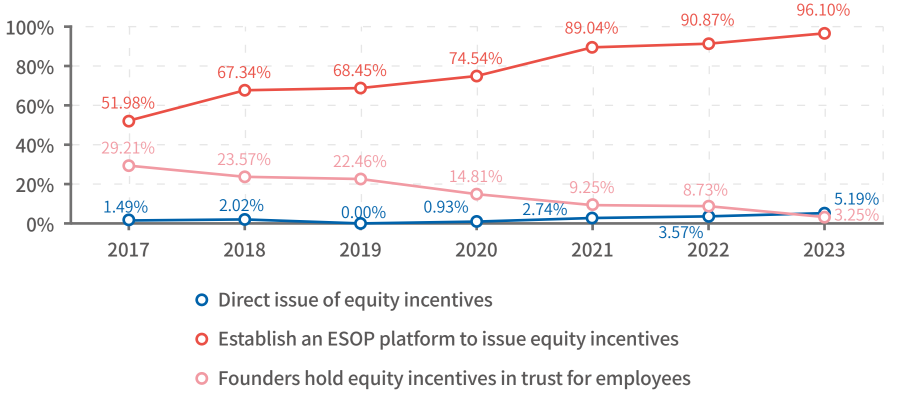
Pursuant to the trust method, on the other hand, founders will hold the incentive shares in trust for the benefit of the employees and formalize the arrangement by contract between them and the employees. The trust method is common in the early stage of start-ups and it is often superseded later in time by the platform issue method.

It is rare for companies in onshore transactions to directly issue incentive shares to their employees.

Onshore transactions increasingly use the platform issue method to implement ESOP program. In 2023, for example, 96.10% of the onshore transactions that provided for ESOPs used the platform issue method, the highest in seven years, while the trust method was 3.25%, the lowest in the same time frame.

For tax purposes, most ESOP platforms in onshore transactions are established as limited partnerships with a tiny minority as limited liability companies. This was true in the 2023 transactions where 96.62% of the platforms were limited partnerships. The ESOP platform acquires the incentive shares either by subscribing for newly issued shares of the company or by acquiring shares transferred from the founders. According to our 2023 data, over 50% of the ESOP platforms subscribed for newly issued shares. It must be added that the Chinese listing rules require any prospective A-share company to have a clear and transparent ownership structure. To comply with this requirement, the company may need to register all the employees holding stock options or incentive shares and handle with care any unexercised options and shares held in trust.

ESOP — Onshore Structure — Issue Methods over the Past Seven Years



Note: The base number includes onshore companies that adopt multiple issue methods concurrently.

Liquidation Preference

Liquidation preference is a common preferential right in VC/PE transactions. It is designed to help distribute a company's assets among shareholders when a liquidation event occurs, such as dissolution, liquidation or trade sale of the company.

Liquidation preference falls into two main categories-participating and non-participating.

- Under the participating preference, investors are entitled to receive their liquidation preference amounts ahead of others based on a pre-agreed formula and subsequently share the remaining distributable assets of the company with other shareholders on a pro rata basis.

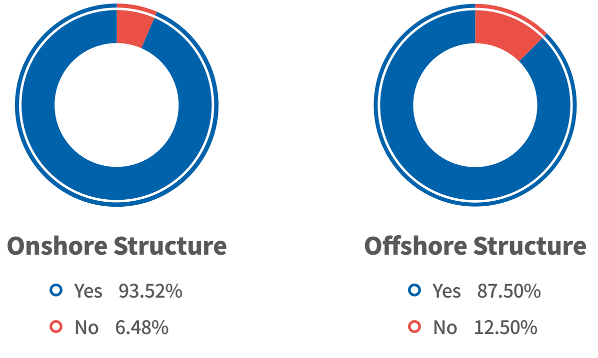
  In some transactions parties agree to cap the amount distributed through the participating preference. For example, if the amount due to an investor under the participating preference exceeds a capped amount (usually certain multiples of the investment principal), the investor would not be entitled to any further distribution. If the capped amount is less than what it would receive based on its shareholding in the company, the investor may opt to receive distribution on a pro rata basis. It may also be agreed that if the company's valuation in the liquidation event or the amount distributable to an investor based on its shareholding in the company exceeds a pre-agreed amount, the participating preference will cease to be applicable to the investor. In this case, distributions will be made only on a pro rata basis.

- Under the non-participating preference, an investor is only entitled to its liquidation preference amount and may not share the remaining assets of the company with other shareholders afterwards. However, if the distribution based on its shareholding in the company is more than what it would get under the non-participating preference, the investor may elect to share the company's assets with all other shareholders on the pro rata basis.

In each of the past seven years, over 90% of the transactions provided for liquidation preference, and the majority chose the participating preference. In 2023, 91.74% of the transactions provided for liquidation preference and 84.47% of them adopted the participating preference, the lowest level in the past seven years, while 15.53% adopted the non-participating preference, the highest in the past seven years. Among the transactions that provided for participating preference, about 4.41% capped the distribution amount.

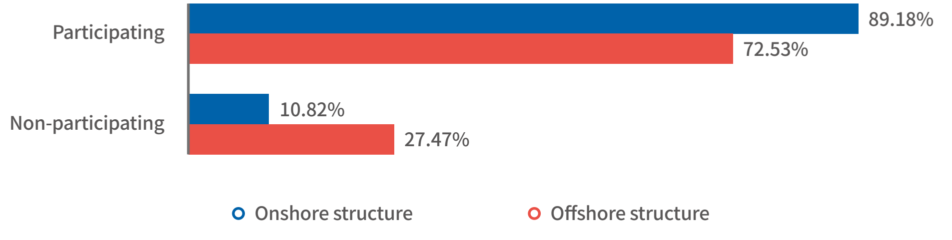
The chart below shows the use of liquidation preference in onshore and offshore transactions in 2023.

Liquidation Preference



The following chart shows the use of participating and non-participating liquidation preference in the 2023 transactions. Our data show that participating liquidation preference was more popular in both onshore and offshore transactions.

Liquidation Preference — Participating vs. Non-participating



The calculation of liquidation preference amounts is typically carried out pursuant to the following formulas:

(a) multiples of the investment principal;
(b) the investment principal (or certain multiples thereof) + simple or compound interest accrued thereon; or
(c) the higher of (i) the amount calculated as per (a) or (b) and (ii) certain other benchmarks such as the fair market value or the audited net assets.

Over the past years, formulas (a) and (b) were both widely chosen for the calculation. In 2023, however, the fortunes of formulas (a) and (b) experienced a dramatic shift, especially in onshore structures. In the 2023 onshore transactions that provided for liquidation preference, formula (a) accounted for 21.59%, a 14.04% decline as compared to 2022, while in offshore transactions it was 40.66%, a 9.66% decline from 2022. In the same year, formula (b) accounted for 68.72% in onshore transactions, an increase of 14.83% over 2022, and 47.25% in offshore transactions, 7.76% more than 2022. The ascendence of formula (b), especially in onshore transactions, was clear and unmistakable. Formula (c) was used in 7.23% of the transactions that provided for liquidation preference, which was consistent with past years.

Where formula (a) was used in 2023 to calculate the liquidation preference amounts, the multiples of the investment principal ranged from 100% to 150%, with a mean of 103.47%, which represented a slight decrease from 108.22% recorded in 2022. Where formula (b) was used, the average interest rate was 8.66% annualized simple interest or 8.21% annualized compound interest, also representing a slight decline as compared to 9.17% and 9.11% recorded in 2022, respectively.

The following is a breakdown of how the formulas were used in 2023.

Onshore Structure

Liquidation Preference Amount	Range	Average
Multiple of investment principal	(100%—150%) of investment principal	102.81% of investment principal
Multiple of investment principal + simple interest	(100%—120%) of investment principal + (4%—15%) simple interest	100.13% of investment principal + 8.69% simple interest
Multiple of investment principal + compound interest	(100%—120%) of investment principal + (5%—10%) compound interest	101.54% of investment principal + 8.15% compound interest

Offshore Structure

Liquidation Preference Amount	Range	Average
Multiple of investment principal	(100%—150%) of investment principal	104.32% of investment principal
Multiple of investment principal + simple interest	100% of investment principal + (6%—15%) simple interest	100% of investment principal + 8.55% simple interest
Multiple of investment principal + compound interest	100% of investment principal + (6%—10%) compound interest	100% of investment principal + 8.33% compound interest

Restrictions on Founders

It is critical to both the company and investors that the founders and management team remain constant. Therefore, in addition to the right of first refusal and co-sale right discussed above, VC/PE transactions often include additional restrictions to deter founders from transferring their shares, including:

- The founders may not sell or otherwise dispose of their shares prior to an IPO or trade sale of the company without consent of the investors (the “share transfer restriction”);

- Shares held by the founders are classified as restricted shares (the "restricted shares") such that if a founder is no longer employed by the company or if certain pre-defined event has occurred, the company and/or the investors (or other designated shareholders) will have the right to acquire all, or part of the restricted shares held by such founder.

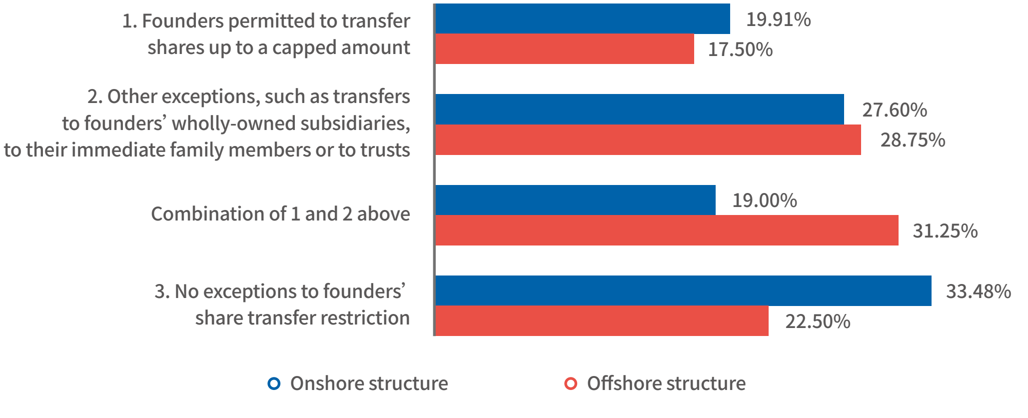
In addition to share transfer restrictions, investors often require founders to (a) devote all their work time to the company and (b) assume non-compete and non-solicitation obligations in favor of the company for as long as they remain employed by, or hold shares in, the company, and for a defined period of time post their employment or ownership of the company shares.

Share Transfer Restrictions

In each of the past seven years, about 88%—93% of the transactions prohibited founders from selling or otherwise disposing of their shares prior to an IPO or trade sale of the company unless otherwise consented to by the investors. In 2023, this percentage was 89.74%.

Founders, on the other hand, often want to retain sufficient flexibility for share transfers and in some transactions they are able to obtain exceptions to the share transfer restrictions such that they may (i) transfer shares up to a specified capped amount and/or (ii) transfer shares in the ordinary course of business including to founders' wholly-owned subsidiaries or, for financial planning purposes, to their immediate family members or to a trust in which they or their immediate family members are beneficiaries. The chart is breakdown of how such exceptions were adopted in 2023. It shows that the absolute restriction without any exception was on a decline over the years, reaching a 7-year low in 2023, although onshore transactions were more in favor of the absolute restriction than offshore ones.

Exceptions to Founders' Share Transfer Restriction

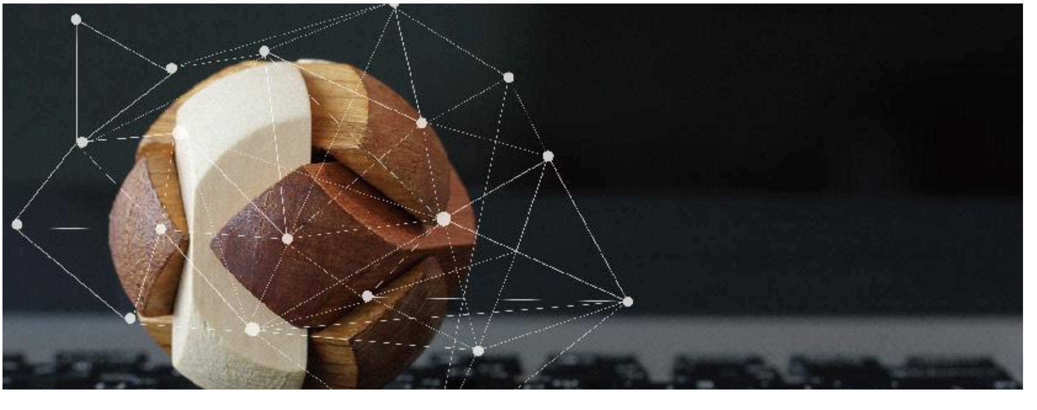


Restricted Shares

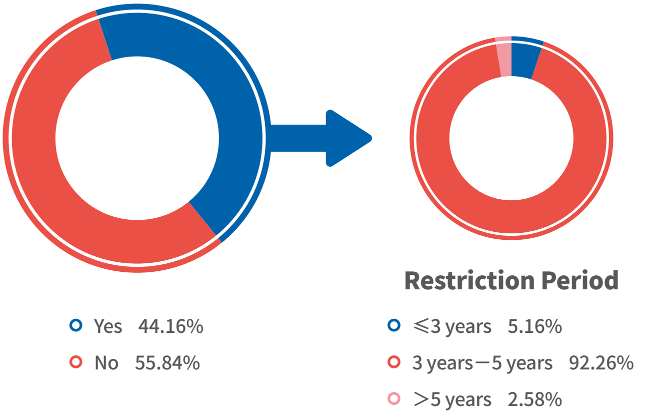
Once classified as restricted, the shares held by a founder are generally subject to a restriction period, (usually known as the release period) during which (i) the founders may not sell or otherwise dispose of the shares and (ii) upon termination of the founder's employment with the company or the occurrence of a pre-defined event, such shares will be subject to mandatory repurchase by the company and/or purchase by the investors (or other designated shareholders).

Shares subject to the mandatory repurchase or purchase may be the restricted shares or all of the shares held by the founder. The sale price may be of the fair market value, at cost or the lowest price permitted by law. The shares involved and the sale price are usually determined by taking into account the nature of termination of the founder's employment with the company, which range from voluntary resignation, dismissal for cause to no-fault departure (such as incapacitation). It should be noted that the restricted shares held by the founder are officially registered shares of the company. As a general matter, the restrictions and release mechanism merely affect the disposal of the shares, and the type, the price and other particulars relating to the purchase of the shares by the company and/or investors (or other designated shareholders). They do not affect the ownership and voting power of the shares for as long as the founder remains employed with the company and no other trigger event has occurred.

According to our data of the past seven years, each year in about half of the transactions the investors required the founders' shares to be classified as restricted shares. In 2023 this percentage was 44.16%, the lowest in the past seven years. The restricted share arrangements are common in early rounds of investment and the restriction period typically ranges from three to five years.



Whether Founders' Shares are Classified as Restricted Shares and the Restriction Period



Share Transfer by Founders

In 2023, 8.26% of the transactions involved instances where founders sold their original shares, the lowest in seven years. In most cases, the founders' original shares were either sold to new investors or repurchased by the company. The repurchase often occurs in offshore transactions and is usually executed concurrently with the investors' subscription of corresponding new shares of the company. There are certain business objectives to have the sale/repurchase of the founders' original shares to coincide with the company's capital raising, such as (i) to realize the price differential between such original shares and the company's newly issued shares; (ii) for founders to cash out; and (iii) to optimize the company's ownership structure.

Share transfers also raise tax compliance issues. In transactions that involved founders selling their original shares in 2023, nearly 70% provided that the selling founders should be responsible for taxes arising from the sale while around 18% did not address the tax issue at all.

Information Right and Inspection Right

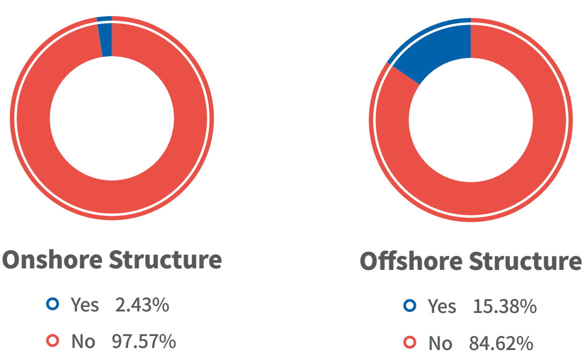
The information right allows investors to demand operational and financial information of the company. Our data show that in each year from 2017 to 2022, about 90% of the transactions provided for the information right. However, this percentage declined to 85.47% in 2023, the lowest in the past seven years.

As a companion, the inspection right allows investors to inspect the books and records of the company. The information right and inspection right give the non-controlling investors an opportunity to monitor the operational and financial conditions of the company. As a general matter, investors decide what type of information to request and the timing and frequency to receive such information to synchronize with their post-investment management needs. The company, on the other hand, seeks to manage its obligation to correspond with its ability to prepare the information and to comply with its confidentiality obligations.

Survival Period of Representations and Warranties

In VC/PE transactions, investors often require that the corporate warrantors (including the company, its subsidiaries and the founders) make representations and warranties regarding such matters as the ownership structure, business operation, tax, assets, labor and litigation of the corporate group, as of the signing date and the closing date. Our data over the past seven years show that most deal documents did not specify the validity period of the representations and warranties. This means that if any of the representations and warranties was found to be untrue, investors could at any time claim for breach of contract against the corporate warrantors to the extent permitted by the applicable statute of limitations. A few exceptions exist where the deal documents impose a time limit (e.g., a few years after the closing date) for the investors to raise claims for breach of representations and warranties or only certain types of representations and warranties. Investors' right to raise such claims will lapse if the claims are not made within this set period. The chart below shows the survival period for representations and warranties in onshore and offshore transactions in 2023.

Survival Period of Representations and Warranties



Based on our 2023 data, among the transactions that set out survival period of representations and warranties, such survival period was generally 1—3 years whether onshore or offshore. Very few offshore deals set out a survival period of less than one year.

Indemnification and Founders' Personal Liability

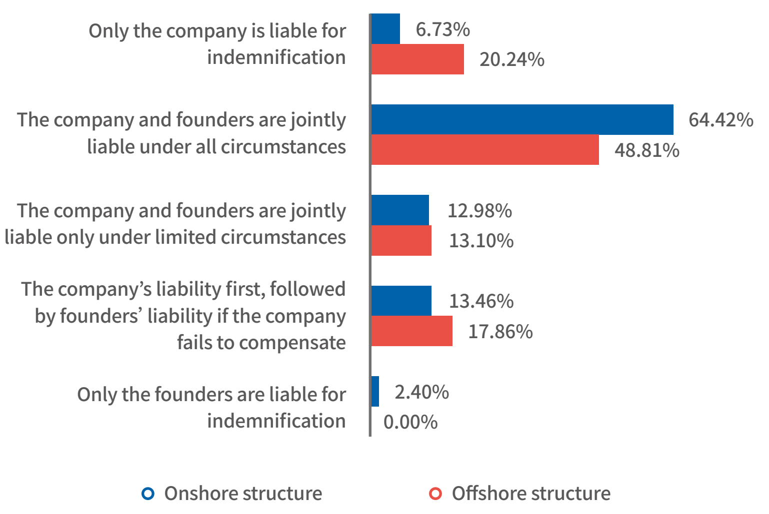
In VC/PE transactions, investors often require the representations and warranties made by the corporate warrantors to be true, accurate and complete, and that the company and/or the founders must be held accountable for any breach thereof. In addition, investors often require the company and/or founders to assume certain obligations and undertakings. For example, before closing the company must undertake not to initiate any material change that would adversely affect the interests of the investors and, for a period after closing, the company must take certain remedial actions (if any) to ensure compliance with law. As to such obligations and undertakings, investors may also require the company and/or the founders to indemnify for any losses resulting from any breach thereof. In 2023, 83.19% of the transactions expressly imposed indemnification liabilities upon the company and/or its founders, among which (i) 19.86% capped the liabilities such that the total amount of damages due to the investors would be subject to a cap; (ii) 7.53% set out a threshold for the liabilities to be payable such that the investors may not claim for damages unless the losses exceeded a pre-agreed amount; and (iii) 13.70% provided for both liability caps and kick-in thresholds.

Very often the company and/or its founders are required to be jointly and severally liable for the obligation to maximize the likelihood that the investors will get indemnified. When so required, the founders usually counter to limit their personal exposure to the liability by (i) not agreeing to bear joint liability, leaving the company alone to be responsible for the indemnification, (ii) assuming joint liability only under limited circumstances, such as the founders themselves having caused the breach or (iii) requiring claims to be made against the company first and that the founders would step in only if the company is unable to satisfy the claims due to legal obstacles or lack of funds.

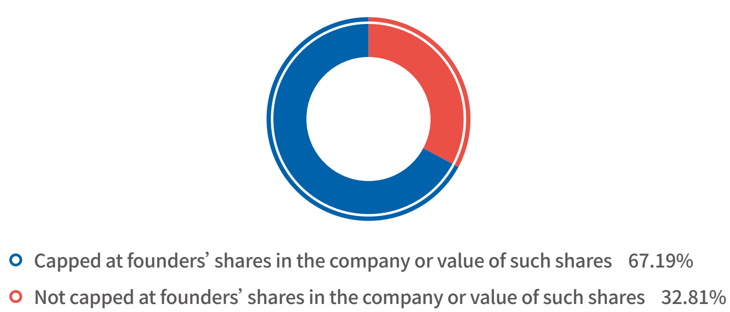
Depending on the circumstances, parties to specific VC/PE transactions have used the following approaches to sort out the joint liability issues: (1) the company and founders are jointly liable under all circumstances; (2) the company and founders are jointly liable only under limited circumstances; or (3) the company is liable first and founders' liability will be triggered only if the company fails to indemnify the investors.

Among the 2023 transactions that provided for such indemnification obligations, nearly 90% required the company and founders to be jointly liable for the indemnification. When faced with joint liability, founders often seek to cap their obligations to the extent of their shares in the company or the value of such shares (under all or limited circumstances) so that their personal and family assets would be protected. Indeed where founders were required to assume the obligation jointly with the company in the 2023 transactions, 67.19% capped the founders' liability to the extent of their shares in the company or the value of such shares.

Typical Forms of Indemnification Liability



Whether Founders' Indemnification Liability is Subject to a Cap



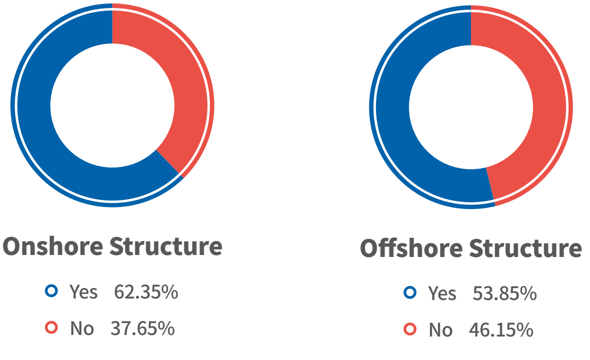
Restrictions on Investors

In VC/PE transactions, the primary restrictions imposed on investors are restrictions on share transfer and on investment.

Share Transfer Restrictions

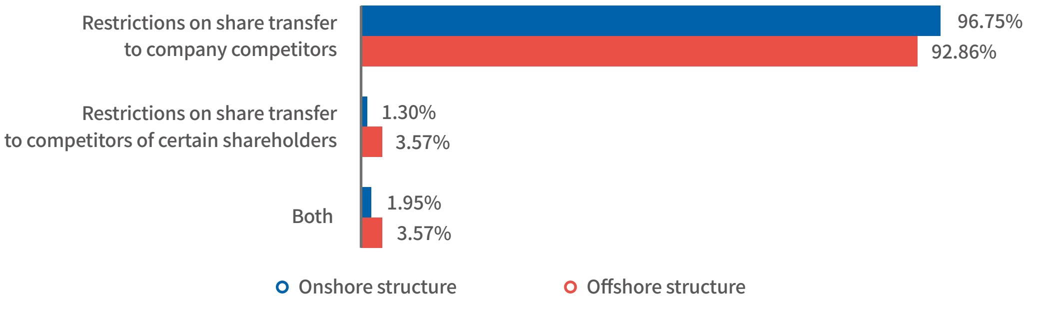
For most financial investors, the sale of their shares in the company is front and center for their exit strategy and, as a result, they naturally resist any hindrance on their freedom to transfer shares. On the other hand, an increasing number of companies in recent years have sought to impose restrictions on the share transfer by investors. In 2023, 59.83% of the transactions placed restrictions on investors for their share transfer. There are three major types of restrictions: (i) no transfer of shares to a competitor of the company; (ii) no transfer of shares to a competitor of certain shareholders of the company (generally, industry or strategic investors); and (iii) a combination of (i) and (ii) above. The following chart presents the landscape of share transfer restrictions on investors in the 2023 transactions.

Investor Share Transfer Restrictions



Our data also show that in most onshore and offshore transactions, investors were prohibited from transferring shares to competitors of the company.

Investor Share Transfer Restrictions — Type of Restrictions



Share transfer restrictions are generally effected as follows:

(a) The share transfer is subject to consent. If the transfer is to a competitor of the company, consent of the company and/or the founders is required. If the transfer is to a competitor of another shareholder of the company, consent from the affected shareholder is required.

(b) The share transfer is subject to the right of first refusal. If the transfer is to a competitor of the company, founders will have the right of first refusal to acquire the shares. If the transfer is to a competitor of another shareholder of the company, the affected shareholder will have the right of first refusal.

(c) The share transfer is subject to both (a) and (b) above.

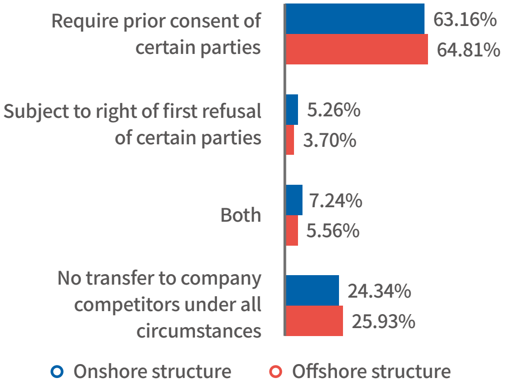
(d) The share transfer is prohibited under all circumstances regardless who the recipient will be.

For investors, option (d) is obviously the most draconian. Considering the sale of shares is a critical part of their exit strategy, investors usually resist absolute restrictions on their share transfers. They may accept a compromise of limited restrictions, such as options (a) or (b). Between these two options, option (a) is more rigorous because it practically grants a veto power to others to deny and block the transfer. Option (b), on the other hand, is the least restrictive because the right of first refusal is not a veto power denying the transfer, although the procedures associated with the right of first refusal are cumbersome enough to deter some transfers. However, our 2023 data show that, in transactions that imposed restrictions on share transfer by investors to competitors of the company, 24.76% chose option (d), meaning absolute restriction on such type of share transfers. This was a significant increase over 2022.

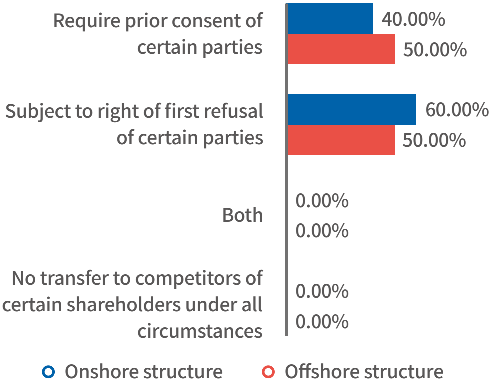
The following chart shows how the various restriction options were adopted in the 2023 transactions.

Investor Share Transfer Restrictions — Restriction Methods

Restrictions on Share Transfers to Company Competitors



Restrictions on Share Transfers to Competitors of Certain Shareholders



Investment Restrictions

In addition to share transfer restrictions, there have been transactions in recent years where companies sought to restrict investment in or cooperation with other entities. Such restrictions typically prohibit investors from investing in or cooperating with competitors of the company. If an investor violates the prohibition, it will be stripped of its preference rights or certain other shareholder rights such as the right to appoint directors, the information right or voting right. Based on our data, 5.98% of the transactions in 2023 imposed such restrictions.

Most-favored Nation Clause

If an investor is treated on terms and conditions less favorably than other shareholders (including existing and future shareholders and investors of the same round), the "Most-favored Nation" ("MFN") clause cures the imbalance by according to this investor the same treatment automatically.

The MFN clause is a common provision during term sheet negotiations. At this stage, most new investors lack the opportunity to conduct a thorough investigation of the company and may not be aware of the terms and conditions that the company has already accorded to the existing investors or shareholders. As the price for a new round of capital raising is often higher than those in the previous rounds, new investors often seek the MFN treatment to ensure that they are given the rights and privileges no less favorable than earlier shareholders. In some cases, new investors may even seek to have the MFN treatment applied to future investors and other investors of the same round of capital raising.

In some transactions, an investor may wish to retain the MFN clause beyond the term sheet stage to regulate the rights among all shareholders including the existing shareholders, other investors of the same round and/or the investors of future rounds. The rational is as follows. First, although the rights and obligations of all investors and shareholders are set out in the deal documents, there may exist other documents (such as side agreements) between the company (and/or founders) and certain other investors or shareholders unbeknown to a new investor. For this reason, a new investor often seeks to retain the MFN clause to ensure that it would be treated the same as the existing shareholders and other investors of the same round. Second, although it is widely accepted that investors of future rounds of capital raisings are entitled to better economic terms because they pay a higher price than did the existing investors in earlier rounds, this does not mean that certain non-economic benefits, such as the right of first refusal, preemptive right, drag-along right and voting right, will be automatically extended to them. Hence, an existing investor often seeks to have the MFN treatment applied to future investors although it may agree that future investors would be entitled to better economic terms to account for the higher price such future investors will pay for their investment.

Our record shows that 49.29% of the transactions in 2023 had the MFN clause govern investors in future capital raisings of the company, the highest level in the past seven years. It should be noted that such MFN treatment is sometimes subject to certain conditions, such as MFN treatment is applicable only if the valuation of the company in a future capital raising is lower than a pre-agreed amount.

Valuation Adjustment Mechanism

Valuation adjustment mechanism (“VAM”), which is different from the redemption obligation discussed above, is not commonly used in VC/PE transactions. Based on our data, about 4.5%－8.6% of the transactions in the past seven years adopted the VAM. In 2023, it was 5.7%.

VAM consists of certain benchmarks, compensation to be paid if the benchmarks are missed and the parties obligated to make the compensation. In the 2023 transactions that provided for the VAM, most of the benchmarks were performance goals to be achieved by the company. In a few transactions the obtaining of certain critical licenses from the government were the benchmarks.

If the benchmarks are missed, the founders, the company or both are usually obligated to compensate the investors on a joint and several basis. If the company is accountable for the compensation, it may (i) adjust the price for conversion of the investors’ preferred shares into common shares (only in offshore transactions); (ii) issue additional shares to the investors at a nominal price; (iii) make compensation in cash; (iv) adopt other methods, often a combination of (i), (ii) and (iii) above. If the founders are responsible for the compensation, they may (i) transfer their shares to the investors at a nominal price; (ii) make compensation in cash; (iii) adopt other methods, which often combine (i) and (ii) above. According to our data over the past seven years, the most common form of VAM compensation was for the company to issue new shares or for the founders to transfer their shares, in either case, to the investors at a nominal price.

Dispute Resolution

According to our 2023 data, over 90% of the transactions chose arbitration as the last resort for dispute resolution. Litigation, on the other hand, remained a lesser choice. This was particularly true in the past four years. The table below shows the relative pros and cons of arbitration versus litigation.

	Litigation	Arbitration
Timing and Predictability	Litigation takes longer time as it involves two trials (first instance and second instance trials) and a trial supervision procedure. No time limit for foreign-related cases.	Arbitral awards are final and arbitration institutions focus on efficiency. Since 2018, their discretion for vacating or not enforcing arbitral awards has been restricted which, together with the practice of internal review of arbitral awards, has enhanced predictability of arbitration results.

	Litigation	Arbitration
Confidentiality	Hearings are open to the public and generally court judgements are published.	Hearings are held in private with no visitors allowed to attend unless otherwise agreed to by parties to the arbitration. Awards are not available to the public.
Service of Process	Methods of service are limited, especially for foreign-related cases where due to judicial sovereignty, cross border service can be done primarily by judicial assistance through courts from the basic level all the way to the Supreme People's Court, and from there to foreign intermediaries and then to the recipients. The process is cumbersome. The procedures for court announcement are also time-consuming.	Service of process is not subject to restrictions imposed by judicial sovereignty. Court documents may be served by hand, registered mail or courier to the address specified by the parties, or via electronic means such as facsimile or email.
Location of Proceeding	Jurisdiction of a court over the dispute (domestic or foreign) is determined by the domicile of the defendant, place of performance of the contract, place of execution of the contract, domicile of the plaintiff, place where the subject matter is located or place of infringement, and the choice of court must follow the rules governing exclusive jurisdiction and centralized jurisdiction.	Jurisdiction of an arbitration institution is contractual and not restricted by factors having connection with the dispute or by nationality. Parties to foreign-related contracts may freely agree on Chinese or foreign arbitration institution for arbitration of a contractual dispute. The place of arbitration may be agreed by the parties, which is not necessary the location of arbitration institution.
Proceedings	The parties may not choose judges, place of hearing, language of hearing or hearing procedures. Courts apply stricter rules of evidence.	Procedures are flexible by comparison. Parties may choose arbitrators, place and language of arbitration, arbitration procedural law, allocation of arbitration costs.

	Litigation	Arbitration
Costs	Litigation costs include filing fees, enforcement fees, and fees for preservation of assets, which are generally lower than arbitration costs.	Arbitration costs include filing fees, case management fees and tribunal fees. For the same claim amount, process costs in arbitration are usually substantially higher than in litigation.
Joining Third Parties	Courts may add an interested third party to the proceedings when the interests of such third party are involved. Joint action can be jointly heard and adjudicated.	Tribunals may not compel a third party to participate in arbitration proceedings. Generally, cases may not be consolidated in the absence of the consent of the parties.
Preservation	The parties may directly apply to the court for asset preservation and behavior preservation. Court processing the preservation request usually hears the case.	Asset preservation requests are referred to courts for execution, which seldom receive priority treatment. Preservation requests from arbitration cases are usually processed by the court of the domicile of the respondent or the court where the subject asset is located.
Enforcement of Judgement	Generally, the enforcement is carried out by the people's court of first instance where the case is heard.	Generally, the enforcement is carried out by the court of the domicile of the respondent or the court where the subject asset is located.

Disclaimer

北京
北京市东城区东长安街1号东方广场
C1座9层
邮编：100738
电话：+86 10 8525 5500
传真：+86 10 8525 5511 / 5522
Email：beijing@hankunlaw.com

Beijing
9/F, Office Tower C1, Oriental Plaza,
1 East Chang An Ave., Dongcheng District,
Beijing 100738, PRC
Tel: +86 10 8525 5500
Fax: +86 10 8525 5511 / 5522
Email: beijing@hankunlaw.com

上海
上海市静安区石门一路288号兴业太古汇
香港兴业中心二座33层
邮编：200041
电话：+86 21 6080 0909
传真：+86 21 6080 0999
Email：shanghai@hankunlaw.com

Shanghai
33/F, HKRI Center Two, HKRI Taikoo Hui,
288 Shimen Road (No. 1), Jing'an
District, Shanghai 200041, PRC
Tel: +86 21 6080 0909
Fax: +86 21 6080 0999
Email: shanghai@hankunlaw.com

深圳
深圳市福田区中心四路1-1号嘉里建设
广场第三座20层
邮编：518048
电话：+86 755 3680 6500
传真：+86 755 3680 6599
Email：shenzhen@hankunlaw.com

Shenzhen
20/F, Kerry Plaza Tower 3, 1-1 Zhongxinsi Road,
Futian District, Shenzhen 518048,
Guangdong, PRC
Tel: +86 755 3680 6500
Fax: +86 755 3680 6599
Email: shenzhen@hankunlaw.com

香港
香港中环皇后大道中15号置地广场告罗
士打大厦43楼4301-10室
电话：+852 2820 5600
传真：+852 2820 5611
Email：hongkong@hankunlaw.com

Hong Kong
Rooms 4301-10, 43/F, Gloucester Tower,
The Landmark, 15 Queen's Road Central,
Hong Kong SAR, PRC
Tel: +852 2820 5600
Fax: +852 2820 5611
Email: hongkong@hankunlaw.com

海口
海口市龙华区滨海大道105号百方广场
A座19层1903室
邮编：570100
电话：+86 898 3665 5000
传真：+86 898 3665 5011
Email：haikou@hankunlaw.com

Haikou
Room 1903, The Form Plaza Tower A,
105 Binhai Road Longhua District,
Haikou 570100, Hainan, PRC
Tel: +86 898 3665 5000
Fax: +86 898 3665 5011
Email: haikou@hankunlaw.com

武汉
武汉市洪山区珞喻路10号群光中心31层
3107-18室
邮编：430070
电话：+86 27 5937 6200
传真：+86 27 5937 6211
Email：wuhan@hankunlaw.com

Wuhan
Room 3107-18, Chicony Center, 10 Luoyu
Road, Hongshan District, Wuhan 430070,
Hubei, PRC
Tel: +86 27 5937 6200
Fax: +86 27 5937 6211
Email: wuhan@hankunlaw.com

新加坡
莱佛士坊1号#53-00
莱佛士坊一号1座
邮编：048616
电话：+65 6013 2999
传真：+65 6013 2998
Email：singapore@hankunlaw.com

Singapore
1 Raffles Place #53-00,
One Raffles Place Tower 1,
Singapore 048616
Tel: +65 6013 2999
Fax: +65 6013 2998
Email: singapore@hankunlaw.com

纽约
美国纽约市第五大道620号2层
洛克菲勒中心
邮编：10020
电话：+1 646 849 2888
Email：newyork@us.hankunlaw.com

New York
620 Fifth Avenue, 2nd Floor,
Rockefeller Center, New York,
NY 10020, USA
Tel: +1 646 849 2888
Email: newyork@us.hankunlaw.com

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Beijing · Shanghai · Shenzhen · Hong Kong · Haikou · Wuhan · Singapore · New York