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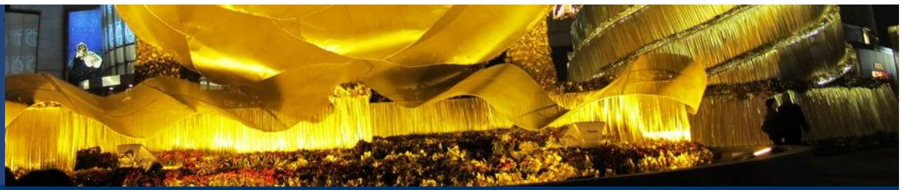

China Regulatory Updates

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- *Simplicity, but always with a focus on key points and attention to details*

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- *Cost Efficiency and Effectiveness*
- *Constant Self-Improvement Towards Perfection*

In-Depth Analysis

Brief News

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In-Depth Analysis

China's First Tort Law Promulgated

After four rounds of discussion in the past seven years, the *PRC Tort Liability Law* (the "Tort Law") was finally approved by the Standing Committee of PRC National People's Congress on December 26, 2009 which will officially come into effect on June 1, 2010. The Tort Law is an indispensable part of the proposed PRC Civil Code that the Chinese legislation authority is working on. The Tort Law has consolidated and refined the rules on tort liabilities that are stipulated separately in various currently effective laws and regulations and has further added many new provisions. The Tort Law provides comprehensive, systematic and in-depth protection of the civil rights of individuals and entities in China and is of great significance for the construction and improvement of relevant legal system in China.

Overview of the Tort Law

The Tort Law is composed of 192 articles which fall under 12 chapters. Chapters I to IV stipulate general provisions with respect to tort liabilities, including without limitation general principles on tort liabilities, constitution and manners of tort liability undertaking, circumstances where tort liabilities can be exempted or reduced, special provisions on certain responsible party. Chapters V to XI focus on some special tort liabilities, i.e., product liability, medical malpractice liability, environment pollution liability, high-risk activity liability, and liability for damages caused by motor vehicles, traffic accidents, domesticated animals and objects. Chapter XII is about misc matters related to the Tort Law.

The Tort Law has generally provided that any infringement of the others' civil rights caused by a person's fault will result in corresponding tort liabilities of such person. In other words, in principle, a person is only responsible for tort liabilities in the case that the relevant infringement is due to such person's fault (i.e., intentional acts or gross negligence of such person). However, under some special circumstances, such as environment pollution and high-risk activities, the infringer's fault is not necessary for tort liability undertaking. In addition, if the damage is caused by the willful act or negligence of the victim, or is caused by situations such as force majeure events, self-defense or urgent danger prevention, the tort liabilities can be exempted or mitigated (as the case may be).

The forms of tort liabilities include cessation of infringement, exclusion of hindrance, elimination of danger, return of property, restoration to the original state, indemnification, apology, and/or elimination of ill effects and rehabilitating one's reputation.

Compared with the currently effective laws and regulations, the highlights of the Tort Law are as follows:

- Compensation for Mental Damages Explicitly Recognized for the First Time. According to the Tort Law, if a person infringes the others' personal rights and consequently causes severe mental damage, the victims are entitled to claim for compensation for mental damages.

- Joint and Several Liabilities of Website Operators. If an internet user infringes other people's civil rights via internet, the internet service provider should, at the request of the victim or on its own initiatives, adopt necessary measures such as deleting, shielding or disconnecting the links to the infringing contents. The failure to do so will subject the internet service provider to joint and several liabilities for the tort activities conducted by the internet infringer.

- Product Recalling System and Punitive Liabilities Added. The Tort Law has introduced a recalling system and punitive liabilities for defective products (*please see below for more details*).

- Liabilities of Medical Institutions for Defective Drugs. Pursuant to the Tort Law, if the patients suffer damages from any defective drugs, disinfectant, medical equipment, or the injection of unqualified blood provided by relevant medical institutions (*such as a hospital*), they may claim for compensation against either the product manufacturer /blood provider or the medical institution.

Noteworthy Points for Corporate Entities

(a) Product Liability

On product liability related matters, in addition to the inheritance of the current regulations in the *PRC Product Liability Law* that the manufacturers and distributors should be jointly responsible for defective products, the Tort Law further specifies that even if the defect of the product is caused by a third party such as transportation firms or warehouse keepers, the manufacturer or distributor should still be liable for the defective products, who of course have the recourse right against the responsible third party thereafter.

Moreover, the Tort Law has for the fist time introduced a recalling system and punitive damage liabilities for defective products. When the manufacturer discovers any defect of its products which have been put on the market, it should adopt necessary measures such as making a public warning and/or recalling such defective products. In the aforesaid case, if the manufacturer or the distributor continues to manufacture or sell the defective products, and the products cause death or material damages to the health of others, the victims are entitled to claim for a punitive compensation against the manufacturer or distributor.

(b) More Stringent Environment Pollution Liability

The Tort Law has adopted a more rigid liability system with respect to environment pollution activities compared with the current regulations, including without limitation:

(i) According to the Tort Law, the fault of the polluter is not a prerequisite condition for the environment pollution liability. That is to say, even if the polluter discharges pollutants within the limit permitted by applicable law, it may also be held liable if any damage is caused by its pollution;

(ii) It is the polluter's sole reasonability to prove that there is no cause-and-effect relationship between its polluting activities and the claimed damages, which is contrary to the burden of proof for most types of tort cases; and

(iii) Even if the environment pollution is caused due to the fault of any third party, the polluter should be responsible for the relevant tort liability in the first place, in which case, the polluter has the recourse right against the responsible party afterwards.

(c) Employer's Liability

According to the Tort Law, the employer (including entities accepting dispatched employees from labor dispatching companies) should be responsible for its employees' tortious acts arising from or in connection with their performance of duties. As to labor dispatching companies, they may only be held liable under circumstances that the relevant tortious acts are conducted due to all or part of their faults.

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As the first act on tort liability in China, the Tort Law inevitably includes some provisions that are still not practical or conflict with currently effective laws and needs supplementary and implementing rules to make it perfect. It is believed that appropriate preparation measures will be taken by the competent authorities to effectively apply and enforce the Tort Law. For companies that operate in China, on the one hand, their legitimate rights will be better protected by the Tort Law and on the other hand, they may need to review and amend their internal risk control rules, especially those with respect to product quality, environment pollution and employee management for the avoidance of various potential tort liabilities.

In-Depth Analysis

Policy on Capital Gain Tax Related to SPVs Tightened

At the end of 2009, PRC State Administration of Taxation ("SAT") released two circulars to tighten the control over the income of both individuals and enterprises from capital gains.

One circular (the "IIT Circular") is about the individual income tax issues related to the transfer of restricted shares of a listed company. From January 1, 2010, any individual's income from the selling of restricted shares of a listed company is subject to the individual income tax at a proportional tax rate of 20%. The withholding agent is the securities firm where such individual opens securities investment account. This policy will surely have great influence on the individual founders and senior executives of listed companies that hold the listed company's shares. Still, individual investors on China's stock market will not be affected by the IIT Circular.

The other circular (the "EIT Circular") is about the enterprise income tax ("EIT") issues related to the transfer of equity interests (excluding shares that are publicly purchased and sold on stock exchanges) in PRC target companies by non-resident enterprises ("NRE"). The EIT Circular, which is dated December 10, 2009 but effective retroactively to January 1, 2008, will have a great impact on many foreign investors, whether corporations or private equity funds, especially those who usually use offshore intermediate holding companies ("SPV") to invest in China.

Indirect Equity Transfer of PRC Company by NRE Subject to Scrutiny of PRC Tax Authorities

(a) Offshore Equity Transfer to Be Reported to PRC Tax Authorities

According to the EIT Circular, when the foreign actual controller of a PRC company in which such foreign investor invests through a SPV transfers the equity interests held by it through a complete offshore M&A, i.e., transferring the equity interests of such company's offshore shareholder outside China, and if the SPV is located in a tax jurisdiction with an effective tax rate of lower than 12.5%, or a tax jurisdiction which exempts income tax on foreign-derived gains for its tax residents, the selling party should submit certain documents to the local PRC tax authority where the PRC company is located within 30 days after the execution of the equity transfer agreement. The documents required are mainly about the SPV's status and its relationship with the Chinese company and the foreign actual controller.

According to the EIT Circular, strictly speaking, "SPVs" should include all levels of entities between the foreign actual controller and the Chinese company. The requirement to disclose all of the information concerning the transactions may create an enormous burden to the selling party, especially in a global M&A.

(b) Offshore Equity Transfer Involving Pass-through SPV to be Levied EIT

The relevant tax authorities will carefully review the documents submitted by NREs based on the "substance-over-form" principle under the General Anti-Avoidance Rule (the "GAAR"). Suspicious offshore M&As will be reported to SAT for its final review and decision. If the offshore equity transfer is deemed as lack of reasonable business purpose and for purpose of escaping from PRC tax burden, it will be recognized as direct equity transfer in China with the relevant EIT to be paid by the foreign actual controller.

It is the first time for the Chinese tax authorities to expressly provide (although in principle) that indirect equity transfer conducted offshore should be scrutinized. However, it is a controversial international legal and tax issue with respect to how far the Chinese GAAR and the EIT Circular could be reached to require a NRE to disclose the deal information and to unveil the SPV outside China. In addition, disputes with the home jurisdiction of NRE transferor may also occur.

Given the complexity of the issue and the lack of explanatory rules, it is not clear now how the PRC tax authorities will implement the EIT

Circular in practice. However, it is time for foreign investors to take necessary measures to endow SPVs with commercial substance, so as to mitigate the tax risk resulting from the GAAR investigation by the PRC tax authorities.

Other Provisions Related to NRE's EIT Obligation

The EIT Circular has particularly clarified that if retained earnings and after-tax reserves of the PRC target company are transferred together with the equity interest, they should not be deducted from the equity transfer price. Thus a NRE transferor should practically pay EIT for the retained earnings and after-tax reserves. The parties to an M&A deal should therefore consider whether to distribute the retained earnings and after-tax reserves prior to the closing to save tax.

According to the EIT Circular, if a NRE transfers its equity interests in several onshore and offshore companies at the same time, the detailed information (especially the transfer price) with respect to the PRC target being transferred should be submitted to the competent tax authority for its review.

Brief News

Draft Measures on Application of Insurance Funds Circulated for Public Comments

On December 25, 2009, the China Insurance Regulatory Commission issued the draft *Administrative Measures on the Operation of the Insurance Funds* (the "Draft Measures") for public comments. The Draft Measures provide systematic regulations covering the overall aspects of the application of insurance funds, including without limitation, the principal forms for insurance funds application, the decision-making and operating systems, the risk control and the supervision mechanisms, and etc. However, it does not include implementing rules on the investments in real property and private companies with insurance funds as eagerly expected by the insurance market.

There are several key features in the Draft Measures that deserve more attention:

- Further to the green light in the newly revised *PRC Insurance Law* with respect to the investment in real property section with insurance funds, the Draft Measures further specify that insurance funds may be used to invest in both infrastructural and non-infrastructural real property;

- The Draft Measures provide that the insurance group / holding companies and insurance companies are permitted to use insurance funds to make equity investment in companies for controlling purpose. The investees include insurance enterprises, non-insurance financial enterprises and insurance-related enterprises. However, the Draft Measures have not clarified whether equity investments not for controlling purpose and private equity investment with insurance funds are permitted;

- Insurance funds are prohibited from high-risk investments such as those in GEM stocks or "ST" stocks. However, whether the prohibition includes the primary market investment in a GEM company remains unknown. Further, investments with insurance funds are not allowed to be made in high-energy consumption, high-pollution sectors that are not consistent with China's industry policies or real property without stable cash returns.

- From the risk control concern, the Draft Measures specify the floor level of the investments in government bonds, policy bank bonds and central bank bills as well as the upper limits for the investments in high-risk sectors such as non-secured corporate bonds, stocks and funds, real property and real property related financial products. However, the specific limitation amounts of such investments remain to be clarified.

The Draft Measures are expected to bring positive effect on the expansion of the investment channels for insurance funds. However, such effect may be a long-term and gradual one as the expansion process may be slow and the newly opened investment channel may still be subject to a relatively low ratio of the total insurance funds.

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