



China notes

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Mutual assistance between Hong Kong and the Mainland

Certainly, there is a world of difference between the systems of justice in Hong Kong and Mainland China. As such, a number of questions came to mind when the Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region Pursuant to Choice of Court Agreements between Parties Concerned (the Reciprocal Arrangement) was signed last month. In particular, we wanted a clear understanding of the reach of this new mutual legal assistance agreement.

At present, mutual assistance between Hong Kong and the Mainland is limited to arrangements for the service of judicial documents in civil and criminal awards and, importantly, the enforcement of arbitral awards. Extending mutual assistance to court judgments raises the possibility of new protection, but might also bring exposure to greater risk.

The Reciprocal Arrangement is intended to apply within a carefully defined scope. Importantly, it may only be used where the parties have chosen to do so in writing. This requires an explicit choice to submit to the jurisdiction of a designated Hong Kong or Mainland court to settle their disputes. Furthermore, the Hong Kong or Mainland court that is chosen must be given exclusive jurisdiction for resolving any such disputes.

Money judgments that arise out of commercial contracts are the only types of cases covered by the Reciprocal

Arrangement. In this context, commercial contracts do not include 'employment contracts and contracts which a natural person acting for personal consumption, family or other non-commercial purposes is a party'. It is not available for orders for specific performance or injunctions.

There are, as you might expect, a number of specific, technical aspects to the Reciprocal Arrangement. One relates to which courts in Hong Kong and the Mainland should be within its scope. In Hong Kong, the Reciprocal Arrangement covers a judgment or order issued by a Hong Kong District Court or above. In the Mainland, the judgment of an Intermediate People's Court or above is clearly within the scope of the Reciprocal Arrangement, yet so is a judgment issued by a Basic People's Court that has been authorised to exercise jurisdiction in civil and commercial cases involving foreign parties.

The Reciprocal Arrangement aims to establish a convenient mechanism for reciprocal enforcement of judgments within a carefully defined range of circumstances. Whether it will be sought as an alternative to arbitration, which is presently the preferred method of dispute resolution for many investors in the Mainland, remains to be seen.

China issues new M&A rules

Five government bodies, including the Ministry of Commerce and the China Securities Regulatory Commission (CSRC), issued the Rules on the Merger with and Acquisition of Domestic Enterprises by Foreign

Investors [No 10 of 2006] (the New M&A Rules) on 10 August 2006. These rules amend and supersede the Provisional Rules on the Merger with and Acquisition of Domestic Enterprises by Foreign Investors (in place since 2003), and are set to take effect on 8 September 2006.

Of particular relevance to capital markets transactions is the new article 40, which provides that the overseas listing (ie on stock exchanges outside of Mainland China) of 'special purpose companies' shall require the approval of the CSRC. Article 40 further provides that the overseas exchanges on which special purpose companies are listed must have signed a memorandum of understanding with the CSRC on matters related to regulatory co-operation. Article 39 of the New M&A Rules defines 'special purpose companies' as companies incorporated outside of Mainland China that are directly or indirectly controlled by Chinese domestic companies or natural persons and established for the purpose of achieving an overseas listing of interests in domestic companies beneficially owned by such companies or persons.

Special purpose companies are essentially non-PRC incorporated companies that operate PRC-based businesses or assets and whose ultimate beneficial owners are PRC companies or individuals. Special purpose companies typically come about through a restructuring of the ownership of PRC companies by PRC individuals by interposing a non-PRC incorporated (typically Cayman Islands or Bermuda) holding company that is then used as the listing vehicle in a listing on the Hong Kong stock exchange or the NASDAQ market. Special purpose companies are commonly referred to as 'red chip companies', and include China Mengniu Dairy, China Yunnan Foods, China Paradise Electronics Retail and Baidu.com.

Following the publication of the New M&A Rules, there has been significant uncertainty over the application of the provision regarding CSRC approval of overseas listings of special purpose companies. On the face of article 40, it would appear that the requirement for CSRC approval only applies to restructurings where special purpose companies are interposed into the chain of ownership through a share swap, rather than cash. However, talk in the market since the issuance of the New M&A Rules suggests that the CSRC's intention is to approve all 'red chip IPOs', and not just those involving a restructuring by

way of a share swap. At the same time, the CSRC has not issued any further guidance or regulations that confirm this view or detail how approval may be obtained. For this reason, and to ensure that a 'clean' (ie 'all approvals obtained') legal opinion can be delivered on closing of capital markets transactions, a number of transactions have been accelerated for completion on or before 7 September 2006.

Criminal Law amendments expand industrial liability

Given the large number of mine disasters and serious accidents due to poor construction in the past year, we were not surprised to learn that officials in Beijing are moving to address the problem in various ways, including providing for tougher penalties. The amendments to the Criminal Law issued on June 30 are the central government's most recent response to this problem, but probably not its last. Many of the new provisions make good sense. The concern we have when reviewing these latest changes is how they may be applied to the range of operational or commercial situations in which our clients may be involved.

Among the most significant changes is that criminal liability for industrial accidents is no longer limited to certain types of enterprises (factories, mines and tree farms). The move implies that workers in all industries may now be eligible to seek redress from their employer in the event that they are the victim of a major accident or other serious consequence resulting from a violation of safety management rules, or from having been forced to work under hazardous conditions.

In considering applicable principles of criminal liability previously, we have given much thought to the concept that the 'person or persons directly responsible for the crime' should bear the liability for an industrial accident. Little guidance has been given as to what 'directly responsible' should mean, in particular whether higher management should bear responsibility. The recent amendments to the Criminal Law add new law on this point. Within a company, the scope of criminal liability for accidents resulting from substandard facilities or operational safety conditions has been expanded to include not only the 'person or persons directly responsible for the crime', but also 'persons directly in

charge'. While there is still much to understand about the phrase 'persons directly in charge' we can see that the intention of the law is to bring managers within the scope of potential liability.

New rules aim to cool property sector

Heavy investment in fixed assets continues to be a driving force in China's rapid economic growth, making certain trends in the country's property market – the inflow of speculative 'hot money', large investments by international investment funds and the resulting dearth of affordable housing for local residents – worrisome for the government as it struggles to avoid overheating the economy.

In response, China's policy makers have issued a series of austerity measures over the past few months aimed at cooling the country's residential real estate sector. These measures are primarily aimed at businesses operating in the real estate sector (not merely holding land use rights for own use), but may also impact individuals who own real estate in China. They include:

- levying a business tax on residential properties sold within five years of the original purchase;
- increasing the minimum down payment ratio from 20 to 30 per cent for residential units larger than 90 square metres;
- requiring that 70 per cent of the total area of all residential properties approved or commenced after 1 June 2006 be smaller than 90 square metres; and
- prohibiting banks from providing loans if paid-in capital is less than 35 per cent of the total investment required for the development.

Projects that have already received approval but have not yet received construction permits, and which do not conform to the above requirements, must make adjustments to apartment units in accordance with these requirements.

Foreign investment in the real estate sector is already restricted to joint ventures in high-end apartment and office projects, as stated in China's WTO commitments, and is extensively regulated by various rules, most prominently the 1998 State Council Regulations on the Administration of Urban Real Estate Development Operations. Now, with the Opinions on Standardising Market Entry and Administration of Foreign Investment

in the Real Estate Market (Opinions) issued on 20 July 2006, foreign investors in the real estate sector must deal with additional regulatory hurdles. These include higher debt-to-equity ratios, stricter requirements for paying in land grant fees and obtaining business licenses, and, in some cases, the need to produce a performance guarantee.

Foreign entities and individuals buying real estate for their own use also face tighter rules. Purchases of residential properties must be made using the 'real name' of the foreign entity or foreign individual. Foreign institutions that have no branches or representative offices in China, and foreign individuals who study or work in China for less than a year, are prohibited from purchasing real estate.

China tackles online IP infringement

With the rapid proliferation of information resources and technologies in China, IP infringement through online platforms has become an increasingly visible problem, and one that has prompted the government to make a greater effort to supplement and strengthen the country's current IP protection regime.

Copyright owners already enjoy an exclusive right to the transmission of their work over information networks under the PRC Copyright Law (see June 2006 *China notes*), but the government recently strengthened these rights with a new regulation, effective as of 1 July 2006, which in combination with other administrative rules issued in 2005 (together, the Copyright Rules), makes it easier for copyright owners to enforce their rights online.

An important feature of the Copyright Rules is their provision for a 'take-down' mechanism; if a copyright owner notifies an internet service provider (ISP) of copyright infringing activities on a website and such notice qualifies as an effective take-down notice, the ISP must then remove or disable access to the material immediately. An ISP's failure to do so will expose it to the risk of being a joint tortfeasor in any later administrative or judicial proceeding. In practice, therefore, ISPs are willing to co-operate with copyright owners in responding quickly to their take-down requests, assuming that such notices comply with the Copyright Rules.

In contrast, China has yet to issue specific rules addressing patent and trade mark infringement activities through online platforms. Thus, patent and trade mark owners must rely on the general provisions of the PRC Patent and Trade Mark laws when enforcing their rights online. These laws apply to corporations or individuals who directly engage in infringing activities, such as offering the infringing products for sale or selling them online. It is unclear, however, under what circumstances the ISPs will be held liable for secondary infringement, as different courts have reached different verdicts.

Although specific rules do exist governing ISPs, including the Measures on the Administration of Internet Electronic Bulletin Services and the Measures on the Administration of Internet Information Services, IP infringement is not directly addressed. These rules prohibit an internet information service provider (IISP) from copying, publishing or transmitting messages that constitute libel and might infringe upon the lawful rights and interests of a third party, or any other content that is prohibited by law. They also require IISPs to cease transmitting such messages upon discovery, to keep relevant records and to make reports to relevant government bodies. Failure to do so may result in the forfeiture of an IISP's operating licence. These measures are focused on control of content for other policy purposes, however, and are not particularly effective in IP enforcement, as it is arguable whether the concept of prohibited content extends to IP infringing materials.

Consequently, not all ISPs respect and honour letters from patent or trade mark owners, or their lawyers, requesting that they remove or disable access to infringing materials based on the above instruments. However, most ISPs, particularly the larger market players, are willing to co-operate with IP owners to avoid disputes and negative publicity. In fact, many ISPs, including Alibaba.com, a major Chinese ISP, provide guidance to IP owners on how to enforce their rights regarding infringing materials on the relevant website, and their user policy provisions reserve the right to remove any materials that they deem inappropriate, with no liability to the content provider or users.

If you would like to discuss any matter arising from this newsletter or would like more information on regulatory developments in China, please contact

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