



JONES DAY  
**COMMENTARY**

## LEGAL CONSIDERATIONS FOR MANAGING RESTRUCTURINGS IN CHINA

Many multinational corporations (“MNCs”) are either restructuring or actively considering restructuring their China operations, given the current economic conditions and forecasts. Restructuring efforts often include consolidating legal entities, business units, and operations; closing down operations and factories; and workforce reductions. Implementing such restructuring efforts often raises complicated legal issues, many of which require careful analysis in light of recent legislation and policy considerations.

### CONSOLIDATING OPERATIONS

An MNC may consolidate operations spread across different localities through the use of a statutory merger, which is permitted under the Regulation on Mergers and Spin-off of Foreign Invested Enterprises. After merging the target entity into the surviving entity, the target entity will be dissolved, and the surviving entity will assume the rights and liabilities of the dissolved entity. Statutory mergers

between two foreign-invested enterprises (“FIE”) involves cumbersome government approval procedures and must fulfill numerous statutory requirements. For these reasons, the statutory merger of FIEs is often considered a complicated and inefficient method of consolidation.

A more efficient method to consolidate two or more legal entities in China with identical or similar business functions is through an asset transfer process, whereby one FIE transfers all or substantially all of its assets into another FIE. Usually the transfer will be followed by a dissolution of the selling entity, and the employees not transferred to the purchasing entity will be dismissed (see related discussion below). An asset transfer allows the purchasing entity to select key assets, without assuming most, but not necessarily all, of the existing liabilities of the seller. In addition, there are no PRC regulations that specifically require government approval for an asset transfer between two FIEs (although the purchase price for such assets

will need to comply with certain requirements to ensure that the selling entity can be dissolved in compliance with law).

The assets to be transferred can include, among others, land use rights and associated real property, machines and equipment, inventory, motor vehicles, intellectual property rights (e.g., trademarks, patents, and trade secrets), business contracts, accounts receivable and prepaid funds or deposits, and books and records. However, operation licenses and permits, such as production licenses for dangerous chemicals, are not transferable, which means purchasers need to have in place all licenses and permits necessary for the operation of the purchased assets and business.

The ownership and title of most assets can be transferred upon delivery, unless otherwise agreed upon by the parties involved. However, the effectiveness of transferring certain assets is subject to specific requirements of PRC law. For example, the transfer of land use rights and associated real property, as well as registered trademarks and patents, are effective only upon the amendment of registrations on file with the relevant administrative authorities. In addition, the transfer of contractual rights requires notice to the obligor, while the transfer of contractual obligations is subject to the consent of the obligee.

Restructuring through asset transfer may also give rise to significant tax costs. Transfer taxes are payable for certain assets, including a land appreciation tax on the transfer of land use rights and associated real property; VAT on transfers of inventory, machines, and equipment; and business tax on transfer of intellectual property rights. The selling party's net gain from the transaction is subject to corporate income tax. Also, stamp duty is payable by both the seller and the purchaser for the execution of the asset transfer agreement. Among these taxes, the amount of the land appreciation tax could be significant, particularly if the land price has increased substantially since the date of purchase. Additionally, if certain assets are subject to a customs supervision period and the titles to such assets are not fully vested with the owner (e.g., certain restrictions are imposed for five years for machines and equipment that are imported on a tax-free and duty-free basis), the assets may not be transferred without payment of the previously exempted customs duty and VAT. It should also be noted that an asset transfer transaction between two entities in China within the same foreign investor group

is regarded as a related party transaction and is required to be conducted on an arm's-length basis. This is of special relevance given that China has recently strengthened enforcement of its transfer pricing laws.

## FACTORY CLOSURES

A foreign investor may voluntarily terminate and liquidate its Chinese subsidiary before the expiration of its business term. Once all of the debts, liabilities, and expenses following a statutory dissolution order are paid in full, the liquidation proceeds can be repatriated to the foreign investor.

In China, dissolution of an FIE is subject to approval from the authority that originally approved its establishment, and it needs to comply with the clearance and deregistration procedures imposed by the authorities in charge of various aspects of the FIE's business. In this regard, please note that the specific rules governing the liquidation of FIEs was abolished on January 15, 2008, and that all of the FIEs now are required to follow the provisions of China's Company Law for guidelines on dissolution and liquidation. However, the Ministry of Commerce issued a notice on May 5, 2008, setting out certain procedural requirements specific to the liquidation of FIEs. Based on the relevant laws, the general procedures in relation to the dissolution of an FIE include: (i) preliminary application for approval of the dissolution with the approval authority; (ii) formation of a liquidation committee and publication and notification to creditors (creditors may, within 30 days after receiving the notice or within 45 days after the publication if it did not receive a notice, report their creditor's rights to the liquidation committee); (iii) liquidation (including tax clearance with the Tax Bureau and the Customs Authority in China); (iv) formal application for approval of the dissolution with the approval authority; and (v) deregistration with various authorities (such as the Tax Bureau, the Customs Authority, the State Administration of Foreign Exchange, and the State Administration for Industry and Commerce or their local branches).

In practice, the whole dissolution process can take several months and, under some special circumstances, can drag on for a year or longer. One major uncertainty in the dissolution process that often causes delays is the issue of obtaining a tax clearance certificate, which can be a difficult and

complicated process. Thus, it is prudent to thoroughly review and prepare the tax payment evidence prior to the commencement of the dissolution process. It should also be noted that some manufacturing FIEs with an operating term exceeding 10 years continue to enjoy the standard tax holiday in China (i.e., two-year exemption and a three-year 50 percent reduction of corporate income tax). However, if the relevant FIE's actual period of operation falls short of 10 years as a result of early dissolution, the FIE will be required to retroactively pay the previously exempted tax.

In the past year or two, a few foreign investors with insolvent FIEs abandoned the FIE without going through the statutory dissolution and liquidation process. These incidents have attracted government attention primarily because of the impact on employees who could not receive compensation and benefits owed to them, and the incidents consequently have raised concerns within the central government about the related impact on social stability. In November 2008, the Chinese government issued a guideline reinforcing the legal basis for cross-border investigation and litigation claims arising from the "abnormal exit" of foreign investors and the liabilities of foreign investors and directors. Although this guideline can be regarded as symbolic and the probability of enforcement is limited in practice, it does reflect the decision of high-level government officials to address issues of this nature.

Rather than abandoning an insolvent FIE and facing potential claims from the government, foreign investors may consider voluntary bankruptcy protection provided by the PRC Enterprise Bankruptcy Law. Voluntary application by an FIE for bankruptcy reorganization or settlement may force its creditors to accept an agreement with the FIE, which may help reduce or restructure the FIE's debts and other liabilities.

## WORKFORCE REDUCTIONS

For many FIEs, especially those in labor-intensive industries, significant reductions in the work force may be an effective way to cut costs. The Labor Contract Law of China defines "mass layoff" as a reduction of at least 20 employees, or more than 10 percent of the total employees of an employer. In order to undertake a mass layoff, an employer must have encountered "severe difficulties in production and

management." The employer also needs to follow statutory procedures, including communicating with employees regarding the mass-layoff plan and reasons behind the plan, taking into consideration the opinions of the representatives of the employees, reporting the plan to the local labor bureau, and commencing dismissal procedures in accordance with the plan. Although the statute does not obligate the employer to obtain written approval from the local labor authorities, the employer must communicate with the local labor authorities as a practical matter, and during this process, the local labor authorities may have their own opinions regarding the necessity of the layoff and the legality of the layoff plan. For example, some local government policies may require an employer to consider certain alternative solutions to a mass layoff and prove that it is still suffering losses after taking such alternative solutions for a certain period. These alternative solutions may include hiring freezes, stopping overtime, dismissing temporary workers first, and decreasing compensation packages. Efforts to comply with the requirements of the local labor authorities may substantially delay the layoff process.

When compared with the relatively burdensome statutory requirements and complex procedures associated with a mass layoff, the dismissal of employees during the dissolution of an FIE might be a more manageable option offering the advantage of less government involvement. As discussed in the sections above, in an asset transfer arrangement, after transferring all or substantially all of its assets to the purchaser, the seller can apply for its dissolution, upon approval of which, the employment relationships of the employees remaining with the seller will be terminated. An employee settlement plan is often one of the key elements of a dissolution plan, and the approval authority would be expected to evaluate it closely when considering approval of the dissolution. However, once the dissolution is approved, as a general matter, there are no further statutory requirements with respect to the dismissal of the remaining employees, except for the statutory severance payments required under the Labor Contract Law and other relevant regulations.

If neither the mass layoff nor dismissal as part of a dissolution plan is feasible, an FIE employer may have to terminate the labor relationship with its employees on an individual basis. In this regard, the employer may first consider not renewing labor contracts upon their expiration dates. If the

employer intends to terminate a labor contract before its expiration, mutual agreement between the employer and the employee will be needed; otherwise, the employer must have a statutory ground for such termination. A wrongful termination could expose an employer to higher termination costs or even reinstatement of the employment relationship. Except in very limited cases where the employee has seriously breached his/her contractual obligations, the grounds for termination provided for in the Labor Contract Law are not easily proven as a practical matter. Among these grounds, incompetence is most frequently relied upon. However, the Labor Contract Law is silent on the definition of “incompetence.” Therefore, many companies try to clarify the definition of “incompetence” in their employee handbooks or labor contract templates. Under certain limited circumstances (e.g., during the period when an employee is pregnant), termination for incompetence is not allowed unless there is a severe breach of contractual obligations by the employee.

Finally, severance is required in almost any termination, including mutually agreed-upon terminations and the normal expiration of a labor contract that is not renewed. The general rule of severance calculation is that severance pay will be calculated on the basis of one month’s salary as compensation for each year the employee has worked for the employer. The monthly salary as the base for severance calculation should be the average monthly salary of the employee in the 12 months immediately preceding the termination. However, if the average monthly salary of the employee in the 12 months immediately preceding the termination is greater than three times the local average monthly salary (e.g., currently, three times the average monthly salary in Shanghai amounts to RMB8,676—the “Capped Amount”), then the Capped Amount, and not the employee’s actual salary, will be used to calculate severance pay. However, this limitation does not apply to the calculation of severance pay for the period prior to January 1, 2008.

## SUMMARY

Managing restructurings in China is no easy task for MNCs, most of whom have become accustomed to years of consistent growth. The adoption of any restructuring strategy requires a thorough understanding of the legal requirements and local practice rules to minimize adverse legal exposure. Legal developments in related areas should be monitored closely to ensure compliance.

## LAWYER CONTACTS

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