

Employee Stock Plans for Companies Listing on a Domestic Exchange

By Christophe Han and Kuno Shen

Since the resumption of domestic IPOs, increasing numbers of private and foreign-invested companies hope to first become share-limited companies and then list on the domestic A-share market. In a large number of these companies, for historical reasons, the employees' shareholding structure does not comply with current regulations. Given that the A-share market requires all shares to be freely tradable, these flawed shareholding structures frequently lead to disputes and other problems. These shareholding structures must therefore be corrected prior to any IPO. Additionally, some companies, in consideration of their long-term development, also wish to create employee stock ownership plans prior to their IPOs. Currently, one of the following three methods is usually used to arrange such plans:

Employees Hold Stock Directly

In order to settle property rights, the entity that previously held stock for the employees (such as the union, an employees' stockholding agency, or key management) may choose to directly transfer its stock to the employees. However, this type of direct transfer is governed by the PRC Company Law. Under the PRC Company Law, limited liability companies may not have more than 50 shareholders. Therefore, if more than 50 employees that wish to participate in the stock ownership plan, it may be difficult to directly transfer stock to them.

Establishing a Holding Company

A holding company is a limited liability or share limited company established by capital contributions from the employees. The holding company's only purpose is to hold stock in the target company and help employees indirectly hold the target company's stock. The current PRC Company Law removed limitations on a company's investment ratios, so that employees can create holding companies and participate in employee stock ownership plans with little cost. The limit on the number of shareholders means that it may be necessary to create several holding companies. Based on publicly available information, a number of recently listed companies used holding companies to implement their employee stock ownership plans.

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下列人员联系：

韩东红: (86 21) 6881 8100 - 6609
Publication@llinkslaw.com

If you would like other Llinks
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Lily Han: (86 21) 6881 8100 - 6609
Publication@llinkslaw.com

Llinks Law Offices
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When using holding companies to carry out an employee stock ownership plan, future tax costs should be considered. For example, when a parent company distributes dividends, the holding company must pay enterprise taxes and deduct contributions to the statutory common reserve before distributing dividends to its employee-shareholders, who will not receive the same dividend as if they directly held the parent company's stock. If holding companies dissolve after the lockup period [when sales of their stock are forbidden], and their tradeable A-shares are distributed to shareholders, the holding company will again need to pay enterprise taxes. On the other hand, when employees receive their shares of stock from the dissolution of the holding company, the employees will again have to pay personal taxes on the shares.

Equity Trusts

Equity trusts are a system whereby the principal authorizes a trustee to manage or dispose of his stocks. The trustee acts in his own name for the benefit of the trust's beneficiary of some other specially defined purpose.

Most business trusts are conducted through trust companies' capital trusts. It is important to note that the *Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds*, which took effect on 1 March 2007, make substantial changes to the prior *Interim Measures for the Administration of Capital Trust of the Trust and Investment Companies*. Under the new regulations, no more than 50 natural persons may participate in a single trust plan of assembled funds (**a trust plan**), and each person must be a qualified investor. A qualified investor must either: have a minimum investment in the trust plan of more than 1 million Yuan; have individual or family financial assets exceeding 1 million Yuan at the time of subscription to the trust plan; or have annual income exceeding 200,000 Yuan for the past three years. These regulations will raise the threshold for participating in trust plans, and will impact the use of trust plans to implement employee stock ownership plans.

After promulgation of the PRC Trust Law, equity trusts were initially considered to be an effective way of implementing employee stock ownership plans. However, because trust arrangements may conceal the actual beneficiary, the China Securities Regulatory Commission (**CSRC**) has not encouraged the use of trust arrangements by companies applying to list on a stock exchange. The CSRC also discourages the use of equity trusts by controlling shareholders or actual controllers of companies applying to list. Trust arrangements by controlling shareholders or actual controllers can easily lead to property disputes, misappropriation of profits, or transfer of controlling rights. There are very few A-share listed companies that have successfully used a trust structure to implement their employee shareholding plans.

Both holding companies and equity trusts help employees indirectly hold a target company's stock. According to the CSRC and other securities regulatory institutions, the total number of registered shareholders and employees indirectly holding stock cannot exceed 200. According to the CSRC, this restriction is based on two laws: 1) Article 79 of the PRC Company Law, which states that a company limited by shares shall have no more than 200 founding shareholders; and 2) Article 10 of the PRC Securities Law, which states that a company issuing shares to more than 200 recipients constitutes a public offering.

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Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual Llinks contact.

Shanghai	Beijing
Christophe Han Tel: (86 21) 6881 8100 - 6618 Christophe.Han@llinkslaw.com	Wayne Chen Tel: (86 10) 6655 5050 - 1022 Way.Chen@llinkslaw.com
Grant Chen Tel: (86 21) 6881 8100 - 6613 Grant.Chen@llinkslaw.com	

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