HAN KUN
汉坤律师事务所
Han Kun Law Offices

HAN KUN 2022 VC/PE DATA ANALYSIS

2023.09

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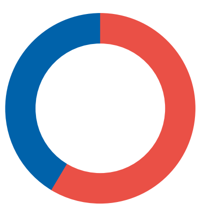
Part 1 Introduction

Each year, we serve as legal counsel in a wide variety of venture capital and private equity (VC/PE) transactions featuring the full range of VC/PE investments from the angel/seed round to the pre-IPO round, structured either onshore or offshore, and denominated in either RMB or US Dollar. Our clients, who represent a broad spectrum of the investment community, include the most prolific domestic and international investors on the one hand, and household name corporations, start-up and unicorn companies positioned at the forefront of many leading industries on the other.

In 2022, we helped clients close approximately 500 VC/PE transactions. In this report, we assess the data distilled from those transactions and analyze the investment structures and key legal terms prevalent in those transactions. In addition, the data collected from the nearly 3,500 transactions we worked on during the past six years are horizontally compared, where appropriate, to demonstrate the trends and changes in the investment structures and key legal terms over this time span. Specifically, this report examines the usage and changes of the following legal terms: (i) liquidation preference; (ii) redemption right; (iii) preemptive right; (iv) right of first refusal and co-sale right; (v) drag-along right; (vi) anti-dilution right; (vii) dividend preference; (viii) restrictions on founders; (ix) share transfer by founders; (x) control right (protective provisions and board composition); (xi) information right and inspection right; (xii) employee equity incentive plans; (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 indicated, the VC/PE transactions referred to in this report are the transactions we worked on as legal counsel.

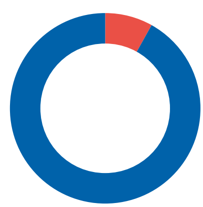
We publish this report annually in the hope that readers will find it useful to assess the past and forecast the future of China's VC/PE industry.

2022 VC/PE Transactions



Transactions by Investment Currency

- USD 41.43%
- RMB 58.57%



Transactions by Investor Type

- Financial investors 91.90%
- Strategic investors 8.10%

In summary, the 2022 VC/PE transactions transpired the following:

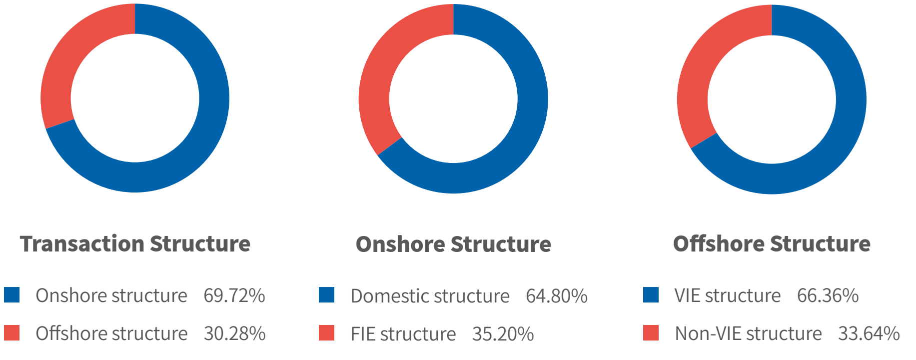
Both the number of transactions and total deal value declined in 2022, while early-stage investments bucked the trend. As uncertainties bore down the global economy, the VC/PE market experienced a notable slowdown in 2022. Compared to 2021, the number of VC/PE transactions completed in 2022 and the total deal value of such transactions declined by around 23% and 11%, respectively. On the other hand, early-stage investments (such as seed, angel and Pre-A rounds) continued an upward trend with both the number of transactions closed and their share in all VC/PE transactions, which reached the highest level of the past six years. In contrast, Series B and subsequent rounds of investments and their share in the total VC/PE transactions declined for the year.

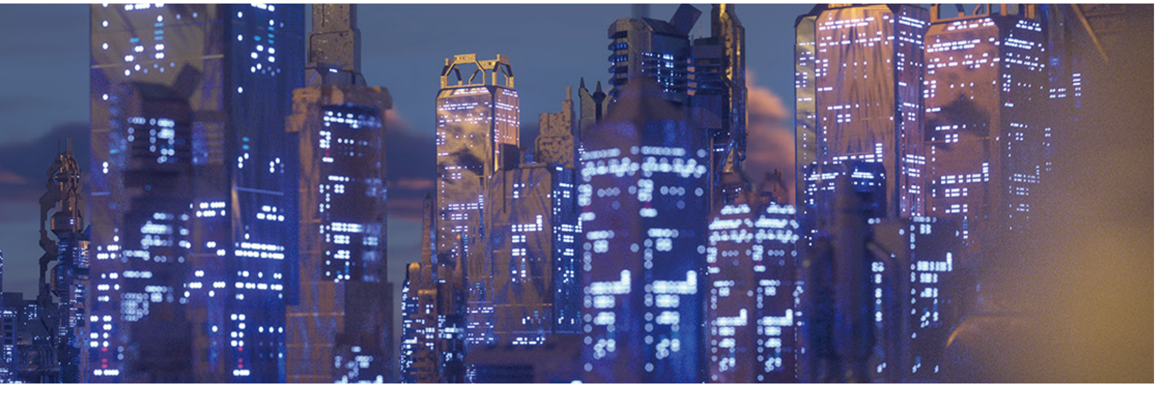
Onshore transactions continued their upward trend. An onshore transaction refers to a structure in which the investee company (the "company" or the "investee company") uses an entity registered in China as its financing vehicle to which investments will be directly made. By contrast, an offshore transaction is where the investee company sets up an entity registered outside of China (in most cases, the Cayman Islands) as its financing vehicle to which investments will be made while the principal business of the investee company remains in China.

In 2022, the onshore transactions accounted for 69.72% of all VC/PE transactions, a record high of the past six years. The onshore structure is further divided into (i) pure domestic structure, where the company is a 100% domestic company free of any foreign ownership; and (ii) FIE structure, where the company is partially owned by foreign investors and registered under the PRC law as a foreign-invested enterprise. Of all the onshore transactions completed in 2022, those with the pure domestic structure accounted for 64.80%, representing a slight increase from 60.64% in 2021, and those with the FIE structure accounted for 35.20%, showing a slight decline from 39.36% in 2021.

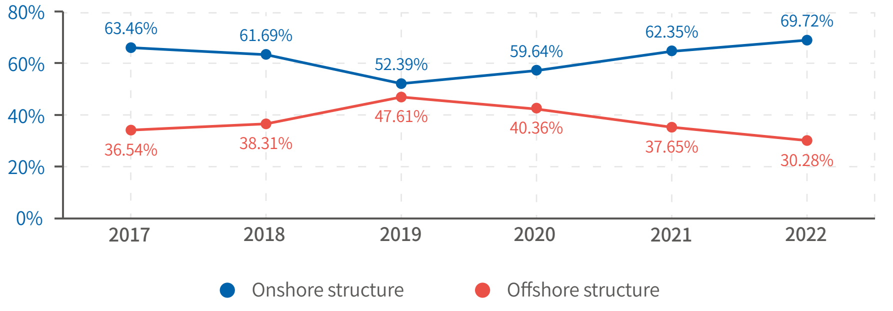
Based on our data, the offshore transactions accounted for 30.28% of all VC/PE transactions completed in 2022, the lowest level of the past six years. The offshore structure is further divided into (i) VIE structure, where the offshore financing vehicle indirectly controls the onshore operating company through a set of contractual arrangements; and (ii) non-VIE structure, where the offshore financing vehicle directly owns the equity interests of the onshore operating company without the need of any contractual arrangement in the corporate structure. In 2022, 66.36% of the offshore VC/PE transactions adopted the VIE structure, representing the lowest percentage of the past six years, while the non-VIE transactions accounted for 33.64%, the highest level in the past six years.

2022 VC/PE Transactions — Transaction Structure

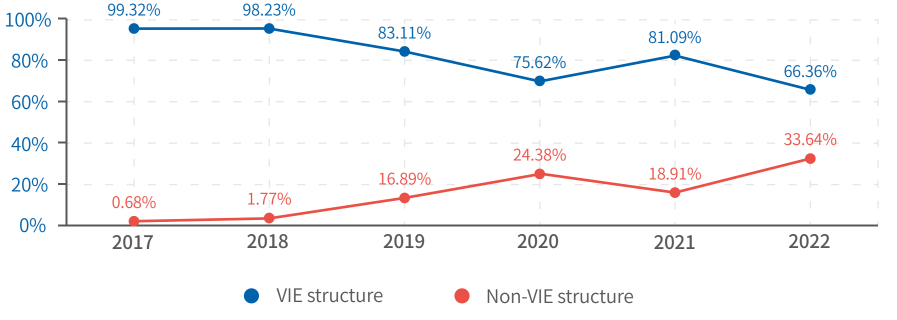




Changes in VC/PE Transaction Structures over the Past Six Years



Changes in VC/PE Transaction Structures over the Past Six Years — Offshore Structure



Beijing, Shanghai, Shenzhen, Hangzhou and Suzhou were the most favored domiciles for investee companies to base their principal operations. Among the VC/PE transactions completed in 2022, 76.33% of the investee companies had Beijing, Shanghai, Shenzhen, Hangzhou and Suzhou (in that order) as their principal domicile of business operations. Our data of the past six years indicate that Beijing, Shanghai and Shenzhen have remained the top three choices for investee companies to base their operations even though their dominance softened a notch in 2022. It is worth noting that companies based in Suzhou continued to attract an ever greater share of VC/PE investments. In 2022, the number of VC/PE investments made in Suzhou-based companies accounted for 5.34% of the total, making Suzhou the fifth most favored city for VC/PE investments. By contrast, the number of VC/PE investments made into Guangzhou-based companies dropped noticeably in 2022 squeezing the city out of the top five, a position it had enjoyed for many years.

The top five market sectors for VC/PE investments were biomedical, semiconductor, smart hardware, e-commerce and food catering. The biomedical sector continued to attract the largest share of VC/PE investments. In 2022, 20.15% of the VC/PE transactions involved companies engaged in biotechnology, medical and pharmaceutical business, followed sequentially by semiconductor, integrated circuit and chip; smart hardware (e.g., artificial intelligence, augmented reality); e-commerce and food catering. These sectors accounted for over 50% of the VC/PE transactions completed in 2022. Corporate services sector, which had been a perennial top-five investment destination over the years, suffered a severe decline in 2022 as it received less VC/PE investments than any of the past six years.

Transactions by financial investors trended upward. In 2022, transactions initiated by financial investors accounted for 91.90% of all VC/PE transactions, the highest level in the past six years. As a corollary, the number of VC/PE transactions driven by strategic investors in 2022 declined to 8.10% of the total, as compared to the range between 9.64%—16.44% in the previous years.

Part 2 Analysis of Specific Terms

Liquidation Preference

Liquidation preference is a common preferential right designed to help distribute a company's assets among its shareholders when a liquidation event (often defined to include dissolution, liquidation or trade sale of the company) occurs. Liquidation preference falls into two main categories-participating and non-participating.

- Under the participating liquidation preference, investors (usually holding preferred shares of the company) are entitled to receive their liquidation preference amounts first based on a pre-agreed formula and subsequently share the remaining distributable assets of the company with other shareholders on a pro rata basis [1] .

  Alternatively, parties to VC/PE transactions sometimes agree to a capped distribution arrangement for the participating liquidation preference. For example, if the amount due to an investor under the participating liquidation preference exceeds a capped amount (usually certain multiples of the investment principal), the investor would not be entitled to any further distribution. In this case, however, if the distribution due to the investor based on its shareholding in the company is greater than such capped amount, the investor may choose instead to receive its distribution on a pro rata basis. It may also be agreed that the participating liquidation preference ceases to be applicable to an investor if the company's valuation in the liquidation event or the amount distributable to such investor based on its shareholding in the company exceeded a pre-agreed threshold. In this case, distributions will be made only on a pro rata basis.

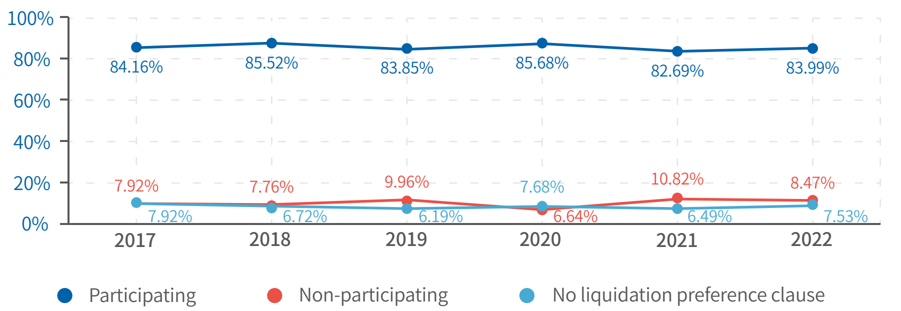
[1] Under offshore VC/PE transactions, an investor's pro rata share (or shareholding) in a company is usually determined based on the number of common shares deliverable to it upon conversion of its preferred shares (or on an as-converted basis). Under onshore and offshore VC/PE transactions, parties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

- Under the non-participating liquidation preference, an investor is only entitled to its preference amount and is not in a position to share the remaining assets of the company afterwards. In this case, however, if the distribution accorded to the investor based on its shareholding in the company is greater than its liquidation preference amount, the investor may instead elect to share the company's assets with all other shareholders on the pro rata basis.

In each of the past six years, over 92% of the VC/PE transactions provided for liquidation preference and among which the overwhelming majority adopted participating liquidation preference. In 2022 the landscape remained unchanged when 83.99% of the VC/PE transactions adopted the participating liquidation preference while 8.47% the non-participating liquidation preference.The remaining of 7.53% did not provide for any liquidation preference in their deal documentation.Among the transactions that provided for participating liquidation preference, about 6.5% capped the distribution to a pre-agreed amount.

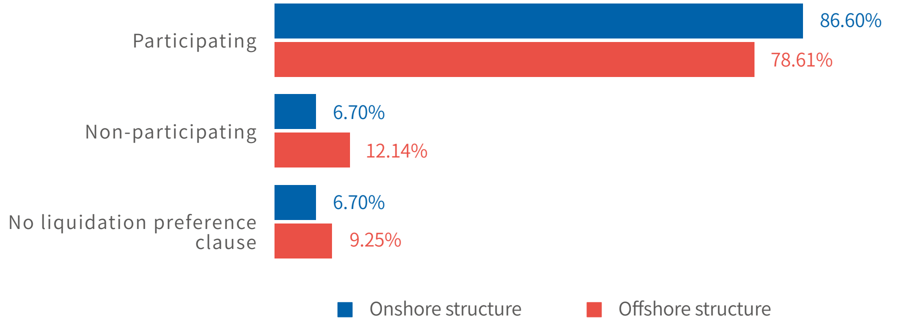
The following chart shows the trend of liquidation preference in the past six years.

Changes in Liquidation Preference over the Past Six Years



The chart below shows how in 2022 the liquidation preference was adopted in onshore and offshore VC/PE transactions. Our data show that participating liquidation preference was the most popular for both onshore and offshore transactions.

Liquidation Preference



Liquidation preference amounts are typically calculated using the following formulas:

(a) the multiples of 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.

According to our 2022 data, among the VC/PE transactions that provided for liquidation preference, formulas (a) and (b) were the most common for calculating the liquidation preference amounts, accounting for 40.33% and 49.29%, respectively, while formula (c) accounted for 8.35%. Our data in 2022 also show that formula (a) was more commonly used in offshore VC/PE transactions while formula (b) was more popular in onshore VC/PE transactions.

Where the liquidation preference amounts were calculated using formula (a), the multiples of principal investment ranged from 100% to 170%, with the average being 108.22%. Where the liquidation preference amounts were calculated using formula (b), the average interest rate was 9.17% annualized simple interest or 9.11% annualized compound interest.

The following shows the calculation of liquidation preference amounts under onshore and offshore structures.

Onshore Structure

Liquidation Preference Amount	Range	Average
Multiple of investment principal	(100%—170%) of investment principal	109.03% of investment principal
Multiple of investment principal + simple interest	(100%—150%) of investment principal + (3%—20%) simple interest	101.14% of investment principal + 9.27% simple interest
Multiple of investment principal + compound interest	100% of investment principal + (6%—12%) compound interest	100% of investment principal + 9% compound interest

Offshore Structure

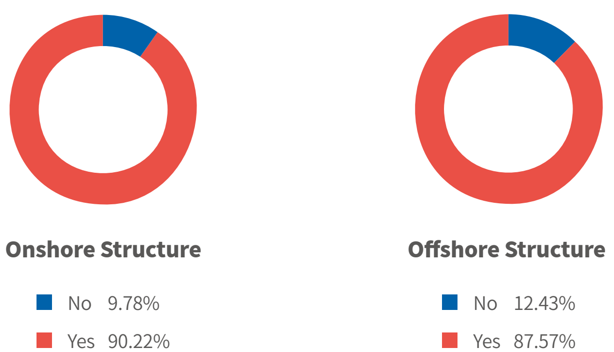
Liquidation Preference Amount	Range	Average
Multiple of investment principal	(100%—150%) of investment principal	107.03% of investment principal
Multiple of investment principal + simple interest	(100%—110%) of investment principal + (6%—15%) simple interest	100.21% of investment principal + 8.87% simple interest
Multiple of investment principal + compound interest	100% of investment principal + (6%—15%) compound interest	100% of investment principal + 9.33% compound interest

Redemption Right

The redemption right (also known as the repurchase right) provides investors with a mechanism to divest their investment off the company. In VC/PE transactions, the investors usually have the right to require the company and/or the founders to redeem their shares at a pre-agreed price upon the occurrence of one or more trigger events (the "redemption trigger events"), which often include, (i) failure of the company to consummate a qualified IPO or a trade sale within a pre-agreed period of time after closing or (ii) material breach or certain non-compliance on the part of the company and/or the founders. Based on our data of the past six years, the redemption right was overwhelmingly adopted in VC/PE transactions sponsored by Chinese companies regardless whether the transactions were structured onshore or offshore. This demonstrates that share redemption is the preferred exit strategy for investors in this type of VC/PE transactions.

The following chart shows the use of redemption provisions in onshore and offshore VC/PE transactions in 2022.

Existence of Redemption Provisions



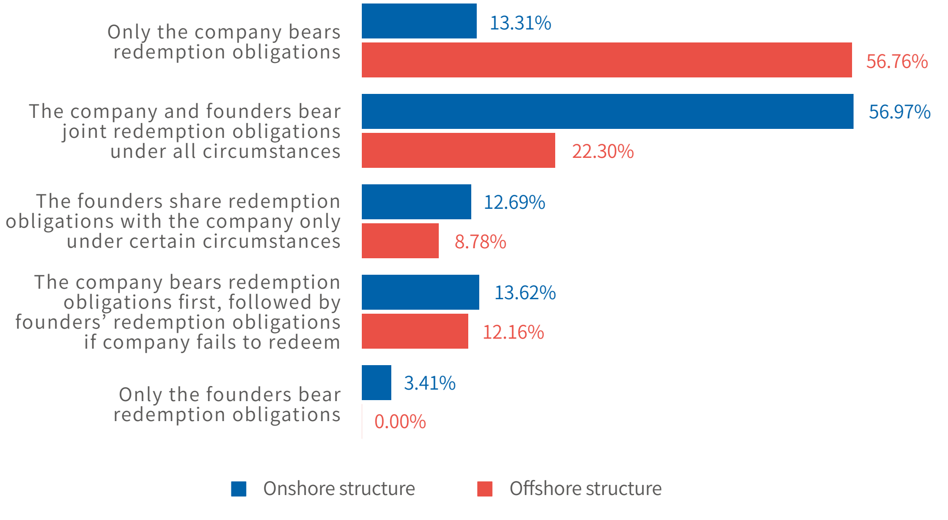
The onshore and offshore VC/PE transactions differ substantially when it comes to the parties bearing the redemption obligation. In most offshore transactions, the redemption obligation falls solely upon the company. In onshore transactions, on the other hand, the founders and the company usually share the redemption obligation or, in some cases, only the founders alone are responsible for the redemption. This divergence comes mainly from the differences in law of the jurisdictions where the financing vehicles of investee companies are established. In many foreign jurisdictions (e.g., the Cayman Islands) the share redemption is permissible by law and the redemption procedures are clearly set out and easy to implement. The PRC law, on the other hand, does not provide a clear path for share redemption by limited liability companies and there have been cases where some valuation adjustment agreements between the companies and their shareholders (which usually involve share redemption) were rendered invalid by court judgements. However, recent legal developments in China appear to be more accommodating to share redemptions. For example, the Minutes of Civil and Commercial Trial Work of the National Courts, issued by the Supreme People's Court in November 2019, state that the valuation adjustment mechanism between investors and companies should be upheld as valid in the absence of a statutory provision to the contrary. In practice, however, when an investor requests the company to redeem its shares, Chinese courts will uphold such a request only if the company has completed the capital reduction procedures. Given the complexity of the capital reduction procedures (which include preparation of balance sheets and property inventories, creditor notification, and public announcement), investors in onshore VC/PE transactions usually require the founders and companies to be jointly and severally responsible for the redemption obligation to minimize any hindrance for the investors to exercise their redemption right. In this context, it is noteworthy that even in offshore VC/PE transactions, the instances where companies are solely responsible for the redemption obligation have steadily declined. In 2022 offshore VC/PE transactions that had redemption provisions, only 56.76% agreed that companies alone should be responsible for the redemption obligation, as compared to 62.62% in 2021 and 70.76% in 2020. This shows that investors in offshore transactions demanded higher flexibility than before to ensure their investment exit.

When founders are required to bear the redemption obligation jointly with the company, they often seek to limit their personal risk exposure by predicating their obligation on certain conditions, such that their redemption obligation be triggered only (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 summarizes the different variations of which party is responsible to carry out the redemption obligation:

- the company alone bears the redemption obligation;
- the founders alone bear 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 redemption obligation first, but the founders would come to its rescue if the company fails to fulfill its obligation.

The chart below presents a breakdown of the allocation of responsibility for the redemption obligation in the 2022 VC/PE transactions that had redemption provisions.

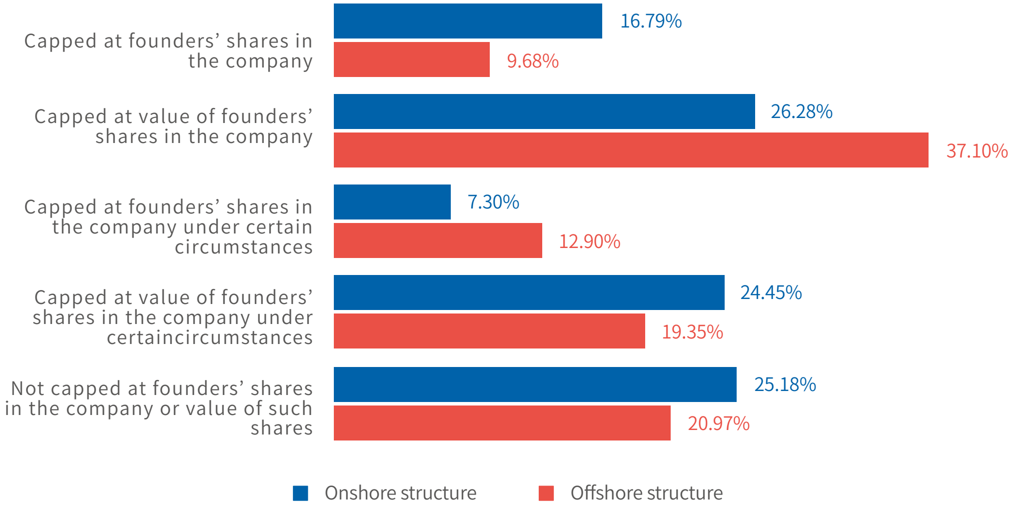
Redeeming Parties



Where founders are obligated for the redemption, they 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 as to shield their personal and family assets from such obligation.

The chart below shows the various caps the founders used to limit their redemption obligation in the 2022 VC/PE transactions where they assume the redemption obligation.

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



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

(a) the multiples of the investment principal; or

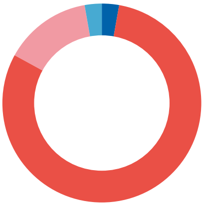
(b) the investment principal (or certain multiples thereof) + simple or compound interest accrued thereon; or

(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 of the past six years show that formula (b) was the most popular method for the calculation of the redemption price, regardless whether the underlying transactions were structured onshore or offshore. According to our 2022 data, formula (b) was used in 81.95% of the VC/PE transactions that had redemption provisions. 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. In contrast, formula (a) was used in only 2.76% of the VC/PE transactions that had redemption provisions in 2022, the lowest in the past six years. Over the same time span, formula (c) gained some popularity. As times change, so do the methods for calculating the redemption price.

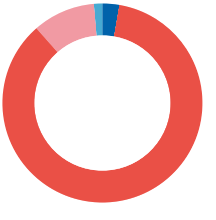
The chart below shows the formulas for calculating the redemption price used in the 2022 VC/PE transactions that had redemption provisions.

Calculation of Redemption Price



Onshore Structure

- Multiples of investment principal 2.79%
- Investment principal (including multiples thereof) + simple/compound interest 80.19%
- Higher of two or three models 14.24%
- Others 2.79%

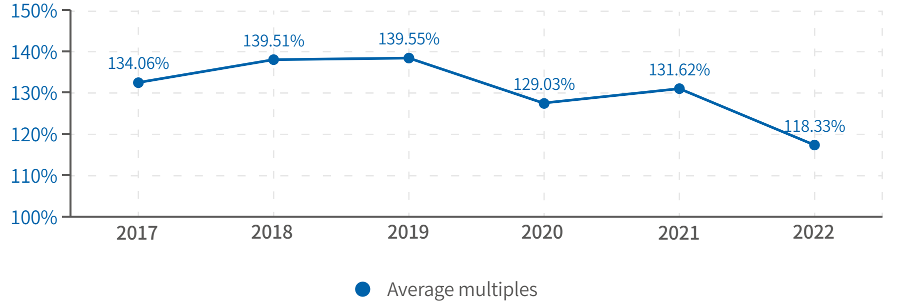


Offshore Structure

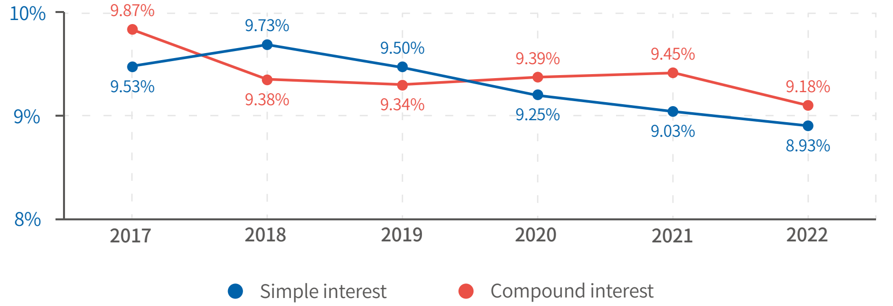
- Multiples of investment principal 2.70%
- Investment principal (including multiples thereof) + simple/compound interest 85.81%
- Higher of two or three models 10.14%
- Others 1.35%

Based on our 2022 data, (i) where the redemption price was calculated based on the "multiples of the investment principal", the average multiple was 118.33%, a significant drop as compared to the previous year and the lowest in the past six years; (ii) where the redemption price was calculated based on the "investment principal (or certain multiples thereof) + simple or compound interest accrued thereon", the average interest rate was 8.93% annualized simple interest or 9.18% annualized compound interest, representing a slight drop as compared to the previous years. In our view, the drop of the redemption price seemed to correlate with the global economic slowdown in 2022 which prompted the investors to lower their expectations on the internal rate of return of investee companies. Similarly, some companies and founders may have become increasingly sensitive to the redemption price as the economic slowdown heightened the probability of their redemption obligation.

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

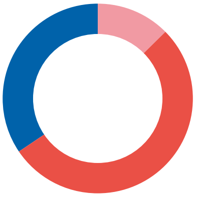


Redemption Price — Investment Principal (or certain multiples thereof) + Simple/Compound Interest
Average Interest Trend over the Past Six Years



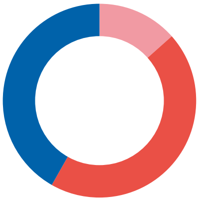
Investors have the right to demand the company and/or the founders to fulfill their redemption obligation only upon the occurrence of one or more redemption trigger events. The most common redemption trigger event is the company's failure to consummate a qualified IPO within a pre-agreed time limit. As shown in our 2022 data, in 85.77% of the VC/PE transactions that set out the redemption right, deal documentation provided that if the company failed to complete a qualified IPO within the required time limit, the investors may exercise their right of redemption. In most cases, this time limit ranged from three to five years. Some early-stage investments accommodated a time limit beyond five years. Three years or less were rare, which appeared primarily in pre-IPO investment transactions.

Redemption Trigger Event — Company's Failure to Complete Qualified IPO within Required Time Limit Length of Time Period



Onshore Structure

- >5 years 34.44%
- 3 years—5 years 52.96%
- ≤3 years 12.59%

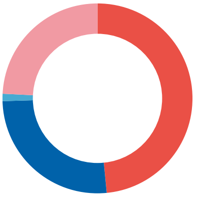


Offshore Structure

- >5 years 41.79%
- 3 years—5 years 44.78%
- ≤3 years 13.43%

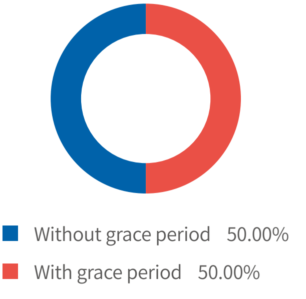
In each round of financing, the required time limit for consummating a qualified IPO is typically set to run from the financial close. In the case of multiple rounds of financing, the deadline for a qualified IPO specified in a subsequent round of financing is usually later in time than those set in the preceding rounds. Thus, the redemption obligation in a subsequent round of financing would be triggered later in time than those in the preceding rounds. Since the investors in subsequent rounds of financing do not want the company to deplete its cash to redeem earlier investors and depress the company's valuation, they sometimes require the investors in earlier rounds of financing to extend their IPO deadline so that all IPO deadlines would be synchronized. Companies often welcome such an extension as it would ease the time pressure to accomplish the IPO. According to our 2022 data, in around 50% of the VC/PE transactions that were in Series B or later rounds, the investors in earlier rounds agreed to extend the existing IPO deadlines, and such extension occurred more frequently in offshore VC/PE transactions. In case the investors in previous rounds of financing insist on sticking to the original IPO deadline, subsequent investors often request a cross-trigger right so that they are able to enforce their redemption right simultaneously with the investors of previous rounds of financing.

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



In addition to the "company's failure to consummate a qualified IPO within a set time limit" and the "initiation of the redemption right by earlier round investors" (which is the cross-trigger right mentioned above), other redemption trigger events commonly adopted by the investors include (i) failure by the founders or the management team to meet integrity tests; (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 redemption trigger events, the "material breach by the company and/or founders of the transaction documents" is frequently adopted by the investors to trigger redemption right. However, since the parameters of what is material are often elusive and uncertain, companies and founders often request a grace period to cure the breach so that the redemption obligation may be triggered only if the breach is not cured within the grace period. In 2022, the grace period was provided for in about 50% of the VC/PE transactions where the "material breach by the company and/or founders of the transaction documents" was a redemption trigger event, representing a six-year high.

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



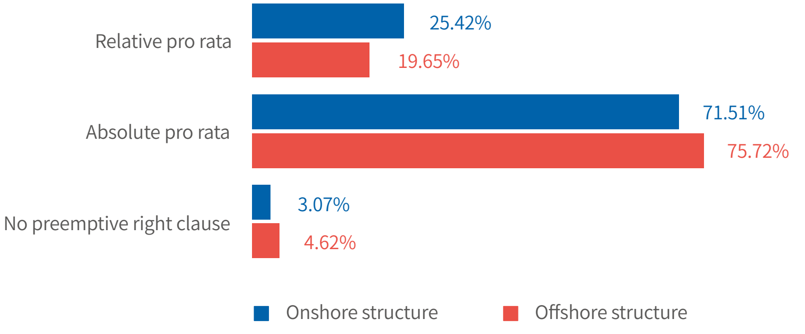
Preemptive Right »»

The preemptive right accords certain shareholders (typically investors holding preferred shares) a priority over other shareholders and third parties to subscribe for any new shares (or new registered capital) to be issued by the company. This right is designed to preserve the shareholding of an investor from being diluted by the company's future capital raisings. According to our data, in each of the past six years around 94%—97% of the VC/PE transactions adopted the preemptive right. The preemptive right is further divided into the "absolute pro rata" and the "relative pro rata". Under the absolute pro rata, the number of newly issued shares that an existing investor is entitled to subscribe for is calculated based on its current shareholding percentage in the company. As a result, the existing investors cannot collectively subscribe for all of the newly issued shares of the company. Under the relative pro rata, 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 may collectively subscribe for all of 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. Our data of the past six years show that about 70%—80% of the VC/PE transactions that provided for the preemptive right adopted the absolute pro rata approach. In 2022, this percentage was 75.59%. On the other hand, in each of the past six years about 3%—6% of the VC/PE transactions did not expressly provide for the preemptive right. It is worth noting that under the PRC Company Law, shareholders of a limited liability company have a preemptive right to subscribe for any increased capital of the company in an amount commensurate with their current paid-up capital in the company's registered capital. Thus, even if the preemptive right is not expressly provided for in an onshore VC/PE transaction, the existing shareholders are still entitled, as a matter of law, to such right unless all shareholders agree to the contrary.

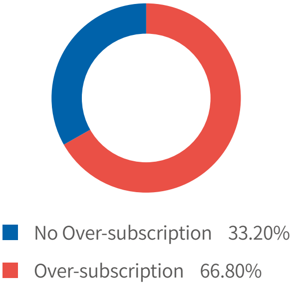
The chart below shows how the preemptive right was adopted in the VC/PE transactions in 2022.

Preemptive Right



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 in excess of its pro rata allotment if another preemptive right holder has not fully exercised its own preemptive right. According to our 2022 data, about 66.80% of the VC/PE transactions that provided for the preemptive right also provided for the over-subscription right. The over-subscription right was more popular in offshore structure than in onshore structure transactions.

Preemptive Right — Over-subscription Right



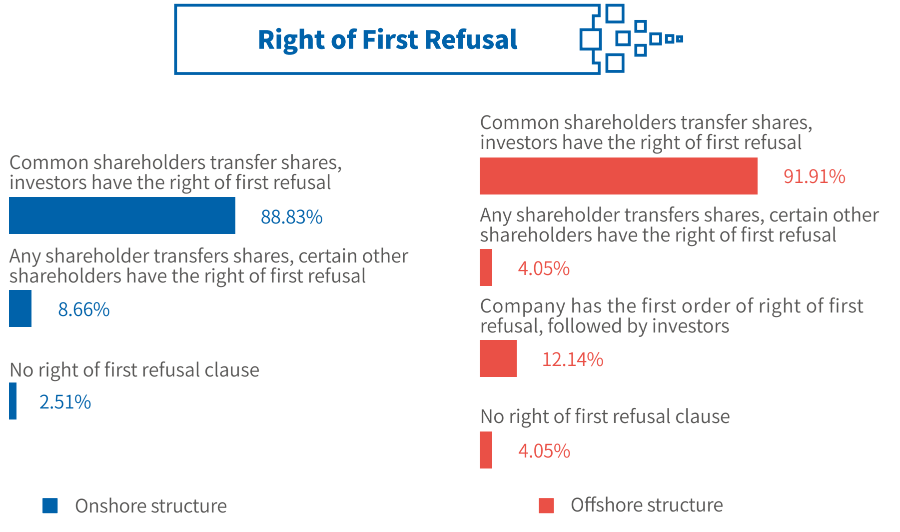
Right of First Refusal and Co-sale Right

Right of First Refusal

In the context of VC/PE transactions, when a shareholder intends to transfer its shares of the company, the right of first refusal ("ROFR") gives certain shareholders (typically investors holding preferred shares, the "ROFR holders") a priority over any third party and/or other shareholders of the company to purchase the offered shares on the terms and conditions that are at least equal to those offered by the proposed buyer. This right is designed to restrict share transfers by specific shareholders and, when exercised, to increase the shareholding of the ROFR holders.

In most VC/PE transactions, the ROFR is used to restrict the share transfers by common shareholders (typically the founders). Our data of the past six years indicate that in about 90% of the VC/PE transactions, deal documents provided that when common shareholders proposed to sell their shares, preferred shareholders (typically investors) had the ROFR to purchase the selling shares (known as the "common shareholders transfer shares, investors have the right of first refusal"). In addition to this approach, in some offshore VC/PE transactions, the company is given the ROFR to purchase the offered shares ahead of the preferred shareholders. Only if the company elected not to fully exercise this right may the preferred shareholders exercise their ROFR to purchase the remaining shares proposed to be sold by the common shareholders (known as the "company has the first order of right of first refusal"). Based on our 2022 data, among the offshore VC/PE transactions that provided for the ROFR, 12.65% adopted the "company has the first order of right of first refusal" approach, the lowest level in recent years. Furthermore, there have always been a small number of transactions where, in case of a proposed share transfer by any shareholder, certain ROFR holders have the right of first refusal (in this case, the ROFR holders may be all investors or all non-selling shareholders) (known as "any shareholder transfers shares, certain other shareholders have the right of first refusal"). As per this approach, shares to be sold by investors are also subject to the ROFR.

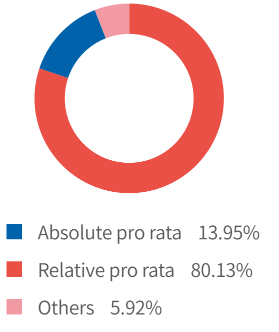
The figure below shows how the ROFR was adopted in the 2022 VC/PE transactions. Regarding the transactions that did not provide for the ROFR, it is worth noting that under the PRC Company Law the transfer of shares of limited liability companies is expressly subject to the ROFR. Unless the articles of association of the company provide otherwise, (i) a shareholder of a limited liability company may freely transfer its shares to other shareholders, and (ii) if the shareholder intends to transfer its shares to a third party, the other shareholders will have the ROFR to purchase such shares on terms and conditions at least equal to those offered by such third party. Thus, in onshore VC/PE transactions, even if the ROFR is not expressly provided for in deal documentation governed by the PRC law, the right is statutorily available to shareholders of limited liability companies.



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

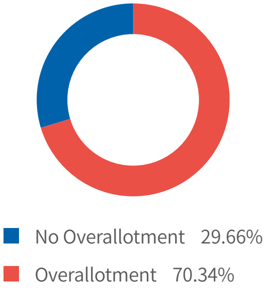
Similar to the preemptive right, the ROFR may also be exercised on an absolute pro rata or relative pro rata basis. Unlike the preemptive right, however, the relative pro rata has been predominately employed in connection with the ROFR. According to our 2022 data, the relative pro rata approach was used in 80.13% of the VC/PE transactions that adopted the "common shareholders transfer shares, investors have the right of first refusal" model. The rationale is that the relative pro rata maximizes the ability of investors to purchase all the offered shares and maximally restricts the founders from selling their shares to third parties.

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



The overallotment right is designed to enhance the ROFR to further restrict share transfers by specific shareholders and to allow the ROFR holders to purchase additional shares. Thus, if a ROFR holder fails to exercise its ROFR with respect to all or part of the offered shares to which it is entitled, each other ROFR holder who has fully exercised its ROFR will be entitled to purchase any remaining offered shares. Based on our 2022 data, the overallotment right was stipulated in 70.34% of the VC/PE transactions that adopted the "common shareholders transfer shares, investors have the right of first refusal" model.

Rights of First Refusal — Overallotment Right



Co-sale Right

If a common shareholder (typically a founder) proposes to sell its shares, the co-sale right allows an investor who has not exercised its right of first refusal to participate in such share transfer, such that it has the right to sell its shares at a pre-agreed ratio together with such common shareholder. The co-sale right is a common feature in VC/PE transactions as it allows the investors to simultaneously exit with the founders. It also functions to restrict the founders' freedom to transfer shares. The key issue for the co-sale right is the formula for calculating the maximum number of shares an investor can co-sell. The table below sets out how each calculation formula was adopted in the 2022 VC/PE transactions that provided for the co-sale right. The first formula, which maximizes the number of shares an investor can offer to sell, was the most popular for both onshore and offshore VC/PE 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)	67.82%	71.43%
Shares held by the investor / (shares held by all investors entitled to exercise co-sale right + shares held by the transferor)	20.58%	22.36%
Shares held by the investor / (shares held by all investors + shares held by the transferor)	4.06%	1.86%
Shares held by the investor / all issued and outstanding shares	1.45%	1.24%
None of the above	6.09%	3.11%

Drag-along Right

The drag-along right accords certain investors the right to require all other shareholders to participate in a trade sale of the company when pre-agreed conditions materialize. A trade sale entails the sale of all or substantially all of the equity/assets of the company to a third party. When the price and/or conditions of a trade sale are optimal, an investor may want to exit through the trade sale and realize a desirable return on their investment. However, an equity sale cannot be accomplished unless enough equity of the company is up for sale, nor can an asset sale be achieved if other shareholders object to it. Thus, investors, which are usually minority shareholders not in control of the company, may not be able to exit through a trade sale without consent of other shareholders. To break this impasse, such investors may demand the drag-along right so that when the price and/or conditions of the trade sale are optimal they can require other shareholders to consent to or otherwise follow along with the trade sale.

As a general matter, the investors are usually motivated to exercise the drag-along right when one of the following occurs: (i) the company operates well but decides not to consummate an IPO or falls short of the listing requirements or (ii) the company falls short of the listing requirements due to poor operating conditions, making it difficult for the investors to exit via share redemption. When that happens, the drag-along right comes handy to help the investors exit through a trade sale of the company.

Since the drag-along right could cause drastic changes to the equity/asset composition of the company, the right is usually wrapped around with certain preconditions such that it may only be exercised when the preconditions are materialized. The most common preconditions are as follows:

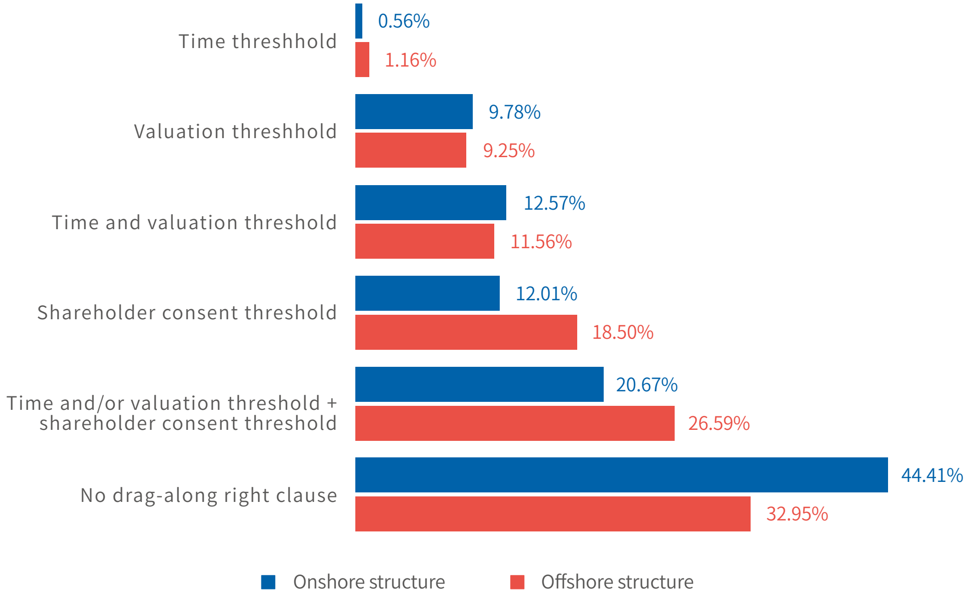
- A period of time has elapsed after the financial close of investment (the "time threshold"). This gives the company a period of time to operate under stable condition;
- Valuation of the company in the trade sale has reached a set target (the "valuation threshold"). This ensures both the investors and the dragged shareholders to obtain a satisfactory return on their investments and allows the founders to cash-out with desirable returns;
- Satisfaction of both the time threshold and valuation threshold (the "time and valuation threshold");
- Shareholders holding a certain percentage of shares have consented to the trade sale and its terms (the "shareholder consent threshold");
- Satisfaction of the time threshold and/or valuation threshold, and shareholders holding a certain percentage of shares have consented to the trade sale and its terms (the "time and/or valuation threshold + shareholder consent threshold").

Based on our data, each year from 2017 to 2021 over 60% of the VC/PE transactions provided for the drag-along right. In 2022, however, the percentage dropped to 59.32%, the lowest in six years. Generally, the drag-along right is more prevalent in offshore transactions than in onshore ones. According to our 2022 data, 55.59% of the onshore transactions provided for the drag-along right versus 67.05% for offshore transactions.

Among the preconditions to trigger the drag-along right, the use of only "time threshold" has been in decline and, in 2022, it only accounted for 1.27% of the VC/PE transactions that provided for the drag-along right. The "time and/or valuation threshold + shareholder consent threshold", on the other hand, was the most popular precondition, accounting for 38.10% of the VC/PE transactions where the drag-along right was provided for.

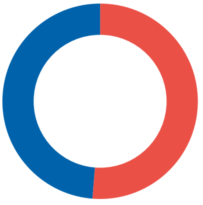
The chart below shows the use of the drag-along right and a breakdown of the preconditions in the 2022 VC/PE transactions.

Drag-along Right — Preconditions



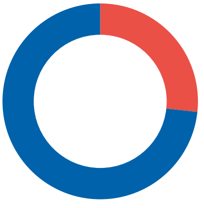
The parties entitled to the drag-along right are usually the investors (including specified investor(s) or a group of investors holding a requisite percentage of shares). In some VC/PE transactions, the founders may also insist on having this right to approve the trade sale such that the drag-along right would be subject to the consent of the founders or their appointed directors too. Among the 2022 VC/PE transactions that provided for the drag-along right, 42.22% required only the consent of the investors to effectuate the drag-along right, the lowest in the past six years. Transactions where the consent of the founders or their appointed directors was required to effectuate the drag-along right trended upward to 57.78%, and such case is more popular in offshore transactions than in onshore ones.

Drag-along Right — Exercising Parties



Onshore Structure

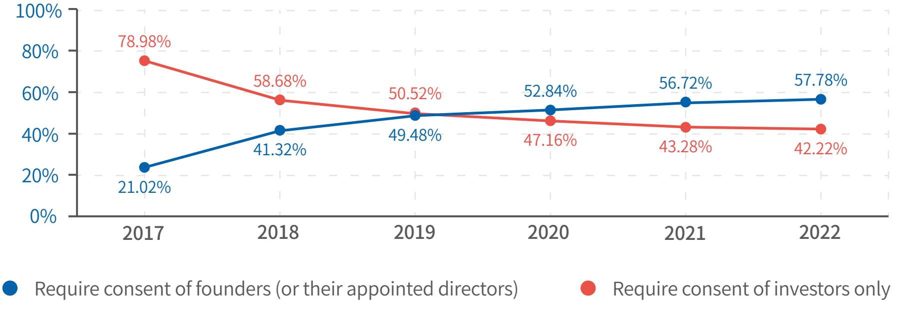
- Require consent of founders (or their appointed directors) 48.74%
- Require consent of investors only 51.26%



Offshore Structure

- Require consent of founders (or their appointed directors) 73.28%
- Require consent of investors only 26.72%

Drag-along Right — Exercising Parties Trend over the Past Six Years



Anti-dilution Right

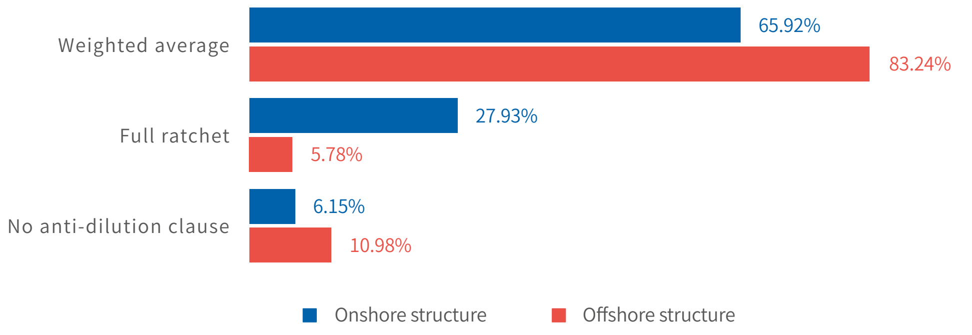
When the company raises a new round of funding at a price lower than the previous round (the down round), the anti-dilution right allows the existing investors to adjust the price per share they paid in the previous round pursuant to a pre-agreed formula, so that they would be entitled to receive additional shares to compensate for the higher price they paid before the down round. In offshore transactions, the anti-dilution right is often effectuated by adjusting the conversion price between the preferred shares and common shares such that each preferred share may be convertible into more common shares. In onshore transactions where share conversion is not expressly permissible by law, the adjustment is often effectuated by (i) requiring the company to issue additional shares to the affected investors at a nominal price; (ii) requiring the founders to transfer part of their shares to the affected investors at a nominal price; or (iii) requiring the company and/or founders to provide cash compensation to the affected investors. In onshore transactions where method (i) is adopted, if the affected investors are required by law to pay higher than the nominal price for the newly issued shares of the company, the company and/or founders are generally required to reimburse the investors for the additional costs they have to incur.

Based on different calculation methodologies for adjusting the share price, anti-dilution right is divided into the “full-ratchet” and the “weighted average” methods. 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.

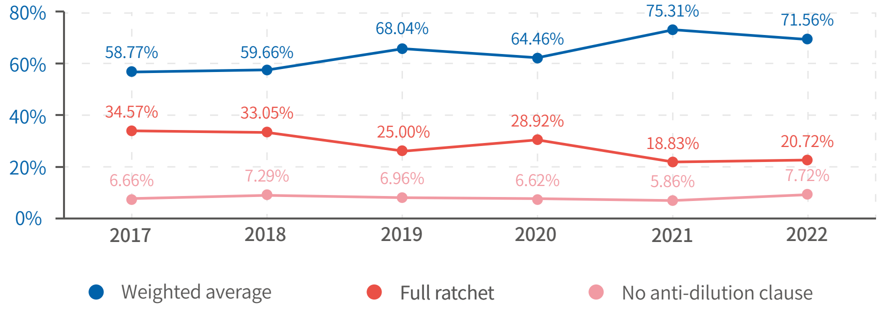
According to our 2022 data, VC/PE transactions which adopted the weighted average method accounted for 71.56% of the total and this method was adopted more often in offshore transactions than in onshore ones. On the other hand, each year about 6%—7% of the VC/PE transactions did not provide for any anti-dilution right.

The chart below shows that the weighted average outruns the full-ratchet method by a large margin in both onshore and offshore VC/PE transactions in 2022.

Anti-dilution Right



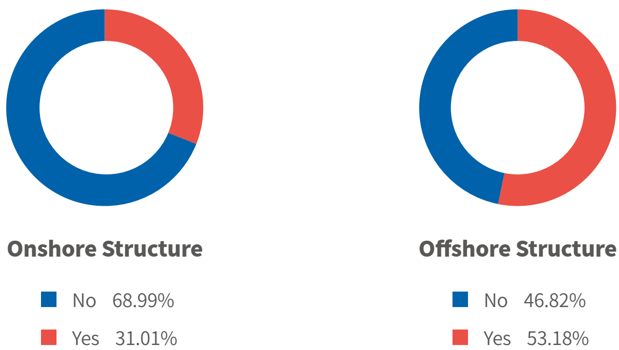
Anti-dilution Right over the Past Six Years



Dividend Preference

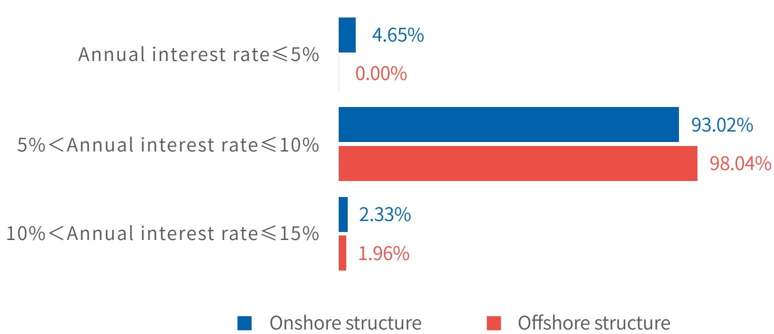
The dividend preference provides the investors with a right to receive dividends ahead of common shareholders (typically founders). In practice, many investors do not insist on having dividend preference because dividend income is not the primary motivation for their investment in the first place, especially investment in start-up companies that are not expected to become profitable in the immediate future. Our data validate this attitude. In 2022, 61.77% of the VC/PE transactions did not provide for the dividend preference, the highest level in six years. In addition, onshore transactions that did not provide for dividend preference outnumbered their offshore counterparts.

Existence of Dividend Preference



Where the dividend preference is written in deal documentation, sometimes the investors will not only receive their dividend ahead of all other shareholders, but also the dividend will carry interest accrued on their investment principal. Based on our data of the past six years, where this model was adopted such interest rate ranged between 5%—10% per year in most instances. The dividend yields are set out in the following chart.

Preferential Dividend Yields



Restrictions on Founders

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

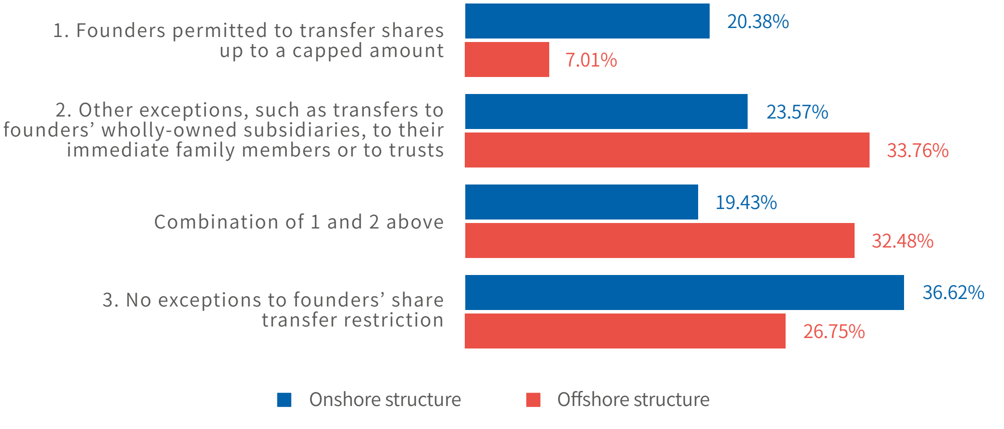
In addition to the restrictions on share transfer, the investors often require the founders to (a) devote all their work time to the company and (b) assume non-compete and non-solicitation obligations in favor of the company for as long as they remain employed by, or hold shares in, the company and for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

Share Transfer Restrictions

Based on our data, in each of the past six years about 88%—93% of the VC/PE transactions prohibited the founders from selling or otherwise disposing of their shares prior to an IPO or trade sale of the company without consent of the investors. In 2022, this percentage was 93.03%, the highest in the past six years.

The founders, on the other hand, often want to retain sufficient flexibility for share transfers and in some VC/PE transactions they are able to carve out exceptions to their share transfer restriction so that (i) transfer of shares up to a specified capped amount; and/or (ii) transfer of shares in the ordinary course of business (such as transfers 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) will not be subject to the share transfer restriction. The chart below shows how such exceptions were adopted in the 2022 VC/PE transactions that provided for the share transfer restriction. Our data of the past six years show that the share transfer restriction without any of the exceptions gradually decreased over the years, the percentage in 2022 reached the lowest in the past six years. The instance where deal documents do not provide for exceptions to founders' share transfer restriction appear more frequently in onshore VC/PE transactions.

Exceptions to Founders' Share Transfer Restriction



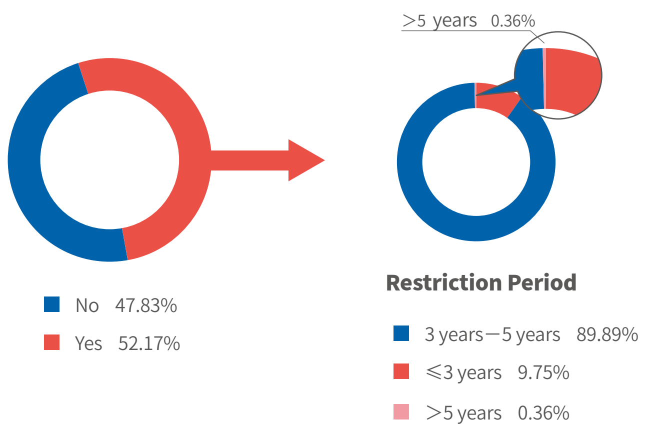
Restricted Shares

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, the company and/or the investors (or other designed shareholders) will be entitled to acquire the shares from the founder.

The type of shares subject to acquisition by the company and/or the investors (or other designed shareholders) may be the unreleased restricted shares or all of the shares held by founders. The acquisition price may be of the fair market value, at cost or the lowest price permitted by law. The manner of termination of the founder's employment with the company, ranging from voluntary resignation, dismissal for cause to no-fault departure (such as incapacitation), is a factor often used to determine the type of shares the founder is required to surrender and at what price. It should be noted that the restricted shares are officially registered shares of the company, whether or not the restrictions have been released. The restrictions and release mechanism merely affect the disposal of the shares, and the type, the price and other particulars relating to the acquisition of the shares by the company and/or investors (or other designed 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 six years, each year in over half of the VC/PE transactions the investors require the founders' shares be classified as restricted shares. In 2022 this percentage was 52.17%. The restricted share arrangements are common in early rounds of financing and the restriction period typically ranged from three to five years.

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



Share Transfer by Founders

In 2022, 9.23% of the VC/PE transactions involved sales by the founders of their original shares, the lowest in six years. In most cases, the founders' original shares were either sold to new investors or repurchased by the company. The repurchase by the company happened more frequently in offshore transactions than in onshore ones and was usually executed concurrently with the subscription by the investors of newly issued shares of the company. The sale and purchase of the founders' original shares during a company's capital raising were transacted for various business objectives so as (i) to realize the price differential between the price of the founders' original shares and the company's newly issued shares; (ii) for founders to cash out; and (iii) to optimize the company's ownership structure.

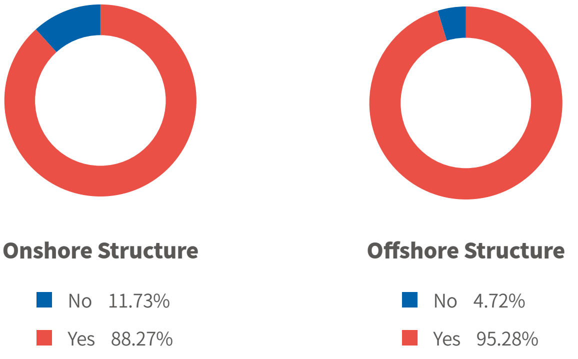
Share transfers raise tax compliance issues. Based on our 2022 data, in the VC/PE transactions which involved founders selling their original shares, more than 70% provided that the selling founders should pay the taxes arising from the sale while around 14% did not address the tax issue at all.

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 that are subject to the veto right are called "reserved matters", which often relate to the major issues of the company such as the company's share structure, business operations, disposal of assets and incurrence of debt. According to our data, over 90% of the VC/PE transactions in 2022 set out the protective provisions. The chart below shows the use of the protective provisions in VC/PE transactions in 2022.

Existence of Protective Provisions



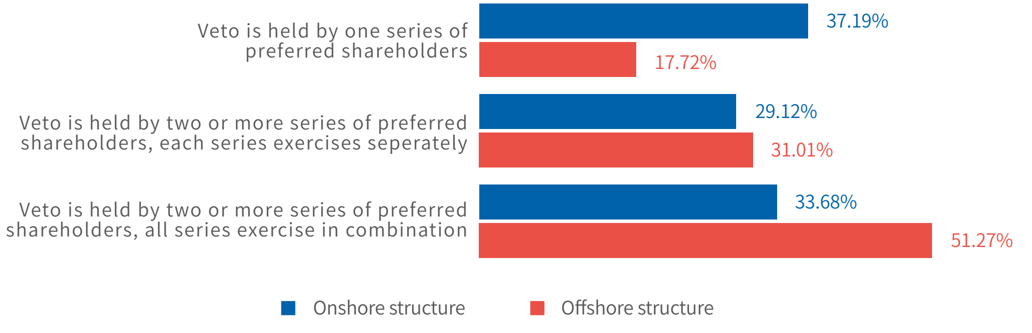
Since the protective provisions are meant to protect the interests of investors, the veto right is generally granted to the investors or their appointed directors. The veto right may be exercised in full or in part either at the shareholder level or the board level. Reserved matters subject to the veto right at the shareholder level are generally related to the share structure, shareholder rights, liquidation, dissolution and other major issues 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) only by one series of preferred shareholders (including by specific preferred shareholder(s)); (ii) by holders of certain percentage of voting rights in each series of 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, because most board seats are usually occupied by founder-appointed directors, 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.

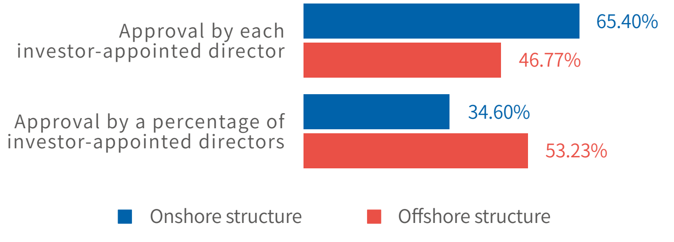
The chart below presents a breakdown of the veto right mechanisms in the 2022 VC/PE transactions that provided for veto right at the shareholder level.

Protective Provisions — Veto Right Mechanisms at Shareholder Level



The chart below presents a breakdown of the veto right mechanisms in the 2022 VC/PE transactions that provided for the veto right at the board level.

Protective Provisions — Veto Right Mechanisms at Board Level



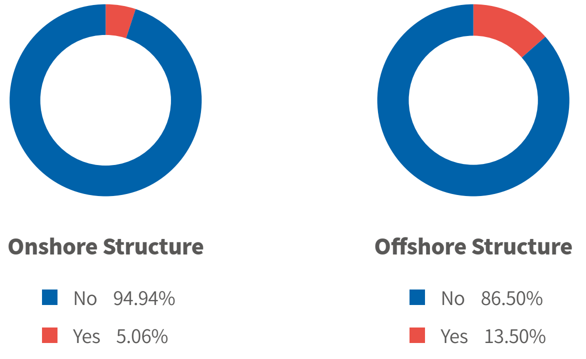
Two issues about the veto right dynamics are particularly noteworthy:

(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 an 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. Faced with this potential deadlock some companies seek to design the veto right mechanism differently to prevent this from happening. Separately, as in recent years the Chinese government has tightened anti-trust regulations, an investor (or its appointed director) having the exclusive veto right over certain reserved matters may be deemed to have control over the company, which may increase the risk of triggering the obligation to file a concentration report for the transaction to the regulatory authorities if the revenues of such investor and/or the company exceed a certain benchmark. Due to the above reasons, some investors have become more cautious about acquiring the exclusive veto right.

(2)Thresholds to the veto right. As investors grow in number, companies often seek to establish certain 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 held by such investor falls below the threshold either as a result of a share transfer or dilution by new rounds of financing. In the 2022 VC/PE transactions which set out protective provisions, 20.46% established thresholds for investors' veto right and such thresholds were more common in offshore transactions than in onshore ones.

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 certain issues critical to the company. Our data show that in each of the past six years about 4%—9% of the VC/PE transactions gave the founders (or their appointed directors) such special veto right. In 2022, this percentage was 7.93%.

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 the founders tend to dominate the company board, as evidenced by our data. In each of the past six years, there were only 2%—5% of the VC/PE transactions where the number of votes controlled by founder-appointed directors were less than or equal to that controlled by investor-appointed directors.

In order to participate in the decision-making process regarding matters critical to the company, the investors usually demand the right to appoint directors to the board. However, our data of the past six years show that the percentage of VC/PE transactions that accorded the investors the right to appoint directors trended downward from 93.83% in 2017 to 74.58% in 2022. Neither do companies sit idle on this issue. As investors grow in number, companies often want to limit their representation on the board by requiring an investor to hold at least a certain number or percentage of shares to qualify to appoint directors. This is similar to the thresholds regarding the investors' veto right discussed above. If the number or percentage of shares held by an investor falls below the threshold, the investor's right to appoint directors to the company will be relinquished. Our data of the past six years show that more and more transactions set out thresholds regarding the investors' right to appoint directors. It was 10.66% in 2017 and 35.11% in 2022, and such thresholds were more common in offshore transactions than in onshore ones.

The chart below shows the use of thresholds regarding the investors' right to appoint directors in the 2022 VC/PE transactions.

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

Onshore Structure

No 72.18%

Yes 27.82%

Offshore Structure

No 49.61%

Yes 50.39%

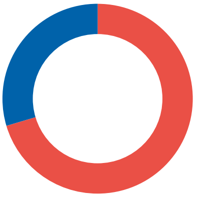
Information Right and Inspection Right

The information right allows the investors to demand relevant operational and financial information of the company. Our data show that in each of the past six years about 90% of the VC/PE transactions provided for the information right. Similarly, the inspection right allows the 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, the type of financial information and the timing and frequency to receive such information are matters to be decided by the investors to synchronize with their post-investment management needs. The company, on the other hand, seeks to satisfy the information and inspection rights to the extent of its ability to prepare the information as requested and in compliance with its confidentiality obligations.

Employee Equity Incentive Plans

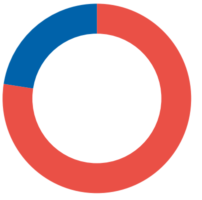
Employee equity incentive plans (known as "ESOPs") are a standard feature in most start-up companies. They are designed to motivate senior officers and key employees to serve and create value for the companies on a continuing basis. A company may adjust from time to time the amount of share capital allocated to ESOPs to meet the needs of the company and accommodate multiple rounds of capital raising. According to our data, from 2017 to 2021, 72%—82% of the companies in onshore VC/PE transactions adopted ESOPs while 79%—94% of the companies in offshore VC/PE transactions did the same. In 2022, however, fewer transactions adopted ESOPs with the percentage down to 70.39% in onshore transactions, and 77.46% in offshore transactions, both the lowest in the past six years.

Existence of ESOPs



Onshore Structure

- No 29.61%
- Yes 70.39%

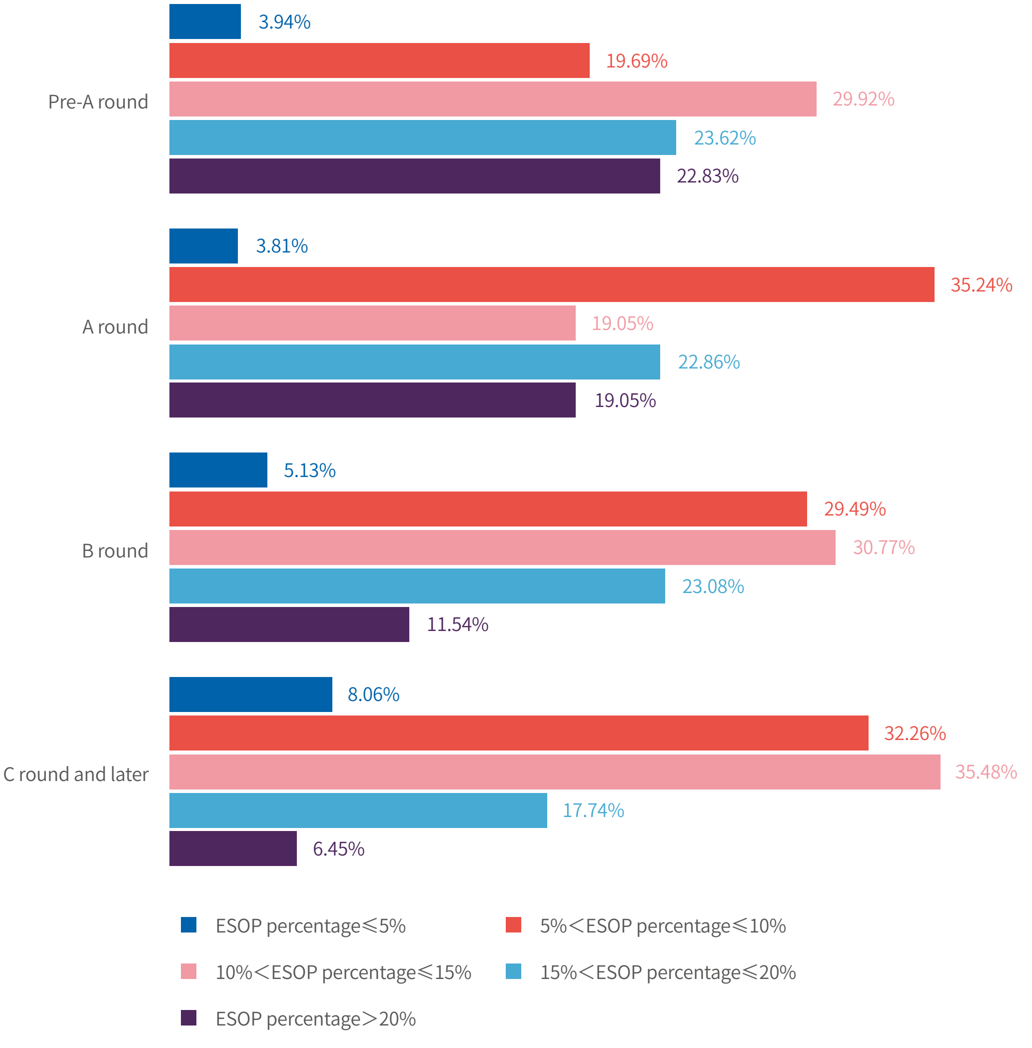


Offshore Structure

- No 22.54%
- Yes 77.46%

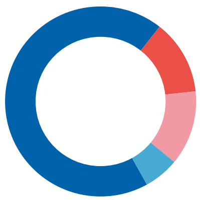
Where ESOPs are set up, companies generally allocate an average of 5%—20% of their share capital to ESOPs. Those who allocate less than 5% or greater than 20% of their share capital to ESOPs are the exceptions. The chart below shows the percentage of shares reserved for ESOPs in each financing round of the VC/PE transactions in 2022.

Percentage of Shares Reserved for ESOPs in Each Financing Round



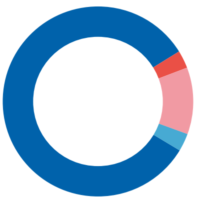
Equity incentives under ESOPs may take various forms, the most common being stock options and restricted shares. According to our 2022 data, stock option was the most widely used incentive form across the board and it was particularly true in offshore transactions. In 2022, around 94% of the offshore transactions granted stock options to employees (including stock options only and a combination of stock options, restricted shares and/or other forms of incentives). Each year, a small number of companies relied only on restricted shares or other forms of incentives to incentivize employees.

Forms of Equity Incentives



Onshore Structure

- Options 68.65%
- Restricted Shares 12.70%
- Options + Restricted Shares 12.70%
- Others 5.95%



Offshore Structure

- Options 82.57%
- Restricted Shares 3.03%
- Options + Restricted Shares (+ Others) 11.37%
- Others 3.03%

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

(a) Directly issuing the equity incentives to the employees (the “direct issue method”).

(b) Establishing an ESOP platform and issuing the equity incentives to the employees through the platform (the “platform issue method”).

(c) Holding by the founders of the equity incentives in trust for the employees (the “trust method”).

Due to differences in law, the offshore transactions are different from onshore ones in how the equity incentives are issued to the employees.

(1) Offshore Structure

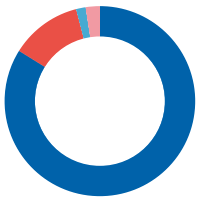
For either stock options or restricted shares, offshore companies often effectuate the ESOPs through the direct issue method, the platform issue method or a combination of the two. This is because in many foreign jurisdictions (e.g., the Cayman Islands) the procedures for directly issuing stock options or shares are easy to implement. However, 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 complete foreign exchange registration.

Based on our 2022 data, in offshore transactions where the stock option arrangement was adopted, around 83.87% of the companies chose the direct issue method for issuance. This method is implemented by the company reserving certain number of shares from its share capital for the ESOP program (known as the "ESOP pool") and assigning the stock options to the employees against the shares in the ESOP pool. Only when the employees exercise their stock options will the company issue corresponding shares from the ESOP pool. Prior to the exercise, the employees do not legally own the shares in the ESOP pool. The direct issue method is easy to implement and is commonly adopted in offshore transactions.

Our 2022 data further indicate that, in offshore transactions where the restricted shares arrangement was adopted, 52.63% of the companies chose the direct issue method, while 47.37% chose the platform issue method to implement the ESOP program.

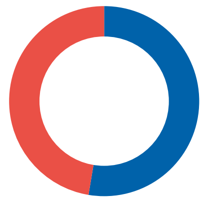
The platform issue method can be deployed to effectuate various types of equity incentives. When this method is used, the founders or the company management would directly or indirectly set up an ESOP platform to which the company would issue shares. The employees would hold units of stock options, restricted shares or other types of incentives at the platform level in an amount that corresponds to their entitlement in the company under the ESOPs. The use of this method is usually for one of the two purposes. First, it would enhance the voting power of the founders. The shares held by the platform are duly issued shares of the company with full voting right and it is customarily agreed that the founders are entitled to vote on such shares on behalf of the platform. Second, it could help manage the company's incentive shares. For example, the senior officers or key employees who have completed foreign exchange registration under the PRC law can directly hold the shares at the platform level and have the platform manage the shares.

ESOP — Offshore Structure — Issue Methods



Stock Options

- Direct issue method 83.87%
- Platform issue method 12.10%
- Direct issue method and platform issue method 2.42%
- Others 1.61%



Restricted Shares

- Direct issue method 52.63%
- Platform issue method 47.37%

Note: The base number includes offshore companies that issue stock options and restricted shares concurrently.

(2) Onshore Structure

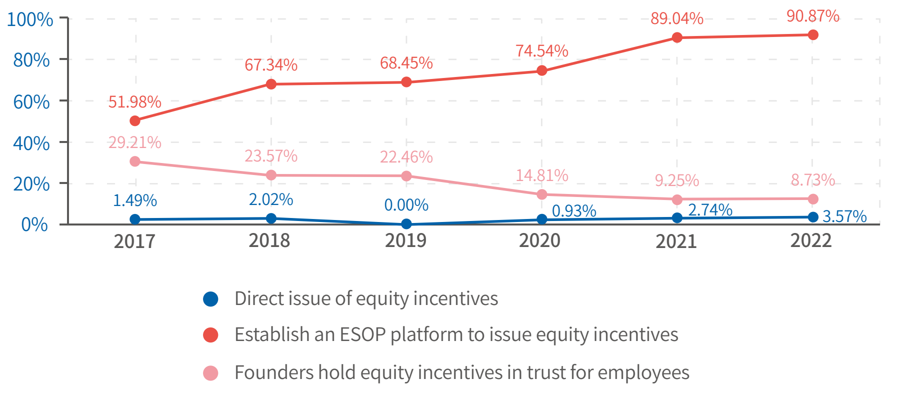
Under the PRC Company Law, the concept of reserved shares is not recognized and the number of shareholders of a limited liability company may not exceed 50. Thus, in onshore VC/PE transactions, companies often implement the ESOPs via the platform issue method, the trust method or a combination of the two. Under the platform issue method, the founders usually set up an ESOP platform to hold the incentive shares issuable by the company pursuant to the ESOPs, and the eligible employees will receive the economic benefits of their incentives through the platform. At the platform level, each eligible employee may (i) directly own the shares or interests of the ESOP platform corresponding to their entitlement under the ESOPs, or (ii) through contractual arrangements, determine the amount of the shares or interests he/she is entitled to without being registered as the owner of such shares or interests.

Under the trust method, on the other hand, the founders will hold the equity incentives in trust for the benefit of the employees and enter into an agreement with each of the eligible employees. The trust method is quite common in the early development of a startup company. Once an ESOP platform is established, the trust method will be replaced by the platform issue method. Finally, in onshore transactions, it is exceedingly rare that the company would directly issue equity incentives to the employees.

Our data of the past six years show an increasing number of onshore companies having adopted the platform issue method to implement ESOPs. Among the 2022 onshore VC/PE transactions that provided for ESOPs, 90.87% adopted the platform issue method, the highest in six years, while the use of the trust method trended down to 8.73%.

As to the form of ESOP platform, for tax purposes, almost all ESOP platforms in onshore VC/PE transactions were established as limited partnerships while only a few as limited liability companies. Among the onshore VC/PE transactions in 2022 that adopted the platform issue method to implement ESOPs, 98.25% of the platforms were limited partnerships. Furthermore, the ESOP platforms receive the company shares either by directly subscribing for newly issued shares of the company or by acquiring shares from the founders. According to our 2022 data, over 50% of the ESOP platforms obtained shares of the companies by subscribing for the newly issued shares of the companies. Finally, the Chinese listing rules require that any company preparing for the A-share listing must have clear and transparent ownership structure. To comply with this requirement, when preparing for an A-share listing, the company must register the employees who hold stock options or incentive shares under an ESOP and properly handle the unexercised options and shares held in trust.

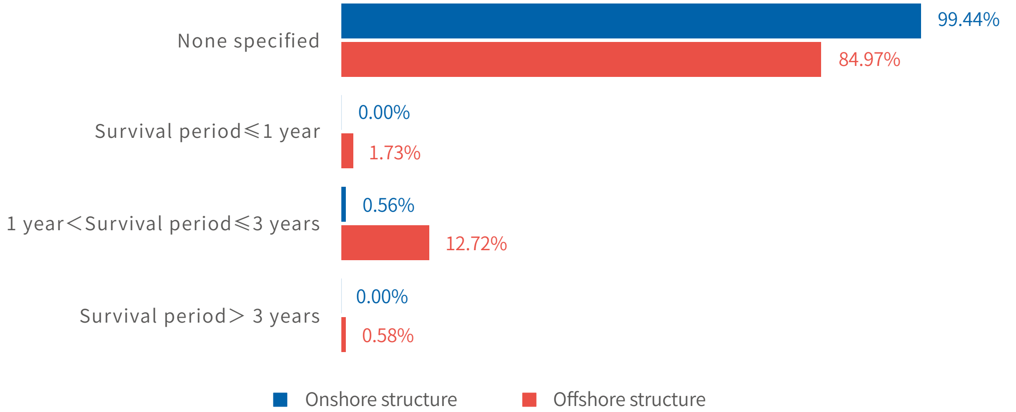
ESOP — Onshore Structure — Issue Methods over the Past Six Years



Survival Period for 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 of the past six years show that most VC/PE deal documents did not specify the survival period for the representations and warranties. This means that if any of the representations and warranties was found to be untrue as of the signing date or the closing date, the 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, mostly in offshore transactions, 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 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 various survival periods for representations and warranties in VC/PE transactions in 2022.

Survival Period for Representations and Warranties



Indemnification and Founders' Personal Liability

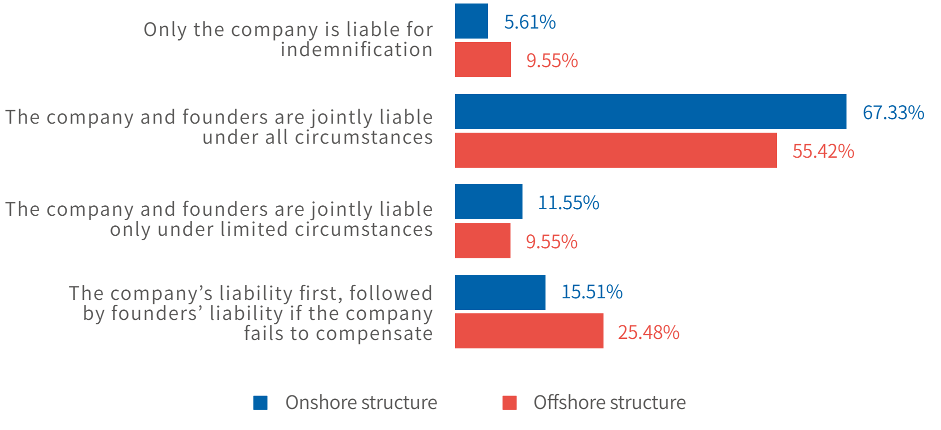
In VC/PE transactions, the investors often require the representations and warranties made by the corporate warrantors be true, accurate and complete, and that the company and/or the founders must be liable for any breach thereof. In addition, the investors often require the company and/or founders to assume certain obligations and undertakings. For example, before closing the company must undertake not to initiate any material changes that would adversely affect the interests of the investors, and after closing and for a period thereafter, the company is obligated to take certain remedial actions to ensure compliance with law. As to such obligations and undertakings, the investors would also require the company and/or the founders to indemnify for any losses resulting from any breach thereof. Based on our 2022 data, 86.63% of the VC/PE transactions clearly set out the indemnification liabilities of the company and/or its founders, among which (i) 21.09% capped the indemnification liabilities such that the total amount of compensation due to the investors would be subject to a cap; (ii) 7.61% set out a threshold for the indemnification liabilities such that the investors may not claim for damages unless the losses they suffered exceeded a pre-agreed amount; and (iii) 11.74% provided for both liability caps and indemnification thresholds.

In order to ensure maximum compensation, in most cases the investors would require that the company and/or its founders be jointly liable for the indemnification. When so required, the founders usually counter to limit their personal exposure to the indemnification liability by: (i) not agreeing to bear the joint liability, leaving the company alone to be responsible for the indemnification; (ii) assuming joint liability with the company only under limited circumstances (such as the founders themselves having caused the breach); or (iii) requiring the investors to claim damages against the company first and that the founders would step in only if the company was unable to satisfy the claims due to legal obstacles or lack of funds.

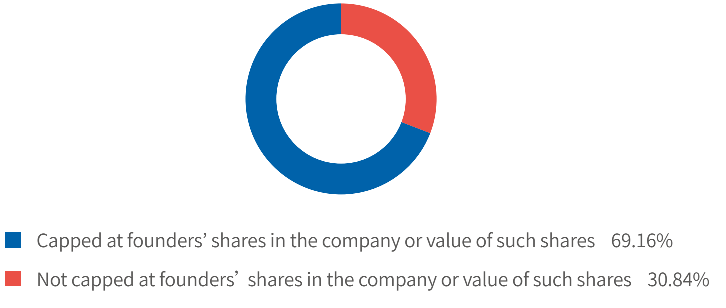
As such, when the founders are held jointly liable for the indemnification, the following options have been used to deal with the joint liability: (1) the company and founders are jointly liable under all circumstances; (2) the company and founders are jointly liable only under limited circumstances; or (3) the company is liable first and founders' liability kicks in only if the company fails to indemnify the investors. In these cases, the founders often seek to cap their exposure to the extent of their shares in the company or the value of such shares so as to shield their other personal and family assets from such liabilities.

Among the 2022 VC/PE transactions that provided for the company's and/or the founders' indemnification liabilities, over 90% set out that the company and the founders should be jointly liable for the indemnification (including cases (1)—(3) above). In transactions where the founders are required to assume the indemnification liability, 69.16% capped the founders' liability to the extent of their shares in the company or the value of such shares. The following figure shows the typical forms of indemnification liability and limitations on founders' liability.

Typical Forms of Indemnification Liabilities



Limitation on Founders' Indemnification Liability



There have always been a very small number of VC/PE transactions where the founders alone would be liable to indemnify the investors. Since they are in the extreme minority, we do not single them out for analysis.

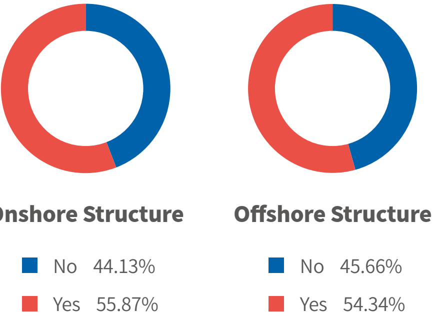
Restrictions on Investors

In VC/PE transactions, the primary restrictions imposed on the investors have always focused on the share transfer and the investment

Share Transfer Restrictions

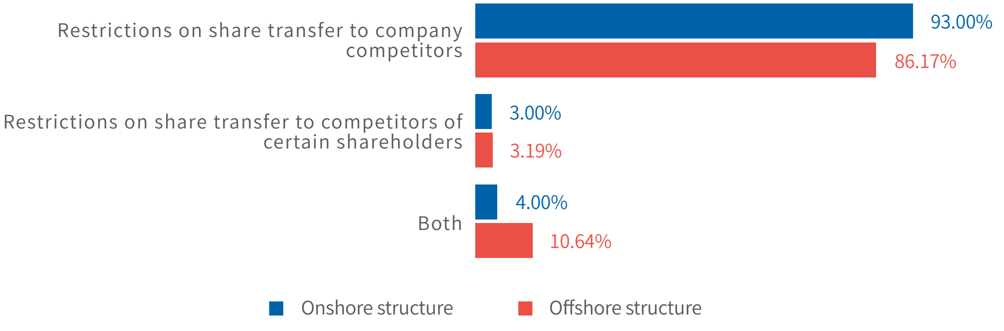
For most financial investors, the sale of their shares in the company is the front and center of their exit strategy and as a result, they naturally resist any hindrance on their freedom to transfer shares. On the other hand, an increasing number of companies in recent years have sought to impose restrictions on the freedom of the investors to transfer their shares. The restrictions generally fall into the following categories: (i) the investors may not transfer their shares to a competitor of the company; (ii) the investors may not transfer their 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 chart on the right shows the landscape of the investor share transfer restrictions in the 2022 VC/PE transactions.

Existence of Investor Share Transfer Restrictions



Our data also show that in both onshore and offshore transactions, most restrictions were imposed on share transfers by the investors to competitors of the investee companies.

Investor Share Transfer Restrictions



Share transfer restrictions on investors are generally implemented 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, the founders generally will have the right of first refusal. 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.

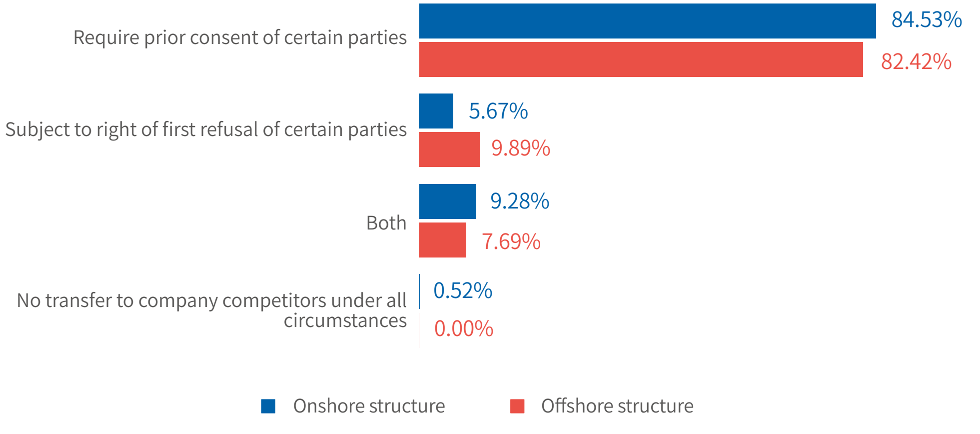
(d) The share transfer (to competitors) is prohibited under all circumstances.

For investors, option (d) above is obviously the most draconian but it is rarely put in practice (in 2022, we encountered only one transaction where option (d) was written in transaction document). Since the sale of shares is the critical part of their exit strategy, investors usually resist restrictions on their freedom to transfer shares, and they are only willing to compromise to a limited scope of share transfer restrictions. Between options (a) and (b) above, option (a) is more rigorous simply because it practically grants a veto power to others to deny and block the transfer. Option (b), on the other hand, is softer because the right of first refusal does not automatically block the transfer, although the conditions and procedures of the right of first refusal will circumscribe the transfer.

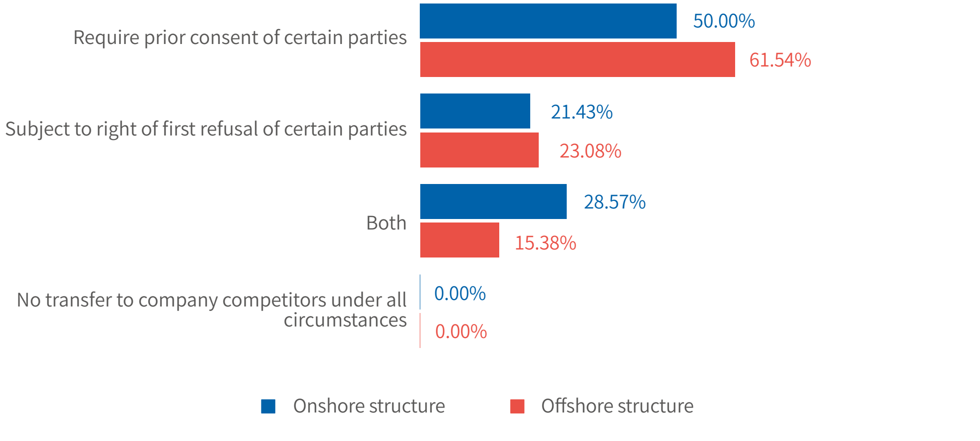
The following chart shows how the above options were adopted in the 2022 VC/PE transactions that imposed share transfer restrictions on investors. Our data make it abundantly clear that option (a) was the most widely accepted, whether the transfer was to a competitor of the company or to a competitor of another shareholder of the company.

Investor Share Transfer Restrictions

Restrictions on Share Transfers to Company Competitors



Restrictions on Share Transfers toCompetitors of Certain Shareholders



Investment Restrictions

In addition to share transfer restrictions, there have been transactions in recent years where companies sought to restrict the freedom of the investors to invest in or cooperate with other entities. These restrictions typically prohibit the 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, information right or voting right). Based on our data, 4.52% of the VC/PE transactions in 2022 restricted investors' freedom to invest in or cooperate with other business entities.

Most-favored Nation Clause

If an investor is treated on terms and conditions less favorably than other shareholders (including any existing and future shareholders, and investors from the same round of capital raising), the "Most-favored Nation" ("MFN") clause helps rebalance the situation by automatically entitling this investor the same terms and conditions as enjoyed by such other shareholders.

The MFN clause is a common provision during term sheet negotiations. At this stage, most new investors often 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 at least the same rights and privileges accorded to the shareholders of previous rounds. In some cases, new investors even seek the MFN treatment with respect to the future investors as well as with other investors of the same round of capital raising.

In some VC/PE transactions, the investors wish to retain the MFN clause beyond the term sheet stage to regulate the rights among the existing shareholders, the investors of the same round and/or the investors of future rounds of capital raisings. The rational is as follows. First, although deal documents may have set out the rights and obligations of all investors and shareholders, 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, the new investor often wishes to retain the MFN clause to ensure that it is treated the same as the existing shareholders and other investors of the same round. Second, although it is widely accepted that the investors in future capital raisings are entitled to better economic terms because they pay a higher price than did existing investors in previous 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, investors often request the MFN treatment be also applied to the investors in future capital raisings, but based on market practice they will agree to carve out the better economic terms the future investors would deserve to account for the higher price they will pay in the future capital raisings.

According to our deal data, 38.55% of the VC/PE transactions in 2022 provided for MFN treatment regarding the rights and privileges of the investors in future capital raisings, which represented a slight increase as compared with previous years. The MFN treatment regarding future capital raisings is sometimes subject to certain conditions. For example, such kind of MFN treatment is applicable only if the valuation of the company in a future capital raising is lower than the current valuation or lower than a pre-agreed amount.

Valuation Adjustment Mechanism »

Valuation adjustment mechanism ("VAM", excluding the redemption clause mentioned above) is not commonly used in VC/PE transactions. Based on our data, in each of the past six years about 4.5%—8.6% of the VC/PE transactions adopted the VAM. In 2022, it was 5.46%.

The VAM usually sets out a commitment target, a method of compensation if the target is missed and the parties obligated to make the compensation. In 2022 VC/PE transactions that provided for the VAM, most of the commitments were performance targets to be met by the company. A few transactions set out as a target the obtaining of critical licenses from the government within a time limit.

If the targets are missed, the founders, the company or both would be obligated to compensate the investors on a joint-and-several basis. If the company is liable, it may be required to do one or more of the following for compensation: (i) adjust the price for conversion of the investors' preferred shares into common shares (only in offshore VC/PE transactions); (ii) issue additional shares to the investors at a nominal price; (iii) make compensation in cash; (iv) adopt other methods, which often combine (i), (ii) and (iii) above. If the founders are liable, they may be required to do one or more of the following for compensation: (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 of the past six years, the most common form of VAM compensation was for the company to issue new shares or for the founders to transfer their shares to the investors at a nominal price.

Dispute Resolution »

According to our 2022 data, over 90% of the VC/PE transactions, whether onshore or offshore, chose arbitration as the last resort of dispute resolution. Litigation, on the other hand, has trended down over the past three 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 Chinese 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.
Confidentiality	Hearings are open to the public and 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.

	Litigation	Arbitration
Service of Process	Service of process is an impediment, especially for foreign-related cases where it can only be done 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. It is time-consuming and inefficient.	Service of process is not subject to restrictions imposed by judicial sovereignty. 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 domicile of defendant, place of the contract being performed, place of execution of the contract, domicile of plaintiff, place where the subject matter is located or place of infringement, and the choice of court must be in compliance with rules governing exclusive jurisdiction and centralized jurisdiction.	Jurisdiction of an arbitration institution is contractual and not restricted by place of dispute or nationality. Foreign-related contracts may freely provide for arbitration under the auspices of either Chinese or foreign arbitration institution as the final arbiter of a contractual dispute.
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.
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.

	Litigation	Arbitration
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 third parties to participate in arbitration proceedings. 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.	Asset preservation requests are referred to courts for execution, which seldom receive priority treatment. As for behavior preservation, applications for injunctions or interim decisions can be made in litigation, but not in arbitration.

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北京·上海·深圳·香港·海口·武汉·新加坡
Beijing · Shanghai · Shenzhen · Hong Kong · Haikou · Wuhan · Singapore

北京办公室
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 Office
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

上海办公室
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 Office
33/F, HKRI Centre 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

深圳办公室
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 Office
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

香港办公室
香港中环皇后大道中15号置地广场公爵大厦39楼3901-05室
电话:+852 2820 5600
传真:+852 2820 5611
Email:hongkong@hankunlaw.com

Hong Kong Office
Rooms 3901-05, 39/F., Edinburgh Tower,
The Landmark, 15 Queen's Road
Central, Hong Kong SAR, PRC
Tel: +852 2820 5600
Fax: +852 2820 5611
Email: hongkong@hankunlaw.com

海口办公室
海南省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 Office
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

武汉办公室
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 Office
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

新加坡办公室
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 Office
1 Raffles Place #53-00
One Raffles Place Tower 1
Singapore 048616
Telephone: +65 6013 2999
Fax: +65 6013 2998
Email: singapore@hankunlaw.com