

# Legal Commentary

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## Insights into China Biotech's New Approach: Spin-off-NewCo Model<sup>1</sup>

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### Background

China's pharmaceutical industry is witnessing a notable surge in "pipeline spin-off projects", a model commonly referred to as the "Spin-off-NewCo" or "SON" model. Within the past two months, we've been advising on nearly ten SON projects. Leading pharmaceutical companies in China are more frequently adopting the SON model to separate parts of their pipelines into new, independent companies. These spin-off projects have garnered considerable interest from multinational industry leaders and international investment institutions, underscoring substantial opportunities for global collaboration.

The SON model is a response of the market to changes in the financing environment and cross-border investment regulatory environment. In the current China and international capital market environment, traditional exit paths for investment in China biopharmaceutical industry have become less clear. Some biopharmaceutical companies, particularly those that achieved high valuations through financings before 2022, are now facing increased financing challenges. Certain sectors, like AI pharmaceuticals and gene therapy, find it difficult to place China and foreign businesses under the same group entity for overseas financing due to risks associated with changes in cross-border investment regulations, foreign investment, and regulatory restrictions. These factors prompt Chinese pharmaceutical companies and investors to seek alternative ways to achieve financing or investment exit, with the SON model offering a solution.

This article tackles key industry concerns by offering an in-depth analysis of the SON model from a practical standpoint. It aims to support pharmaceutical companies and investors in exploring new strategies for global expansion and to serve as a reference point for industry discussions and collaboration.

<sup>1</sup> For the Chinese version, please click [《药企出海新热点：管线分拆"SON"模式的实践解读》](#).

## Overview of the SON model

While the traditional license-out transaction model typically generates revenue through license fees, the SON model introduces a more diversified approach. Unlike the traditional models, the SON model's consideration is not confined to licensing fees; it also includes equity interests and operational control in a newly established autonomous company (“**NewCo**”). This innovative model allows companies and investors to benefit not only from licensing revenues but also from the financial gains of NewCo pursuing exit strategies, including, without limitation, private equity funding, acquisitions, and independent public offerings.

The essence of the SON model lies in creating NewCo around specific pipeline products with promising market potential. This structure provides NewCo with focused core asset and greater operational flexibility in areas such as operations, sales, and capital market activities. For instance, NewCo can efficiently attract global partners and more easily license its products to multinational pharmaceutical companies. NewCo is also well-positioned to execute an outright or reverse merger, as well as a De-SPAC transaction overseas as part of its exit strategy. Notably, some pipeline spin-off projects even secure external licensing agreements or complete business sales immediately upon the completion of spin-off.

Particularly when spinning off the pipeline to overseas markets, NewCo can capitalize on comparative advantages offered by cross-border investment regulations, as well as eased restrictions on foreign investments and import-export policies. Moreover, through strategic tax planning, NewCo has the potential to achieve more advantageous tax positions on a global scale.

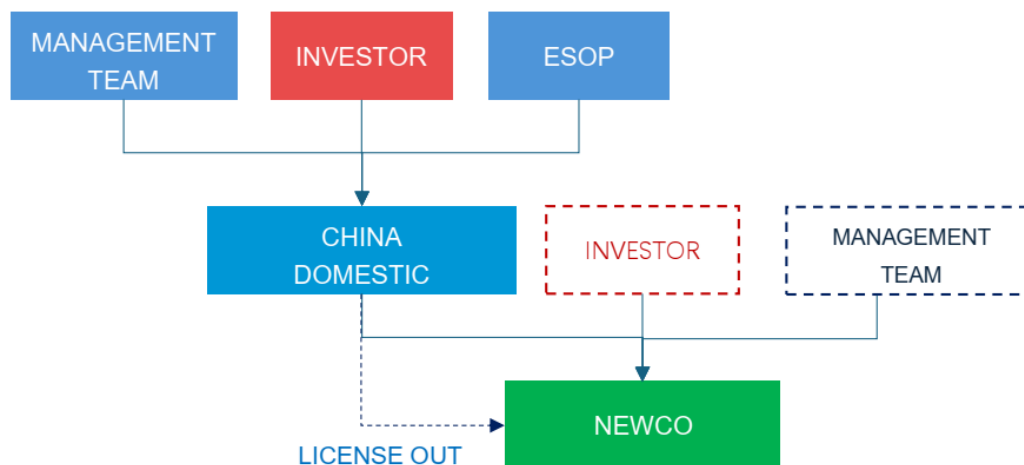
As active participants in the life sciences industry, we have recently had the privilege of assisting numerous clients in executing customized SON projects centered around their innovative pipeline products. While pipeline or business spin-offs in the pharmaceutical sector are not a novel concept, the current wave of industry enthusiasm has brought renewed focus to these strategies. Over the years, we have amassed extensive experience in facilitating pipeline spin-offs aimed at both international expansion and entry into the Chinese market. The successful completion of these projects has provided us with invaluable practical insights and significantly enhanced our expertise with the SON model.

## Key points in implementing the SON model: a multifaceted view

### I. Shareholding structure: common shareholding structures in the SON model

The common structures in the SON model include controlling or minority shareholding structure, and parallel structure. Based on practical experience from multiple projects, we briefly introduce these structures and the considerations for choosing them as below:

1. Controlling or minority shareholding structure

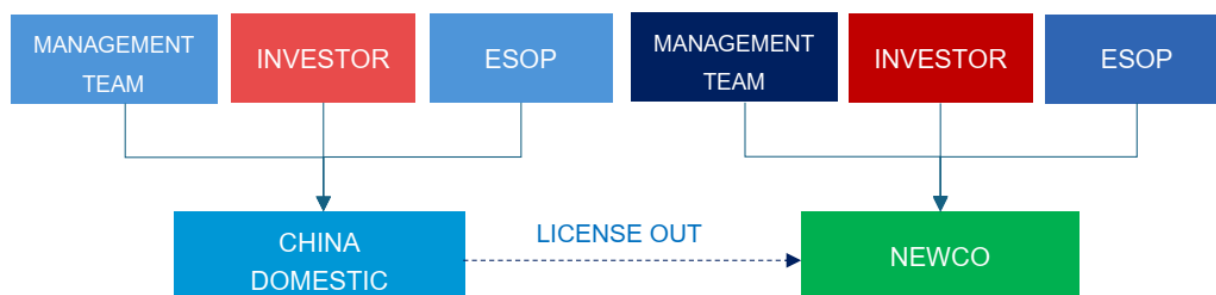


In a controlling or minority shareholding structure, the China domestic company will directly or indirectly hold shares in NewCo. Shareholders of the China domestic company (usually including the management team, investors and employee stock incentive platforms) can indirectly hold NewCo shares through the China domestic company or rollover of part of their shares in the China domestic company proportionally down to NewCo level to hold the shares of NewCo directly.

When deciding whether to take the controlling shareholding structure or the minority shareholding structure, the following factors are usually considered:

- The possibility of the China domestic company's listing and the possibility of the NewCo's independent spin-off listing;
- Whether NewCo will be in competition with the China domestic company, which may affect the China domestic company's listing;
- Whether NewCo already has expectations or potential opportunities for license-out or sale: if so, shareholders of the China domestic company may prefer to roll over most of their shares in the China domestic company proportionally down to NewCo level to hold the shares of NewCo directly, forming a minority shareholding structure, facilitating shareholders to directly gain from NewCo's license-out or sale transactions;
- Whether NewCo has expectations or potential opportunities for new external financing: if so, new external investors may require NewCo to operate independently and request the China domestic company to reduce its shareholding in NewCo so that the China domestic company will not control NewCo. According to our practical experience, if there is some business synergy between the China domestic company and NewCo, and the China domestic company adds value or resources to NewCo's operations, new external investors of NewCo often require that the China domestic company's shareholding in NewCo not be too low to enhance the interest connection between the two companies.

## 2. Parallel structure



In a parallel structure, the China domestic company does not directly or indirectly hold shares in NewCo. In some pipeline spin-off projects with a parallel structure, all or part of the shareholders of the China domestic company will hold shares in NewCo in proportion to their relative shareholding in the China domestic company. In some other cases, the management team and investors investing in NewCo will hold shares in NewCo, without mirroring the shareholding structure of the China domestic company.

When deciding whether to take the controlling or minority shareholding structure or the parallel structure, the following factors are usually considered:

- Whether the business being spun off overseas has clear independent listing expectations or expectations of obtaining a suitable independent financing valuation;
- Whether the China domestic company is prohibited or unsuitable to hold shares in NewCo from the perspective of business operations, and investment review and compliance regulation;
- The synergy and relevance between the China domestic company and NewCo's business, in light of which whether investors have demands for the China domestic company to hold shares in NewCo.

## II. Licensing transactions

Changes in pipeline-related rights remain a critical focus of licensing transactions under the SON model. Therefore, all arrangements involving pipeline rights must be meticulously organized. For example, the following terms need to be clearly defined and appropriately arranged: upstream intellectual property (IP) related to the spin-off pipeline, contractual arrangements with downstream vendors, financial terms, and the rights and obligations to be undertaken by NewCo.

### 1. Upstream IP

In the SON model, the pipeline being spun off may involve licensing from an upstream licensor. In such cases, it is crucial to pay close attention to the specifics of the upstream licensing and authorization. Additionally, consider how changes in IP rights during the spin-off might affect the responsibilities of all parties involved. These responsibilities could include obtaining necessary approvals, sending required notifications, and making payments for upstream license fees.

In practice, professionals must meticulously review all agreements related to upstream IP, including master agreements, supplementary agreements, and other collaboration agreements. It is crucial to

thoroughly consider the existing arrangements of upstream IP when drafting the collaboration agreement for spin-off transactions.

## **2. Financial terms**

In the SON model, the spin-off party typically acquires certain equity interests in NewCo. If NewCo has multiple shareholders, it is essential for all shareholders to agree on the distribution of proceeds generated from future potential mergers and acquisitions (M&A) and financing transactions. In practice, the consideration provided by future third parties often comes in various forms, such as upfront fees and milestone payments. Additionally, the spin-off party may request to obtain royalties from the licensed product through multiple layers, which differs from the typical forms of consideration in standard M&A and financing transactions.

To ensure smooth sailing for the spin-off project, it's essential to nail down the financial terms upfront. This involves defining the scope of NewCo's future proceeds to be shared and crafting a clear distribution mechanism — whether by specific indications, fields, or types of proceeds. Additionally, setting royalty rates, whether fixed or progressive, and harmonizing financial terms before and after M&A transactions are key steps.

## **3. Contractual allocation of rights and obligations**

In addition to sorting out upstream IP, attention must also be given to the relationship between the spin-off party and downstream vendors. If the spin-off party had commissioned CRO/CDMO/CMO and other partners for product R&D and/or manufacturing, these partnerships need to be redefined in new contracts during the spin-off project.

Moreover, the rights and obligations that NewCo needs to undertake under the SON model also need to be considered in new contractual relationships, including but not limited to the application and execution obligations with respect to the relevant clinical trials and marketing authorizations.

## **III. Taxation and other aspects**

Tax planning is also an indispensable part of the SON projects. For instance, in internal spin-off projects (i.e., projects conducted within the corporate group), or in the internal spin-off phase of external projects (i.e., projects conducted with entities outside the corporate group), it is crucial to focus on the pricing of internal spin-off assets (which may require asset evaluation procedures), intra-group financial arrangements, and the optimization of tax structures.

Given the variations in tax systems across different jurisdictions, careful tax planning in cross-border transactions — such as selecting the optimal location for establishing NewCo — may significantly reduce tax costs. Additionally, the unique asset profiles (such as IP status), profitability stages, and future business plans of different companies necessitate tailored solutions based on specific circumstances. These require the assistance of professionals familiar with tax, legal, and industry expertise to optimize the project process and ensure the smooth establishment and implementation of the arrangements.

## **Analysis and prospects**

As Chinese pharmaceutical companies increasingly expand their global presence, the concept of “In China for Global” is being embraced by a growing number of companies. In this context, Chinese pharmaceutical companies are actively exploring new strategies to advance the international development of their innovative drug pipelines with huge market potential.

We have observed that an increasing number of Chinese pharmaceutical companies are consulting and exploring SON transactions, with many already initiating related projects. This international transaction model is more complex than standard licensing deals, as it encompasses not only product and technology licensing but also cross-border financing, transaction structure design, tax planning, and other critical aspects. Successfully navigating these complexities requires a comprehensive professional team for thorough consideration and meticulous planning. We recommend that companies stay attuned to these trends, assess the market potential and international competitiveness of their pipelines, and pursue broader market development through innovative international strategies.

## ***Important Announcement***

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