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Important Legal and Strategic Considerations when Investing in China

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Important Legal and Strategic Considerations when Investing in China

The mergers and acquisitions (M&A) market in China has grown steadily since 2000. In 2000, there were 225 completed M&A deals with a total disclosed value of approximately US\$42.8 billion. In 2006, approximately 800 M&A deals were completed with a total disclosed value of approximately US\$95 billion. By the end of October 2007, there were 528 completed deals for the year with a total disclosed value of approximately US\$64 billion.

Three legislative movements partly drove this market boom. First, in 2006, China's Ministry of Commerce (MOC) issued new regulations on M&A transactions in China, the Regulations on the Merger and Acquisition of Domestic Companies by Foreign Investors (the Regulations), which clarified previously vague regulations regarding M&A activity. Second, effective 1 December 2007, the revised Catalogue Guiding Foreign Investment in Industry (the Catalogue) was issued, which opened a number of new areas of the Chinese economy to direct foreign investment. Third, effective 31 January 2006, the Measures for Strategic Investment by Foreign Investors upon Listed Companies (the Measures) were implemented, which for the first time allowed foreign investors to invest in Chinese public companies.

Acquirers looking to Chinese companies for potential targets should have a general understanding of the governing corporate regulations in China and conduct careful due diligence to avoid some of the common pitfalls that may be experienced in M&A transactions.

Understanding Corporate Regulations in China

Before an acquirer commits to acquire a Chinese target company, the acquirer should have a very clear understanding of the regulations that govern any proposed acquisition of the target company. The most important applicable regulations governing M&A activity are: (1) the Regulations, which govern all foreign-related M&A transactions in China; (2) the Catalogue, which divides China's economy for foreign investment purposes into four categories (encouraged, prohibited, restricted and permitted); and (3) the Measures, which open the door for foreign investors to invest in Chinese public companies in the A-Share market, which was formerly available only to domestic investors (in contrast to the B-Share market, which was originally available only for foreigners, but was opened to domestic investors in 2001).

The Regulations

The Regulations, which went into effect on 8 September 2006, for the first time allowed non-Chinese companies to acquire Chinese domestic companies using a stock swap. Prior to the Regulations, foreign acquirers were only allowed to purchase Chinese companies with cash or tangible or intangible assets. However, the Regulations limit the entities that are qualified to use a stock swap only to listed or public companies in jurisdictions with sound regulatory systems, and offshore special purpose vehicles directly or indirectly controlled by Chinese companies or Chinese nationals. As a result, few stock swaps have been approved since the Regulations went into effect.

The Regulations permit two types of M&A transactions: (1) equity acquisitions where foreign investors buy existing or newly issued shares of a Chinese company and (2) asset acquisitions where non-Chinese investors buy the assets of a Chinese company. The Regulations also set out the rights and obligations of non-Chinese investors, including approval authority, capital requirements and share distribution between non-Chinese and domestic Chinese investors.

The investment vehicles most frequently used by non-Chinese investors to acquire assets or equity of a Chinese company include: wholly foreign-owned enterprises (WFOE), equity joint ventures with a Chinese partner (EJV), contractual joint ventures with a Chinese partner (CJV) and joint stock companies (JSC). WFOEs, EJVs, CJVs and JSCs are frequently referred to as “foreign invested enterprises” (FIEs). A WFOE organised as a limited liability company is the preferred legal entity for non-Chinese investors since it does not require the participation of a Chinese partner. There may be legal minimum or maximum capital contribution requirements for a non-Chinese investor to establish an FIE, depending on the specific industry in which the FIE intends to engage or its intended business scope. Generally, capital may be contributed in cash or tangible or intangible assets, but intangible assets (including intellectual property and technology) may not exceed 70 per cent of the fair market value of the contributed capital.

A JSC is the only FIE that qualifies for public listing in China, which may be important to acquirers, as the Chinese domestic stock markets have started to gain prominence. Any other form of FIE must be converted into a JSC before it can be listed on a Chinese stock exchange. The minimum required registered capital of a local JSC is RMB5 million. However, the registered capital threshold for a foreign-invested JSC is RMB30 million, and the foreign investor(s) must hold no less than 25 per cent of the total registered capital. Also, in order to be listed on a Chinese stock exchange, a JSC must have share capital of at least RMB30 million.

Governmental approval is required for a number of transactions involving FIEs, including formation, transfer of shares, M&A transactions, increase or decrease of capital, and dissolution. The Regulations also require MOC approval for any foreign acquisition that would result in the transfer of a controlling interest in a domestic company relating to key industries with an actual or potential effect on “national economic security”. While “national economic security” is not defined in the Regulations, which may lead to broad and possibly divergent interpretations, acquirers may gauge the level of MOC review by looking to the Catalogue.

The Catalogue

Investments in the “encouraged” industries are subject to fewer approval formalities. “Encouraged” industries make up the vast majority of the Catalogue and include projects related to new agricultural technology, new energy sources and use of renewable resources, projects that develop manpower and resources of central and western China, projects using new technology and projects that fulfill international market demand and increase exports. Some projects in the “encouraged” category may be eligible for preferential treatment, particularly if they are located in certain geographical locations.

The “restricted” industry projects are subject to government examination and approval, but such approval cannot be assured. “Restricted” projects include projects that may have an adverse effect on the environment and energy conservation, projects relating to exploring for or extracting rare or precious mineral resources, and projects involving technology already used in China and where existing capacity already meets market demand.

“Prohibited” projects include projects that endanger state security or harm public interest, pollute the environment or endanger health, occupy large tracts of farmland or endanger the security or efficient use of military resources, use manufacturing techniques or technologies unique to China, or are otherwise prohibited under state laws and administrative regulations.

“Permitted” projects refer to projects where foreign investors are allowed to invest with no encouragement or discouragement from the Chinese Government. Unlike the other categories, the Catalogue does not list the “permitted” projects or areas. “Permitted” projects could be viewed as a catch-all, since any project not covered by the “encouraged”, “restricted” or “prohibited” categories could be inferred to be “permitted”. Foreign investors may enter into any such project just like domestic investors.

The Measures

In accordance with the Measures, approval from both the MOC and the China Securities Regulatory Commission are necessary for foreign investors to invest in and exit from Chinese public companies. A foreign investor that wishes to assign or transfer its holdings in a Chinese public company must apply for approval of such assignment or transfer by the local Chinese foreign exchange authority.

Foreign investors in Chinese companies must also follow certain other rules, including the following:

- A purchase of public shares must be made by transfer agreement or subscription agreement.
- An investment may be made in installments; however, the proportion of the shares obtained after the first installment must be no less than 10 per cent of the issued shares.

- If the shares owned by foreign investors are less than 10 per cent of the total number of shares outstanding, such public company shall not be entitled to foreign investment status.
- The public shares held cannot be transferred for a period of three years after acquisition.
- The foreign investor's or its parent's total overseas paid-in capital must be no less than US\$100 million, or the total overseas paid-in capital under its or its parent's management must be no less than US\$500 million.

Conducting Due Diligence

Acquirers need to keep in mind that some Chinese target companies are either still state owned or were recently privatised, which has implications for the attitude of management and employees as well as management style. For example, many Chinese companies and employees are not used to review or compensation based on performance or milestone targets. Accurate record keeping is also often lacking, and basic financial information may not be available or be of customary quality, either as a result of different standards and record keeping practices or accidental oversight. For example, some acquirers have encountered Chinese companies with two sets of financial record books, an internal book and an external book that is used to under-report profits, which implicates custom duties, income tax, VAT, business tax and local taxes.

Acquirers should also keep in mind that all land in China is state owned. Acquirers can only purchase land use rights for a limited period of time. For industrial use, the maximum period is 50 years with the option to renew. The price for the land use rights were set by regulation in 2006 in which land was classified in 15 levels in accordance with location. In order to attract foreign and domestic investment, certain locations' land prices can be set at a fairly low level, and local governments may also provide additional financial incentives. Acquirers need to consider land status, land price payments and any possible side deals with local governments, all of which may affect the purchase price.

In all potential M&A deals, detailed diligence is required to uncover hidden liabilities (including possibly delinquent taxes, regulatory violations and penalties) and to confirm that the target company has clear title to its assets. Problems with either of these may affect the structure of the acquisition and price.

Conclusion

As China's M&A market and activity continue to grow and attract a greater number of non-Chinese investors, those entering the Chinese market should be aware of the newly revised and implemented rules and regulations, and be sensitive to the cultural and diligence issues that may be unique to Chinese target companies and related M&A transactions.