

〈논문〉

## The Legal Considerations of Doing M&A with Chinese Companies\*

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### Abstract

This Paper lines up the important issues which a foreign business or its attorney need to note when engaging in M&A with Chinese companies. In the context of either share or asset acquisition, China is bringing its rules more in line with the international standards. Nevertheless, certain specific points deserve attention and should not be taken for granted, while many others are still undergoing evolution. Some most recent development such as VIE is also reviewed.

Keywords: investment in China, securities regulation, merger and acquisition, foreign invested enterprise, takeover of listed companies, variable interest entity, anti-monopoly review

### I. Introduction

There is no doubt that the role China is going to play in the near future at international level is going to grow in importance, and its influence on the rest of the world will become more evident. Not only its economic and financial power

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are having an impact on the markets all around the world, but also the wise leadership is developing a modern, harmonious and high income society (as described by the World Bank)<sup>1)</sup> which will help the government in maintaining its power granting to a population of more than 1.3 billion people a better standard of life, contributing at the same time to reanimating and revitalizing the global economy. In this globalized world China is becoming every day more integrated and an unchangeable player who will be of paramount importance also for the success of a “green sustainable development.” All these expectations are reflected in the 12<sup>th</sup> *Five Year Plan*, with its focus on quality of growth. Naturally, this improved “quality” in investments will be replicated with regard to cross-border operations, and will not only interest the local market.

Mergers and Acquisitions (M&A), and Takeovers are the new forms of investment foreign investors are considering to enter China, but they are also the same instruments Chinese business people are using to expand their influence abroad.

This paper, however, will examine the characteristics of the Chinese legal environment only, because the object and the purpose are to highlight opportunities in China for foreign investors. Investing in China is not only vital for those businesses that in this moment are struggling to survive, but this also, should contribute to fostering new initiatives in China to allocate the new foreign resources arriving in China. Even though complicated, it has clearly emerged that *M&A* and *Takeovers* are the most effective and efficient ways to currently enter the Chinese market.

## II. Prospective of New Forms of Investment in China

China is one of the world’s leading economic powers today, and confidence in the world’s second-largest economy is still mounting as we can witness from the

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<sup>1)</sup> Report by the World Bank: “*China 2030 – Building a Modern, Harmonious, and Creative High-Income Society*,” 2012, International Bank for Reconstruction and Development/International Development Association of The World Bank.

ever increasing foreign direct investments (FDI). It is foreseeably predicted that China will soon become the new frontier of capital investments. In fact, recently China is bolstering the strength of its capital market in a move to encourage M&A activities, in addition to the restructuring of listed companies. One of its financial center, Shanghai, now ranks as the sixth most competitive financial center worldwide and its importance is expected to grow in the near future.

It is a matter of fact that Chinese deal activity in this sector, namely “M&A”, both inbound and outbound, has been a key driver of the global M&A rebound in 2010 and 2011. Analysts said that domestic strategic M&A activity is expected to increase in industries previously only accessible to State-owned enterprise. Meanwhile foreign investors are expected to re-enter the market at volumes last seen before the financial crisis.

It is also worth stressing that Shanghai is making moves to enhance its mergers and acquisitions market with the aim to make itself a global financial hub by 2020 (an ambition which was approved by the state Council in March 2009). Just to confirm the importance China is giving to its financial markets it is worth reporting that the Shanghai Stock Exchange will implement "round-the-clock trading" by 2020. No Stock Exchange in the world has yet implemented 24-hour trading. Furthermore, the local government is considering setting up a *China Mergers and Acquisitions Association* in Shanghai, and according to figures from the Shanghai headquarters of the People's Bank of China, there are 11 financial institutions running M&A loan business in the city. This represents another confirmation of the trend which at present China is experiencing.

Chinese authorities are accelerating the process to allow overseas companies to float shares in the domestic A-share markets as a way to ease and facilitate inflows of new investments and to give Chinese investors new room to allocate their money. The “international board” was to be launched at the end of 2011, however it should fully functioning and operating in 2012, though the schedule is not fixed. However, it seems that the approval procedure for overseas companies seeking listing on the board will be made simpler and faster than that for domestic companies. The central bank hopes the international board will be launched

and be operative as soon as possible, adding the market and industry demand for the board is real. The securities regulator affirmed that overseas companies could list on the new board through initial public offers (IPO)<sup>2)</sup> or depositary receipts

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2) The *China Securities Regulatory Commission* introduced the *IPO sponsor system* in 2004: under the system, Chinese companies seeking an IPO on Shanghai or Shenzhen exchange are required to obtain the endorsement of a qualified sponsor. The sponsors are to complete a due diligence checklist and sign a declaration that they are aware of the legal consequences before they recommend an IPO candidate to the commission for approval. The sponsors are required to make sure financial data and other information provided in the IPO prospectus are truthful. Sponsors also continue to oversee disclosure information, to be sure it is valid, for one or two years (depending on the trading board) after the company floats its shares. The system is aimed at improving the quality of public companies and better protecting investors' interest. Hua Sheng, president of Yanching University in Beijing, told a forum in Beijing in November that the main problem is the sponsor system's mild punishment of wrongdoing by sponsors and their representatives. Regulations issued by the securities commission stipulate that if a public company's earnings decline more than 50% in the year went public, or if there are any irregularities in information disclosure, the IPO sponsor will be banned for 3 to 12 months, and in serious cases, a sponsor's business license can be revoked. Gaoxin Zhangtong Co. Ltd., a tube maker, was delisted last year (2010) after reporting a loss in three consecutive years after going public. The punishment given the two sponsor representatives with Bohai Securities Co. Ltd. was a "notice of criticism" from the commission. "The punishment should be much tougher", Liu Jipeng, a professor at China University of Political Science and Law, wrote on his blog. "The situation now is that nobody is to be blamed if there are problems. The sponsors are actually committing fraud at no risk". Hong Kong also has an IPO sponsor system but is much tougher when it punishes wrongdoing. Sponsors face huge fines and possible criminal charges if their transgressions are caught: e.g. Hong Kong Economic Times reported in September 2011 that Mega Capital (Asia) Co. Ltd. faces fines of up to HK\$ 100 million (\$ 12.85 million) after making inaccurate statements in the prospectus of Hontex International Holdings Co. Ltd. Even in Hong Kong, where the sponsor system dates to 1999, there are flaws. Late last month (November 2011), the Hong Kong Monetary Authority said it found inadequacies in the activities of five banks that sponsor IPOs in the city, including their handling of the due diligence and disclosures in IPO prospectuses. However, the sponsor system is only a temporary method adopted on the way to China's IPO mechanism reform. China's stock issuing should soon go from administrative examination and approval to registration. Under the registration system, which is used in the United States, regulators check only the format of a company's information disclosure. Investors decide which companies will survive, and they correct wrongdoing through legal action. In the US if a company makes false statements in its prospectus, investors will make it pay a huge price through class actions. Following the rise of its IPO market in recent years, development of

traded in Chinese stock exchanges. The China Regulatory Securities Commission (CSRC) is also exploring the possibility of overseas companies issuing yuan-denominated bonds and other debt instruments. The launch of the international board is being widely watched because it could draw a string of multinational companies to the mainland fundraising pool.

Furthermore, a “pilot program” to allow HK investors to buy mainland stocks with RMB was launched in the middle of December 2011 in order to allow overseas investors to use off-shore RMB deposits to invest in the mainland’s capital markets. Experts said the deregulation will increase the popularity of the currency and expedite its internationalization. The initial quota of the program, known as the RMB Qualified Foreign Institutional Investor, is 20 billion *yuan* (about \$ 3.1 billion), according to the China Securities Regulatory Commission. According to the regulator, 80% of the quota will be allowed to invest in the mainland’s fixed-income markets such as government and corporate bonds while only 20% will be allowed to enter stock markets. This move seems to be part of Beijing’s ambition to raise the global profile of the local currency to reduce reliance on the US dollar in cross-border transactions.

It is a matter of fact, according to the data gathered by the CSRC, that mainland China is going to maintain IPO lead. Despite the weakening in new offerings in the second half of 2011 China will continue to lead the global IPO market next year, this is also the sentiment of the accounting firm Ernest & Young LLP (E&Y) as stated in an article published in the *China Daily*.<sup>3)</sup> The Shenzhen Stock Exchange was the world’s most active IPO market in 2011, ranking first in the number of issues and second in the amount of capital raised in the first 11 months of 2011. Edward Ho, managing partner of assurance services at E&Y declared that “the IPO pipeline of Chinese issuers remain healthy and we expect the total amount of capital raised in the first half of next year to be at least 300 bil-

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China’s mergers and acquisitions (M&A) market also has picked up. As a result, the securities commission is introducing a financial adviser system, a counterpart to the IPO sponsor system.

<sup>3)</sup> *Mainland to maintain IPO lead*, *China Daily*, December 22, 2011.

lion *yuan*”(about \$48 billion).

The Shenzhen exchange, including the small and medium-sized enterprise board and the start-up board ChiNext, raised 181 billion *yuan* in 243 deals in 2011 according to E&Y. Though the global IPO activity has declined significantly since mid-2011 due to market concerns about the Eurozone debt crisis and the downgrade of the US sovereign debt rating Mr. Edward Ho remains optimistic about next year’s IPO situation, with increasing liquidity in the markets as China gradually loosens monetary policy to support growth. Furthermore, he added that “a speedy resolution of Europe’s debt crisis would help stabilize global markets and restore investor confidence”.

It seems that other opportunities are emerging for foreign companies wishing to invest in China, especially related to the protection environment. While technology and innovation in general is central to China’s development in the future, some specific words should be given to opportunities regarding ‘green technology’ in China. In recent years China has poured a lot of money and resources into development of ‘green technology’ and this is not without reason. A recent report from the World Bank, released in March of 2012, estimates that the cost of environmental degradation and depletion of resources has caused China nearly 10% of its GDP over the last decade. While this is of great concern for China it is also a chance to drive China’s economy forward through investment and implementation of ‘green technology’. In particular, foreign companies that have developed green technology or patents related to green technology could easily see an increase in their business activities if they are willing to get involved in China. Regardless of the exact method used, there is no doubt that in the near future foreign companies that have coveted technology will be at an advantage in regards to any M&A activities they wish to engage in China. Therefore, such companies should actively investigate the most advantageous way to use their technological advantage to gain a presence or larger presence in China.

### III. Consolidation and Restructuring of Businesses and a New Reform to Improve the Securities Markets

While China has gone through considerable restructuring of its SOEs since its reform and opening policy there is still work to be done. One clear decision of the *12<sup>th</sup> Five Year Plan* is that China should continue to consolidate fragmented business sectors and restructure SOEs. One of the major reasons why restructuring will continued to be encouraged in one form or another is that various reports (including the World Bank's China 2030 report) show that from China's reform in the late 1970's till recently SOEs are 1/3 as efficient as private enterprises.

In regards to SOEs the State-Owned Asset Supervision and Administration Council (SASAC) has already decided and implemented plans to reduce the number of SOEs to 80 by 2020 (down from 120 in 2010). Most SOEs tend to have large and complex organizational structures with many business units. While this might be overwhelming it also offers many M&A opportunities if foreign investors can work on reorganizing and splitting these various business units into M&A targets. With nearly 40 SOEs planned to be dismantled in the coming years, opportunities abound for those are savvy in their negotiation process.

Furthermore, China is pushing for wider based consolidations both publicly and privately in a number of sectors in order to create large corporate entities that will help to make industrial development more efficient. The main drive in this effort was to restructure six key industries including automobiles, steel, cement, machinery, rare earths and aluminum. In the summer of 2011 three more industries were added to this list including manufacturing, IT and medical supplies and equipment. While foreign companies and capital are welcomed to aid in the process of consolidating these industries it must be understood that the majority of the transactions will be instigated by Chinese firms that are looking to consolidate within China or expand outside China. Still opportunities abound particularly in Shanghai where the local government is putting in place policies to financially aid M&A transactions that will come from the restructuring of the industries mentioned above. As quoted by the China Daily, Shanghai's Vice-Mayor Tu Guangshao said,

“The city will initially actively propel the construction of its financial market and M&A-related auxiliary services, especially the agents who facilitate deals, to aid these activities.” Companies seeking to list on Shanghai’s so-called “international board” should achieve market capitalization of more than 30 billion *yuan* (about €3 billion) and have a combined three year net income of more than 3 billion *yuan*.

In a move to set up sound, fair market for investors, top securities regulator could introduce delisting procedures for the main board by mid-year in 2012 to insure fair market in which investors’ interests are protected. “A *delisting system, which can improve market efficiency, should be launched on the foundation of an investor protection system*”, expressed Guo Shuqing, chairman of the China Securities Commission (CSRC) and a deputy of the National People’s Congress (NPC), as reported by the China Daily on Tuesday, March 6, 2012. Substantially, delisting procedures allow stock exchanges to suspend and cancel share trades for companies that have been in red for a certain period of time.<sup>4)</sup> The absence of a delisting procedure has prompted speculation in unprofitable public companies, increasing overall market volatility.

When China joined the WTO a decade ago it opened up many of its sectors for the first time and one of these is the “securities market”. According to the promises made in 2001, offices of foreign securities firms in China were allowed to become special members of the Chinese securities stock exchanges and to set up joint ventures to operate securities investment and fund management with a maximum stake holding of 33%.<sup>5)</sup> Ten years after China’s admission to the WTO, there are only 12 joint venture securities firms operating in Chinese mainland (those include China International Capital Co. Ltd., the first jointly funded investment bank in China). This liberalization made China a world investment destina-

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<sup>4)</sup> The Shenzhen Stock Exchange released a draft delisting procedure for the growth enterprise market on November 29, 2011. That procedure allows for delisting if the daily closing price drops below book value for 20 consecutive trading days.

<sup>5)</sup> Three years later (2004), foreign stake holding in a Chinese financial institution were allowed to reach 49%. By the end of 2006, the establishment of six joint venture securities firms and 24 fund management companies had been approved, and foreign held shares had reached 49 % in 11 fund management companies.



tion and Shanghai was one of the cities that benefited most from that trend. As China's financial hub, Shanghai has seen its financial sector developing very fast, so does Hong Kong.<sup>6)</sup> However, the expansion of foreign investment institutions in China remains slow and joint-venture securities firms are still struggling to gain clients. While foreign investment institutions have taken part in facilitating Chinese companies selling shares in Hong Kong or foreign markets, their business in the domestic A share market was not so significant according to "Wind Info", a Shanghai based integrated service provider of financial data (Dec. 2011).

The China Securities Regulatory Commission introduced rules in June 2002, which set the maximum foreign stake in a Chinese brokerage at 33% as mentioned above. Following this move, UBS, Goldman Sachs, Credit Suisse and Deutsche Bank each formed a Chinese JV with local securities firm by holding a minority stake.<sup>7)</sup> Despite the local market restrictions, foreign investment institutions are eager to expand their business in China, the world's second largest economy with a capital market that raised about \$72 billion in IPO deals in 2010, which exceeded that of Hong Kong and New York stock exchanges for the first time.

The lunch of the international board in Shanghai will help provide more business opportunities for joint ventures firms in Chinese A share market. The international board will allow foreign companies to float shares on the Chinese stock markets. Just to illustrate how lucrative the Chinese market can be, the CITIC Securities Co. Ltd., the country's largest brokerage by market value, earned 10.9 billion *yuan* in net profit in 2010, even though the country's stock market was among the worst performing in 2010. According to the China Securities Association

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<sup>6)</sup> The number of mainland companies that listed in Hong Kong in create to more than 600 from around 90 in 2001, according to Hong Kong Exchange and Clearing Ltd., the holding company for the stock exchange.

<sup>7)</sup> Most joint venture Securities firms are formed by foreign investment banks and domestic small and medium sized Securities firms. It must be noted that the sharp differences in corporate culture and attitudes to operation and management between Chinese and foreign companies have turned the expected advantages of joint venture into disadvantages. For example, in 2007, a joint venture between domestic Changjiang Securities Co. Ltd. and BNP Parisbas Bank, has dissolved after three years due to differing opinions on its future and operation.

the 106 securities brokerages together earned about 108.5 billion *yuan* in net income from the underwriting business in 2010.

#### IV. Concept of “M&A” and Content of the M&A Regulations 2006

By 2006 China revised and made its M&A laws more precise with its *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (more generally referred to as the *M&A Regulations 2006*).<sup>8)</sup> These new regulations allowed more sophisticated ways to enter Chinese market, like share swaps, and showed China’s slow but steady progress in liberalizing its legal regime. In particular, the Chinese legislator has recently enacted and updated a new legal framework regulating *M&A* transactions which seems to respond well to the needs of international investors, as to attract investments needed to sustain and foster the Chinese economy. Thanks to these more precise requirements and rules, it is easier than ever to invest in China.

Before we take a more in-depth look at these regulations it is necessary to understand how mergers and acquisitions are defined in China:

The term “*M&A*” (*binggou*, 并购) refers generically to any combination of two or more business enterprises.

- A *merger* (*hebing* or *jianbing*, 合并/兼并) is the legal combination of two discrete economic entities in which only one entity survives and assumes all the assets and liabilities of both entities.
- In contrast, an *acquisition* (*shougou*, 收购) can be defined as the purchase by

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<sup>8)</sup> The *2006 M&A Regulations*, have been issued by six governmental agencies orchestrated by the Ministry of Commerce (MofCOM), and became effective on September 8, 2006. These agencies include: Ministry of Commerce (MofCOM), China Securities Regulatory Commission (CSRC), State Administration of Taxation (SAT), State Administration for Industry & Commerce (SAIC), State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) and State Administration of Foreign Exchange (SAFE).

one economic entity of all or part of the *shares* (i.e. *equity interest*) or *assets* of another economic entity.

However, it must be noted that under Chinese law there does not exist a concrete definition of “mergers and acquisitions”; a general definition is stated in the *Company Law* (art. 173):

*“The merger of a company may be effected by way of merger or consolidation:*

- *In the case of merger (xishouhebing, 吸收合并), a company absorbs any other company and the absorbed company is dissolved;*
- *In the case of consolidation (xinshehebing, 新设合并), two or more companies combine together for the establishment of a new one, and the existing ones are dissolved.”*

The *Company Law* in China underwent a substantial revision in 2005, with the goal of facilitating the incorporation of a company and capital raising, to better protect the interest of minority shareholders, and to improve the corporate governance. Among other things, the revised *Company Law* removed the restraints on outbound investments which could be made by a company in which the aggregate amount of outbound investments shall not exceed 50% of the net assets of the company,<sup>9)</sup> making it more likely for companies to become the object of M&A and mobilizing financial leverage of companies. At the same time, the revised *Company Law* streamlined generally the procedure of M&A, provided simplified solutions to dispose for existing claims and debts and improved the efficiency of M&A. It is interesting to note how the Chinese legislator has changed one of the provisions of the *Company Law* to facilitate these transactions: Art. 184 of the

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<sup>9)</sup> Art. 12 of the *Company Law* (2004 version) : *“A company may invest in other limited liability companies or companies limited by shares and bear responsibility to such companies in which it has invested in proportion to the amount of investment it has made. Apart from investment companies and holding companies as specified by the State Council, where a company invests in other limited liability companies or companies limited by shares, the aggregate amount of the investment shall not exceed 50% of the net assets of the company, without counting the portion gained from the capital increase caused by the invested company through converting its profit.”*

Company Law 2004 Version was formulated as follows: “*The companies concerned shall notify their creditors within ten days as of the date when the merger resolutions of the companies are taken and announce in the newspapers at least three times within 30 days. Creditors have the right to demand the companies to clear their debts or provide corresponding guarantees within 30 days after the notifications received or within 90 days as of the date of the first announcement in cases in which notifications have not been received. Without clearing debts or providing guarantee, the merger may not be carried out*” this provision was replaced by art. 174 of the Company Law 2005 Revision: “*The companies concerned shall, within ten days as of making the decision of merger, notify the creditors, and shall make a public announcement on a newspaper within 30 days. The creditors may, within 30 days as of the receipt of the notice or within 45 days as of the issuance of the public announcement if it fails to receive a notice, require the company to clear off its debts or to provide corresponding guarantees.*” Meanwhile, art. 175 was added that mandated that when companies merge, the surviving company or the newly established company shall succeed to the claims and debts of each party to the merger.

However, the M&A Regulations 2006, in respect of the Company Law, give us a more precise definition of *mergers and acquisitions*, in fact art. 2 states that:

***“mergers and acquisitions of a domestic enterprise by foreign investors shall mean”***

- Purchase of an ***equity interest*** (*goumaiguquan*, 购买股权) from shareholders of a domestic enterprise (not a FIE);
- Subscribing to the ***increase in the registered capital*** (*rengouzengzi*, 认购增资) of a Domestic Enterprise; (the DE changes into a FIE);

Or

- Establishing a FIE which will acquire the ***assets*** (*zichan*, 资产) of a domestic enterprise and operate such assets;
- Purchasing ***assets*** of a Domestic Enterprise and use such assets as investment to establish a FIE to operate such assets. Noteworthy the assets purchasing agreement shall be governed by laws of China.<sup>10)</sup>

In particular the purchase of an equity interest by foreign investors may be operated directly or indirectly (either registered capital or shares) in a target company registered in China. In a *direct equity acquisition*, the foreign investor acquires equity in a domestic enterprise or a foreign-invested enterprise (FIE) from the existing Chinese or foreign equity holders pursuant to a share purchase agreement or from the target through a subscription for new equity. In an *indirect equity acquisition*, if the Chinese target company is an existing FIE, a foreign investor may acquire or increase control of the Chinese target company through the offshore purchase of some or all of a foreign party's interest in the FIE. Such a transaction is invariably conducted offshore in the jurisdiction of the FIE's existing foreign investor and generally does not attract Chinese legal implications, except in certain circumstances pursuant to the new antitrust review regime in China.

Not all provisions of the M&A Regulations 2006 apply to a M&A transaction for equity interest in an existing foreign-invested enterprise, but the *Provisions for the Alteration of Investors' Equity Interests in Foreign-invested Enterprises*<sup>11)</sup> shall first apply to these transactions. According to such Provisions, a direct equity interest acquisition/transfer in a foreign-invested enterprise requires the approval of the governmental authority for foreign investment which has originally approved the establishment of such foreign-invested enterprise.

## V. Evaluation of the *Target Company*

One major effect of the *M&A Regulations 2006* is the valuation requirements for all types of eligible targets. It is worth noting that based on the *Regulations*, only Chinese domestic companies organized in the form of a limited liability com-

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<sup>10)</sup> In this sense, art. 24, M&A Regulations 2006.

<sup>11)</sup> The provisions were promulgated by the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce and entered into force on May 28, 1997.

pany or a company limited by shares regulated by the PRC Company Law are directly qualified to be the targets of an *equity interest M&A transaction* involving foreign investment. Other entities such as *wholly people-owned enterprise* or *collective-owned enterprises* are not properly structured and prepared to directly introduce foreign investors in an equity interest acquisition. In fact, a number of domestic enterprises are still organized today in the traditional forms and these enterprises may have no articles of association, no board of directors and even no concept of shares. Therefore, they must be restructured into limited liability companies to prepare themselves to be introduced to foreign investors. However, there is no restriction for what type of target an *asset transaction* can accommodate. That is to say, a Chinese domestic enterprise which is not organized in the form of a limited company may also act as the vendor of the target assets in an asset transaction.

The investor must inquire whether the target company is “state-owned”. If it is the case, he should discuss the proposed acquisition with the *State Asset Supervision and Administration Commission (SASAC)*<sup>12)</sup> to determine the value of the assets or of the equity to be acquired. The *State-owned Asset Valuation Administrative Procedures 1991* and the *Regulations on Several Issues on the Valuation and Administration of State-owned Assets 2002* are two pieces of law of general application when evaluating ‘State-owned assets’ including enterprises and units. In particular the *State-owned Asset Valuation Administrative Procedures 1991* require a ‘unit occupying State-owned assets’ to carry out a valuation if: (i) *it auctions or transfers its assets;* (ii) *it undergoes a merger or sale, enters into a cooperative arrangement, or operates as a company limited by shares;* (iii) *it forms an equity or cooperative joint venture with a foreign company;* (iv) *it undergoes liquidation;* or (v) *on the occurrence of any other event, it is required by law to carry out a valuation.* On the other hand the *Regulations on Several Issues on the Valuation*

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<sup>12)</sup> In 2003, the PRC Government decided to strengthen the regulatory regime governing state-owned asset by creating the SASAC, namely the State-owned Assets Supervision & Administration Commission, a commission directly under the State Council, which is charged with the responsibility of supervising the assets of State-owned enterprises at the national level directly subordinate to the Party Central Commission.

*and Administration of State-owned Assets 2002* expanded the range of transactions for which an enterprise is required to carry out a valuation. They include: (i) a whole or partial conversion of the enterprise into a limited liability company or a company limited by shares; (ii) the use of non-currency assets for foreign investment; (iii) a merger, division, or liquidation of the enterprise; (iv) a change in the equity percentages of the original shareholders, (v) a transfer of all or part of its property rights or equity interests; (vi) a transfer, exchange, or auction of its assets; (vii) a lease of all or part of its assets to a non State-owned unit; (viii) confirming the value of assets that are the subject of litigation; and (ix) any other transaction for which valuation is legally required (in this sense Art. 3).

In an equity or asset acquisition, the seller and the buyer must use a valuation conducted by a properly established asset appraiser in the PRC as the basis for agreeing the transaction price.<sup>13)</sup> The valuation must be done in accordance with commonly accepted international methods of valuation. The valuation result should be used as a reference for the parties to agree on a price but, where the actual transaction price is less than the valuation by a margin of 10% or more, the party subject to the valuation must explain the difference in writing to the appropriate level finance bureau.<sup>14)</sup> If the price is less than 90% of the valuation, the transaction cannot proceed without the approval of the authority responsible for approving the transaction.<sup>15)</sup> It is noteworthy, valuations are valid for a period of one year from the valuation date.<sup>16)</sup> Under valuation has been deemed a serious offense as siphoning and injuring the state assets, which might affect and impede the M&A plan.

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<sup>13)</sup> Art. 14, M&A Regulations 2006.

<sup>14)</sup> Art. 12, Regulations on Several Issues on the Valuation and Administration of State-owned Assets 2002.

<sup>15)</sup> Art. 22, Interim Administrative Procedures on the Valuation of State-owned Assets of Enterprises 2005; Art. 13 Interim Procedures on the Administration of Transfers of Enterprises state-owned Property Rights 2004.

<sup>16)</sup> Art. 21, Interim Administrative Procedures on the Valuation of State-owned Assets of Enterprises 2005.

## VI. Takeover of Listed Companies

Foreign companies wishing to enter the Chinese market can opt for the *takeover* of a listed company. Along with other laws and regulations mentioned before, the *Measures for regulating Takeovers of Listed Companies* (better known as “Takeovers Code”)<sup>17)</sup> sets up the most comprehensive legal framework for takeovers of Chinese listed companies. The Takeovers Code represents the continued efforts of the Chinese government to develop a modernized regulatory system for takeovers. The ongoing revisions are to suit and facilitate the new environment whereby the national economy is facing strategic restructuring.

Chinese companies may be listed on one of China’s two national stock exchanges, namely, Shanghai,<sup>18)</sup> and Shenzhen,<sup>19)</sup> (Hong Kong is considered a market apart), and there are several different types of shares,<sup>20)</sup> distinguished by rules governing their ownership and trading. It must be stressed that the acquisition of

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<sup>17)</sup> *Measure for regulating Takeovers of Listed Companies*, promulgated by the China Securities Regulation Commission (CSRC), 31<sup>st</sup> July, 2006, and effective from 1<sup>st</sup> September, 2006, and amended in 2008.

<sup>18)</sup> In 1946, Shanghai Securities Exchange was created on the basis of Chinese Security Exchange, but it ceased operations in 1949 when the communists took over China. With the development of socialist market economy under Chairman Deng Xiaoping’s opening up policy in the 1980s, treasury bonds and stocks gradually resumed trading. On November 26, 1990, Shanghai Stock Exchange (SSE) was established and it started operation on December 19, 1990. After several years’ operation, SSE had become the most prominent stock market in China. SSE is a membership institution directly governed by the China Securities Regulatory Commission (CSRC). Further information about Shanghai Stock Exchange available at: <http://chinastockventure.com/2009/12/shanghai-stock-exchange/>

<sup>19)</sup> Shenzhen Stock Exchange (the SSE) was established in 1990, governed by the China Securities Regulatory Commission (CSRC).

<sup>20)</sup> The two exchanges in mainland China classify the stocks into A-share and B-share. Foreign investors take an active part in mainland China stock markets as QFIIs (Qualified Foreign Institutional Investors). In 2003, China permitted qualified foreign institutional investors to invest in listed domestic securities denominated in local currency, subject to a quota approved by The State Administration of Foreign Exchange (SAFE), China’s foreign exchange controller. It must be noted that the Hong Kong Stock Exchange classifies the Hong Kong shares with mainland China background into H-share and Red Chip, for its derivatives market.



the shares of a Chinese listed company does not always lead to a change of control, in fact foreign investment in listed companies has traditionally taken the form of a negotiated minority stakes for the purpose of developing a strategic relationship rather than seeking operating control. Depending on the share classification, <sup>21)</sup> foreign investors may acquire shares through a negotiated acquisition, a private placement, an open market acquisition or a block trade transaction. As it will be discussed later on, different rules and restrictions apply to each class of shares, and each class has different ownership and transfer procedures. Valuations (in particular by SASAC if state owned assets or SOEs are involved) are required for most negotiated acquisitions and statutory lockups are applicable to many types of acquisition.

Starting from February 2001, China permitted domestic individual residents to open B shares accounts with legally-obtained foreign currency and trade in B shares. With other forms of stocks flourishing, the importance of B shares de-

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<sup>21)</sup> There are two main classes of domestically listed shares: *A shares* and *B shares*: *A shares* are basically limited to domestic investors, including individuals, legal persons, and the state, both denominated and treated in the local currency, i.e. the Chinese Yuan (RMB). Historically speaking, *A shares* were further sub-divided into three sub-sets in light of the strictly defined groups of shareholders, namely: i) state shares (*guoyou gu*, 国有股), ii) legal person shares (*faren gu*, 法人股), and iii) public shares (*shehui gongzhong gu*, 社会公众股). Only public shares used to be freely traded on the stock exchange, and therefore were called “tradable shares”, while state shares and legal person shares were subject to severe trading restrictions, and therefore collectively called “non-tradable shares”. In the past five years, the Chinese government has completed a substantial shareholding structure reform program pursuant to which the former non-tradable shares (including those held by foreign parties) gradually becoming converted at a certain discount into tradable shares that shall be freely traded on the stock exchange at the expiration of statutory lock-up periods.

Listed domestically, *B shares* are denominated in Chinese Yuan (RMB) but subscribed to and traded in US dollars (for those listed in Shanghai) or Hong Kong dollars (for those listed in Shenzhen). *B shares* had emerged against the shortage of foreign currency and tight foreign exchange control in the early 1990s and were originally available only to overseas investors. *B shares* were introduced to allow foreign (and HK, Macau, Taiwan) investors to participate upon their requests amid the open-up policy, to gain experience from western countries, and to prevent sophisticated foreign investors to exploit the inexperienced Chinese counterparts. (In November 1991, Shanghai Vacuum Electronic Devices Company Limited was the first Chinese company to issue *B shares*).

clined, and trading volume and market capitalization shrank.<sup>22)</sup>

Now, as the economic reform proceeds, the Chinese government has been making great efforts to gradually solve the problem of market segmentation, with a view to bring the market more in line with international norms and standards. Therefore, control transactions are now becoming more technically feasible. As will be discussed later, there are two main methods of takeovers in China: 1) takeover by public tender offer, which is used for tradable shares, and 2) takeover initiated by privately negotiated agreement, which was the common practice in the era of non-tradable shares. (CSRC approval in one form or another is required in both cases).

## VII. Features of the New “Takeover Regime in China” and Content of the *Takeover Code*

Since the new Securities Law and Company Law took effect in China in 2006, international fluid capital has begun to shift investment from the field of fixed assets to stock acquisitions, private equity as well as enterprise realignment and mergers. Both these two pieces of legislation have contributed in shaping the present framework governing takeovers of listed companies. The Securities Law has introduced a new takeover regime which was refined by the new Takeovers Code. Therefore, the Takeovers Code has greatly completed China’s takeover legal regime and is now constituting a sound basis for takeover activities.<sup>23)</sup> The takeover

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<sup>22)</sup> Li Guo, in *Chinese Business Law* (edited by Bu, Ch. 4 *Securities*), C. H. Beck Hart (Germany & UK), p. 87 (2010).

<sup>23)</sup> The other sources of law which may be relevant to takeover transactions are the mentioned Company Law which contains some provisions about merger and acquisitions, and in addition, the listing rules of the stock exchanges must also be consulted when conducting takeovers of listed companies as the *Shanghai Stock Exchange, Share Listing Rules*, promulgated 1998, amended 2000, 2001, 2002, 2004, and 2006. As to takeovers of listed companies by foreigners, there is a separate group of regulations in addition to those for domestic acquirers. These regulations impose limits on the access of foreigners to the domestic market, but if access is granted, foreigners will

of listed companies shall be conducted in line with the principles of *openness, fairness and equity*.<sup>24)</sup>

Control acquisitions are subject to special regulations and may trigger tender offer obligations. The dispositions of the Takeovers Code are applicable to acquisitions of over 30% of the outstanding shares of a listed company. In accordance with this equality of opportunity principle, a mandatory bid rule sits also at the heart of another China's takeover law, namely the Securities law. In fact, art. 88 of the Securities Law states that *Where an investor holds or holds with any other person 30% of the stocks as issued by a listed company by means of agreement or any other arrangement through securities trading at a stock exchange and if the purchase is continued, he shall issue a tender offer to all the shareholders of the said listed company to purchase all of or part of the shares of the listed company.*

Before analyzing in detail both the “mandatory bid rule” and the “tender offer” rules it is necessary to underline that the Takeovers Code puts an emphasis on takeovers by “tender offers”. Takeover by tender offer should now be seen as the main way to acquire shares in listed companies with a view to gaining corporate control of a target company. However, takeover by private agreement remains also a common method of gaining control of the target company. It is worth to note that, the Takeovers Code strengthens the regulations that prevent opportunistic takeovers, for instance, art. 6 states that an investor is barred from taking over any listed company if it has certain problems. In particular it is stated that an investor may not damage the legitimate rights and interests of a target listed company and its shareholders by taking advantage of the takeover of the listed company. A listed company may not be taken over under any of the following circumstances: (i) The purchaser owes a large amount of debts, and has not paid off its due debts, and the said circumstance is in a continuous state; (ii) The purchaser has ever committed any major illegal act or has ever been suspected of being involved in any major illegal act during the past 3 years; (iii) The purchaser has ever committed any serious credit-breaking act in the securities market during

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comply with basically the same takeover laws as Chinese nationals.

<sup>24)</sup> In this sense, Takeovers Code, art. 3.

the past 3 years; (iv) The purchaser, be it a natural person, is under any of the circumstances as prescribed in Article 147 of the Company Law; or (v) Any other circumstance as prescribed by laws or administrative regulations or as recognized by the CSRC under which no listed company can be taken over.<sup>25)</sup> Furthermore, when making a takeover bid to be paid in cash, the bidder must deposit no less than 20% of the total amount of the offered price in the bank designated by the securities depository and clearing institution as the performance guarantee.<sup>26)</sup>

### 1. Mandatory Bid Rule

Once the 30% threshold is reached, any further acquisition must be made by general or partial tender offer.<sup>27)</sup> Although the CSRC will continue to grant exemptions on a case by case basis, the new Takeovers Code sets a more stringent regime, its rules and dispositions are more detailed, so to obtain exemption is more difficult. An acquirer can also agree to takeover a company by agreement with the company's shareholders (known as *negotiated takeovers* or "Takeover by Agreement", regulated in Chapter IV of the Takeover Code). However, once the acquirer acquires 30% of the issued shares of the target company and it continues to acquire shares, it must make a general offer for all (or part) of the company's issued shares unless the CSRC grants a waiver from making an offer.<sup>28)</sup> The takeover rules also apply to indirect acquisition (see Chapter V of the Takeover Code, "Indirect Takeovers"),<sup>29)</sup> i.e. where the acquirer has acquired an interest in an intermediate company that holds at least 30% of the issued shares of the listed company. This for example, can occur if a person acquires control of a controlling shareholder. In such a case, a general offer is required to be made. The mini-

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<sup>25)</sup> Art. 6, Takeovers Code.

<sup>26)</sup> Art. 36, Takeovers Code.

<sup>27)</sup> Art. 47, Takeovers Code.

<sup>28)</sup> See arts. 94 to 96 of the Securities Law, and art. 47 of the Takeovers Code.

<sup>29)</sup> The term "indirect takeovers" refers to the situation where although an investor does not itself take over a listed company by directly acquiring its shares, the investor gains the control of the listed company by other means such as private agreement, investment relationship or any other arrangement, see Art. 56 of the Takeovers Code.

mum partial tender offer is for 5% of the outstanding shares.<sup>30)</sup> Prior to 2006, a general tender offer for all shares was required upon reaching the 30% threshold. Through the indirect takeover model and without obtaining a waiver from the CSRC, Nanjing Iron & Steel Co. Ltd. in 2003 was the first Chinese listed company which faced the mandatory bid. In China, the obligation to make mandatory bids can be exempted by the CSRC. The Takeover Code has paid considerable attention to this issue, clarifying the grounds upon which the CSRC may grant an exemption.<sup>31)</sup> In the past A share restrictions precluded foreign parties from making tender offers, but it is necessary to stress again, the recent regulatory changes, which opened the A share market to foreign investors, make foreign participation in tender offers feasible. The take-over regulations now also permit the use of non-cash consideration<sup>32)</sup> (i.e. *share swap*, which will be treated later), allowing the use of equity consideration and more complex structuring arrangements in such a tender offer, although cash consideration must always be made available as an option. In order to improve the efficiency of the system, the CSRC sets out two application processes. More specifically, in some cases where the matter is complicated, the application needs to go through a formal process;<sup>33)</sup> in other cases where crossing the 30% threshold appears to be technically caused by non-takeover activities such as inheritance or underwriting arrangements, a simplified procedure is to be followed to allow quicker processing.<sup>34)</sup> It is necessary to highlight that under Article 62 of the Takeover Code, apart from the CSRC, the shareholders of the target company can also pass a resolution to exempt the acquirer from the

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<sup>30)</sup> Significant disclosure and reporting requirements attach to holding a 5% interest in a listed company. The reporting requirements, however, have been simplified compared with the prior reporting requirements.

<sup>31)</sup> See Takeovers Code, arts 61 and 62. For example, exemptions may be granted if the acquirer and the transferor can prove that the transfer has not caused the change of the factual controller of the listed company.

<sup>32)</sup> Cash or shares can be used as consideration and the duration of the tender offer is subject to time limitation. A registered financial advisor must be engaged to review the transaction from a legal and business perspective.

<sup>33)</sup> Art. 62, Takeovers Code.

<sup>34)</sup> Art. 63, Takeovers Code.

mandatory bid rule in certain cases.<sup>35)</sup> There is also a newly introduced exemption under which an investor can increase its shareholding by less than two (2)% in a rolling period of twelve (12) month.<sup>36)</sup>

## 2. Tender Offer Rules

In conformity with the fairness and openness principles, see in particular art 26,<sup>37)</sup> the *Takeovers Code* sets out detailed provisions on how to conduct a takeover bid (Chapter III and IV of the Takeovers Code). With the introduction of this new takeover regime, partial bids are also permitted (see the combined dispositions of arts. 23, 24, 25, 43, 47, and 56 of the Takeovers Code). The partial offer allows to gradually increment the control in a listed company, without the obligation to launch a tender offer on the rest of the capital until the investor reaches the 30% (if a waiver is not granted), granting to the investor a great flexibility. However, it must be stressed that under Article 43 (Takeovers Code), if the bidder in a partial bid receives acceptances for a greater number of shares than specified in the offer, each acceptance shall be *pro-rata* basis (*ex art. 88, Securities Law; and art. 43, Takeovers Code*) and the excess returned to target shareholders. In any case, it should be noted, that although proportional bids can ensure achievement of equality of opportunities among target shareholders, they shift to bidders the uncertainty as to the number of shares ultimately sold.<sup>38)</sup> Then, it is easy to imagine that if

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<sup>35)</sup> Art. 62 (2) and (3), Takeovers Code.

<sup>36)</sup> Art. 63 (2) of the Takeovers Code states in fact: ...*“In the case the shares of which the entitlements are held by the investor in a listed company reach or exceed 30% of the issued shares of the company, the shares of which the entitlements in the company are held by the investor as increased during every 12 months may not, within one year as of the occurrence of the aforesaid fact, exceed 2% of the issued shares of the company;”*

<sup>37)</sup> Art. 26 of the Takeovers Code requires that in a takeover bid, all the shareholders of the target company be treated equally and fairly: *“In case a listed company is taken over by means of tender offer, the purchaser shall equally treat all the shareholders of the company under takeover. And all the shareholders that hold the same kind of shares shall be treated equally”*.

<sup>38)</sup> It would be unusual for all target shareholders to accept a proportional bid, therefore a bidder must pitch a proportional bid at such level as it estimates will take into

there are more acceptances than expected, the investor may have to acquire more shares and spend more than is necessary to gain corporate control.

Another point to be stressed is that the price offered under a takeover bid must not be less than the maximum price that the bidder has paid for the bid security during the six months preceding the date of the bid.<sup>39)</sup> In particular article 35 states that if the offer price is below the arithmetic average value of the daily weighted average prices during the thirty trading days prior to the date of the bid, a financial consultant must be hired by the bidder to produce a report on issues such as whether there is any manipulation of stock prices, whether the bidder has failed to disclose its concerned parties, whether there is any other arrangement for the bidder to obtain the shares of the target company during the previous 6 months, and finally whether the offer price is “rational” (*...as well as the rationality of the price offer price*. Art. 35, Takeovers Code).

The Takeovers Code has also established another set of rules to ensure that the takeover bid will be conducted in accordance with the principle of equal opportunity previously mentioned and expressed in art. 26, which provides that all shareholders should be treated equally in takeovers. In fact, this fundamental norm is reinforced by a prohibition against giving of collateral benefits during the bid. Namely, art. 38 (Takeovers Code) states that “in the case of tender offer, the purchaser may not, after the announcement is made and before the takeover terms expires, sell any share of the company under takeover, nor may it buy any share of the company under takeover by any other means that hasn’t been stipulated in the tender offer or that goes beyond the conditions as stipulated in the tender offer”. Then, the principle of openness is also embodied in the information disclosure regime (Chapter II of the Takeovers Code, “Entitlement Disclosure”, and also art. 29: information to be contained in the tender offer report). These rules provide a safeguard for target shareholders to prevent coercive tender offers through adequate information disclosure about the tender offer and the right to have rea-

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account non-acceptances in order to attain the shareholding it wants to acquire. If there are more acceptances than expected, the bidder may have to acquire more shares and spend more than is necessary to gain corporate control.

<sup>39)</sup> In this sense, art. 35, Takeovers Code.

sonable time to consider it. For example, the bidder must inform the market of the terms of the offer,<sup>40)</sup> and the offer should be open for a minimum time to avoid shareholders making a hasty decision.<sup>41)</sup> It must be stressed, if the bidder wants to change and vary the terms of the offer, the approval of the CSRC is required,<sup>42)</sup> and variation cannot occur within 15 days prior to the expiration of the bid unless a competing bid is made.<sup>43)</sup> Moreover, the target's shareholders can withdraw their acceptance within 3 days before the expiration of the bid.<sup>44)</sup>

In order to ensure equal treatment of all target shareholders, the China's takeovers regime pays particular attention to minority shareholders after takeover: if the tender offer expires and the acquirer has enough shares, usually 75% (90% when the total capital of the listed company exceeds 400 million *yuan*) of all outstanding shares, to cause the de-listing of the target company, the remaining shareholders have the right to enforce the sale of their shares on the same terms as those in the offer. In this sense art. 97, Securities Law, and art. 44, Takeovers Code. According to the listing requirement, a listed company must meet a number of criteria, one of which is that the publicly held shares in a company must account for more than 25% of all outstanding shares, and if the total amount of the issued capital of the company exceeds 400 million *yuan*, then the publicly held shares must be more than 10%, in this sense, art. 50, Securities Law.

However, there is a clear loophole from the acquirer's perspective. Unlike many other foreign countries, the squeeze-out right is not stipulated in Chinese Securities Law, therefore the tender offeror can't force out with ease the held-up shareholders even after getting 90% or more of all the total shares. In practice, in order to wipe out those remaining shareholders, a troublesome and controversial cash-out merger has to be employed following the cash or share tender offer.

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40) Article 29 of the Takeovers Code requires the bidder to disclose relevant issue such as the purpose of the takeover, the offer price, and the payment arrangements.

41) Article 37 of the Takeovers Code stipulates that the effective period of the offer must be no less than thirty days and no more than sixty days, except where there is a contested offer.

42) In this sense art. 39, Takeovers Code.

43) In this sense art. 40, Takeovers Code.

44) In this sense art. 42, Takeovers Code.



## VIII. Takeover Defenses

Under Article 67 of the Securities Law, if a ‘major event’ occurs which may impact the trading price of the company’s shares and which is not known to the investors, the listed company shall report such event to the CSRC and to the Stock Exchange, and announce the same.<sup>45)</sup> A special takeover committee is established by the CSRC to assist in dealing with the transaction, the committee provides consultation opinions on whether or not the takeover of a listed company is constituted, whether or not there is any circumstance under which a listed company may not be taken over, as well as other related matters.<sup>46)</sup>

Once the bid is announced, the target’s ability to engage in frustrating action is constrained (art. 33 of the Takeovers Code). The Takeover Code further requires that any defenses adopted by the board of directors must be in the interests of the company and the shareholders, and the board may not abuse its powers by improperly obstructing the takeover. Generally, the directors have to remain in a neutral position and they don’t have the right to jeopardize the bid by making acts of extraordinary administration just to create obstacles. Article 8 of the Takeovers Code provides that when taking defensive measures, target directors must meet their fiduciary duties owed to their company and that the defensive measures should be beneficial to the target company and shareholders and must not pose an inappropriate obstacle to the attempted takeover.

The board is required to investigate the bidder and report to the CRSC within 20 days after the bid is announced. In particular “the board of directors of the company under takeover shall make investigation into the capacity, credit status and purpose of takeover of the purchaser, analyze the conditions for tender offer, bring forward suggestions on whether or not the shareholders should accept the tender offer, and employ an independent financial consultant to issue professional

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<sup>45)</sup> Art. 67 (8) states that the target company shall make this report when “*a considerable change in the holdings of shareholders or actual controllers who each hold or control no less than 5% of the company’s shares*”.

<sup>46)</sup> In this sense, Art. 10, Takeovers Code.

opinions”, moreover, “in case the purchaser makes any major alteration to the conditions for tender offer, the board of directors of the company under takeover shall, within 3 working days, submit the supplementary opinions of the board of directors and of the independent financial consultant on the alteration of conditions for tender offer, and give a report and make an announcement”.<sup>47)</sup> This report is likely to be influential, and obtaining CSRC approval may be more difficult if the takeover is hostile.

Under Article 33 of the Takeovers Code, after the bidder announces its offer, the target may not dispose of assets, undertake external investment, change the company’s principal business or change any security arrangements for loans if such actions would materially affect the company’s assets, liabilities, rights and interests or results of operations, unless the shareholders’ general meeting approves. These transactions will usually have a significant effect on the company’s financial condition and business performance thus influencing the price of the shares at the stock exchange.

These restrictions do not apply to carrying on normal business activities or enforcing the resolutions of the shareholders’ general meeting, although they would rule out the possibility of issuing shares or disposing of crown jewels to the preferred bidder in order to frustrate a hostile bid, unless such action is approved by the shareholders’ general meeting. In other words, there could be some provisions with the effect of anti-takeover preloaded in the company’s article of association if adopted by the shareholders’ general meeting. It has become even more feasible when the amended Company Law which took effective on 1<sup>st</sup> Jan., 2006, granted more autonomy towards the article of association. In the 1998 case of *Shanghai Ace*, a provision for the staggered board was considered to be against the compulsory Company Law format and deemed invalid. But within the new Company Law regime, things such as staggered board, gold parachute, voting rights restriction, and super-majority vote, etc., have been added into some listed companies’ article of association. It should be noted that such provisions are still uncommon in general and have not yet been contested in court, largely due to the fact that the hos-

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<sup>47)</sup> In this sense Art. 32, Takeovers Code.

tile takeover is rare in China.

In bringing about a takeover of a listed company, a party cannot engage in “prohibited trading activities” as defined in the Securities Law 2006.<sup>48)</sup> Generally speaking, these “prohibited trading activities” are essentially the equivalents of insider dealing<sup>49)</sup> and market manipulation activities.<sup>50)</sup> Certain persons are considered to be “informed person with insider information on securities trading” (see arts. 74 and 76, Securities Law), they include: (i) directors, supervisors, and senior officers; (ii) companies in which the company has a controlling interest and their directors, supervisors, and senior officers; (iii) persons who have access to insider information of a company by virtue of the positions they hold; and (iv) a *de facto* controlling shareholder and its directors, supervisors, and senior officers. (Also included are shareholders who hold at least 5% of the shares of the company and their directors, supervisors, and senior officers even though a 5% shareholder may not necessarily in fact have access to insider information). The basic prohibition is that “informed persons” with insider information,<sup>51)</sup> on securities trading and persons who have unlawfully obtained insider information are prohibited from: (i) using such information to trade in securities; (ii) disclosing such information; or (iii) making recommendations to third parties to buy or sell securities.<sup>52)</sup> One important ambiguity here is whether the focus should be on the possession of such information itself (knowing) or the informed persons should also act due to such in-

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<sup>48)</sup> See Section IV of the *Securities Law*. Article 73 in particular states that: *Any insider who has access to any insider information of securities trading or who has unlawfully obtained any insider information is prohibited from taking advantage of the insider information as held thereby to engage in any securities trading.*

<sup>49)</sup> This expression means dealing with “insider information” which is information concerning the company to be acquired which has not been disclosed and which may have a major effect on the market price of the company’s shares, the Securities Law sets out various examples of information that could be considered to be “insider information”, see art. 75, Securities Law.

<sup>50)</sup> The *Securities Law* prohibits various types of activities that have the effect of manipulating the securities market and imposes civil, administrative and even criminal liabilities on the perpetrator, see art. 77, 203, and 231 of the Securities Law.

<sup>51)</sup> In this sense, *Securities Law*, art. 73.

<sup>52)</sup> In this sense, *Securities Law*, art. 76.

formation (using). Art. 76 and art. 73 seem conflicting in this point, the first of which suggests a tougher stance against the insiders without carving out any exception for the dealings out of other reasons.

## IX. Share Swaps : a Critical Development in M&A Transactions

*Share swaps* represent a critical development in the M&A panorama. This not only represents a new form of payment for a target company, but also a newly allowed form of investment to establish a presence in China. Basically the shares of an existing company (or of a newly established company, namely the Special Purpose Vehicle or “SPV”) are used as consideration for the shares of the target company. Except for SPVs, only companies listed on recognized stock exchanges may use equity for acquisition in China (arts. 28 and 29 of the M&A Regulations 2006). In any case, approval from MOFCOM is required for all acquisitions in which equity is used as consideration (art. 32 of the M&A Regulations).

The most straight forward means of acquiring an enterprise in China is to acquire its off shore holding company. This does not typically require Chinese government approval, although approval might be needed if certain competition law reporting thresholds are met (see paragraph on Anti-monopoly review).

It is also worth noting that it is uncertain whether CSRC was only given the authority to approve all SPV companies’ offshore listing or only the listings of those that are limited to equity interest exchange transactions. This does not mean that the CSRC has no jurisdiction over the overseas listing of SPV upon its acquisition of a related domestic company via cash transaction. If CSRC’s jurisdiction over the said transaction under the M&A Regulations 2006 maybe uncertain even though the presence of article 40,<sup>53)</sup> it seems more appropriate to af-

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<sup>53)</sup> Art. 40, M&A Regulations 2006, states that: “Where a special purpose company to be listed overseas, the listing shall be proved by the security regulatory authority under the State Council. The country or region where the special purpose company is listed shall have a sound legal and regulatory system, and the securities regulatory authority of such country or region has concluded a memorandum of understanding

firm that the CSRC's regulatory power over such case is granted by Article 238 of the Securities Law.<sup>54)</sup>

More precisely the SPV, which was not mentioned under the 2003 Interim Regulations, is defined under the 2006 Regulations as an overseas company directly or indirectly controlled by the PRC companies or PRC individuals for the purpose of consummating the listing in an overseas securities exchange of the shares in a PRC domestic company actually owned by the PRC companies or individuals. As an exception to general rule under Article 29 of the 2006 Regulations, shareholders of the SPV may use unlisted shares in the SPV or newly issued shares in the SPV as the consideration for the acquisition of shares in a domestic affiliate. If a PRC domestic company wants to set up a SPV, it must submit application documents to the Ministry of Commerce for approval, and once MOFCOM grants approval for the SPV, the shareholders shall go through the relevant foreign exchange registration formalities with the local branch of the State Administration of Foreign Exchange. The listing of a SPV in an overseas exchange is subject to the approval of the China Securities Regulatory Commission (CSRC). Prior to the submission of the listing application to CSRC, the related M&A transaction with share swaps must be approved by MOFCOM. The total value of the shares issued should not be lower than the value of the shares in the domestic enterprise under the share swap based on the appraisal report issued by a qualified PRC asset appraisal firm. Within 30 days of the completion of the overseas listing, the domestic company must report to MOFCOM regarding the overseas listing and the plan for the repatriation of the proceeds from the listing back into China.

Before the 2006 Rules, there was no explicit statutory guidance on using equity for acquisition in China, so applications to do so were generally rejected. Foreign

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*on cooperation in regulation with the securities regulatory authority under the State Council, and has kept the effective relationship of cooperation in regulation.”*

<sup>54)</sup> Article 238 of the Securities Law provides that “*the direct or indirect share offering and listing of domestic enterprise shall get the approval of the securities regulatory authority of the State Council in accordance with relevant regulations of the State council.*”

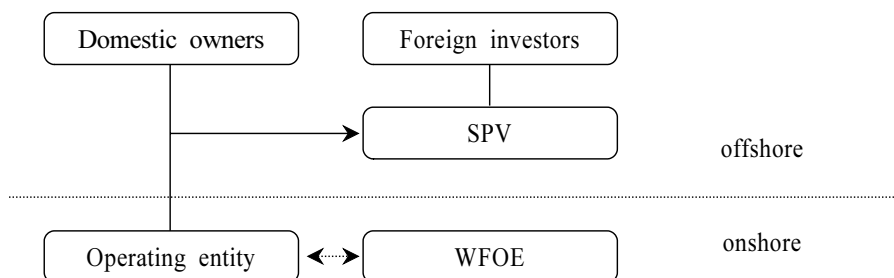
acquirers must engage a PRC registered M&A consultant, which will conduct a *due diligence*<sup>55)</sup> on the foreign shares and issue a consulting report for review and examination by the approval authorities, and an acquirer must pre-execute certain documents which would be used to roll-back the transaction and re-implement the original share structure of the domestic company if certain conditions - including the share swap- are not completed within a certain period of time.

## X. A Review and Outlook of VIE (Variable Interest Entity): a Brief Introduction

In the past, many technology companies in China have done business through Variable Interest Entities (“VIE”) in order to gain access to foreign capital and to help expand their business. Recently, the dispute over the ownership of Alipay, a leading online payment service provider in China that decided to cancel all of their VIE agreements, has not only created debates about business ethics in China but more importantly has brought up questions as to why China’s regulatory authorities are stepping up scrutiny of the VIE structure, the Pandora’s box behind the dispute.

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<sup>55)</sup> An important step in the acquisition process, whether acquiring shares or assets, is thorough financial and legal *due diligence*. A due diligence is basically a formal legal and financial investigation to identify the correct assets and liabilities of a target company. Where the acquisition involves the purchase of an interest held by a foreign company, the due diligence process may be routine, but not always in China. The due diligence is still relatively a new process to SOEs (State Owned Enterprises) and other domestic PRC enterprises, and therefore problems may occur, this is the reason why it should be done by local Chinese, in fact they have the cultural and background knowledge needed to make this process the most efficient and smooth.



## 1. Definition of VIE

The VIE (Variable Interest Entity) structure is a corporate structure which includes a series of contractual arrangements to enable foreign investors to obtain a degree of control over, as well as a substantial economic interest in Chinese companies without having to directly own their shares, the above is a typical VIE structure.

## 2. Key Elements of VIE

### (1) SPV

Under a VIE structure, domestic owners and foreign investors will jointly set up a SPV (Special Purpose Vehicle) for the purpose of capital operation. Any financial arrangement or public offering can be realized on SPV level.

### (2) Operating entity

Operating entity is a company which has all necessary licenses to run its business in China and more importantly, is the source of benefits and losses under a VIE structure. In most cases, domestic owners of operating entity are its founders.

### (3) WFOE

To build up connections with the operating entity and to avoid potential needs to deal with China's government, the offshore SPV will set a wholly foreign-owned enterprise (WFOE) under PRC laws. A WFOE can sometimes also conduct a portion of operating entity's business in China.

(4) Legal agreements

The concept that underpins VIE is that any control or economic benefit is obtained through legal agreements rather than share ownership. From the accounting perspective, a SPV could consolidate the operating entity by using contractual arrangements, the following agreements can be typically found under most VIE structures:

- **Loan agreement** : The domestic owners borrow funds from WFOE to capitalize the operating entity. This agreement usually forms the main underlying obligation for the following equity pledge agreement.
- **Equity pledge agreement** : The domestic owners pledge their shares in the operating entity to the WFOE as collateral, to secure the full performance of domestic owners' obligation under loan agreement and other agreements. Under PRC laws, this agreement needs to be duly registered with relevant authority.
- **Call option agreement** : With its discretion, the WFOE has the right to acquire all the operating entity's shares from the domestic owners, and the payment price can be offset against the loan provided by the WFOE. From a practical viewpoint, this option cannot be exercised until some point in the future China's regulatory authorities allow the foreign share ownership in the operating entity.
- **Power of attorney** : The domestic owners grant a power of attorney to the WFOE, which means the WFOE is justified to exercise all shareholder rights in the operating entity.
- **Consulting service agreement** : The operating entity agrees to use the WFOE as its service provider and pays it service fee. It is through this way that the WFOE transfers profits of the operating entity to itself, ultimately the SPV and all of its equity owners.



## XI. Why China's Regulatory Authorities are Challenging the VIE Structure?

Today, the VIE structure faces substantial uncertainty in China because regulatory authorities are challenging its legitimacy under PRC laws and regulations. Undoubtedly, an earthquake will be caused in the capital market if VIE agreements are held invalid, since it is widely used in many offshore listed Chinese companies, especially in the internet sector. The question presents itself: Why does it appear that China's regulatory authorities are re-examining and changing their attitudes toward VIE structures? The answer can be found by looking into the history of VIE in China.

Dating back to 2000, the VIE structure first became known to the public in Sina's IPO, which is why the VIE structure is also commonly referred to as the "Sina model". At this time the VIE structure was a popular alternative to certain businesses for the following reasons:

1. Systematical obstacles ... like harsh IPO rules and lack of venture capital ... prevented private sectors ... especially emerging industries from raising money in China's capital market.
2. Sector-oriented regulation limited foreign investment in certain sectors. Ideally, if the operating entity could be a WFOE then the complex VIE is no longer needed (that's why the call option agreement would exist), which, however, is not permitted because the operating entity belongs to a prohibited sector.<sup>56)</sup> Generally speaking, foreign investment is classified into three levels according to different sectors, "encouraged", "restricted", and "prohibited" ... for some sectors, the foreign ownership of equity is either completely prohibited or restricted to a small proportion after an unpredictably long time approval process.

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<sup>56)</sup> Take Sina as an example, in China, ICP (Internet Content Provider) license will only be chartered to a domestically funded company. However, this license is indispensable for an internet company which holds a portal website as its core asset like Sina.

Under these circumstances, VIE provided an alternative solution for capital-hungry entrepreneurs and eager foreign investors, especially venture capitals and private equity funds, which hold great capital for economic return.

Obviously China's government was aware of VIE, because many large and famous companies used this corporate structure. And if the Chinese government wanted, they could have shut it down which by process of negation means that while VIE structure might not have been a preferred investment vehicle it was accepted. During that period of time : 1. Regulatory authorities had realized that small enterprises in the internet sector needed capital but they couldn't get it onshore because of systematical obstacles and sector-oriented regulation, as discussed above; 2. The internet sector did not cause too much concern for regulatory authorities. As a result, they tacitly accepted the use of VIE structure in the internet sector.

In several years after Sina's IPO, more companies like Sohu, Xiecheng, Tcent and Baidu, most in the internet sector, have accomplished offshore financing and listing through the VIE structure. All these companies were successful and their success further justified the use of the VIE structure.

To conclude, VIE was just a product of time, a technical method that provides regulatory authorities an "excuse" to naturally accept internet enterprises' offshore financing and listing ... on which regulatory authorities do not have any material disagreement no matter if the VIE exists or not ... without amending laws or regulations. Moreover, since VIE is still an arguable issue, this unfinished controversy gives regulatory authorities more leverage in regulating these companies.

Now, it is time to use that leverage. For the following reasons, China's regulatory authorities are now taking steps against VIE structure:

### 1. National Security Concern

Compared to the first several years of 21<sup>st</sup> century, time has changed. Unlike ten years ago, internet regulation now becomes a politically sensitive and national security-related issue for China's government, and the fact that almost every influential internet company is controlled by foreign investors through the VIE structure makes regulatory authorities deeply insecure.

## 2. Public Policy Concern

Regulatory authorities cannot tolerate VIE becomes a manipulated tool that helps companies transfer their assets and profits offshore and even deliberately circumvent PRC laws and regulations. VIE started in the internet sector, then moved to other sectors like media (Focus Media, IPO in 2005) and education (New Oriental, IPO in 2006). However, the use of VIE seems has gone beyond control from then on. In 2009, China Qinfu went public in Hongkong with a VIE structure, which outraged regulatory authorities: 1. Unlike those emerging light-asset companies, Qinfu is a traditional heavy-asset company which engages in coal operation business; 2. Qinfu circumvented Chinese M&A rules,<sup>57)</sup> foreign currency exchange regulations and industry-admission policy. This shows, as mentioned above, while VIE serves as a comfortable “excuse” for regulatory authorities to acquiesce the offshore financing and listing of emerging light-asset companies, it doesn’t mean that VIE is acceptable in any other sector, especially those traditional heavy-asset industries like Qinfu.

## 3. Systematical Obstacles Disappear

The growth of China’s capital market has been remarkable over the past decade. On the one hand, VC/PE industry has boomed in recent years and private sectors now have diverse channels to raise capital onshore, from early-stage venture capital to ultimate public offering. On the other hand, Shenzhen Stock Exchange has set up ChiNext in 2009, where qualified small and growing enterprises’ shares can be publicly traded. Rules of listing on ChiNext are more flexible than traditional IPO rules and moreover, regulatory authorities encourage and support those leading companies in emerging industries to go listing in the A share market.

However, despite all the dissatisfactions on VIE, China’s government is not likely to clear existing VIE structures in offshore listing companies in the near future because the government has to consider its reputation in the international com-

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<sup>57)</sup> *Provisions for the Acquisition of Domestic Enterprises by Foreign Investors*, enacted in 2006.

munity and other political factors. According to a report purportedly issued by the CSRC (China Securities Regulatory Commission)<sup>58)</sup> the use of VIE may have to be approved by regulatory authorities in the future and relevant legislation in this regard is already being pushed forward; however, those offshore listing companies which have used the VIE structure may be safe harbored.

## XII. The New *Merger Control Regime*: an Introduction and Further Developments

The Anti-monopoly law (hereinafter indicated as AML), which went into effect at the beginning of August 2008,<sup>59)</sup> has added an additional level of complexity to acquisitions. The AML applies to both foreign and domestic parties. The new AML introduces the concept of *concentration* to describe transactions which may be subject to *merger control*. “Concentration” is defined in the AML as: (i) a merger between business operators; (ii) acquisition of control over other business operator by way of equity or asset acquisition; (iii) acquisition of control over other business operator or of the ability to wield a decisive influence over other business operator by way of contract or other means.<sup>60)</sup>

Anti-monopoly review has now become one of the most important and sometimes controversial process during MOFCOM review process.

Basically the AML aims to protect fair competition and it targets three types of “monopolistic conduct” : (i) Anti-competitive “monopoly agreements”, (ii) Abuses of dominant market position, and (iii) Concentration that are “likely to eliminate or restrict competition.”

The AML also prohibits certain anti-competitive *monopolistic agreements* among

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<sup>58)</sup> See <http://www.eeo.com.cn/2011/0928/212678.html>, please note this report is not officially verified.

<sup>59)</sup> Anti-monopoly Law (AML), passed by the Standing Committee of the National People’s Congress on August 30, 2007, effective from August 1, 2008.

<sup>60)</sup> In this sense, art. 20 of the AML.

multiple firms. Several types of horizontal agreements among competitors, such as price-fixing cartels and agreements to divide markets, and certain vertical agreements limiting the prices at which purchasers may resell products to their downstream customers are expressly prohibited.

The Anti-Monopoly Bureau,<sup>61)</sup> assisted by the *Ministry of Commerce*, the *State Administration for Industry and Commerce*, and the *National Development and Reform Commission*, is in charge of market concentration review for foreign acquisitions and investments.

Generally, the acquisition of any interest in a Chinese company by a foreign investor requires the government's approval and one critical issue is the approval level that is required. An approval from a local or provincial office of MOFCOM is typically sufficient for most transactions. However, certain types of acquisitions, such as those described below and those that involve a purchase price that exceeds a certain thresholds, require central government approval: (i) Investment in a company that holds a famous trademark or trade name; (ii) Investment in a critical industry or an important industry that potentially affects China's economic security; (iii) Restructure of a Chinese company to a jurisdiction outside China; and (iv) Cross-border equity swap or share exchange.

## 1. Notification

Under the Anti-monopoly Law, within 30 days of the receipt of all documents necessary for a merger notification, the Anti-Monopoly Bureau should review the merger notification and issue a decision on whether to conduct an in-depth investigation.<sup>62)</sup> However, it does not mean that the 30-day period starts since then. It is very likely that the MOFCOM would find that the submitted documents are not detailed enough and thus would ask for more supplementary documents. In

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<sup>61)</sup> The *Anti-monopoly Bureau* is a subordinated department of MOFCOM and the latter is also the authority in charge of foreign investment approvals in China. When the Anti-monopoly Bureau carries out a merger review, it will be inevitably influenced by MOFCOM.

<sup>62)</sup> Art. 25, Anti-monopoly Law.

this case, the 30-day period will start again once the required documents are submitted. Such rounds of supplementary document submission could occur many times in the process of anti-trust filing. If according to the decision of the Anti-Monopoly Bureau no in-depth investigation is necessary or if the Anti-Monopoly Bureau fails to make a decision within the above time limit, then clearance for the concentration shall be deemed to be given. If the Anti-Monopoly Bureau initiates an in-depth investigation, it will have an additional 90 days for the in-depth investigation. Under the circumstances contained in article 26 of the AML, Anti-Monopoly Bureau may extend such period for another 60 days.

If the Anti-Monopoly Bureau fails to complete their review and to issue their decision within the above time limits, the parties to the transaction may implement the concentration.

## 2. Thresholds for Reporting Concentrations

According to the *Regulations on the thresholds for reporting concentration*<sup>63)</sup> all combinations must apply to Authorities in charge of anti-monopoly review if: (i) the turnover in the aggregate achieved by all parties to the M&A transaction exceeds 10 billion *yuan* world-wide or 2 billion *yuan* in Mainland China; and/or (ii) the turnover achieved by at least two of them respectively exceed 400 million *yuan* in Mainland China.

Merger notification to the Anti-Monopoly Bureau is mandatory if the transaction meets any of the notification thresholds.<sup>64)</sup> The transaction may not be consummated until the review is complete, and no transaction may be implemented before clearance.

The MofCOM's Anti-Monopoly Bureau has issued a series of guidelines: (i) *Opinion on Guidance of Merger Review ("Guidelines for Merger Review")* 1 January 2009; (ii) *Opinion on Guidance of Notification of Concentration of*

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<sup>63)</sup> Provision on the Notification Thresholds for Concentration of Business Operators, also known as the *Regulations on the thresholds for reporting concentration* were promulgated by the PRC State Council on 3 August 2008 and entered into force on the same day.

<sup>64)</sup> In this sense, art. 21, *Anti-monopoly Law*, 2008.

*Business Operators*, dated 5 January 2009; (iii) *Opinion on Guidance of Notification Documents of Concentration of Business Operators*, dated 7 January 2009, which give detailed technical requirements for merger filings, and also list the information that must be submitted, but they do not clearly specify a filing deadline and some concepts remain unclear (e.g. geographic market). However, there is still uncertainty though regarding a number of key issues relating to the application of the AML, including whether and how the Anti-Monopoly Bureau will apply the AML to joint ventures and how turnover should be calculated.

For many years China was a planned economy and competition against the state was a non-factor, however, as more aspects of a market economy began to take root in China the need to develop an anti-monopoly law became apparent to Chinese authorities. Even now, with new legal developments most SOEs still are not considered in such reviews of market competition because Chinese regulators have taken the position that their pricing and policy decisions are made by state directives rather than market principle. That is why these SOEs can be referred to as “administrative monopolies” because their market position is artificially created by government policies and protection. Through their policies Chinese authorities have split “administrative monopolies” into two main groups based on their importance to state development and security. The first group is referred to as “strategic” industries in which the states should keep complete control. There are seven “strategic” industries : defense, electric generation and distribution, petroleum and petrochemicals, telecoms, coal, civil aviation and waterway transport. The second group has been dubbed “basic or pillar” industries in which the state should keep a strong influence. “Basic or pillar” industries include: machinery, automobiles, information technology, construction, steel, base metals and chemicals.

While foreign businesses have invested in some of these industries their investments are limited to the point where they have no input or say over the direction of the SOE. This situation has caused concern to many foreign companies and organizations like the World Bank which have tried to persuade China to open up such sectors to market forces. In particular, they want China to limit its protection of certain industries and create the circumstances for a more level playing field so

private enterprises can enter those sectors. By doing so they are trying to convince China that private enterprises can help the Chinese themselves by making those sectors more efficient. However, at the same time are hoping to make China more integrated with international market principles. With regards to China's anti-monopoly law there is a hope within many foreign groups that China's regulatory regime will use their powers to break down certain "administrative monopolies".

Regardless of whether a transaction involves the purchase of *assets* rather than *equity*, on February 3, 2011, the General Office of the PRC State Council issued the *Notice Regarding the Establishment of National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the "Notice" in force from March 5, 2011), which applies to both those types of transactions, and which renders the entire process of approval of the transaction more strict especially when are involved SOEs and National interests, thus National security. The Notice represents another major step that the Chinese government has taken in recent years in the area of regulating mergers and acquisitions of domestic companies by foreign investors in China. The Notice sets up a ministry-level intra-agency joint meeting as the "national security review committee".<sup>65)</sup> Two broad transaction types are subject to National Security review: (i) a non-Chinese investor's "acquisition" of any stake (even a small one) in a military enterprise, a supplier to a military enterprise, a company located near sensitive military facilities, or any other company relating to national defense; and (ii) a non-Chinese investor's "acquisition" involving "control" of a Chinese company whose business involves "key" agricultural products, energy and resources, infrastructure, transportation

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<sup>65)</sup> The national security review committee will review, approve or block a transaction based on the following aspects: (i) influence on national defense security, including influence on domestic manufacturing capabilities, services and related facilities and equipment required by national defense; (ii) influence on national economic stability; (iii) influence on basic social order; and (iv) influence on China's ability to research and develop key technologies for national security. The foreign investment security review committee will be guided by the State Council and led by the National Development and Reform Commission and MOFCOM, which will conduct reviews together with other agencies on as needed basis.



services or technologies or manufacturing of equipment and machinery “affecting national security,”<sup>66)</sup> although the *Notice* does not provide guidance as to the meaning of “key” or “affecting national security.” Under the *Notice*, the term “*de facto control*” refers to the following circumstances: (i) owning 50% or more of the equity of a company (including where multiple non-Chinese investors together own 50% or more of the company’s equity); (ii) having voting rights sufficient to exercise a major impact on resolutions of a shareholders’ meeting or board meeting; or (iii) having decision-making authority over a company’s business, financial affairs, personnel or technology.

### XIII. Taxation framework for Enterprises Restructuring in China: a General Introduction

The new Enterprise Income Tax Law (EIT Law) has a direct impact on M&A activity. The adjustment of tax rates, the reduction of fiscal incentives both have to be considered in structuring an M&A transaction.

In an equity acquisition transaction, where the target entity is a domestic company, income earned will be treated as part of enterprise’s taxable income for enterprise income tax purpose. If the target company is a FIE, income will be subject to withholding tax at 10% rate.

In an asset acquisition transaction, any gains or losses on transfer of assets shall be included in the taxable income of the target company for enterprise income tax purposes. Business tax shall be levied on the sales of real properties and intangible assets.

However, in planning such a transaction it has also to be considered “The Circular on Several Issues Concerning the Enterprise Income Tax Treatment of Enterprise Reorganizations”(i.e. “Circular 59”), issued on 30 April 2009 and retroactive from 1 January 2008. It outlines the tax treatment of equity transfers in

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<sup>66)</sup> Acquisition of financial institutions are expected to be covered by future rulemaking.

connection with an enterprise reorganization; in other words Circular 59 creates a taxation framework for enterprise restructuring in China.

The State Administration of Taxation (SAT), following uncertainty on how to implement “Circular 59”, published the *Administrative Measures on Enterprise Income Tax for Enterprise Restructuring* (SAT Public Notice No. 4, or “Notice 4”) which provides guidance on key elements of Circular 59. Noteworthy “Notice 4” may also retrospectively affect restructurings completed in the past two years.

Basically “Circular 59” imposes on a business restructuring either (a) general tax treatment, or (b) special tax treatment. The general principle for General treatment is that the tax incentives enjoyed by parties before a restructuring cannot be inherited by the resulting entity, but with the following exceptions: (i) in a merger, only the surviving enterprise can continue to enjoy certain transition tax incentives provided by the EIT Law during the remainder of the EIT transition period; (ii) For certain projects that enjoy exemptions under the EIT Law, such as infrastructure, environmental protection, and energy saving projects, if the projects are transferred in the restructuring, the recipient may continue to enjoy them during the remaining EIT exemption period.

Special treatment allows a party to defer payment of enterprise income tax if its restructuring satisfies the following conditions: (i) the restructuring has its motivation a reasonable commercial objective, and not the avoidance or deferral of tax payments; (ii) substantial change to legal or economic structure, namely in the case of share or asset acquisitions, at least 75% of the total assets or shares are transferred; (iii) there is no change to the “substantial” business for at least 12 consecutive months after the restructuring; (iv) at least 85% of the total consideration is in shares (i.e., “Non-cash transactions”- the legislator, it is evident, has specifically considered *share swaps*); (v) the major shareholder of the acquisition target must not transfer the “share consideration” it received for at least 12 consecutive months after the restructuring.

Notice 4 clarifies that all parties involved in a restructuring must use the same tax treatment, and select the same tax year for filing. Furthermore, as highlighted above Circular 59 states that the shares of the acquiring enterprise and of its con-

trolling enterprise can be used as consideration, Notice 4 defines a “controlling enterprise” as *an enterprise that has received direct investment from the acquiring enterprise*.

Special rules for Cross-border restructurings are also contained in “Circular 59”. It allows Special treatment only for cross-border and asset acquisitions that satisfy all the general conditions, and which fall within any of the following four situations: (i) a non tax-resident enterprise transfer its shares in a tax resident enterprise to another non-resident enterprise it wholly owns. The transfer cannot change the withholding tax burden of the parties. The transferor must commit to the tax authorities, in writing, that it will not transfer the shares in the other non tax-resident enterprise within three years; (ii) A non tax-resident enterprise transfers its shares in a tax resident enterprise to another tax-resident enterprise it wholly owns; (iii) A tax-resident enterprise invests in a non tax-resident enterprise it wholly owns using assets or shares it owns; (iv) Other circumstances approved by the Ministry of Finance and State Administration of Taxation.

#### XIV. Employees as an “asset” and a Key Factor for the Success of the M&A Transaction

Although acquiring a local enterprise may facilitate the establishment of a company’s presence in China, for the smooth business operation it is not only necessary to retain the key Chinese personnel but also to become familiar with their way of thinking. Only by understanding the locals and their culture is it possible to develop your business in the most profitable way. The inability to integrate organizational cultures is generally acknowledged as a top source of post-deal failure and lost value. It is also necessary to stress that foreigners naturally expect to have a strong role in running target companies, but they should be aware that the Chinese management team has the experience and the contacts (*guanxi*) it needs to be successful here in China.

Whether an M&A transaction is structured as an equity or an asset deal, the in-

terests of the employees of the target company are usually involved. For a state-owned target enterprise, formal consultation with the employees on their settlement arrangement is required by law, and the final settlement arrangement plan of the employees is subject to the discussion and adoption of the employee representatives' assembly.

In an asset acquisition, employees employed in the business that is being sold are not automatically transferred with the business. Each employee must agree to transfer to the buyer's employment. If an employee agrees to transfer, his employment with the seller will be terminated and he will be re-employed by the buyer. Because an employee cannot be compelled to transfer, there is a risk that some employees may defect and find alternative employment which may affect business operations in the short term. Whether an employee decides to transfer will depend on variety of personal and economic factors, including the relative attractiveness of the new terms offered by the buyer compared with either existing terms or to the benefits he would be entitled to if he is made redundant. There is no rule in the PRC that provides that employees are automatically transferred on the same terms and conditions under which they are employed. There is therefore potential for abuse in that transferring employees could be offered terms less favorable than their current terms.

If an employee does not agree to transfer, the seller can either continue to employ him, make him redundant,<sup>67)</sup> or terminate his employment on the ground that the 'objective circumstances' existing at the time he was employed no longer exist.<sup>68)</sup> The seller will be liable for certain statutory severance payments. Such pay-

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<sup>67)</sup> The redundancies must be made in accordance with a statutory procedure. A redundancy scheme has to be prepared that includes the names of employees to be made redundant, the timing of redundancy, and compensation to be paid. The scheme together with the views of the employees or labor union have then to be submitted to the local labor bureau before the redundancies can be implemented, in this sense art. 27, *Labor Law* 1995, and art. 4, *Reduction of Staff for Economic Reasons Regulations* 1995. The buyer should therefore request to inspect these documents where the scale of redundancies is material.

<sup>68)</sup> On termination of employment, an employer is liable to compensate an employee whether the termination was mutually agreed; in this sense, art 5 of the *Economic Compensation*

ments have to be made even if the employee unreasonably refuses an offer of suitable alternative employment with the buyer.

In an equity acquisition, the employees of the target company remain as employees. In fact, there is no change in their status and there is likely to be more stability in the workforce. In the case of contract workers engaged through a services company, there is also no change in their status as they remain employed by the services company that has seconded them to the target company. It is unlikely that there will be any disruption to this arrangement assuming the services company wishes to continue doing business with the new owners of the target company. As regarding social insurance obligations, in an equity deal, each group company will remain liable for social insurance payments.

## XV. Conclusion

When China joined the WTO in 2001, it embarked on a journey that would have led it becoming the world's second largest economy within a decade only. However, to sustain its growth and development China has to introduce some reforms to further open its market, has stressed by the Report by the World Bank. This opening should also include sectors that before were not considered so important, in particular investments now are encouraged in environmental protection and new renewable sources of energy. Foreign companies that have developed green technology now have an opportunity to increase their business activities if they are willing to invest in new environmental oriented projects in China. There is no doubt that in the near future foreign companies that have gained experience in this field and have developed technologies intended to improve the efficiency in using scarce resources for a sustainable green development, they will be at an ad-

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*for Breaches and Termination of Labor Contracts Procedures 2005.* The employee is entitled to one month's salary for each full year of employment up to a maximum of 12 months. Where the employee has worked less than one year, he is entitled to compensation on the basis that he has worked for one year.

vantage with regards to any M&A activities they wish to engage in China.

Foreign companies all around the world are under pressure to establish, or rapidly expand their presence in Chinese market which has resulted immune to the recent international crisis, though its expansion is slowing down. However, any company wishing to do business in China should never forget the difficulties of doing business there, in fact adapting the business to a vastly different culture and environment it is not an easy task.

M&A and Takeovers have recently developed into the preferred method to establish a presence in China. Though China has made considerable advances in the last several years in trying to develop a coherent and predicable regulatory framework for M&A and Takeovers, its legal framework is extremely vast, complex, and fragmented. Therefore, in order to grow along with the Chinese market through these transactions it is necessary to hire a team of lawyer familiar with this framework able to suggest the right move, in fact without a disciplined acquisition process, it is easy to waste time, money and resources on chasing the wrong targets.

China has made evident progress to bring its merger control regime more in line with prevailing international standards; however its Anti-monopoly Bureau needs to gain more independence and anti-trust expertise. In fact, it must be noted that the discretionary powers of the authorities in charge of reviewing proposed concentrations has increased and this could impede the realization of an M&A transaction.

With positive economic outlook and with plenty of available targets and also with the introduction of the reforms auspicated by the World Bank, China will remain an attractive investment environment for a long time. However, a foreign investor that eagers to use these new instruments of investment must consider a series of variables: it is not only necessary to understand the legal framework regulating these transaction, but also necessary to find the correct target and to understand the cultural and investment environment, otherwise it is better to reconsider an investment only after it is possible to master all these elements.

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