JULY 2006

MERGERS AND ACQUISITIONS IN CHINA

Despite much anticipation and surrounding fanfare, cross-border M&A in China has yet to induce the same level of investment fever as foreign direct investment into the country. Although the number of transactions has significantly increased over the years, average deal sizes are reportedly still under $20 million, and the few larger transactions can be met with heavy scrutiny during the approval process. But legal factors that might have hindered companies from undertaking M&A activity in the past are being addressed by the Chinese government, and there is no doubt that cross-border M&A activity is poised to increase. In this article, we will provide an overview of the recent changes in M&A-related laws and regulations and some practical considerations when undertaking an M&A transaction in China.

FOREIGN INVESTMENT IN CHINA–THE BASICS

TYPES OF FOREIGN INVESTED ENTERPRISES. Direct foreign investment into the People's Republic of China ("PRC") is generally carried out through the establishment of a Sino-foreign joint venture (either an equity joint venture ("EJV") or a cooperative joint venture ("CJV")) or a wholly foreign-owned enterprise ("WFOE") (such vehicles are collectively referred to as "foreign investment enterprises," or "FIEs"). For more passive, indirect business activities (*e.g.,* liaison and marketing activities), foreign companies may establish representative offices in China.

In terms of the legal form, FIEs are almost always established as limited liability companies, although foreign invested joint stock companies are also permitted under PRC law. FIEs resemble Western-style corporations in many respects but also differ in certain fundamental areas, such as the following:

- Investors in an FIE limited liability company do not hold issued shares *per se*, but instead hold equity interest in the "registered capital" of the relevant FIE;
- Voting and decision-making authority in an FIE is generally vested in the board of directors rather than the investors;
- FIEs generally have a specified term (*e.g.,* 30 years) depending on the nature of the project, which term can be renewed under PRC law, although the

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conditions of any such renewal are not clearly specified in the law;
- Various matters, including the initial establishment of an FIE, transfer of a party's equity interest, increase of an FIE's registered capital, change of an FIE's business scope, and dissolution of an FIE, are subject to approval by the Chinese authorities; and
- FIEs must operate within an approved "scope of business," which tends to be relatively specific and, for manufacturing FIEs in particular, will limit sales activities to the sale of "self-manufactured" products.

TO JOINT-VENTURE OR NOT? In the past, WFOEs were limited to "technologically advanced enterprises" and "export-oriented enterprises." However, these restrictions have now been lifted, and the WFOE structure is being used with increasing frequency by foreign companies. Where cooperation with a Chinese company is required for statutory or strategic reasons, many foreign companies, particularly in the manufacturing sector, are opting for contract-based relationships, such as tolling and/or processing arrangements, rather than forming full-scale Sino-foreign joint ventures.

In weighing the joint venture versus WFOE model, there are no hard-and-fast rules as to which type of investment structure is preferable, and indeed, this strategic investment decision will typically depend on a number of variables, including:
- Restrictions under PRC law with respect to foreign investment in a particular industry;
- The priority the investor places on controlling technology, intellectual property, and the management of the FIE (with regard to intellectual property, some foreign companies take the view that the involvement of a Chinese partner in operations will increase the risk of potential leakage and infringement of intellectual property rights);
- The need for access to established sales and distribution channels;
- The need for a pretrained work force (the Chinese party may be able to supply the requisite personnel); and
- Availability of existing facilities and/or a particular site owned by a Chinese party (for example, if an existing site or factory will form the basis of a new FIE, it may be more cost-effective to form a joint venture with the Chinese party that will contribute the relevant assets).

With regard to the first item listed above, note that all FIE projects are subject to restrictions imposed by the Investment Regulations and the Investment Catalogue. Specifically, the Investment Regulations divide foreign investment projects into one of four categories: (1) Permitted, (2) Encouraged, (3) Restricted, or (4) Prohibited. Foreign investment projects under the latter three categories are expressly listed in the Investment Catalogue according to industry sectors. If an industry sector is not specifically listed, it is deemed to fall within the "Permitted" category. In certain strategic industries, the Investment Catalogue or other policy guidelines may limit foreign participation in FIEs to 50 percent or less of the registered capital. They may also specifically forbid WFOEs or may require investment in the form of either an EJV or a CJV.

M&A LEGISLATION

Since China unveiled its open-door policy in 1978, the Chinese government has made tremendous progress in putting legislation in place to govern private commercial activities, including a series of laws and implementing rules applicable to the different types of FIEs. It is only in recent years, however, that the Chinese government has promulgated legislation specific to M&A activities. Most notably in this regard, the Ministry of Commerce ("MOC"), the State Administration of Industry and Commerce ("SAIC"), the State Administration of Taxation, and the State Administration of Foreign Exchange issued the *Provisional Regulation on Foreign Investors Merging with or Acquiring Domestic Enterprises* (the "M&A Regulation") in 2003, which covers the following types of transactions:

(1) Purchases by foreign investors of shares or subscription to shares of "pure" (nonforeign invested) domestic companies;[1]

(2) Establishment of FIEs to acquire assets of domestic enterprises (the term "domestic enterprises," within the context of the M&A Regulation, would appear to include FIEs); and

1. Note that the M&A Regulation distinguishes between "domestic enterprises" and "domestic companies," with the latter defined to exclude FIEs.

(3) Purchases of assets of a domestic enterprise (again, including an FIE) for the establishment of an FIE on the basis of such assets.

The M&A Regulation represents an important development for China M&A and introduces a number of important breakthroughs (*e.g.*, the provisions permitting foreign investors to subscribe to the increased capital of a domestic company). However, comprising just 26 Articles, the M&A Regulation also has numerous ambiguities, many of which (including, in particular, with respect to the scope of application to asset transfers, the basis on which approvals will be granted with regard to the same and the practical impact of antitrust review procedures) may ultimately be addressed in implementing regulations that are rumored to be under draft.

The M&A Regulation sets out, among other items, the following requirements:

- The M&A Regulation requires the use of "internationally accepted methods" in asset appraisals and further prohibits the "covert outflow of capital overseas in the form of sale of assets at a price evidently lower than the valuation price."
- The selling company in an asset transaction must notify creditors of the proposed transfer and issue a public notice in a newspaper with provincial or nationwide circulation. Creditors are entitled to demand a guaranty from the selling company within 10 days.
- The M&A Regulation also requires the submission of an "employee settlement plan" (addressing retention and/or severance, as applicable) for the company from which the assets will be purchased.
- The M&A Regulation sets out a detailed list of documents that must be submitted to the "appropriate authorities for approval" in connection with an asset purchase. This list includes, among other things, the documents in respect of the aforementioned matters as well as the asset purchase contract, explanation of the condition of the selling company, and a report as may be required on antitrust matters. However, the M&A Regulation does not detail the basis or precise procedure on which approvals will be granted, although it is stipulated that such decisions must be made within 30 days unless an antitrust hearing is required (see below).

ASSET VS. SHARE DEALS

Even before the M&A Regulation was promulgated, foreign investors were active in various types of M&A activities in China. Indeed, an oft-used investment model for Sino-foreign joint ventures is for the foreign company to contribute cash and the Chinese partner to make "in-kind contributions" in the form of equipment, land, etc. Direct investment into a "pure" domestic company is another option, particularly with the M&A Regulation now in effect, with the relevant company then to be "converted" to an FIE if foreign investment accounts for 25 percent or more of the relevant registered capital.

As a general matter, conventional wisdom tends to favor asset deals over share deals as a means of insulating against liabilities of the target company. However, in China, as detailed below, there are a number of factors that may, depending on the relevant circumstances, weigh in favor of a share deal.

TYPE OF DEAL	PROS	CONS
Asset Purchase	• Purchaser avoids liabilities of the seller. • Purchaser can cherry-pick key assets. • Allows a "fresh start," particularly with regard to PRC tax holidays.	• Potential negative tax implications for the seller when seller is an FIE. • Different procedural requirements (*e.g.,* approvals, registrations, etc.) for transfers of different types of assets. • Potential requirement for severance payments to transferred employees. • The purchasing entity must be approved and obtain required operational licenses. • Ambiguity under current law as to impact of new M&A rules.
Equity Purchase	• Subject to government approval and registration, but no other transfer procedures required. • The operational licenses needed for the business should already be in place. • Typically, less burdensome from a tax perspective than an asset deal.	• Exposes purchaser to existing liabilities (corporate debts, pension/social welfare, noncompliance matters, etc.). • Where the target is an existing FIE, no "fresh start," particularly relevant in the context of tax holidays. • Where the target is non-FIE, the conversion to FIE status required may be just as time-consuming as establishing a new FIE. • May require more intensive due diligence and predeal restructuring.

Unsurprisingly, the potential tax implications tend to factor significantly into structuring decisions. In this respect, the tax issues involve potential transfer taxes as well as the availability of favorable tax treatment generally offered to FIEs. For example, under national PRC income tax laws and regulations, manufacturing FIEs with an operating term over 10 years are entitled to a two-year exemption and three-year half reduction of income tax, starting from the relevant FIE's first profit-making year. However, if the relevant FIE's actual period of operation falls short of 10 years (perhaps as a result of the sale of its operating assets), the FIE will be required to pay the previously exempted tax.

Regarding assets, consider that, generally, customs duties and a 17 percent import value-added tax ("VAT") are levied on imported goods and equipment. However, in an effort to encourage foreign investment, the Chinese authorities, over the past few years, have offered various preferential policies in respect of equipment imports by FIEs. One of the conditions of enjoying such preferential benefits is that the imported equipment will be subject to a five-year customs supervision period, during which time the equipment may not be transferred, sold, leased, mortgaged, etc., without customs' approval. In our experience, customs may not agree to requested transfers—as may be required in an asset deal—without payment of the previously exempted duty and VAT.

ADDITIONAL CONSIDERATIONS—LEGAL DUE DILIGENCE

In any M&A deal, it is advisable to confirm through legal due diligence the following (these would be in addition to financial due diligence and are by no means exhaustive of due diligence concerns):

- Legal establishment of the target company, including approvals of any increases in registered capital, transfers of shares/equity interest, etc.;

- Capital verification of all contributions to registered capital;
- Third-party rights over assets of the target company;
- Legal rights in respect of land and buildings;
- Environmental survey in respect of the relevant land;
- Tax status, including any preferential benefits enjoyed with respect to both income tax and imported equipment;
- Existence of any cooperation (technical or otherwise) and/or entrustment relationships that would prevent or hinder proposed transfers/investment;
- Status of intellectual property rights (*e.g.,* trademarks, patents, know-how, copyrights, software, enterprise names, domain names, licenses, etc.); and
- Identity of key employees whose continued participation in the relevant business would be of strategic importance.

In an asset deal, it is also important to confirm whether or not the seller will continue operations and, if so, to consider whether a noncompete agreement with the seller may be appropriate. If the seller will be dissolved, creditor rights and their potential clawback rights under PRC law must also be considered (*i.e.,* certain types of transfers made prior to the insolvency/bankruptcy of a company may be invalidated by creditors).

Other key considerations in structuring a China M&A deal include the following:

- **Use of Special-Purpose Investment Vehicles**—Transfers of equity in an FIE are subject to preemptive rights and consent of the other investor(s), as well as Chinese government approval and registration. This, coupled with the various other restrictions imposed on Chinese corporations, leads many foreign companies to invest in China via special-purpose vehicles ("SPVs") established in tax-efficient jurisdictions such as Hong Kong, Mauritius, Barbados, the Cayman Islands, etc. Shares in the SPV can then generally be transferred without triggering PRC consents and approvals.
- **Project Location and Availability of Preferential Benefits**—Since first introducing market reforms in the late 1970s, the Chinese government has consistently sought to spur economic development and encourage foreign investment by implementing preferential policies in targeted geographic areas. Its first efforts in this regard came with the 1980 designation of three relatively undeveloped areas in southern China as "Special Economic Zones" ("SEZs"). Within a short time, two more SEZs were added and 14 cities were designated as "Open Coastal Cities." Now, more than 25 years later, China's vast array of preferential zones includes the original five SEZs, along with numerous Economic and Technological Development Zones, high-technology development zones, bonded/free-trade areas, and other investment zones and industrial parks established by local municipal and county governments. The PRC government has also introduced preferential policies broadly aimed at encouraging investment in the western and central regions of the PRC.

ANTITRUST MATTERS

China is in the midst of transitioning its planned economy, which has traditionally been dominated by mammoth state-owned enterprises ("SOEs"), to a market economy (albeit one with "Chinese characteristics," as famously stated by Deng Xiaoping during the launch of China's market-opening efforts in the late 1970s) that includes private enterprises (increasingly, "privatized" SOEs) and FIEs. Bolstering this transition has been the gradual emergence of a body of commercial laws and regulations that today includes, among others, a Company Law, Contract Law, Consumer Rights Law, Product Quality Law, Anti-Unfair Competition Law, and Pricing Law.

With the above in mind and considering the steady growth of China's trade figures, it is not surprising that Chinese regulators are beginning to take steps to impose restrictions on what they view as harmful monopolistic activities. The Anti-Unfair Competition Law, with its scant 33 Articles, sets out very general provisions in this regard, while the March 2003 M&A Regulation expressly requires government review for certain M&A activities where certain "market share" hurdles are met. Tangentially related, antidumping legislation has also been promulgated in China, which has been involved in several high-profile disputes involving various WTO market access measures as well.

The Chinese government is also working to put in place the country's first national Anti-Monopoly Law. This much-anticipated law has already been through several rounds of drafting, with a draft only just recently released for public comment. The European Union Chamber of Commerce of China, the ABA Antitrust and International Law and Practice Sections, and Jones Day, among others, submitted detailed comments on the draft law to the PRC government. In terms

of the timing of the Anti-Monopoly Law, some believe that a more realistic timetable for adoption may be by the end of this year or 2007.

Notwithstanding this potential delay, some principles from the draft Anti-Monopoly Law are already being seen in domestic legislation, such as the Prohibition of Acts of Price Monopoly and the M&A Regulation. As detailed below, the M&A Regulation has introduced mandatory government review for certain transactions according to standards that vary depending on whether the deal is an onshore or off-shore transaction:

ONSHORE DEAL		
Scope/Nature of Deals	**Criteria for Antitrust Review**	**Government Review**
Purchases by foreign investors of shares or subscription to shares of "pure" (nonforeign invested) domestic companies;[2] Establishment of FIEs to acquire assets of domestic enterprises (the term "domestic enterprises" would, within the context of the M&A Regulation, appear to include FIEs); or Purchases of assets of a domestic enterprise (again, including an FIE) for the establishment of an FIE on the basis of such assets. Article 24 also provides that the M&A Regulation applies to equity transfer in FIEs with respect to matters not otherwise covered in the specific Provisions on Changes in Equity Interest of FIEs.	The volume of business of either party (in the case of the foreign party, including its affiliates) exceeds RMB 1.5 billion (approximately $181 million) during the year; The foreign party (and its affiliates) has acquired a total of over 10 enterprises in a related industry in China within a year; Either party (in the case of the foreign party, including its affiliates) already has a market share in China of 20%; The transaction will result in either party (in the case of the foreign party, including its affiliates) attaining a market share of 25% in China; or The MOC or SAIC concludes, at the request of a competing domestic business, or any other relevant organization or business association, that a report is necessary.	• If the specified conditions are met, the investors must report the proposed M&A transaction to the Chinese government or may otherwise be requested to report on the proposed transaction if the authorities take the view that "the merger and acquisition by foreign investor(s) will result in major market share held by foreign investor(s) or that there are major factors of significant impact on market competition or the national economy and the people's livelihood and national economic security."[3] • If the authorities view the proposed M&A deal as one that may "lead to excessive concentration of market share, which is detrimental to normal competition and consumers' rights and interests," they will convene a hearing and decide whether to approve or reject the application within 90 days of the receipt of the relevant documentation.

2. Note that the M&A Regulation distinguishes between "domestic enterprises" and "domestic companies," with the latter defined to exclude FIEs.

3. The relevant Article in the M&A Regulation expressly provides that other companies or industry associations in China may also initiate such requests.

OFFSHORE DEAL		
Scope / Nature of Deals	**Criteria for Antitrust Review**	**Government Review**
The M&A Regulation specifies its applicability if certain criteria are met "during the course of an overseas merger or acquisition." The term "overseas merger or acquisition" is not defined in the M&A Regulation.	Any offshore party holds assets in China of over RMB 3 billion (approximately $362 million); The volume of business in China of any offshore party is over RMB 1.5 billion ($181 million) for the year; An offshore party (and its affiliates) has reached a market share in China of 20%; The transaction will result in an offshore party (and its affiliates) attaining a market share of 25% in China; and As a result of the transaction, an offshore party will have direct and indirect ownership in over 15 FIEs in the relevant industry or area (Article 21).	• Where the statutory conditions are met, the parties to an offshore M&A transaction shall submit their plans to the Chinese authorities "prior to public announcement of the merger and acquisition plans or at the time of submission of such plans to the responsible authorities in the relevant country." • The Chinese authorities will then determine whether to approve or reject such plans based on whether or not the transaction will "lead to excessive concentration of market share, which is detrimental to normal competition and consumers' rights and interests in the domestic market." • The M&A Regulation does not specify a time frame for this determination or refer to any hearings with respect to the same.

Under the M&A Regulation, the parties may apply for exemption from antitrust examination if the transaction:

- Can improve conditions for fair competition in the market;
- Involves restructuring of an enterprise that has been losing money, ensuring employment;
- Introduces advanced technology and management personnel into China and promotes the competitive power of the enterprise involved; or
- Can improve environmental conditions.

The Chinese authorities have been sending mixed signals on the implementation of the requirements above, and indeed, the potential scope of the M&A Regulation has created significant controversy within the legal and commercial community in China. It is rumored that implementing rules will be issued this year in respect of the M&A Regulation, hopefully resulting in some greater clarity as to the scope and application of the regulation. In the meantime, the MOC has started to set up a department to review all antitrust or anticompetition and related matters.

M&A AND CHINA'S SOE SECTOR

Since the early to mid-1990s, the Chinese government has made concerted efforts to attract new investment for the benefit of the SOE sector and to consolidate various state-owned companies on a sector-by-sector basis.

Reform and privatization of SOEs have generally been dealt with legislatively on a piecemeal basis, although a more comprehensive regulation—the Tentative Administrative Measures for the Transfer of State-Owned Property Rights ("SOE Transfer Measures")—was effective as of February 1, 2004.

The SOE Transfer Measures touch upon various issues relevant to any deal involving SOE assets, including mandatory appraisal requirements and restrictions on transferring SOE assets at less than 90 percent of the appraised value absent special government approval.

In an attempt to enhance transparency, the SOE Transfer Measures also seek to impose certain new procedural requirements. For example, the SOE Transfer Measures specify that all SOE M&A must now be conducted through a government-approved "exchange" regardless of the location, industry sector,[4] or ownership. Only after all required procedures are followed with the exchange will a certificate to that effect be issued. The certificate is also a condition for registering the SOE M&A with the registration authority. In addition, all SOE M&A must be publicly disclosed in a financial newspaper or web site for 20 days in sufficient detail (such as the SOE's asset composition and valuation, internal decision making and approval, financial data) so as to solicit interested third parties. If more than one potential suitor exists, then the final purchaser must be selected through auction or public tender from them.

The SOE Transfer Measures also provide certain rights to employee representative groups that could, depending on the precise nature of any given deal, require labor's sign-off on potential labor-related changes as a precondition to effecting the transaction.

THE ROAD AHEAD

China continues to enjoy robust growth, with official figures citing an increase of China's GDP by approximately 10 percent for the last three years and hailing China as the world leader in utilized foreign investment since 2002. More and more foreign investors are looking at potential M&A opportunities in China. However, as discussed earlier, acquisition of Chinese companies and assets is a relatively recent development, and related rules and implementation regulations are in the process of development or subject to further clarification. In addition, the increasing political pressure in China to review sizable acquisitions of Chinese companies by foreign investors invokes caution and may add additional difficulties to the already complicated acquisition process. However, the opening of the M&A floodgate in China is irrevocable, and new ground will continue to be broken as multinationals continue to adapt to the local M&A market.

APPENDIX: MAJOR REGULATIONS ON FIE M&A IN CHINA

1. *Provisions on Changes in Equity Interest of FIEs* (Issued by the Ministry of Foreign Trade and Economic Cooperation and the State Administration of Industry and Commerce in May 1997).
2. *Provisional Regulation on Foreign Investors Merging with or Acquiring Domestic Enterprises* (Issued by the Ministry of Foreign Trade and Economic Cooperation, the State Administration of Taxation, the State Administration of Industry and Commerce, and the State Administration of Foreign Exchange in March 2003) ("M&A Regulation").
3. *The Law of the People's Republic of China on the Protection of the Rights and Interests of Consumers,* adopted by the 4th Session of the Standing Committee of the Eighth National People's Congress on October 31, 1993 (the "Consumer Rights Law").
4. *The Contract Law of the People's Republic of China,* adopted at the 2nd Session of the Ninth National People's Congress on March 15, 1999 (the "Contract Law").
5. *The Product Quality Law of the People's Republic of China,* adopted by the Standing Committee of the National People's Congress on February 22, 1993, and revised on July 8, 2000 (the "Product Quality Law").
6. *The Law of the People's Republic of China Against Unfair Competition*, adopted by the Standing Committee of the National People's Congress on September 2, 1993 (the "Anti-Unfair Competition Law").

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4. Article 2 (note that the financial sector and China stock exchange–listed companies are not covered by the SOE Transfer Measures).

7. *Tentative Administrative Measures for the Transfer of State-Owned Property Rights*, issued by the State-Owned Assets Supervision and Administration Commission of the State Counsel and the Ministry of Finance on December 31, 2003, and effective on February 1, 2004 (the “SOE Transfer Measures”).

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