



# Private Equity

in 32 jurisdictions worldwide

Contributing editor: Casey Cogut

# 2013



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# China

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## 1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

In practice, there are various types of private equity transactions that occur in the People's Republic of China (China or the PRC), such as leveraged buyouts, venture capital, mezzanine capital and growth capital transactions, angel investments and private investment in public equity (commonly referred to as PIPE).

In China, there are also two special types of funds that could be called a form of private equity fund – the industry investment fund (IIF) and the start-up investment fund (SIF). IIFs and SIFs are similar to most private equity funds in the sense that they can only purchase shares in non-listed companies. They are the forms of private equity fund referred to in Chinese legislation. IIFs are usually funded by certain institutional investors who are state-owned or state-controlled enterprises. For example, the Bohai Industry Investment Fund is jointly sponsored by the National Social Security Fund, China Development Bank, Postal Savings Bank of China and five other state-owned enterprises. Some IIFs are also funded by large Chinese commercial banks, private insurance companies and security companies.

The central government opened the door for foreign investors to set up SIFs through the Provisions Concerning the Administration of Foreign-funded Start-up Investment Enterprises, effective from 1 March 2003, and later published the Interim Measures of the Management of Start-up Investment Fund for the Start-up Investment Projects in the Emerging Industry on 17 August 2011 so as to facilitate the development of the emerging industry. However, while the central government has allowed for foreign participation, some restrictions still exist. For instance, SIFs in emerging industries must be funded by the government and social capital.

While leveraged buyout funds may play an important role in the global private equity transactions market, they do not currently play a major role in China, as the majority shareholders of Chinese enterprises, whether state or privately owned, are generally reluctant to give up their position as majority shareholders.

Currently, the most commonly used structure is the Foreign-Invested Limited Partnership (FILP), which was introduced in 2010, and is particularly beneficial to foreign investment firms looking to establish RMB funds.

Chinese and foreign (enterprise and individual) investors may both participate in the FILP. The operation of a FILP is largely provided for in the partnership agreement, although it is subject to certain corporate governance structures provided for in the Partnership Enterprise Law (2006). A FILP may be registered directly with the State Administration for Industry and Commerce (SAIC) and is not required to be established with the approval of the Ministry of Commerce (MOC). A FILP is still subject to the foreign investment restrictions provided in the Guidance Catalogue for Foreign Investment

(2011 Amended version) (GCFI), which is explained in further detail in question 17.

In January 2011, Shanghai introduced the Qualified Foreign Limited Partner Programme (QFLP), which allows a qualifying foreign fund manager to establish a 'foreign-invested equity enterprise' (FIE PE Fund) which is subject to a less onerous local approval process. The FIE PE Fund may be treated as a 'domestic' fund subject to the following requirements:

- it should be denominated in RMB; and
- all cash investment should be raised from Chinese investors in RMB (the qualifying funds manager may convert up to 5 per cent of the capital contribution from non-RMB currency into RMB to invest in the FIE PE Fund).

## 2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

The China Securities Regulatory Commission (CSRC) has the right to check and supervise the corporate governance of securities investment companies. The shares of a public company may be transferred upon the satisfaction of certain conditions and submitting the report to the CSRC and the Stock Exchange. For instance, the initiator shall not transfer his, her or its shares within one year as of the day of establishment of the company. The shares issued before the public stocks issue shall not be transferred within one year from the date of listing. The director, supervisor and senior managers shall declare to the company the shares held by them and the changes thereof. During the term of office, the shares transferred by any of them each year shall not exceed 25 per cent of the total shares of the company he or she holds. The shares of the company held by the aforesaid persons shall not be transferred within one year from the date of listing according to the Company Law of the People's Republic of China (the Company Law).

The financing strength of the leveraged buyout in private equity transactions is realised through its innate ability to generate capital through small funds. Most of the acquisition funds are sourced from loans and bonds, thereby keeping the demand for large amounts of cash limited. As opposed to traditional acquisition transactions, the acquirer in a leveraged buyout will focus on the integration of resources which may maximise the efficiency of the management and the grass-roots staff in order to recover the debts. Moreover, the acquirer can start cross-sectoral operations within a relative short period of time through leveraged buyout in consideration of transaction fees and interests.

Private equity transactions are often conducted with the view to eventually turn a listed company private. This is because once a company is no longer public, it no longer has to deal with the onerous

obligations imposed on it, including (but not limited to) the obligations in relation to disclosure (for example, a listed company must publish its financial information and major operational information under article 166 of the Company Law).

Companies that become or remain a publicly listed company following a private equity transaction are subject to the Rules of Corporate Governance of Listed Companies (the Rules), which applies to all listed companies in China. According to the Rules, the business of a public company shall be independent from that of its controlling shareholder. A controlling shareholder of a public company and its subsidiaries may not engage in the same or similar business with such public company. Such shareholder shall refrain from competition with the public company, and the public company may not provide guarantee for its shareholders or affiliated parties.

### 3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What procedural safeguards (eg, special committees of independent directors), if any, do public companies use when considering transactions? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

In China, as in most parts of the world, the board of directors of a public company is a key part of the company's management.

Before the completion of the acquisition, the board of directors is not permitted to dispose of assets of the company, make an investment, provide any others with a guarantee or make loans without approval at the shareholders' meeting, except for those required for the continuous operation of the business or execution of the resolution by the shareholders' meeting. Furthermore, a director may not resign from his or her position during the period of acquisition. Where the controlling shareholders of a public company and its affiliated parties are in debt to the company, encumbered with the security provided by the company or in any other ways to damage the interests of the company, the board of directors shall disclose as such and take action to protect the interests of the company.

The Rules of Corporate Governance for Listed Companies (the Rules) provides that the board of directors may, subject to the resolution by the shareholders' meeting, set up special committees for strategy, audit, nomination, remuneration and performance review and so on. However, there are no provisions in the Rules on the roles of a special committee for a transaction where the directors participate or have interests in the transaction. The company may set up a special committee for such a kind of transaction and lay down the responsibilities of this committee based on its needs according to the approval by the shareholders' meeting.

The Company Law places restrictions on a board of directors' ratification of 'vested-interest' transactions. Directors (or the board of directors as a whole) who have personal interests in the transaction cannot ratify such transactions, nor can they represent other directors (in relation to the other directors' voting rights) on such transactions, and the vested-interest transactions can be resolved only with the majority consent of the other directors without personal interests therein (article 125 of the Company Law). With regard to acquiring a public company in China, an independent qualified auditor must be hired according to Chinese regulations on the acquisition of a public company (articles 49 to 51 of the Rules of Corporate Governance of Public Companies), as such transactions are closely related to the immediate interests of the shareholders of the target company and the board of directors of the target company might damage the interests of the shareholders for their own personal gains (a point elucidated further in question 7). The CSRC and the MOC must give their initial approvals to the acquisition and are able to closely

supervise the acquisition process (article 10 of the Measures for the Administration of the Takeover of Listed Companies).

Furthermore, the Notice On The Issuance Of The Rules For Listing Of Stocks On The Shanghai Stock Exchange stipulates that when a board of directors is considering a related party transaction, the related director shall withdraw from voting and shall not exercise any voting rights as a proxy of other directors (article 10.2.1). If a related party transaction is being considered by the shareholders' general meeting, the related shareholders are required to withdraw from voting (article 10.2.2).

Going private, of course, brings fundamental changes to a company. In China, being public not only brings financial power from the public stock market, but is also a symbol of a company's reputation and credibility, especially when viewed in light of the lengthy and selective process that Chinese companies need to complete to go public in the first place. Thus, until now, most of the public companies in China have been reluctant to be privatised.

### 4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Measures for the Administration of the Takeover of Listed Companies (the Measures for Takeover of Listed Companies), issued by the CSRC and revised on 14 February 2012, established heightened disclosure requirements regarding mergers and acquisitions of public companies. In China, disclosure requirements differ, depending on the ratio of shares being purchased in the target company.

If the investor or other individuals or companies acting in concert obtain between 5 per cent and 20 per cent (inclusive) of the total shares issued by the target company through a stock exchange purchase or share transfer, the acquiring parties only need to submit a share change report to both the CSRC and the relevant Chinese stock exchange (there are two in China, the Shanghai Stock Exchange and the Shenzhen Stock Exchange) within three days upon transfer of the shares (article 16 of the Measures for Mergers and Acquisitions). The report must also be published in the relevant stock exchange's bulletin. This report must include the name and domicile of each acquiring party (namely, the investor), the purpose of the acquisition, the investor's intention in relation to its newly-purchased shares for the coming 12 months and the name, types, volume and ratio of the newly-purchased shares of the target company (public company) as well as the date and method of the shares' ownership (article 16 of the Measures for Mergers and Acquisitions).

If the acquired share ratio is between 20 per cent and 30 per cent (inclusive) of the total shares issued by the target company, a more detailed share change report must be submitted by the acquiring party. Besides the information mentioned above, the report must include details on the share structure of the acquiring company, the price of the purchased shares, the amount of the required capital of the acquiring party that was used in the transaction and a list of the transactions between the acquiring party and the target public company in the past 24 months (article 17 of the Measures for Mergers and Acquisitions). The report should also state whether this is a vested-interest transaction.

If the acquiring party obtains more than 30 per cent of the shares of the target company through a stock exchange purchase, and it still wishes to increase its shareholdings in the target public company, it is legally required to make a tender offer to the target company (article 24 of the Measures for Mergers and Acquisitions). Such a tender offer and any changes thereafter must be submitted to the CSRC and Stock Exchange and disclosed to the public.

Except for the disclosure of the change in equity of the public company, the board of directors, actual controller and the shareholder controlled by such actual controller, shall assume the obligations of disclosure during the going-private transaction or private equity transaction.



In the event that after such transactions the equity structure of the target company does not fulfil the relevant requirements on public companies, the stock exchange will issue a notice to the public regarding the stock transactions of the target public company,

which is also called the ‘exit stock market caution’ (article 13.2.1 of the Rules Governing the Listing Stock on Shanghai Stock Exchange). This notice is to remind the public that the listed company may go private due to either a private equity transaction or through a failure to fulfil the relevant official requirements.

## 5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Actual time considerations vary from case to case. Under Chinese laws and regulations, the following rules apply where the acquiring party (a private or public company) acquires more than 30 per cent of the shares of a public company:

The Measures for Mergers and Acquisitions provides that, unless there are other competitive tender offers, the acquisition period in the tender offer shall be 30 to 60 days (inclusive), and the acquirer shall not change the tender offer 15 days before the expiry of such offer. In the event of the occurrence of competitive tender offer, the initial acquirer may extend the period in its offer.

Where a foreign acquirer wishes to acquire the equity of a public company in China for medium to long term strategic investment, such equity transactions must be approved by the MOC. In general, such kind of transaction shall be completed within 180 days after the issuance of approval by the MOC (article 16 of the Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies).

Where the target company has become private due to the private equity transaction, it shall delist from the stock exchange and register the change of legal form of the company with the relevant Administration for Industry and Commerce (the Chinese business registry) within 30 days upon its receipt of approval from the relevant bureau of commerce.

## 6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

Below is a list of the main clauses that are either specific to, or should be contained in, purchase agreements that deal with Chinese private equity transactions.

### Prerequisites

The first and most important prerequisite is the consent obtained at the shareholders’ meetings of both the acquirer (if a company) and the target company (articles 72 and 104 of the Company Law).

### Representations and warranties

Representations and warranties need to be included regarding the effective completion of the complex administrative procedures that must be completed through various Chinese authorities for private equity transactions, especially if the target company is a public company or a state-owned public company. Obviously, these administrative approvals will sometimes affect the validity of the purchase agreement (for example, in China the equity purchase agreement, while signed, officially becomes effective only after the required administrative approval from the MOC or its competent local counterparts is obtained). Further, warranties need to be included confirming the validity of the transaction in light of any agreements between the main parties and third parties.

### Evaluation of equity

This is equivalent to the price term of a common purchase agreement. In common cases, the acquirer and the target company can negotiate with each other the purchase price of the equity. However, if the acquirer is a foreign company and the target is a Chinese company, the value of the equity under the purchase agreement shall be evaluated and approved by a qualified third-party evaluation agency. If a state-owned enterprise is to be acquired, the equity value shall be evaluated by one of the specific state-owned asset evaluation agencies accredited by the China State-owned Assets Supervision and Administration Commission of the State Council (article 13 of the Interim Measures for the Management of the Transfer of State-owned Property). The asset evaluation report will be utilised as the basis in determining the reasonable purchase consideration by the approval authority, to avoid the domestic or state-owned assets being undervalued.

### Management and profit distribution

After the transaction, if the acquirer is a foreign entity and obtains all of the shares in the target company, the target company will become a wholly foreign-owned enterprise (commonly referred to as a WFOE), which is still a separate Chinese legal entity under the Chinese Company Law. However, if the acquirer obtains only part of the shares of the target company, the target company will become an equity joint-venture company. Such classification affects the distribution of profits and the corporate structure of the new entity and thus should be taken into account in the purchase agreement. The management rights and profit distribution shall be decided in accordance with the shareholding amount each party owns in the company after the transaction. The CGFI may periodically influence the choice of target companies and the shareholding level by the foreign private equity purchaser.

### Employment

Mergers and acquisitions of a company will not influence the current employment relationship between the acquired company and its employees. If the new shareholder wishes to terminate the employment relationship with the employees, severance pay shall be given in accordance with the related labour laws and regulations (articles 47 and 87 of the Employment Contract Law of the PRC). Employment issues, especially the compensation of senior managers of the target company or the compensation to settle the laid-off employees in a state-owned enterprise, are important issues to be addressed in the purchase agreement and may sometimes influence the costs of the entire transaction.

### Financing

Successful financing plays an important role in deciding the success of the transaction. The acquirer is usually required to have a good credit history and financial reputation in a purchase agreement.

### Penalty clause

In most cases, the acquirer may seek a break-up fee from the target company if the transaction is terminated owing to the default of or abandonment of the deal by the target company. It is regarded as a kind of guarantee in the event that the target company reneges on its acceptance after it has already accepted the offer. Reverse break-up fees require the acquirer to pay a fee to the target company (or seller) if the deal fails to conclude because of any breach of contract by the acquirer.

### Limitation on remedies for breach

In China, the general function of civil remedies is to compensate losses (including direct losses and indirect losses) rather than inflict punitive damages. According to articles 113 and 114 of the Contract Law of the PRC, the amount of the compensation shall not exceed

the amount that the breaching party can foresee or should foresee when signing the agreement (this foreseeable amount shall be decided by the people's court if there is dispute between two parties). Where the amount of compensation stipulated in the agreement is lower or higher than the actual losses suffered by the other party, an application can be filed with the relevant court or arbitration tribunal to adjust the amount of compensation to reflect the actual losses. However, the court or tribunal will not entertain such application unless the difference is considerable.

#### 7 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations of when a private equity sponsor should discuss management participation following the completion of a going-private transaction?

Going private is regarded as a crucial decision for public companies. In practice, such a resolution is submitted through the management and presented at the shareholder meeting, and under the current corporate governance stipulations, the management gets involved in the private equity transaction from the very beginning.

The management of the target company can be given the rights to purchase the equity, options and restricted stocks of the target company, or can be offered a golden parachute (which refers to high compensation payouts given to the current management of the target company to get them to leave after the transaction). These dispositions aim at encouraging the management to get involved in the transaction, and to ensure that senior managers will protect the interests of the target company – as well as their own interests. However, the management may also persuade the shareholders to accept unfavourable transactions owing to protecting their own interests (see question 3).

To prevent the management of the target company from damaging the overall interests of the target company and its shareholders during a transaction, the Measures for the Administration of Mergers and Acquisitions provides that the board of directors of the target company must complete a due diligence report on the qualifications, credit, reputation and intentions of the acquirer, and carry out an in-depth analysis and give suggestions to the shareholders as to the terms and conditions of the tender offer rendered by the acquirer. Moreover, the board of directors of the target company shall appoint an independent financial consultant to advise on the going-private transaction (article 32 of the Measures for Mergers and Acquisitions). An important consideration for the buyer is how the parties aim to deal with potential conflicts between the company founder's interests and his influence over the management. The target company typically requires certainty that if the founder decides, after signing the agreement, that he or she no longer wishes to proceed, he or she would not exert influence as head of the company to impede the transaction.

The public company shall determine the remuneration and incentive payments of the executives based on the performance appraisal prepared by the board of directors or the remuneration and performance review commission on the executives. The remuneration and performance review commission might be staffed by the directors, where independent directors shall constitute a majority. The remuneration and incentive payments of the executives shall be approved by the board of directors, presented to the shareholders' meeting and disclosed to the public.

#### 8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

Stamp duty shall be charged to both contracting parties at a rate of 0.05% of the consideration for the transfer of shares. The shareholders of the target company (both individual and corporate) shall also be subject to income tax, whether individual (article 2 of the Individual Income Tax Law) or enterprise (article 3 of the Enterprise Income Law), based on the income obtained from the transaction; however none of the parties shall pay any business tax (article 1 and 2 of the Circular Caishui (2002) No. 191).

Under Chinese tax law, share acquisition is more tax-effective than assets acquisition. For example, when purchasing tangible assets, value added tax (VAT) shall apply to the purchasing party according to the tax rate applicable to each type of assets (article 1 of the Interim Regulations of the PRC on VAT). When transferring the ownership of real estate or intangible assets, the target company shall be subject to a 5 per cent business tax (article 1 and the Schedule of the Interim Regulations of the PRC on Business Tax) and the purchasing party shall be subject to 3 per cent to 5 per cent deed tax if the assets involve land-use rights or property titles (articles 1 and 3 of the Interim Regulations of the PRC on Deed Tax).

The payment method further influences the tax payable in a private equity transaction. In the event that the acquirer pays by cash, the cash received by the shareholder of the target company shall be subject to income tax. If the acquirer pays with unconvertible bonds, the interest earned on the bonds received by the shareholder shall also be subject to income tax, but the interest paid by the acquirer shall be deducted prior to taxation. If the acquirer pays with convertible bonds, the acquirer can defer the process of converting the bonds to shares. By doing so, the interest paid by the acquirer shall be deducted from the taxable amount and the tax on capital gains from the conversion shall be deferred, too, which is beneficial to the acquirer.

Furthermore, if the private equity transaction was carried out through the swapping of shares, it shall be exempted from income tax, as no actual monetary income was earned as a result of the transaction.

Finally, some preferential tax policies apply regarding the level of employees retained after the transaction. For example, according to article 5 of the Notice of the Ministry of Finance and the State Administration of Taxation on Deed Tax Policies Concerning Reorganization and Restructuring of Enterprises and Public Institutions (issued on 12 January 2012), if the acquiring party or parties can keep more than 30 per cent of the employees of the target company and enter into labour contracts with a term of more than three years with these employees, the deed tax involved in any transfer of land-use rights and property title in relation to the transaction shall be halved. If the acquiring party or parties can keep all the employees and enter into labour contracts with a term of more than three years with these employees, deed tax related to the transaction shall not apply.

According to article 1 of the Issues on the Payment of Individual Income Tax regarding Compensation promulgated by the Finance Ministry and Tax Bureau on 10 September 2001, where the amount of the compensation paid to the executives of the target company such as the general manager and other senior management staff (the executives) does not exceed three times the local average salary where the target company is located in the latest year (the average salary), the executives do not need to pay individual income tax. In the event that the amount of compensation (on its own) exceeds the average salary for the related year, the executives shall pay individual income tax on the basis of the exceeding part. This amount will not be added

on to the existing income of the executive but instead will be taxed separately as if it were a separate stream of income.

### 9 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

There are no accounting principles applicable specifically to private equity transactions in China. The Accounting Standard for Business Enterprises No. 2 – Long-term Equity Investment, and the Accounting Standard for Business Enterprises No. 20 – Business Combinations, shall apply to a private equity transaction.

For a business combination involving enterprises under common control (where the acquiring party and the target company are controlled by the same controlling company), the initial investment cost of the long-term equity investment shall be the value of the equity at the date of combination. The difference between the purchase price and the initial investment cost shall be adjusted to capital reserve.

For a business combination not involving enterprises under common control, the initial investment cost of the long-term equity investment shall be the fair values of the assets given, liabilities incurred or assumed and equity securities issued by the acquirer at the acquisition date.

If the cost of the long-term investment exceeds the acquirer's interest in the fair value of the acquirer's identifiable net assets, the difference shall be recognised as goodwill. If the cost of the long-term investment is less than the acquirer's interest in the fair value of the acquirer's identifiable net assets, the acquirer shall recognise the difference in profit and loss for the current period (article 3 of the Accounting Standard for Business Enterprises No. 2 – Long-term Equity Investment).

The initial investment cost in a long-term equity investment acquired other than through a business combination shall be determined as follows (article 4 of the Accounting Standard for Business Enterprises No. 2 – Long-term Equity Investment):

- where a long-term equity investment is acquired by paying cash, the initial investment cost shall be the actual purchase price paid;
- where a long-term equity investment is acquired by the issue of equity securities, the initial investment cost shall be the fair value of the securities issued;
- where a long-term equity investment is contributed by an investor, the initial investment cost shall be the value stipulated in the investment contract or agreement, unless the value stipulated in the contract or agreement is not fair;
- where a long-term equity investment is acquired through an exchange of non-monetary assets, the initial investment cost shall be determined in accordance with the Accounting Standard for Business Enterprises No. 7 – Exchange of Non-Monetary Assets;
- where a long-term equity investment is acquired through a debt restructuring transaction, the initial investment cost shall be determined in accordance with the Accounting Standard for Business Enterprises No. 12 – Debt Restructurings;
- the long-term equity investments shall be accounted for using the cost method if the investing enterprise exercises full control over the target company, the investing enterprise does not have joint control or significant influence over the target company or the investment is not quoted in an active market and its fair value cannot be reliably measured; and
- where an investing enterprise exercises joint control or a significant influence over the target company, a long-term equity investment shall be accounted for using the equity method (article 8 of the Accounting Standard for Business Enterprises No. 2 – Long-term Equity Investment).

### 10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? What issues are raised by existing indebtedness at a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

In China, the LBO process has not been commonly accepted in acquisition practices, owing largely to the lack of regulations and a mature capital market as well as the control issues noted in question 1. In addition, the traditional main source of capital in China is commercial banks. However, under the current banking laws and regulations, the Chinese commercial banks are reluctant to lend money to companies that are unable to offer any guarantee, even if there is the prospect of high returns on the investment. Moreover, according to the statistics from China People's Bank, small to medium enterprises (SMEs) generally receive less than 5 per cent of the loans granted to companies by commercial banks. The social insurance and securities investment funds in China are under strict supervision and can only invest in certain IIFs and SIFs accredited by the National Development and Reform Council and are thus not available for LBO financing purposes.

In practice, some large companies and enterprises do lend each other money, but under the current financial laws, financing between two commercial companies is also restricted (article 61 of the General Rules on Loans) unless this is achieved in other ways, for example, through an entrustment loan arrangement involving qualified financial institutions, as only legally recognised financial institutions such as banks are able to lend money.

The existing indebtedness of the target company may bring about a significant impact on the evaluation of the equity in a private equity transaction. The acquirer must determine the existing indebtedness of the target company, including but not limited to all securities provided to any third party by the target company, all contractual obligations assumed by the target company under the contract with a third party, taxes and charges levied by the governmental authorities, and liabilities and responsibilities borne by the target company subject to the verdict or award made by the court or arbitration organisation. The acquirer must estimate the value of the equity based on the status of the indebtedness. Any assets encumbered with a mortgage or other form of security may depreciate in value. The accounts receivable and accounts payable can present a clear financial status to the potential acquirer. The target company may be subject to tax payment, penalty or even criminal charges in the occurrence of tax fraud, tax arrears or tax evasion.

According to articles 18 and 19 of the Guidelines on Risk Management of Loans Extended by Commercial Banks for Mergers and Acquisitions issued by the China Banking Regulatory Commission (CBRC) on 6 December 2008, it is legal for qualified commercial banks to offer loans for acquisition projects, but the term of the loan shall be five years or less, and the loan shall not be over 50 per cent of the total value of the acquiring transaction. As LBOs in acquisitions are still a new idea to Chinese commercial banks, most of them are still very cautious and still accept the detailed implementation rules prescribed by the Chinese authorities.

Article 9 of The Core Indicators for the Risk Management of Commercial Bank (Trail Implementation) effective on 1 Jan 2006, provides that the credit line granted to a group by a commercial bank may not exceed 15 per cent of the net capital of such bank, and the total loan to a single company in a group may not exceed 10 per cent of the net capital of such bank.

The Chinese government is also cautious about acquisition transactions in China. There are various reasons for this (including a perceived lack of experience, talent and legal support), but the most important relates to the wish to prevent state-owned assets from being dissipated during the acquisitions, as many target companies are state-owned enterprises that play an important role in China's



economy. For example, China Stegy Investment Co (Hong Kong) acquired 196 Chinese enterprises in 1992 and 1993, and most of the target companies were state-owned enterprises. This large-scale buyout activity attracted the attention of the Chinese government and made it reconsider the use of foreign investment in LBOs, especially given that there is a lack of regulations.

Apart from the above, structuring a private equity transaction is restricted due to the difficulty of leveraging equity with debt in China. There are stringent foreign exchange controls imposed by the Chinese government regarding the foreign guarantee and loan provided by the foreign enterprises. Debt finance in China lacks flexibility; this is attributable to the inadequate funds supplied from the Chinese domestic capital market and loans available from the qualified financial institutions, in combination with the unsatisfactory coordination of the central government's policies and the inconsistent local practice of implementing these policies by different local authorities.

### 11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

The LBO market is closely related to the subordinated debt market, especially the high yield bond market. As discussed in question 10, the Chinese capital market is not as mature as that of western countries yet, thus debt or equity-financing (especially in going-private transactions) is not popular. In addition, being public in China is, as mentioned in question 3, very highly regarded and therefore public companies are usually very reluctant to go private.

### 12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

In accordance with the Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies (issued collectively by the MOC, the CSRC, the State Administration of Taxation, the State Administration of Industry and Commerce and the State Administration of Foreign Exchange on 31 December 2005), there are strict requirements as to the qualifications of the acquiring party (capital levels, corporate governance, credit, etc), which aim to lessen the risk of the transaction. Apart from these requirements, the resolution shall be ratified by the board of directors and shareholders of the target company (article 105 of the Company Law) according to the Company Law and the target company's articles of association. Further, elements of the transaction, including but not limited to the transaction plan, the share transfer agreement and the qualifications of the acquirer, shall be firstly reviewed and approved by the MOC and the CSRC. This strict scrutiny prevents, to some extent, fraudulent conveyance. Further, the acquirer often conducts due diligence investigation on the target company and requires the target company to provide consent letters issued by the creditors of the target company to indicate the creditors' consent of the transactions to be carried out, which may mitigate the risk of fraudulent conveyance or other bankruptcy issues by the target company.

The Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies also impose requirements as to the creditability and financial status of the acquiring party to assess the likelihood of the investor going bankrupt at the time of and after the acquisition. One of the utmost criteria for a qualified acquiring party is that it must be validly established and a legally operated foreign entity with sound financial status, good creditworthiness and a mature management system. The balance sheet of an acquiring party for the preceding three years issued by a certified auditor is required to be submitted for approval as one of the application documents regarding the acquisition (articles 6 and 12 of the Measures for the

Administration of Strategic Investments by Foreign Investors in Public Companies).

The investor is allowed to exit on account of bankruptcy, among other reasons, subject to approval from the MOC. Article 21 of the aforesaid Measures sets forth that before the expiry of the term during which the investor has warranted to hold the shares of the listed company, such investor may transfer out its shares, after being approved by the MOC, by reason of bankruptcy and liquidation, etc.

### 13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms? Are there any statutory or other legal protections for minority shareholders?

One important exit mechanism for private equity sponsors (whether singular or multiple) is the share transfer. In order to ensure that a public company can operate smoothly at the beginning stage of privatisation and to prevent the shareholders from engaging in illegal speculation of the securities, the Company Law provides that shares held by the initiators, directors, supervisors and senior management shall not be transferred within one year of the date the shares go public (article 142 of the Company Law). Transfers of equity in an onshore joint venture are subject to a statutory consent right and right of first refusal by all other members.

Most of the minority shareholders do not have directors representing their benefits, owing to their small shareholdings. In practice, majority shareholders have had the final say on major decisions, even if some decisions may be disadvantageous to minority shareholders. In view of this, minority shareholders must pay special attention to the following issues while compiling the shareholders' agreement: accessibility to the accounting books; financial reports and operational documents; voting rules for the selection of directors and supervisors; voting rights of the shareholders; exit strategy and resolution of a deadlock. Under the Company Law, the minority shareholders of a limited liability company are entitled to apply to a court to compel the company to repurchase their shares if they object to certain major resolutions (article 75 of the Company Law). This is because they cannot technically prevent a resolution from being ratified by the board of directors of the company. Such laws should, for the sake of clarity, be included in shareholders' agreements.

### 14 Acquisitions of controlling stakes

Are there any requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

Private funds often face difficulties in obtaining control in a target company in China. One reason for this is that the CGFI considers many industries 'strategic' and therefore foreign investment is restricted, or prohibited. Across all sectors a typical Chinese private-equity investment in an operating company is a non-controlling stake of approximately 15 to 40 per cent. This is usually intended to be used as growth capital.

Article 88 of Securities Law of the People's Republic of China (revised in 2005) and article 24 of the Decision on Amending Article 63 of the Measures for the Administration of the Takeover of Listed Companies (2012) provide that when an investor holds, or holds with any other person, 30 per cent of the stocks as issued by a listed company, and wishes to further increase this percentage, the investor is required to issue a tender offer to all shareholders of the target company to purchase all or part of the target company's shares. The investor is not permitted to revoke the offer during the term of the offer. The Measures for the Administration of the Takeover of Listed Companies provides for several requirements for acquiring a listed company including, inter alia, that any takeover may not damage state security or social public interests (article 4); the purchaser is required to hire a professional institution that is registered in China



and is qualified as a financial consultant (article 9); and once the acquisition of the target company is concluded, the purchaser may not transfer the stocks of the target company within 12 months after the acquisition is concluded (article 74). A further challenge for private funds looking to acquire a controlling stake of either a private or state-owned company is that the Chinese government and the entrepreneur respectively, are usually very reluctant to give up control over their company.

There are currently no capitalisation requirements on the acquirer; however, according to article 6 of the Measures for the Administration of the Takeover of Listed Companies (2012) and article 147 of the Company Law, a natural person or a company owing a substantial amount of debt cannot take over a listed company.

### 15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a buyer? Does the answer change if a private equity firm sells a portfolio company to another private equity firm?

When a private equity firm sells its stake in a portfolio company by way of conducting an IPO, this is known as a secondary sale. Whereas countries in the West and more mature markets have significant experience in conducting IPOs, this is still relatively new in China and is not very flexible. The IPO is the most profitable exit strategy for PE firms, however, it presents many challenges due to the strict access requirements. In November 2010, the Beijing Financial Assets Exchange published the Private Equity Trading Rules of Beijing Financial Assets Exchange (PETR) that officially introduced the private equity secondary sale market in China. This secondary market aims to provide private fund firms with services including fundraising, financing, transfer of equity and fund-portfolio, and exit investment. The implementation of this secondary market has eased some of the challenges faced when conducting an IPO.

PE funds often face difficulties in conducting a public offer in the Main Board Market (MBM) due to the strict access requirements. As private funds tend to invest in high-technology and other promising innovative enterprises, the success ratio in order to access the MBM is usually too low and the cost too high. Therefore, most private funds choose the Growth Enterprise Market (GEM), which was created for developing companies, to conduct IPO of a portfolio company.

The Interim Measures for The Administration of Initial Public Offering and Listing of Stocks on Growth Enterprise Market (2009) set out the following conditions for the issuance on initial public offering stocks:

- the company must possess adequate profit capability. In order to cater for different financing demands of different enterprises, the GEM set forth two standards for the applicant to choose;
  - the issuer must gain profits in the latest two years and the net profit accumulatively amounts to no less than 10 million renminbi; or
  - the issuer must make a profit in the previous year, the net profit of the previous year is no less than 5 million renminbi, the turnover of the previous year is no less than 50 million renminbi and the growth rates of turnover in the last two years are no less than 30 per cent respectively;
- its business income in the previous year must be at least 50 million renminbi;
- its business income growth rate in the last two years must be at least 30 per cent;
- its net assets must be valued at least at 20 million renminbi, with no loss to cover in the most recent period;
- the total amount of capital stocks after offering must be at least 30 million renminbi;

- there must be no major change in the principal business, directors and senior managers of the issuer in the last two years, nor must there have been a change in the actual controller; and
- the core business must be highlighted by the issuer and the funds raised may only be used to develop the core business.

Private equity investors typically expect pro-buyer terms, with extensive representations and warranties with the aim of facilitating a potential indemnification claim. Also, a provision capping a potential claim on the amount of losses as high as the purchase price is often included.

### 16 Portfolio company IPOs

What governance rights and other rights and restrictions typically included in a shareholders' agreement are permitted to survive an IPO? Are registration rights required for post-IPO sales of stock? What types of lock-up restrictions typically apply in connection with an IPO?

The CSRC published the Rules of Corporate Governance of Listed Companies (the Rules), which is applicable to all listed companies within China, and will apply to a company post-IPO. The Rules set forth the basic principles of corporate governance, the means for protection of investors' interests and rights and the basic behaviour rules and moral standards expected. During the restructuring and reorganisation of a company that plans to go public, the controlling shareholders are required to observe the principle of 'first restructuring, then listing', and must emphasise the establishment of a reasonably balanced shareholding structure.

Articles 86 and 87 of the Securities Law and articles 13 to 19 of Measures for the Administration of the Takeover of Listed Companies provide that, after the IPO sales of stock and if the shares whose entitlements are held by an investor reach or exceed 5 per cent, the acquirer is required to submit a report on the alteration of the share entitlements to the CSRC and the Stock Exchange, notify the listed company and make a public announcement.

When dealing with lock-up restrictions, one can generally refer to article 142 of the Company law, which provides that the shares of a company held by the promoters of this company shall not be transferred within one year after the date of the establishment of the company, and the shares issued before the company publicly issues shares shall not be transferred within one year from the day when the stocks of the company are listed and traded in a stock exchange.

The directors, supervisors and senior managers of the company shall declare to the company the shares held by them and the changes thereof. During the term of office, the shares transferred by any of them each year may not exceed 25 per cent of the total shares he or she holds. The aforesaid persons may not transfer their shares within one year from the time the stocks are listed and traded in a stock exchange. The articles of association may include other restrictions on the transfer of shares held by the directors, supervisors and senior managers.

The lock-up restrictions vary according to the specific stock exchange used.

The Notice on the Promulgation of the 'Shenzhen Stock Exchange Shares Listing Rules (Revised 2012)' provides that:

- the director, supervisor and senior manager shall declare and apply for the lock-up of shares before the issuance of such shares, at the time of his or her appointment and increase of shares (article 3.1.7);
- the issuer shall not transfer his or her shares within one year as of IPO if such shares are held by the issuer before IPO (article 5.1.5); and
- the controlling shareholder is not permitted to transfer or have the issuer buy back his or her shares owned before IPO within 36 months from the date of the IPO (article 5.1.6).

**Update and trends**

China's private equity market looks to continue on its upward trajectory, particularly with the lively domestic private equity industry that is emerging. Growth Capital Funds and transactions consisting of minority investment or joint ventures with local partners look to continue to dominate market activity. However, buyout transactions are on the increase as a result of an emerging trend of going-private transactions involving China-based companies listed in the United States. After going private, some of these companies may relist in Hong Kong.

An important recent development is the publication by MOFCOM of the new Interim Measures for Investigating and Disposing of Suspected Concentration of Business Operators Failing to Notify in Accordance with Law (2012), which provides that parties may be penalised if they fail to make an antitrust filing when required to do so, and the penalty may include a fine as well as rescission of the transaction - a strong signal that MOFCOM intends to increase measures to enforce the Anti-Monopoly Law.

While there remain some regulatory concerns in the near-term, the medium-term outlook looks strong for China's private equity industry.

The Shanghai Stock Exchange has similar requirements in Notice On The Issuance Of The Rules For Listing Of Stocks On The Shanghai Stock Exchange (Revised 2012)', as follows:

- the largest shareholder shall not be permitted not to transfer or have the issuer buy back its shares within 36 months from the IPO (article 5.1.5);
- a director, supervisor and senior manager shall not transfer his or her shares within one year from the IPO or within six months after his or her resignation. Any changes of his or her shares during his or her term in the company must be declared, subject to the requirements provided by the Stock Exchange (article 3.1.6); and
- if a director, supervisor, senior manager or shareholder holding more than 5 per cent of the company's shares sells the shares within six months of purchasing the shares, or purchases the shares within six months since he or she sold the shares, the benefit from such sale or purchase will derive to the company. The board of directors shall collect such benefit and declare the relevant situation. (article 3.1.7).

**17 Target companies and industries**

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Recently, the typical going-private transactions in China mainly targeted big state-owned enterprises that are publicly listed in the Hong Kong Stock Exchange and are involved in the natural resource and agricultural industries such as China Petrol, China Pec Group, Aluminum Corporation of China and China Food Corporation. Strictly speaking, these companies shall not be regarded as engaging in a going-private transaction in China mainland because most of them went public in Hong Kong. Privatisations of these companies are mainly for restructuring purposes as they may have more than one listed subsidiary. According to the Report on the Development of Venture Investment in China (2009), the most popular targets for the international private equity sponsors in China are green energy and biotech businesses. Semi-conductor components (industrialisation of electronic products), media and wireless communication industries are also popular targets. IT continues to be a major area of interest.

Strictly speaking, there have been very few privatisation transactions in China (excluding the Hong Kong stock market). Again, the status of being a public company in China is very highly regarded unless the listed company wants to sell its 'shell' to another company that wishes to go public.

One of the most important industry-specific regulatory schemes in China is the above-mentioned CGFI, which indicates the Chinese government's attitudes in directing foreign investment. Industries have been classified into four different categories: allowed, encouraged, restricted and prohibited industries.

These categories reflect the extent to which foreign participation is allowed in a company and the variations that may occur within

these categories. For example, foreign shareholdings in a life insurance company shall not exceed 50 per cent, and those in a securities company shall not exceed one-third of the total shares, and the Chinese shareholder shall be the majority shareholder of a joint-venture security company (both industries, however, fall under the restricted category) (articles 7.2 and 7.3 of the Restricted Industries section of the CGFI). These are the limits on potential targets and may have an implication on investment strategies, as exit strategies are more difficult to implement when one is not the majority shareholder.

**18 Cross-border transactions**

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

Apart from the foreign investment restrictions provided in the CGFI as mentioned in question 17, China adopts a strict foreign exchange control policy and this will definitely bring complexity and difficulties to private equity transactions if the target company is a Chinese public company. The foreign acquiring party must apply for approval to open a bank account in foreign currency in order to receive capital for the private equity transaction with the local Administration of Foreign Exchange where the listed company is located within 15 days upon its receipt of the official approval from the MOC. All transactions must generally be completed within 180 days upon receipt of the official approval. If the foreign acquiring party fails to complete the whole transaction within the above time limit, the official approval will become invalid automatically. The foreign acquiring party shall, upon the approval from the Chinese Administration of Foreign Exchange, purchase foreign currency and remit the capital abroad.

If the target company is a state-owned public company, more considerations shall be taken into account. First, the consideration of the share transfer shall be evaluated by the state-run Assets Administration and Supervision Committee (article 55 of the Law on State-owned Assets). Second, if the acquiring company involves a key industry, has some influence on national economic security or would lead to the transfer of control of a well-known Chinese brand owned by the target company, the contracting parties must apply for approval of the transaction from the MOC, otherwise the MOC may prohibit the transaction. Third, since state-owned enterprises are large-scale companies, the arrangement for employees after the transaction is another key issue. Last, the equity transfer must be handled through an accredited Chinese equity exchange.

**19 Club and group deals**

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Different equity firms will have varying criteria in choosing the target company and different ways to realise their exits from the target company. This will inevitably bring complexity and conflicts to

the transaction. Furthermore, as discussed in question 13, certain requirements apply when the acquiring party acquires a Chinese company (such as financing ability). Every participant must meet the requirements, which are not limited to those stated in questions 4 and 13. Although the funds used in LBOs are mainly from overseas, the financier (such as the bank) will still request that the acquiring party invest more of their own capital, which is an indication of commitment to the acquisition. It may also be taken to mean that the acquiring party will not sell its shares in the target company within a short period of time and will opt for a long-term strategy instead.

#### 20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

The following provisions are usually set forth in an equity transfer agreement for the purpose of enhancing the certainty of closing.

#### Lockup term

This prevents the target company from soliciting or accepting offers from other bidders. In practice, the lockup term defines the negotiation as an exclusive dealing and prohibits both parties from contracting, negotiating or concluding similar arrangements with any third parties who have an interest in the target company.

#### Closing conditions

A private equity buyer will make full payment on condition that the seller meets the specific requirements. Normally, the requirements include:

- the private equity buyer has completed a due diligence exercise on the target company and is satisfied with the results;

- the equity transfer has obtained all necessary internal approvals of the target company and administrative approvals from the competent authorities;
- the seller has fully disclosed the business, operation, assets, liabilities and other details of the target company to the private equity buyer;
- there has been no adverse change in the business, operations, assets, liabilities or other circumstances of the target company; and
- every transaction condition should be fulfilled in a way that does not contravene Chinese law and that is to the satisfaction of the private equity buyer.

#### Termination rights

The agreement may be terminated by mutual agreement. In addition, the rights to unilateral termination should be stipulated under certain circumstances. If the closing conditions remain unsatisfied or are not waived within the lockup period, either the private equity buyer or the seller may terminate the agreement in writing. If any of its representations and warranties are untrue or inaccurate, the private equity buyer may terminate the agreement in writing.

#### Liquidated damages

In the event that the agreement is terminated by the private equity buyer due to the seller's failure to complete the formalities of the equity transfer, liquidated damages, which may be a certain percentage of the transfer price, are often imposed on the seller. Furthermore, if the penalty is insufficient to compensate the losses caused by the private equity buyer, additional compensation may be claimed (please see question 6 for the applicable principles).



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