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in 33 jurisdictions worldwide

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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

In practice, there are various types of private equity transactions occurring in the People's Republic of China, 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 being directly referenced in Chinese legislation. There is currently no legislation at national level that refers specifically to either private equity funds or transactions in general or to other individual types of private equity funds or transactions. However, the PRC central government has drafted a regulation on the administration of private equity funds, although this regulation is not yet promulgated and there is no expected timing for its promulgation.

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. SIFs are allowed to be funded by foreign investors or domestic investors.

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.

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?

In China, many private equity transactions are not conducted with the view of the investing company exiting through the use of an IPO. This is due to the strict corporate governance rules on public companies in general and, in particular, the conducting of an IPO. Although IPO activity was temporarily suspended in China between September 2008 and June 2009 due to money-laundering concerns and the global economic downturn, it was reinstated in June 2009 in an effort to boost the sluggish economy. Furthermore, China's growth enterprises market board was initiated in Shenzhen on 29 October 2009, which furnishes a significant platform for IPO activity.

Private equity transactions are commonly conducted through foreign companies commonly referred to as special purpose vehicles (SPVs) in order to escape the scrutiny of the Chinese authorities and to take advantage of the more favourable tax and legal regime in the countries where these SPVs are incorporated, even though there were specific reporting regulations issued in August 2006 by the Chinese central authorities (namely, the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors). SPVs that are controlled directly or indirectly by the PRC domestic companies or natural persons to purchase the equity of the target Chinese companies for the ultimate purpose of listing overseas are subject to the scrutiny and monitoring of the Chinese authorities. In addition, the stipulations regarding share swaps in these regulations made SPVs (and other foreign companies) subject to Chinese merger and acquisition regulations – previously, the Chinese laws remained silent in this regard and these onerous reporting and approval obligations could be avoided.

The central government also periodically issues guidelines on foreign investment (eg, the Catalogue for the Guidance of Foreign Investment Industries (2007 amended edition)). These guidelines are in reality a set of legally binding rules that classify industries into four different categories depending on the industry sectors involved that indicate a foreign company's (including an SPV's) ability to invest in it and the permissible maximum foreign shareholding: allowed industries, restricted industries, encouraged industries and prohibited industries. It is expected that an updated Catalogue will be released soon.

Private equity transactions are often conducted with the view to eventually turning 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 (eg, a listed company must publish its financial information and major operational information under article 166 of the Company Law).

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 is the role of a special committee in such a transaction where members of the board 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. According to the Rules of Corporate Governance of Public Companies, the board of directors will establish, according to the resolutions made at the shareholders' meetings, special committees such as a strategy committee, an auditing committee, a nomination committee and remuneration and assessing committee, among others. These committees will consist only of directors, and every special committee has its own functions and responsibilities. The strategy committee shall, for instance, carry out research on long-term strategies, including major investment decisions that the company should take, and will submit proposals on their findings to the company. Every member shall fulfil its fiduciary duties as prescribed in the Company Law of the PRC or other related laws and regulations.

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 China Securities Regulatory Commission (the CSRC) and the Ministry of Commerce 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 Mergers and Acquisitions of a Public Company).

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?

The Measures for the Administration of Mergers and Acquisitions of a Public Company issued by the CSRC and effective as of 1 September 2006 heightened the 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 the Administration of Mergers and Acquisitions of a Public Company). 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 (ie, 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 the Administration of Mergers and Acquisitions of a Public Company).

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 the Administration of Mergers and Acquisitions of a Public Company). 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, it is legally required to make a tender offer to the target company if it still wishes to increase its shareholdings in the target public company (article 24 of the Measures for the Administration of Mergers and Acquisitions of a Public Company).

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 3.2.1 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 over 30 per cent of the share of a public company:

- article 37 of the Measures for the Administration of Mergers and Acquisitions of a Public Company stipulates that the period stated in the tender offer given by the acquiring party or parties shall be between 30 and 60 days (inclusive), unless there are other competitive tender offers, in which case the timing limits do not apply;
- if there is any substantial change to the fundamental terms of the tender offer, the acquiring company is required to submit a written report regarding the amendments within two days upon the occurrence of the change to the CSRC and the report shall also be copied to the bulletin of the relevant stock exchange (article 41 of the Measures for the Administration of Mergers and Acquisitions of a Public Company);
- in the event that the acquirer is foreign-based, the Chinese target company or the acquirer shall submit certain documentation to the Ministry of Commerce in relation to the proposed offer, which shall issue its preliminary approval within 30 days upon their receipt of the above documents. The Ministry of Commerce's official approval is usually valid for 180 days (article 12 of the Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies);
- the acquirer must open a specific foreign currency bank account within 15 days upon its receipt of the Ministry of Commerce's approval, and the money to be used for the acquisition shall be remitted into the bank account according to the foreign exchange administration laws and regulations of the PRC (article 14 of the Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies); and
- once the tender offer is accepted, the acquirer shall start its strategic acquisition within 15 days upon the completion of the settlement of the foreign currency and, in general, the acquisition process shall be completed within the 180 days' validity period of the official approval mentioned above (article 16 of the Measures for the Administration of Strategic Investments by Foreign Investors in Public Companies).

The following rules apply when any foreign entity has purchased shares of a Chinese public company:

- the target company shall obtain a new certificate of approval in relation to its amended status as a foreign-invested enterprise, as issued by the relevant bureau of commerce at different levels (the Ministry of Commerce or its local counterparts) within 10 days upon the completion of the acquisition;
- where the target company has become private, it shall file various forms to amend the status of the company after the transaction (from a public company into a private or non-public company) with the relevant Administration for Industry and Commerce (the Chinese business registry) within 30 days upon its receipt of the approval from the relevant bureau of commerce; and
- where the target company has become private, the target company shall proceed with the related formalities with the tax bureau, customs office and the administration of foreign exchange, etc, within 30 days upon the completion of the administrative formalities with the Chinese registry.

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 (eg, in China the equity purchase agreement, while signed, officially becomes effective only after the required administrative approval from the Ministry of Commerce 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 WOFE), 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 Catalogue for the Guidance of Foreign Investment Industries (2007 amended edition) 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 seeks to get 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 breaches by the acquirer of the financing clause (or any other reason as stipulated in the agreement).

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 to 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 for adjusting the amount of compensation that reflects the actual losses. Note, however, that 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?

The Company Law sets forth that if a public company wants to sell (or purchase) its major assets that represent more than 30 per cent of its total capital, the resolution shall be ratified by more than two-thirds of the shareholders with voting rights (article 122 of the Company Law). Therefore, 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 CSRC issued the Measures for the Administration of Mergers and Acquisitions of a Public Company. This regulation 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. More importantly, the Measures for the Administration of Mergers and Acquisitions of a Public Company require the board of directors of the target company to hire an independent third-party auditor to ensure the authenticity of the report, which shall also be submitted at the shareholder meeting (article 32 of the Measures for the Administration of Mergers and Acquisitions of a Public Company).

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?

The stamp duty of the share transfer agreement shall apply to both contracting parties. Use of the company seal on an agreement shall be subject to a 0.05 per cent stamp duty, calculated on the amount stipulated in the agreement (article 2 of the Interim Regulations of the PRC on Stamp Duty). 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, for 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). As for transfer of 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 issued by the Ministry of Finance on 29 December 2008 regarding a deed tax incurred during the restructuring of enterprises (the Regulations on the Deed Tax Applicable upon Restructuring), 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 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How can these issues be resolved?

In a share purchase, the existing indebtedness of the target company will not be affected by the transaction. Obviously, the equity value of the target company is closely related to its net assets. If there is any existing hidden indebtedness when the equity of the target company is evaluated, the real value of the equity will depreciate after the transaction, especially when the assets of the target company are seized, detained or auctioned.

There could be some potential or future indebtedness issues; for example, the target company may lack some required official permit or credentials to legally conduct its activities, which will certainly bring potential legal and financial risks to the acquirer after the transaction (for example, in the form of fines).

Therefore, effective and in-depth due diligence plays an important role in choosing the potential target company.

However, if there are any actual or potential threatened litigation disputes in relation to the company to be acquired, it is difficult for the purchasing party to obtain such litigation information through the due diligence process as Chinese courts are under no obligation to disclose such information. Hence, the inclusion of a warranty clause is common. For example, the acquirer could require the target company to disclose its existing indebtedness clearly in writing in the purchase agreement, and it shall be liable for the indebtedness not listed in the acquiring agreement. More importantly, the acquirer shall have a right of recourse if there is any loss caused by such hidden indebtedness.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions? Are there any other restrictions in your jurisdiction on the use of debt financing for private equity transactions?

In China, the leveraged buyout (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 big 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 – only legally recognised financial institutions such as banks are able to lend money.

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 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 expect the detailed implementation rules prescribed by the Chinese authorities.

The Chinese government is also still 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, which 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 Ministry of Commerce, 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). These 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 Ministry of Commerce and the CSRC. The 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 on 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 acquiring party for the latest 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 for bankruptcy, among others, subject to the approval from the Ministry of Commerce. 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 Ministry of Commerce, by reason of bankruptcy and liquidation, etc.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

One important exit mechanism for private equity sponsors (whether singular or multiple) is the share transfer. In order to ensure that a

Update and trends

In the past seven years private equity funds in China have achieved a compounded growth rate of 40 per cent every year, far exceeding other Asian countries.

As China's pension funds step up their investments, private equity funds are being seen as favourites to attract investments. In addition, domestic insurance companies are allowed to invest in private equity funds according to the new regulation Circular Baojianfa [2010] No. 79, announced by the China Insurance Regulatory Commission in September 2010.

The private equity fund sector is certainly seeing more money being injected; in the first nine months of 2010, the total fund raised in the private equity sector reached US$28.4 billion. Around 144 new funds were established during the same period, of which 90 per cent are RMB-denominated funds. 128 Chinese companies that were backed by private equity funds went for IPO in 2010, gaining as much as US$20 billion from the open market (source: most recent reports by Zero2IPO, a leading Chinese venture capital research and advisory company).

public company can operate smoothly at the beginning stage of privatisation and to prevent the shareholders from engaging in illegal speculation of the securities, under the Company Law the 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).

With regard to foreign acquirers, in accordance with the Company Law and the Catalogue for the Guidance of Foreign Investment Industries (2007 amended edition), the share transfer made by foreign investors shall also be restricted, especially where the foreign party in an equity joint venture wishes to sell its shares as part of an acquisition in the equity joint venture company. This share transfer shall be approved by the Ministry of Commerce or its affiliated bureau and, if the target company is a public company, the share transfer shall also be approved by the China Securities Regulatory Commission. In practice, the target company must also include the transfer restriction clause in the purchase agreement or the shareholders' agreement stating that the shareholder is restricted from transferring his or her shares to the competitors.

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. 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 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

In China, private equity sponsors and private equity transactions are still limited, owing to the lack of regulation, but such limit is not in terms of size.

In accordance with article 166 of the Securities Law, investors who wish to carry out securities transactions shall open a brokerage account with their identity cards (for an individual) or the certificate of incorporation (for a legal entity). Most of the private equity sponsors are not individuals and will usually take the legal form of a limited partnership or trust.

With regard to the registration of private equity sponsors, in accordance with the Partnership Law, the legal form of a limited partnership can be registered under the current registration system. However, there is still a limitation on the number of investors. In accordance with article 61 of the Partnership Law, the partnership shall have more than two but less than 50 (inclusive) partners, and at least one of them must assume unlimited liability.

Apart from private investment in public equity, private equity sponsors mostly choose to invest in non-public companies, operate them and then receive profits through the initial public offering (the IPO) of the target company or share transfer. However, IPO procedures in China are relatively more complex and take a longer time.

According to the Guidelines on Risk Management of Loans Extended by Commercial Banks for Mergers and Acquisitions issued by the Chinese Banking Regulatory Committee on 6 December 2008, a loan granted by a Chinese commercial bank shall not be more than 50 per cent of the total capital to be used in the acquisition.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

There are several types of exit strategies for private equity firms in China such as management buyouts, IPOs and merger and acquisitions, with the IPO being the most popular strategy.

The IPO of a Chinese company can be initiated either abroad or in the Chinese stock markets (article 88 of the Measures for the Administration of Mergers and Acquisitions of a Public Company). IPO offerings in China can be a long and complicated process, so foreign private equity firms prefer listing abroad, where there is looser foreign exchange control policy and lower requirements for an IPO. However, there is an indirect alternative that can allow the private equity sponsor to conduct the IPO and exit shortly afterwards. The Chinese target company will incorporate a company in the British Virgin Islands or other tax haven to be used as the SPV). The SPV will use capital from the private equity transaction to purchase all the shares of the Chinese target company. The Chinese target company will then become a wholly owned subsidiary of the SPV. The private equity sponsor will then help the SPV (or another company that swaps its shares with the SPV) go public in a foreign stock market.

Domestic private equity firms usually choose to do an IPO in China as they are not restricted by foreign currency controls and are more familiar with the procedures of an IPO in China.

16 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 otherwise 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 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).

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 Catalogue for the Guidance of Foreign Investment Industries (2007 amended edition), 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 Catalogue for the Guidance of Foreign Investment Industries (2007 amended edition)). 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.

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18 Cross-border transactions

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

Apart from issues mentioned in questions 2 and 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. As discussed in question 5, the foreign acquiring party shall apply for the approval to open a bank account in foreign currency 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 Ministry of Commerce of the PRC. 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 must 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 Ministry of Commerce, otherwise the Ministry of Commerce 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 questions 4 and 12, 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 12. 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 practise, 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, operation, 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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