

CHINA MATTERS

Paul Hastings Newsletter for Investing & Operating in the People's Republic of China

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Practical Considerations for Acquisitions in China (2008)

INTRODUCTION AND BACKGROUND

Despite the global financial crisis and the resulting decline in worldwide M&A volume, China is one of the remaining bright spots for deal makers and their advisors. Recent major acquisitions in China include Coca Cola's US\$2.4 billion proposed acquisition of Huiyuan Juice and the closing of Blackstone's US\$600 million investment in the BlueStar Group. However, despite such interest from buyers, hurdles in China's regulatory regime is one factor for China's relatively low M&A volume compared to that of the United States and Europe.

For example, the ability of Chinese citizens to use offshore (i.e., outside China) holding companies to hold their businesses in China, and, therefore, the ability of foreign buyers to indirectly acquire Chinese businesses by acquiring offshore holding companies, has become severely restricted since late 2006. More recently, the Chinese government stepped up its scrutiny over acquisitions by unifying its anti-monopoly laws and adopting new rules such as the concentration notification rules. Other regulatory hurdles in China include the promulgation of a new investment catalogue in which foreign acquisitions in certain industries became more restricted and the passage of new foreign exchange regulations that restrict the ability to use converted currency for acquisitions.

In this newsletter, we discuss some of the salient issues that foreign buyers face when structuring an acquisition in China. This newsletter is not meant to be comprehensive and we suggest that you contact your Paul Hastings attorney before you proceed with an acquisition in China.

GOVERNMENT APPROVALS

MOFCOM

Investment Categorization

One of the first determinations to be made in any China deal is whether the business of the target company is categorized as "prohibited", "restricted", "permitted" or "encouraged" under the Foreign Investment Guidance Catalogue jointly issued by the Ministry of Commerce ("MOFCOM") and the National Development and Reform Commission ("NDRC"), which was most recently revised in late 2007. Such categorization determines whether a foreign buyer is allowed to be involved in the target company's business and the extent of its involvement. Generally, foreign buyers are allowed to own up to 100% of a business in the "permitted" and "encouraged" categories, whereas a foreign buyer's ownership interest of businesses in the "restricted" and "prohibited" categories could be severely limited.

Anti-Monopoly Review

Anti-monopoly review has now become one of the most important and sometimes controversial processes during MOFCOM's review process. A newly created Anti-Monopoly Commission coordinates the review process among various central-government level agencies, but perhaps more importantly, the Anti-Monopoly Bureau under MOFCOM is in charge of market concentration review for foreign acquisitions and investments. The Anti-Monopoly Bureau not only meets with the parties involved with the acquisition, but may also meet with competitors of the target company and the relevant industry associations to determine the market's reaction to the proposed acquisition. For example, Coca Cola's proposed acquisition of Huiyuan Juice has met strong opposition from Huiyuan Juice's competitors, who have made several alternative proposals for the Anti-Monopoly Bureau's consideration.

Nonetheless, we believe that the current anti-monopoly law and the related regulations focus on transactions between relatively larger parties and are unlikely to hinder the acquisition of small to mid-size Chinese companies. Most noticeably, the concentration notification rules use a "two-party revenue test" to determine whether a filing is required to be made with the Anti-Monopoly Bureau. Generally, a filing is required when the China revenues of at least two parties to the transaction each exceed RMB400 million (approximately US\$58 million) and the China revenue or the global revenue of all parties to the transaction exceeds certain other thresholds. This is an improvement from the prior rules, which required a filing when only one of the parties met a lower revenue threshold.

Transaction Review

Generally, the acquisition of any interest in a Chinese company by a foreign buyer requires the government's approval and one critical issue is the approval level that is required. An approval from a local or

provincial office of MOFCOM is typically sufficient for most transactions. However, certain types of acquisitions, such as those described below and those that involve a purchase price that exceeds a certain threshold, require central government approval:

- investment in a company that holds a famous trademark or trade name;
- investment in a critical industry or an important industry that potentially affects China's economic security;
- restructure of a Chinese company to a jurisdiction outside of China; and
- cross-border equity swap or share exchange.

An approval from the central government level MOFCOM involves more uncertainty and takes more time to obtain than a local or provincial-level government approval.

Fair Market Price Review

In addition to the increased regulatory scrutiny over concentration, MOFCOM also scrutinizes the purchase price of each acquisition during the transaction review.

Generally, the purchase price must be based on fair market value. In the acquisition of a non-listed company, the fair market value is frequently an appraised value of the target company that, as a practical matter, is close to or above the net asset value. In the acquisition of a listed company, the government would consider the public securities' trading price rather than the net asset value of the target company or a negotiated price to be a more relevant indicator of fair market value. The Chinese government has rejected several high profile acquisitions by foreign buyers because the trading prices of the target companies' securities were substantially higher on the day of closing than the agreed price.

NDRC

In addition to MOFCOM review, NDRC also

has the regulatory authority to verify the viability of any foreign investment “project” in China. However, because the term “project” is not clearly defined in the regulations and is generally understood to cover infrastructure, minerals, shipyard construction and energy projects, few transactions in China involve the NDRC verification process. For projects that do require NDRC verification, MOFCOM generally requires the NDRC verification to be completed before MOFCOM would approve the project.

In addition to the *Foreign Investment Guidance Catalogue*, NDRC issued a separate catalogue called the *Industrial Structure Adjustment Guidance Catalogue* (“**NDRC Catalogue**”), which generally applies to domestic investments. However, the NDRC Catalogue may apply to a foreign acquisition if the target company’s business is categorized as a business to be “phased-out” or a business that is “restricted”.

Industry-Specific Approvals

Investments in certain industries are subject to the approval of government authorities that regulate such industries. For example, an acquisition of a telecommunications company would require the Ministry of Industry and Information’s approval and the acquisition of a pharmaceutical company would require the Ministry of Health’s approval. Industry-specific laws and regulations also set forth special requirements for the buyer, such as the requirement to meet qualification thresholds.

FOREIGN EXCHANGE

China has strict controls over foreign currency conversion and remittance. Both the inflow and outflow of currency are subject to the approval of or registration with the State Administration of Foreign Exchange (“**SAFE**”) on a case-by-case basis. As such, problems arise from the Renminbi’s general inconvertibility. Funds that are successfully remitted into China and converted into Renminbi may be

(i) restricted in its use, and (ii) difficult to remit back out of China. For example, SAFE recently passed a new regulation that explicitly prohibits the use of Renminbi converted from a foreign investor’s capital contribution into a Chinese company to acquire the equity of another company in China. This new rule severely restricts a common practice used by foreign investors, particularly real estate developers, to make acquisitions in China. In addition, the conversion of Renminbi into foreign currency, and remittance out of China, require SAFE approval. This process is particularly uncertain for investors who hold proceeds from the sale of A-shares.

ACQUISITION OF PUBLIC COMPANIES

Listed equity securities in China are generally categorized as “A-shares” and “B-shares”. A-shares are liquid securities that may only be traded by Chinese persons and companies, and foreigners with Qualified Foreign Institutional Investor (“**QFII**”) allocation quota. B-shares are illiquid securities that may be traded by foreign persons and companies, but such shares do not have an active market. Unless the foreign buyer has QFII quota, the only way to acquire equity interest in a listed company is to comply with the *Strategic Investment in Listed Companies by Foreign Investors Rules* (“**Strategic Investment Rules**”) and acquire A-shares as a “Strategic Investor”. Under the Strategic Investment Rules, (i) the Strategic Investor should acquire at least 10% of the outstanding shares of the listed company where the listed company’s business is not prohibited from foreign investment, (ii) the A-shares so acquired are subject to a three-year lock-up period, and (iii) in addition to any other applicable government approvals (such as those from MOFCOM, NDRC, SAFE or others), the acquisition must be approved by the China Securities Regulatory Commission (“**CSRC**”) if it is a share transfer that will result in a *de facto* control position by the foreign buyer over the listed company or a subscription of new shares of the listed company. If a *de facto* control position does

not exist, a CSRC filing, instead of an approval, typically suffices.

In addition to the Strategic Investment Rules, the foreign buyer of listed shares must follow the Listed Companies Takeover Rules, which were most recently revised in 2008. The foreign buyer must disclose to the CSRC and the appropriate stock exchange, and publicly announce the contemplated acquisition, if the buyer and its related parties expect to acquire 5% or more of the outstanding shares of the listed company. The same disclosure obligations arise if the buyer subsequently increases or reduces its ownership in the listed company by 5% or more of the outstanding shares of the listed company. Generally, disclosure obligations are less stringent for a buyer who will not become the largest shareholder or acquire *de facto* control of the listed company. In addition, if the buyer intends to acquire more than 30% of a listed company, such buyer must acquire any share in excess of the 30% threshold through a tender offer made to all shareholders unless a waiver is granted by the CSRC. The tender offer could either be (i) a general offer for all of the outstanding shares, or (ii) a partial offer for a portion of the outstanding shares. If the number of tendered shares exceeds the buyer's offer amount, the buyer will be required to buy the tendered shares on a pro-rata basis.

ACQUISITION OF STATE-OWNED COMPANIES

At the outset of any acquisition in China, the buyer must inquire whether the target company is "state-owned." Since under existing rules, any government ownership, however *de minimis*, makes the target company a state-owned company, a foreign buyer should discuss the proposed acquisition with the State Asset Supervision and Administration Commission ("**SASAC**") to determine if either (i) the asset or equity to be acquired must be listed on an asset exchange for public auction, or (ii) the target company's ultimate owner has the authority to approve the transaction without a public

auction.¹

If there is a public auction, the winner would have a certain amount of time to complete the acquisition. As a result, foreign buyers may run the risk of losing an acquisition to a higher bidder during the auction process.

TAX CONSIDERATIONS

For sellers, capital gains from the sale of the equity interest of a Chinese company are subject to either (i) enterprise income tax of 25% of the capital gain or (ii) a reduced enterprise income tax of 10% of the capital gain if the seller qualifies as a "non-resident enterprise". Gains from a sale of assets may be subject to taxes such as value-added tax at a rate of 0% to 17% of the appreciation amount, business tax at a rate of 5% of the value of transferred properties and land appreciation tax at a rate of 30% to 60% of the appreciation amount. Furthermore, various preferential tax rates or withholding arrangements may be available under bilateral tax treaties or cross-border arrangements such as the *Arrangement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* between Hong Kong and Mainland China. All taxes payable in relation to the sale of equity or asset in China will need to be paid to the Chinese tax authorities before such gains may be remitted offshore.

OTHER CONSIDERATIONS

FCPA: Compliance with the U.S. Foreign Corrupt Practices Act ("**FCPA**") has become an increasing concern for U.S. buyers on two levels. First, due to the fact that many aspects of a foreign buyer's acquisition of a Chinese company require government approval, there have been instances in which improper payments were made to government officials to secure such approvals. Second, the Chinese employees of the target company are often unfamiliar with the FCPA's requirements, which may conflict with the traditional way that business is conducted by the target

company. As a result, both pre-closing and post-closing compliance with FCPA create concerns for foreign buyers.

HR issues: Foreign buyers sometimes shelve human resource issues until after the closing, which result in significant post-closing issues. Given the intricate employment and labor regulations in China, human resource issues often result in significant liabilities for the foreign buyer. For example, the recently enacted Labor Contract Law and its implementing regulations substantially limit an employer's ability to terminate its employees, and SAFE regulations require the registration of employee stock options for an offshore-listed company that are issued to Chinese employees.

Governing law: The *Acquisition of Domestic Enterprises by Foreign Investors Rules* ("Circular 10") require (i) the share subscription agreement, (ii) the share purchase agreement and (iii) the asset purchase agreement for acquiring Chinese companies to be governed by Chinese law. Furthermore, the Supreme People's Court requires all contracts relating to foreign investments in China to be governed by Chinese law. Although these judicial interpretations are non-binding on non-

judicial government authorities, government authorities such as MOFCOM have informally confirmed that they will follow such interpretation. As a result, foreign buyers must now confront the differences between Chinese law, on the one hand, and the laws of jurisdictions such as New York, Delaware, Hong Kong and the United Kingdom, on the other hand.

Paul, Hastings, Janofsky & Walker LLP is a global law firm with over 1,300 lawyers in 18 offices in Asia, Europe and the United States. Paul Hastings has one of the largest, full service, multi-jurisdictional legal practices in Asia with over 200 legal professionals in Beijing, Hong Kong, Shanghai and Tokyo.

Please feel free to discuss any aspect of this newsletter with your existing Paul Hastings contacts or any of the partners listed below:

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¹ A state-owned company's ultimate owner is another state-owned company that is often large enough that it acts as a quasi-government authority. Such ultimate owner may have the authority to approve a transaction in lieu of SASAC's approval or in combination of SASAC's approval, which is to be determined on a case-by-case basis.