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CHAPTER 1

# Introduction: Regulatory Framework of Foreign Investment

## 1.1 OVERVIEW

It is well known that China implements two 'parallel' legal regimes respectively for foreign invested enterprises (*FIEs*) and domestic companies without foreign capital. There are particular requirements applicable to FIEs:

> China has been careful to hedge each form of FIE with complex rules for qualification and approval designed to foster various aspects of Chinese industrial policy, channel foreign investment into particular economic or geographic areas, protect local Chinese business interests, promote China's technological development, or protect China's balance of payments. The result is a complex system of laws, regulations, and guidelines that sometimes apply across-the-board to all FIEs and sometimes only to a particular kind of FIE.[1]

In structuring such complex system, the National People's Congress (*NPC*) is the top organ, acting as the national legislative organ of the People's Republic of China (*PRC*). NPC usually holds its annual session in March of every year, during which many important laws may be passed. During the time beyond its annual session, NPC's permanent organ, the Standing Committee, exercises most of the top legislature powers.

Of mention, Chinese government is now reviewing its much-lagged legal framework regulating foreign investment. Recently, the Ministry of Commerce published the draft Foreign Investment Law (*Draft FI Law*) in January 2015 to solicit public comments. Although it remains uncertain when the Draft FI Law will appear on the top legislature's agenda and when it will become the state law upon approval by the NPC

1. Patrick M. Norton & Nicolas Groffman (O'MM), 'Reorganizing Foreign Invested Enterprises in China: the New Merger and Division Regulations' <www.omm.com/webcode/webdata/content/ publications/APRIL_2000.PDF> (April 2000).

or its Standing Committee, it is clear that the government is considering to restructure the foreign investment regulatory framework. One aim is to keep coherence with the governance structure set up under the PRC Company Law, which is purported to be applicable to all forms of companies established in China. With such efforts, China is to shift its regulating focus away from the rigid current approval system applicable to FIEs to such general matters as corporate governance, negative list, national security and information disclosure.

## 1.2 KEY AUTHORITIES REGULATING FOREIGN INVESTMENT

There is a very high level of government involvement in foreign investment activities in China with government approval, registration or record-filing necessary at nearly every important stage of the FIE's business, corporate changes or restructuring.

The primary executive organ of state power is the *State Council*, being the government, which leads various functional departments usually denoted 'ministry' or 'commission'. Such functional departments play a key role in regulating foreign investment activities.[2] Among others, the following authorities are of key importance.

### 1.2.1 Ministry of Commerce (MOFCOM)

The Ministry of Commerce (*MOFCOM*) <www.mofcom.gov.cn>, which is the successor in powers and authorities of the former Ministry of Foreign Trade and Economic Cooperation (*MOFTEC*), is the approval authority at the centre of all the authorities that regulate foreign investment. It is responsible for the corporate matters in relation to foreign investment, such as the establishment (including a substantial review of the articles of association (*AOA*) or shareholders' agreement) of a new FIE, the equity or shares transfer in, or merger with or by, an existing FIE, cross-border acquisition of domestic companies by foreign investors, and the merger control filing, etc.

Depending on the case, a foreign investment project may require approval of the local or national MOFCOM, or even that of the State Council. The specific authority level is determined based on the total investment amount and the category to which the project belongs. As specified in the recently updated *Catalogue of Investment Projects Subject to Government Approval* (*Government Catalogue*), which was promulgated by the State Council in October 2014, the specific approval authority level is illustrated below in Table 1.1.

2. From the outset, it is to be stated that, when this book uses an abbreviated term of a concerned government authority (e.g., the MOFCOM, SAIC or SAFE), it refers to the authority as a whole, covering the authority at both the national or state level in Beijing and the local levels, unless otherwise specified. For differentiation purpose, the authority at state level in Beijing will be referred to, e.g., as the 'national MOFCOM', while its local counterpart will be referred to, e.g., as the 'local MOFCOM'. On the other hand, when the word 'provincial' is used in this book, it covers not only the provinces, municipalities directly under the State Council and national autonomous regions, but also the five designated cities with independent planning power (namely, Shenzhen, Dalian, Qingdao, Ningbo and Xiamen).





*Table 1.1 Competent MOFCOM Levels in Terms of Total Investment Amount*

| *Authority Level* | *Total Investment Amount (USD)* | |
|---|---|---|
| | *Encouraged/Permitted Sectors* | *Restricted Sectors* |
| State Council | Above 2 billion, only for those requiring Chinese ownership control | Above 2 billion, regardless whether or not requiring Chinese ownership control |
| National | Above 1 billion, below 2 billion; or<br>Above 2 billion not requiring Chinese ownership control | Above 100 million, below 2 billion |
| Provincial | Below 1 billion | Below 100 million |
| Municipal | Below 300 million, or as otherwise specified by provincial government | No power |

Notably, the approval authority for restricted projects, even with a total investment amount of less than USD 100 million, cannot be delegated down to levels below the provincial MOFCOM.

In addition, for certain FIEs of particular nature or in particular sectors, approval of the national MOFCOM is required regardless of their specific total investment amounts, unless the national MOFCOM expressly authorizes, as it does in practice, down to its provincial counterparts of such authority. This is the case for, e.g., a foreign invested holding company (*FIHC*) or a foreign invested company limited by shares (*FICLS*). On the other hand, for foreign investment in a very limited number of sectors, the MOFCOM approval is not required, and the approval of the industry specific regulatory authority plays the role, e.g., the financial sector. For example, approval of the China Banking Regulatory Commission (*CBRC*) suffices for the establishment of a foreign invested commercial bank in China.

### 1.2.2 National Development and Reform Commission (NDRC)

The National Development and Reform Commission (*NDRC*) <www.sdpc.gov.cn>, which is the successor in powers and authorities of the former State Development and Planning Commission (*SDPC*), is another important approval authority regulating foreign investment. It supervises foreign investment mainly from the perspective of industrial compliance, in contrast to the MOFCOM, which is responsible for corporate matters.

The NDRC acts as a powerful macroeconomic planning and policy-making authority, responsible for the approval or record-filing of the FIE's project initiation. As contemplated under the *Measures on Administration of the Approval and Record-Filing of Foreign Investment Projects*, which were promulgated by the NDRC (NDRC Order No. [2014] 12) in May 2014 (as amended in December 2014), the said project initiation approval or record-filing of the NDRC is a general compliance requirement for all kinds of foreign investment projects, not confined only to investment in fixed assets. In



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practice, however, enforcement of this NDRC approval/record-filing is somewhat weakened as the MOFCOM or SAIC does not deem such NDRC approval/record-filing a precedent matter during the former's review. However, particularly for manufacturing or construction projects or other investment in fixed assets, or projects classified as 'restricted' in the Industrial Catalogue, the NDRC approval/record-filing is of particular importance.

As for the specific authority level of the NDRC, this is determined based on the same rules as those applicable to the MOFCOM (see Table 1.1 above).

### 1.2.3 State Administration for Industry and Commerce (SAIC)

The State Administration for Industry and Commerce (*SAIC*) <www.saic.gov.cn> is the corporate registrar. It is responsible for the registration of corporate matters of not only FIEs but also domestic companies. The competent SAIC level is usually the same as the MOFCOM approval level required.

Of mention, that the SAIC also acts as an industry specific regulatory authority in some sectors, responsible for, e.g., the permit of the advertising business.

### 1.2.4 State Administration of Foreign Investment (SAFE)

The State Administration of Foreign Exchange (*SAFE*) <www.safe.gov.cn> is the authority of foreign exchange controls, responsible for, e.g., foreign exchange registration of the FIE, remittance and settlement approval or registration of foreign currency. The competent SAFE is usually either the provincial SAFE or local SAFE of where the foreign exchange transactions are conducted, while the national SAFE is mainly a policy-making body.

Of particular notice, since June 2015, the SAFE has authorized most of its authority in relation to the FIE's foreign exchange registration matters down to the commercial banks of the FIE's capital account according to the *SAFE Circular on Further Simplifying and Improving the Policies of Foreign Exchange Control on Direct Investments* (*HuiFa* No. [2015] 13) issued in February 2015.

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### 1.2.5 Other Authorities That May Be of Concern

Apart from the above, other regulators may be of concern to foreign investment. These include, in general, the State Administration of Taxation (*SAT*) and the Ministry of Finance (*MOF*), responsible for the taxation and accounting matters; and the General Administration of Customs (*GAC*), responsible for the export and import and customs duties.

After the establishment, FIEs may have to obtain additional permit of the industry specific regulator in certain particular sectors before they can actually commence the concerned business, e.g., the permit of China Food and Drugs Administration (*CFDA*), regulating investments in pharmaceutical industry. Furthermore, the nature of the deal may raise additional approval or registration requirements. For instance, the China





Securities Regulatory Commission (*CSRC*) is involved in securities matters or transactions targeting listed companies (*ListCos*); approval of the State-owned Assets Supervision and Administration Commission of State Council (*SASAC*) or its local counterparts is required if a state-owned enterprise (*SOE*) is involved.

## 1.3 INDUSTRIAL GUIDANCE

Today, foreign investors are permitted to invest in a wider scope of industries in China. Such an investment, however, shall comply with the industrial guidance:

> Despite substantial liberalisation pursuant to China's WTO commitments, investment in China by foreign investors (and, indeed, by many domestic parties) remains tightly circumscribed. Many sectors of the economy remain fenced off from foreign investors, while investors in other sectors face a gauntlet of regulatory approvals.[3]

Specifically, 'to direct foreign investment into certain priority industry sectors while restricting or prohibiting investment in other sectors',[4] China classifies all foreign investment projects into four categories: 'encouraged', 'permitted', 'restricted' and 'prohibited'. This classification is established under the *Regulations on Guiding the Orientation of Foreign Investment* (*FI Guiding Regulations*), which were promulgated by the State Council (State Council Order No. [2002] 346) and became effective as of 1 April 2002. It has very important implications to foreign investors, determining, among other things:

- the level of the competent approval authority;
- the permissible level of foreign ownership; and
- the eligibility to certain preferential treatments.

Among other things, the FI Guiding Regulations provide for the publication of two catalogues, namely the *Industrial Guidance Catalogue for Foreign Investment* (*Industrial Catalogue*) and the *Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions* (*Regional Catalogue*). The two Catalogues constitute the basis for the applicable policies regarding the examination and approval of foreign investment projects and FIEs. The Industrial Catalogue lists specific industries and economic activities in which foreign investment in China is 'encouraged', 'restricted' or 'prohibited'; and projects not included in the Industrial Catalogue belong to the 'permitted' category. On the other hand, to encourage foreign investment into the central, western and north-eastern regions of China,[5] the Regional Catalogue specifies a list of foreign investment projects that shall be deemed 'encouraged' in terms of the

3. Michael J. Moster & Nathan Bush (O'MM), *supra* note 1.
4. Franki Cheung (Deacons), 'Doing Business in China' <www.deacons.com.hk/eng/knowledge/knowledge_205.htm> (January 2007).
5. These regions cover twenty-one provincial regions: Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Chongqing, Sichuan, Guizhou, Yunnan, Xizang (Tibet), Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, Neimenggu (Inner Mongolia), Guangxi and Liaoning.

Industrial Catalogue, which projects may share the preferential policies applicable for the 'encouraged' foreign investment projects.[6]

Both Catalogues are subject to amendments from time to time. The latest version of the Industrial Catalogue is the 2015 version, which, superseding the 2011 version, was jointly promulgated by the NDRC and MOFCOM recently in March 2015 (NDRC and MOFCOM Order No. [2015] 22) and became effective as of 10 April 2015, while the latest Regional Catalogue remains the version promulgated in May 2013.

Finally, certain general concepts relating to the *Chinese shareholding requirement*, as used in the FI Guiding Regulations and the two Catalogues, are to be kept in mind:

- 'limited to equity or contractual joint venture [with Chinese parties]', meaning that no WFOE is allowed;
- 'with Chinese party having controlling shareholding', meaning that the aggregate Chinese shareholding shall exceed 50%; and
- 'with Chinese party having relatively controlling shareholding', meaning that the aggregate Chinese shareholding shall be higher than the shareholding of any single foreign shareholder.[7]

6. FI Guiding Regulations, Art. 11.
7. *Ibid.*, Art. 8. It should be mentioned that the last of the three cases implies that the aggregate foreign shareholding can be higher than the aggregate Chinese foreign shareholding, or, a single foreign investor can be the largest shareholder, provided that this largest shareholding possesses a shareholding lower than the aggregate Chinese shareholding.



# PART I
# Investment Vehicles

## INTRODUCTION: LATEST DEVELOPMENTS IN RELATION TO INVESTMENT VEHICLES

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Investment vehicles available to foreign investors have expanded since the days when China opened its doors to foreign investment, the early 1980s. China accords several investment vehicles to foreign investors: Wholly Foreign-Owned Enterprise (*WFOE*), Sino-foreign Equity Joint Venture (*EJV*), Sino-foreign Cooperative Joint Venture (*CJV*), Foreign Invested Holding Company (*FIHC*) and Foreign Invested Company Limited by Shares (*FICLS*). Collectively, these vehicles are referred to as foreign invested enterprises (*FIEs*).

Among the FIEs, the WFOE, EJV and CJV, called 'common FIEs' herein, are the most prevalent and will be discussed in *Chapter 2*. The FIHC is by its nature either an EJV or WFOE. However, in light of the investment nature of the FIHC and the particular regulations applicable to the FIHC, this vehicle will be deemed a particular FIE and separately discussed in *Chapter 3*. Both the common FIE and the particular FIHC are usually a limited liability company (*LLC*) in the sense of the Company Law. They are distinguished from the FICLS, which issues shares and is by its nature a company limited by shares (*CLS*) in the sense of the Company Law. As another particular FIE, the FICLS will be separately discussed in *Chapter 4*.

Apart from the above forms of FIE, which is a limited liability company (either an LLC or a CLS) with independent personality under the Company Law, foreign investors now have another option for entering into China, to set up a foreign invested partnership enterprise (*FIPE*) with limited liability. This is very important for private equity (*PE*) investments. Such an FIPE became an available investment vehicle since March 2010, when the State Council brought into force the *Measures on Administration of the Establishment of Partnership Enterprises in the PRC by Foreign Enterprises or Individuals*. Details in this regard will be given in *Chapter 5*.

Of notice, apart from the specifically applicable FIEs regulations, the PRC Company Law also applies to the FIEs (other than the FIPE) in general. In December 2013, the Company Law has adopted significant amendments in relation to the rules on the registered capital of a company, which shall apply to FIEs as well and will be discussed in Chapters 2-4 where relevant. Also, the draft Foreign Investment Law, which was published for comments in January 2015, contains very important implications or challenges to existing regulations applicable to the FIEs. Such implications will be discussed where relevant.

In addition, according to the relevant rules recently issued by the State Council or its departments in 2015, since October 2015, China combines the FIEs' establishment registration with the SAIC, the tax registration with tax bureaus and the allocation of national credibility code by quality supervision authority, which may be now one-stop done at the establishment registration with the SAIC; since June 2015, the FIEs may handle its foreign exchange registrations directly with the commercial bank of its capital bank, instead of the local SAFE as before; and, since February 2015, FIEs are not required to handle the financial registration with local MOF as before.



CHAPTER 2

# Foreign Invested Enterprises

## 2.1 INTRODUCTION

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China accords several investment vehicles to foreign investors, the most common of which are the wholly foreign-owned enterprise (*WFOE*), the Sino-foreign equity joint venture (*EJV*) and the Sino-foreign cooperative joint venture (*CJV*). These three common investment vehicles are usually a limited liability company (*LLC*) in the sense of the Company Law, different in nature from a company limited by shares (*CLS*).

Regarding the investment vehicles, general rules are set forth in the basic law, the *PRC Company Law* (*Company Law*), which was promulgated by the NPC Standing Committee and most recently amended in December 2013 (President Order No. [2013] 8) and became effective (as amended) as of 1 March 2014; and the *PRC Regulations on Administration of the Registration of Companies* (*Registration Regulations*), which were promulgated by the State Council and most recently amended in February 2014 (State Council Order No. [2014] 648) and became effective (as amended) as of 1 March 2014 as well.

On the other hand, it is well known that China implements two 'parallel' legal regimes respectively for FIEs and domestic companies. Specifically for the foreign invested enterprises (*FIEs*) such as WFOE, EJV or CJV, apart from the general rules set forth in the Company Law and the Registration Regulations, there are certain special regulations, among which are the followings:

- the *PRC Law on Wholly Foreign Owned Enterprises* (*WFOE Law*), promulgated by the PRC NPC and amended by its Standing Committee (President Order No. [2000] 41), effective (as amended) as of 31 October 2000, including its *Implementation Rules*, promulgated by the then MOFTEC and approved and amended by the State Council (State Council Order No. [2001] 301), effective (as amended) as of 12 April 2001;
- the *PRC Law on Sino-foreign Equity Joint Ventures* (*EJV Law*), promulgated and amended by the PRC NPC (President Order No. [2001] 48), effective (as

amended) as of 15 March 2001, including its *Implementation Rules*, promulgated and amended by the State Council (State Council Order No. [2001] 311), effective (as amended) as of 22 July 2001;

- the *PRC Law on Sino-foreign Cooperative Joint Ventures* (*CJV Law*), promulgated by the PRC NPC and amended by its Standing Committee (President Order No. [2000] 40), effective (as amended) as of 31 October 2000, including its *Implementation Rules*, promulgated by the then MOFTEC (MOFTEC Order No. [1995] 6) upon approval by the State Council, effective as of 4 September 1995; and
- the *Implementing Opinions on Certain Issues Concerning the Application of Laws on Administration of Approval and Registration of Foreign-invested Companies* (*FIE Implementing Opinions*), jointly promulgated by the SAIC, MOFCOM, GAC and SAFE (*GongShangWaiQiZi* No. [2006] 81), effective as of 24 April 2006.

Of mention, in the draft Foreign Investment Law published in January 2015 for comments (the *Draft FI Law*), a three-year transition period is given for FIEs (especially for CJVs) to make necessary changes to keep in consistency with the general requirements under the Company Law once the Draft FI Law were adopted in future.

As a rule, the above-mentioned FIE Laws (WFOE Law, EJV Law and CJV Law, collectively) prevail over the Company Law as the former plays as *lex specialis*, although both are at the same hierarchy level (adopted by the NPC or its Standing Committee). As a matter of fact, however, since the FIE Laws contain only very general provisions (none of the three FIE Laws contains over thirty articles), most specific matters in relation to foreign investment have been dealt with under the administrative regulations promulgated by the State Council or its functional departments (particularly, the MOFCOM). As the State Council or its functional departments are legislative authorities below the NPC (or its Standing Committee) level, there have been confusion and concerns in the foreign business community relating to the discrepancies between such administrative regulations and the Company Law. Such confusion was magnified by the overhaul of the Company Law in October 2005, which had adopted many significant developments that may bring implications to FIEs. To clarify some of such aforementioned confusions and to keep FIE laws in pace with the developments of the Company Law, the four Chinese government authorities promulgated the FIE Implementing Opinions in April 2006. The FIE Implementing Opinions cover some very important issues that may be of concern to FIEs. These will be discussed in details in the following sections where relevant. For present purposes, it is to note that the hierarchy rule clarified therein for the application of laws and regulations to FIEs.

Specifically, as specified in the FIE Implementing Opinions, the hierarchy order of authority of laws and regulations that may apply to the FIEs shall be:

(a) the WFOE Law, the EJV Law and the CJV Law (collectively, the *FIE Laws*);
(b) the Company Law and the Registration Regulations;
(c) respective Implementation Rules to the FIE Laws; then



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(d) other regulations of the State Council, the MOFCOM (including its predecessor, the then MOFTEC) or other ministries or commissions of the State Council such as the SAIC or SAFE.[1]

The rule is that the laws or regulations at the higher level prevail over those at the lower levels. It is very important to have a clear and appropriate understanding of the above hierarchy order of the authority of laws and regulations applicable to FIEs.

## 2.2 FEATURES SHARED BY THE FIES

### 2.2.1 MOFCOM Approval

In most cases, the establishment of an FIE requires approval of the MOFCOM (national or local), even if it is an FIE with less than 25% foreign capital.

In a very limited number of sectors, however, the MOFCOM approval is not required while the approval of the industry specific regulatory authority plays the role, particularly in the financial sector. For example, the approval of the China Banking Regulatory Commission (*CBRC*) suffices for the establishment of a foreign invested commercial bank in China, and the approval of the China Insurance Regulatory Commission (*CIRC*) suffices for the establishment of a foreign-invested insurance company. In either case, the MOFCOM approval is not required.

### 2.2.2 Legal Personality

All the EJVs shall be incorporated as an LLC with independent legal personality,[2] which means that the shareholders are liable for the EJV only to the extent of their capital contribution, i.e., a limited liability.

The WFOE shall also be an LLC with independent legal personality in principle, with the exception that other liability or organization forms may be possible.[3] However, as the establishment of a WFOE without legal personality requires approval of the national MOFCOM,[4] almost all the WFOEs, in practice, are incorporated as an LLC with independent legal personality.

The CJV, as contemplated under the CJV Law, may be incorporated either as an LLC with independent legal personality or a purely cooperative joint venture. The latter is a so-called true CJV, in which no independent legal personality is created and the shareholders shall bear unlimited liability for the CJV. In essence, the 'true' CJV is 'akin

1. FIE Implementing Opinions, Art. I.
2. EJV Law, Art. 4.
3. WFOE Law, Art. 8; Implementation Rules to the WFOE Law, Art. 18.
4. See Art. IV of the *Circular on Interpretation of Certain Articles of the Implementation Rules to the WFOE Law*, which was promulgated by the then MOFTEC (*WaiJingMaoFaFa* No. [1991] 760) and became effective on 6 December 1991.

to a contractual arrangement between the parties'.[5] 'The "true" CJV is a rare animal in today's market as few investors are willing to entertain the prospect of unlimited liability.'[6]

In today's practice, the most prevalent form of an FIE is the LLC with independent legal personality; and, for purposes of this analysis, the FIEs to be discussed will refer only to those established as an LLC with independent legal personality, unless otherwise specified.

Of additional mention, once the Draft FI Law would become effective in future, those WFOEs and CJVs which had been set up as enterprises without independent legal personality must take transformation steps to become a company with independent legal personality to keep conformity with the Company Law.

### 2.2.3 Chinese Individual Shareholders

Under the EJV Law and CJV law, the foreign investor may be either an entity or an individual person; in contrast, the Chinese party must be a company, enterprise or other commercial entity.[7]

It implies that a Chinese individual person cannot be the shareholder of an EJV or CJV. 'No domestic Chinese natural person is allowed, for the time being, to establish an FIE with a foreign company, enterprise or other commercial entity or individual by way of either new establishment or acquisition.'[8]

Nevertheless, in practice, there are locations where Chinese individual persons are allowed to become the shareholder of an EJV or CJV. Chinese government authorities in certain locations (such as Beijing Zhongguancun, Shanghai Pudong or Chongqing) indeed have changed the outdated attitude not allowing Chinese individuals to incorporate an FIE jointly with foreign investors. In addition, as a national policy, where the EJV or CJV has been established by way of acquiring an existing domestic company, the then existing Chinese individual shareholders are allowed to be the shareholders of the post-acquisition EJV or CJV.[9]

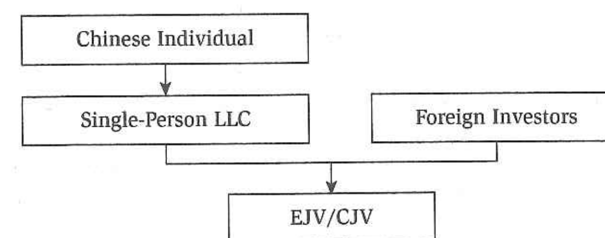
5. Vai Io Lo & Xiaowen Tian, *Law and Investment in China: The legal and business environments after WTO accession* (London, Routledge Curzon, 2005), 70.
6. Lovells, 'Overview of Common Foreign Investment Vehicles and Transaction Structures in China – Original Note and Addendum' (July 2004).
7. EJV Law, Art. 1; CJV Law, Art. 1.
8. Article V of the *Circular on Issues Concerning the Strengthening of the Administration of Examination and Approval, Registration, Foreign Exchange and Taxation on FIEs* (Circular No. 575), which was jointly promulgated by the then MOFTEC, SAT, SAIC and SAFE (*WaiJingMao-FaFa* No. [2002] 575) and became effective as of 1 January 2003.
9. This argument is especially confirmed by the fact that the M&A Rules (for details, see Chapter 6) adopted in August 2006 have thoroughly abandoned the policy of the superseded M&A Rules 2003. Specifically, under the M&A Rules 2003 (Art. 10), in a cross-border acquisition deal, only those Chinese natural persons having a shareholding record *of over one year* in the domestic target company may, subject to approval, continue to be the shareholders of the post-acquisition FIEs. Under the M&A Rules, a Chinese individual shareholder of the target domestic company may, subject to approval, remain the shareholding after the acquisition, no matter whether such a shareholder has been holding shares in that company for a period over one year.





Indeed, one may even hold the view that, with the EJV Law and CJV Law yet to be revised, while a Chinese individual person cannot join into the incorporation of an EJV or CJV, the person may bypass such a prohibition by way of establishing a single-person LLC (as permitted under the Company Law), which may then be used as the vehicle to incorporate an EJV or CJV. This may be illustrated as in Figure 2.1.

*Figure 2.1 EJV/CJV Involving Chinese Individuals*




### 2.2.4 Profit-Sharing Not in Proportion

Under the Company Law, it is permissible that the shareholders of a company agree in the shareholders' agreement and/or AOA that their distributable profits in the company will be shared not in proportion to their respective capital contribution.[10] Non-proportional profit-sharing is not a novel thing of the Company Law. Indeed, the CJV Law has expressly stated that shareholders of a CJV may share distributable profits in the CJV in accordance with the arrangements specified in the CJV Contract.[11] It implies that '[t]he distribution of profits from a CJV does not have to conform rigidly to the ratio of the parties' capital contribution'.[12] The significance of the general rule (Article 34) of the Company Law is that it now makes clear that the shareholders of a WFOE may also determine in the AOA that their profit-sharing will be made not in proportion to their capital contribution.

There exists an exception to this general rule, however. Unless when the Draft FI Law became law superseding the EJV Law in future, the shareholders of an EJV must handle the profit-sharing rigidly in proportion to their capital contribution to the EJV. In this sense, 'CJVs [and WFOEs] are considerably flexible than EJVs, permitting schemes whereby the profit-sharing of the parties is not necessarily tied to the value of the contributions'.[13] This is because it is the EJV Law that has clearly set forth such general principle of the EJV's profit-sharing rigidly in proportion to their capital contribution, while the EJV Law (Article 4), as *lex specialis*, prevails the Company Law.

10. Company Law, Art. 34.
11. CJV Law, Arts 2, 21.
12. Lovells, *supra* note 6.
13. *Ibid.*



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## 2.3 FEATURES PECULIAR TO VARIOUS FIES

### 2.3.1 Features Peculiar to WFOE

#### *2.3.1.1 Not All Open Industries Available to a WFOE*

The WFOE appears to become the most preferred investment vehicle for the vast majority of foreign investors in the past few years. This is because, under the sole controlling by foreign investors without the negotiation need with Chinese parties, a WFOE is 'easier to establish and exit from than an EJV or CJV'.[14]

However, WFOEs are prohibited in certain industries, even such industries generally open to foreign investors. As specified in the Industrial Catalogue, foreign investment in certain industries requires the form of an EJV or CJV or even the (absolute or relative) controlling by Chinese parties. Other industry specific regulations may have a similar requirement. In such cases, foreign investors have to incorporate a joint venture together with Chinese parties.

#### *2.3.1.2 Single-Person WFOE*

A single-person WFOE has already been contemplated under the WFOE Law, and in practice there exist many single-person WFOEs.

On the other hand, domestic investors were not permitted to establish single-person LLCs before the significant amendments to the Company Law in October 2005. The Company Law as amended in 2005 for the first time permits the incorporation of a single-person LLC by Chinese investors; however, it also sets forth certain particular requirements for such single-person LLCs, which are mainly contemplated under Article 58 of the Company Law as below:

(a) one individual person can only establish one single-person LLC (one legal person may establish more than one single-person LLC); and
(b) the single-person LLC established by an individual person cannot establish another single-person LLC (the single-person LLC established by a legal person may establish another single-person LLC).

Would the above requirements apply to a single-person WFOE (an LLC in nature) as well? In this regard, the FIE Implementing Opinions clarify as below:

- the above (a) does *not* apply to a single-person WFOE, one foreign individual person *may* establish more than one single-person WFOE; and

14. *Ibid.*

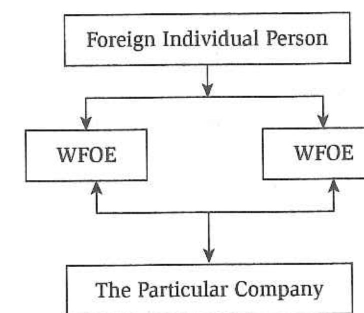




- the above (b) applies to a single-person WFOE, that is to say, the single-person WFOE established by a foreign individual person *cannot* establish another single-person LLC.[15]

Despite the application of the above (b) to a single-person WFOE, if a foreign individual person prefers to maintain a sole controlling of a particular company in the PRC, the structure may be followed as in Figure 2.2.

*Figure 2.2 Sole Foreign Controlling through WFOEs*




### 2.3.2 Features Peculiar to EJV

#### *2.3.2.1 Profit-Sharing Rigidly in Proportion*

As mentioned above (see 2.2.4 above), the shareholders of an EJV shall handle the profit-sharing rigidly in proportion to their respective capital contributions to the EJV. This is an exception to the general rule of the Company Law (Article 34) and the existing practice of the CJV law. What underlies this exception? The answer lies in the fact that the EJV Law clearly stipulates that '[p]arties to the joint venture shall share the profits, risks and losses in proportion to their respective contributions to the registered capital'.[16] According to the hierarchy rule specified in the FIE Implementing Opinions (see 2.1 above), the express provision of the EJV Law prevails over the general rule of the Company Law. This would change once all FIEs including EJV were required to comply with the same rules under the Company Law when the Draft FI Law will become law in future.

Despite the above, the other significant development under Article 34 of the Company Law – that the shareholders of a company may agree, in the event of an increase of the registered capital, to subscribe for the increase on a priority basis *not* in proportion to their paid-in capital – applies to the EJV (as well as other FIEs), as the EJV

15. FIE Implementing Opinions, Art. II.
16. EJV Law, Art. 4.



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Law (as well as the CJV Law or WFOE Law) does not contain an express provision to the contrary in this regard.

#### *2.3.2.2 Negotiated Pricing of the Non-monetary Assets Contribution*

The EJV has a particular advantage as compared with the other two (i.e., CJV or WFOE) in respect of the capital contribution. Specifically speaking, as reiterated under the FIE Implementing Opinions, it is a general rule that shareholders' capital contribution to an FIE shall comply with Article 27 of the Company Law, which requires that non-monetary assets contribution shall be duly appraised and valued. As for the EJV, however, this general rule of Article 27 does not apply.

As confirmed under the FIE Implementing Opinions, the shareholders of an EJV may determine, *through negotiation*, the price or pricing method for their non-monetary contribution assets, such as buildings, factory premises, equipment or other materials, intellectual property or proprietary technologies. This exception is given because the EJV Law has an express provision to this effect (in Article 5), which again prevails over the general rule of the Company Law.[17]

To clarify, as expressly stated in Article 5 of the EJV Law, land use rights that are contributed to the EJV remain subject to valuation by a PRC qualified appraising firm. What is interesting is that, if the asset is the land use right of a piece of land without buildings thereon, valuation of the land use right is necessary; in contrast, in cases where there are buildings on the land, since the shareholders may negotiate the value of the buildings, the valuation of the underlying land is unnecessary. The point here is that valuation of the underlying land is unnecessary if the contribution is made with the buildings, which contribution does not require valuation. The difference is whether there is any building on the land, and such difference seems to make no sense in China, as ownership of the buildings and use rights of the underlying land cannot be disposed of separately.[18]

In addition, where the non-monetary assets to be injected into the EJV are state-owned assets, a valuation is necessary as required under the regulations on state-owned assets (for details of such particular regulations, see Chapter 7).

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### 2.3.3 Features Peculiar to CJV

#### *2.3.3.1 Provision of 'Cooperative Conditions'*

So far as the two Sino-foreign joint ventures are concerned, '[a] legal person CJV is similar to an EJV, but offers a more flexible capital structure'.[19] Specifically speaking, instead of making contributions to the registered capital, parties (particularly Chinese

17. *Ibid.*, Art. 5; Implementation Rules to the EJV Law, Art. 22; FIE Implementing Opinions, Art. X.
18. See Jinrong Liu & Chengwei Liu (Global Law Office), 'Development in Laws of Foreign Invested Enterprises' <www.globallawoffice.com.cn/en/UpFile/2006/200666104739754.ppt> (June 2006).
19. Perkins Coie, 'Doing Business in China: A Primer' (December 2003).





parties) to a CJV may also provide 'cooperative conditions' in exchange for a dividends-sharing in the CJV:

> The primary difference between a CJV and an EJV is that parties to a CJV, instead of or in addition to contributing to the registered capital, may provide 'cooperative conditions' that may consist of access to or use of certain assets and/or rights that cannot be or are not assigned formally to the CJV, such as market access rights or undertakings to supply certain services or cooperation that will promote the business prospects of the CJV. In the most common scenario, the Chinese party provides such non-equity 'cooperative conditions' in exchange for an agreed share of the profits, while the foreign party contributes most or all of the true registered capital in the form of cash or other permitted in-kind contributions.[20]

#### *2.3.3.2 Advance Recovery of Investment*

Another peculiar feature of the CJV is that, in accordance with the CJV Law (Article 21), foreign investors in a CJV may recover their capital investment even before the termination and liquidation of the CJV. This is what is usually called 'advance recovery of investment' or 'advance investment recovery', which may take place through the following ways:

- distribution of the dividends to the foreign shareholder either (a) of all the CJV's dividends, or (b) in a greater proportion than the foreign investor's capital contribution, for a certain period;
- distribution of excess cash flow (before paying the enterprise income tax (EIT)), typically generated from the sharing of either (a) depreciation (or, even an accelerating depreciation upon approval of the tax authority) of fixed assets, or (b) amortization of intangible assets; or
- other ways that may be approved.[21]

To conduct the advance investment recovery, the foreign investor shall (via the CJV) submit an application to the provincial MOF of where the CJV is located. In this regard, the MOF issued the *Measures on Examination and Approval of the Advance Investment Recovery by Foreign Investors of the CJV* (*Advance Investment Recovery Measures*), which became effective as of 1 September 2005 (MOF Order No. [2005] 28). The Advance Investment Recovery Measures specify the conditions and procedures for foreign investors to conduct the advance investment recovery in a CJV.

20. Lovells, *supra* note 6.
21. Implementation Rules to the CJV Law, Art. 44; see also *Official Reply of the SAT on Issues Concerning the Advance Investment Recovery by Foreign Investors of the CJV during the Term of CJV*, which was promulgated by the SAT (*GuoShuiHanFa* No. [1991] 502) and became effective as of 9 April 1991; the *Letter of Reply of the MOF on Issues Concerning Funds Sources of the Advance Investment Recovery by Foreign Investors of the CJV*, which was promulgated by the MOF (*CaiGongZi* No. [1993] 393) and became effective as of 12 October 1993; and the *Statements on Implementing Certain Articles of the Implementation Rules to the CJV Law*, which were promulgated by the then MOFTEC (*WaiJingMaoFaFa* No. [1996] 658) and which became effective as of 22 October 1996.

According to the Advance Investment Recovery Measures (Article 4), to qualify for an advance investment recovery, the following conditions shall be satisfied:

- all the shareholders have agreed in the CJV Contract that the Chinese party shall be given the ownership, free of charge, of all the fixed assets of the CJV upon expiration of the CJV's term;
- the CJV undertakes to discharge the CJV's debts with precedence over the advance recovery;
- the foreign investor applying for the advance recovery undertakes to bear joint and several liability for the debts of the CJV to the extent of the advance recovery;
- the registered capital of the CJV has been duly paid in full; and
- the CJV is in good business and financial situation without losses that have not been made up.

## 2.4 COMPANY NAME

The company name of companies registered in the PRC including FIEs shall be composed *in turn*, of: (a) a regional name of the competent SAIC; (b) a trade name; (c) a term indicating the business industry or sector; and (d) the company's nature (LLC or CLS). In this regard, the investors shall comply with the standardization requirements implemented in the *Implementing Measures on Administration of the Registration of Enterprise Names* (*Names Registration Rules*), which were promulgated and amended by the SAIC (SAIC Order No. [2004] 10) and became effective (as amended) as of 1 July 2004.

Among the above-mentioned components, the former two deserve particular discussions. Respectively, in light of the provisions of the Registration Regulations and the Names Registrations Rules (Articles 6-20) as well as the requirements in practice, the following points should be kept in mind when applying for the registration of a company name for the proposed FIE:

*Regional name*: (a) The company name usually shall commence with the regional name (above county level), e.g., 'Beijing XXX Co., Ltd.', and sometimes FIEs may also place the bracketed regional name in the middle, e.g., 'XXX (Beijing) Co., Ltd.'; (b) only those established under the State Council's approval may use a company name commencing with Chinese characters equivalent to 'China', 'PRC', 'National', 'State' or 'International'; (c) a WFOE or foreign-controlled EJV/CJV may use the aforementioned Chinese characters (other than the one equivalent to 'International') in the middle with brackets, e.g., 'XXX (China) Co., Ltd.', but such name shall be registered with the national SAIC and the proposed FIE shall have a registered capital of no less than RMB 50 million; and (d) only those established under the State Council's approval, established under the national SAIC's registration or having a registered capital of more than RMB 50 million may choose not to commence with or contain in the middle a





regional name, but such name without regional name contained therein shall be registered with the national SAIC.

*Trade name*: (a) The trade name shall consist of two or more Chinese characters; China does not accept registration of names in foreign language unless it is an existing trade name of the foreign investor, e.g., 'LG (China) Co., Ltd.'; (b) in cases where the foreign investor would like to use its own trade name as the trade name of the proposed FIE, (i) if the foreign investor has already used such trade name in an existing FIE within the same SAIC's jurisdiction, or even, (ii) unfortunately, it is found that a third party has already used the same trade name in an existing company within the same SAIC's jurisdiction,[22] then the foreign investor shall obtain an authorization letter from the existing FIE or the third party's company to allow the use of the trade name in the proposed FIE; and (c) the name of the individual shareholder of the proposed FIE may be used as the trade name, however, such name of an individual person cannot be injected as the capital contribution assets, though China does not prohibit the FIE using such name from paying to the concerned person for the use of the latter's name.

## 2.5 REGISTERED CAPITAL

### 2.5.1 Capital Requirement

One very important portion of the amendments to the Company Law made in December 2013 (effective as of March 2014) (*the 2013 Amendment to Company Law*) is the abolishment of the minimum capital requirement for a company including FIE in general. Now, under the Company Law (as amended in 2013), the outdated capital requirement of RMB 30,000 (Article 26 of the Company Law 2005) ceased to apply. In June 2014, the MOFCOM promulgated the *Circular on Improving the Review and Administration of Foreign Investment* (*MOFCOM 2014 Circular*) to make it clear that FIEs are not subject to the minimum capital requirement as well.

On the other hand, certain industry specific regulations may still maintain a specific capital requirement, mainly in the financial sector. In that case, the higher requirement prevails.

### 2.5.2 Contribution Assets

Cash is the most common contribution assets. Generally, as required in practice, the cash that the foreign investor can use as capital contribution into an FIE shall be in a freely convertible foreign currency. In certain particular cases, the foreign investor may also use its lawful Renminbi assets, gained from transactions such as liquidation of or

22. In this latter case, the foreign investor may sue against the third party's infringement under the trademark law only if the foreign investor has already registered its trade name as a trademark in an international scope that extends to the PRC jurisdiction, or seek protection in accordance with the international treaties or conventions to which the PRC accedes.

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Furthermore, on the strength of the MOFCOM approval of the acquisition, if granted, the new FIE can then apply for the FIE Approval Certificate.[35]

Step 4: Post-approval Registrations

Post-approval registrations in the assets deal are most similar to those presented above in Step 4, 6.4.2.1, except that the applicant here is the new FIE established to operate the acquired assets, instead of the seller or target company.

Step 5: Payment Time Limits

As for the payment in an assets deal, most important points given above in Step 5, 6.4.2.1 apply here. As for the payment time limits to be applied in the assets deal, of mention here is that the purchaser shall, apart from the specification in the assets purchase agreement, additionally specify the capital contribution time limits in the shareholders' agreement and/or AOA of the new FIE. In determining the time limits for such a capital contribution, the purchaser (i.e., the shareholder of the new FIE) shall comply with the provisions of the M&A Rules. That is to say, among the capital injection into the FIE, the portion equivalent to the assets purchase price shall be injected in line with the time limits illustrated above in the Table 6.2.[36] Of mention, following the 2013 Amendments to the Company Law in relation to registered capital (see Chapter 2), it is now up to the parties to decide whether the remaining portion should be injected (instead of the previous two-year mandatory requirement).

Step 6: Title Transfer of the Acquired Assets

As the foreign purchaser cannot be registered in the PRC as the owner of the acquired assets, the title transfer of such acquired assets are usually handled in the name of the new FIE upon its establishment after the SAIC registration, which is conditional on the MOFCOM approval of the purchase deal.

35. M&A Rules, Art. 25.
36. *Ibid.*, Art. 16.



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CHAPTER 7

# Acquisition of State-Owned Enterprises

## 7.1 INTRODUCTION

Acquisition of state-owned enterprises (*SOEs*) may be either an equity or assets deal. In this regard, particular procedures and requirements shall apply, in addition to those discussed in Chapter 6. Of key importance are the following regulations:

- the *PRC Law on State-owned Assets of Enterprises* (*SOA Law*), promulgated by the Standing Committee of the PRC NPC (President Order No. [2008] 5), effective as of 1 May 2009;
- the *Tentative Measures on Administration of the Transfer of State-Owned Assets and Equity in Enterprises* (*SOE Transfer Rules*), jointly promulgated by the SASAC and MOF (SASAC and MOF Order No. [2003] 3), effective as of 1 February 2004;
- the *Circular on Certain Matters Concerning the Transfer of State-Owned Assets and Equity in Enterprises* (*Circular No. 306*), jointly promulgated by the SASAC and MOF (*GuoZiFaChanQuan* No. [2006] 306), effective as of 31 December 2006;
- the *Circular on Certain Issues Concerning the Transfer of State-Owned Assets and Equity in Enterprises* (*Circular No. 268*), promulgated by the SASAC (*GuoZiFaChanQuan* No. [2004] 268), effective as of 25 August 2004;
- the *Operating Rules on Transactions of State-owned Assets in Enterprises* (*SOA Public Transfer Rules*) promulgated by the SASAC (*GuoZiFaChanQuan* No. [2009] 120), effective as of 1 July 2009; and
- the *Tentative Measures on Administration of the Valuation of State-Owned Assets in Enterprises* (*Valuation Rules*), promulgated by the SASAC (SASAC Order No. [2005] 12), effective as of 1 September 2005.

Based on currently effective regulations, the acquisition of an SOE requires approval by or record-filing with the SASAC (including its local counterparts at

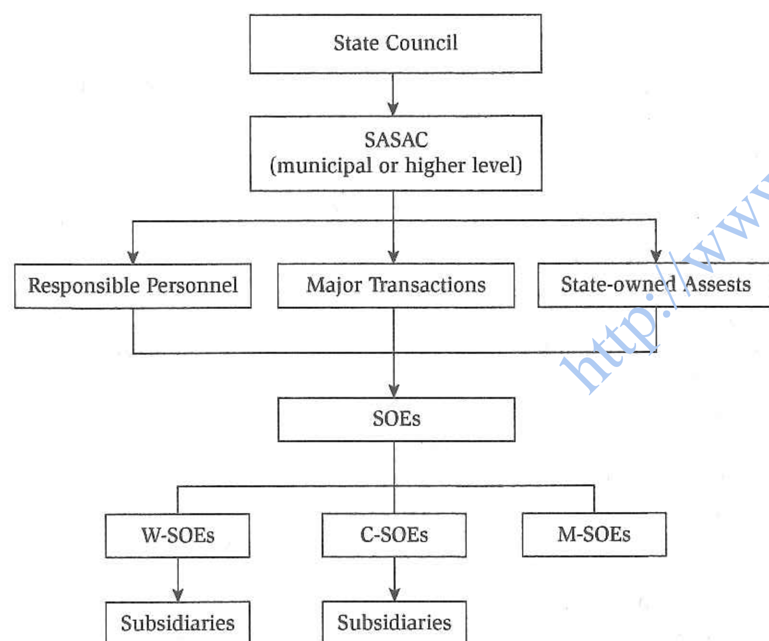
municipal or higher level), in addition to the MOFCOM approval (for foreign investors). The SASAC plays a very significant role in such deals, covering the supervision of:

- so-called Investee Enterprises – enterprises invested by the state (via national or local SASACs), composed of wholly state-owned enterprises (*W-SOEs*), state-controlled enterprises (*C-SOEs*) and enterprises with minor state capital (*M-SOEs*); and
- subsidiaries of the W-SOE and C-SOE.

For discussion purpose, the 'SOE' referred to herein covers both: (a) the Investee Enterprises, and (b) the subsidiaries of the W-SOE/C-SOE.

Generally, the SASAC implements a very extensive supervision over SOEs, in relation to: (a) the transfer, dilution or increase of state capital in the SOE; (b) the execution of major transactions in or of the SOE, such as restructuring, merger or division; and (c) the appointment and performance assessment of responsible personnel of the SOE. This is illustrated in Figure 7.1.[1]

*Figure 7.1 SASAC Supervision over SOEs*




1. For a detailed illustration, see Xiaoliang Jia (SASAC), 'The Organization of the Ownership Function within the State Administration' (May 2006), at <www.oecd.org/dataoecd/61/21/37339651.pdf>.





As in practice the equity deal is more frequently resorted to than the assets deal, this Chapter will focus on the equity transfer in SOEs. In line with the definition of state ownership in SOEs under the SOE Transfer Rules, the equity transfer to be discussed herein will refer to: (a) the transfer by SASAC in the Investee Enterprises; and (b) the transfer by W-SOEs and C-SOEs in their subsidiaries.

## 7.2 TRANSFER OF SOES IN GENERAL

### 7.2.1 Transfer Ways

China implements so-called floor-based trading system for the equity transfer in SOEs. As a rule, equity transfer in SOEs, including the transfer to foreign investors, shall be conducted in a public way through listing on a duly established local equity exchange to widely seek for potential purchasers.[2] The emphasis is on the transfer in an open way, no matter on which specific equity exchange the seller lists its equity. For example, the shareholder of a Beijing SOE, regardless of which specific sector its business belongs to or to which it subordinates, may list the equity to be transferred on the Tianjing equity exchange. Details on such floor-based trading will be given below in 7.4.

On the other hand, a negotiated transfer by agreement over the counter (i.e., outside the equity exchange) (transfer by agreement) is possible, as an exception, only in certain but very limited cases where the SASAC has so approved.[3] Such a negotiated transfer is subject to the SASAC approval under very strict conditions and procedures, except that it is a case the listing on the equity exchange only produces one qualified purchaser. In this regard, the recently issued Circular No. 306 has clarified under what specific circumstances the parties can apply for a transfer by agreement. These will be detailed below in 7.3.1.

Still, the transfer may be an administrative assignment without consideration. However, as this kind of transfer is conducted without consideration, it goes beyond the application scope of the SOE Transfer Rules. Furthermore, the one eligible for an administrative assignment without consideration is limited only to governmental entities or institutions and W-SOEs; foreign investment cannot place a foot in this kind of transfer.[4] Thus, assignment without consideration will not be detailed herein.

In addition, the transfer may be a management buy-out (*MBO*). In practice, however, the SASAC implements very stringent controls over MBO and has seldom permitted an MBO deal, this kind of transfer will not be detailed herein, either.[5]

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2. SOE Transfer Rules, Art. 4; SOA Law, Art. 54; Circular No. 306, Art. II(1).
3. SOE Transfer Rules, Art. 18.
4. For details on administrative assignment without consideration, see the *Tentative Measures on Administration of the Assignment without Consideration of State-owned Assets and Equity in Enterprises*, which were promulgated by the SASAC (*GuoZiFaChanQuan* No. [2005] 239) and became effective as of 29 August 2005.
5. For details on MBO, see the *Tentative Provisions Concerning the Transfer of State-owned Assets and Equity in Enterprises to Management*, which were jointly promulgated by the SASAC and MOF (*GuoZiFaChanQuan* No. [2005] 78) and became effective as of 11 April 2005.

### 7.2.2 Transfer Approval by Competent Authorities

Equity transfer in SOEs requires approval of the SASAC or other competent authorities. Generally, such a competent approval authority may be:

- *the SASAC*, which is competent to the transfer in the Investee Enterprises, respectively, (a) national SASAC competent to the transfer in central SOEs (i.e., Investee Enterprises of the national SASAC), and (b) local SASACs above municipal level competent to the transfer in local SOEs; or
- *the W-SOE* or *C-SOE*, which is competent to the transfer in its subsidiaries.[6]

As for the latter case, however, if it is a transfer in the 'major subsidiaries' of a W-SOE/C-SOE that would constitute a substantial transfer, then the approval power is vested in the competent SASAC (countersigned by the MOF) just as in the event of a transfer in the W-SOE/C-SOE.[7] Unfortunately, however, no uniform standard exists as for what constitutes a 'substantial transfer' or 'major subsidiaries'. In practice, some local governments publish a list of the so-called major subsidiaries within their jurisdictions. In this regard, it is clarified in Circular No. 268 that, before the enacting of a uniform standard by the national SASAC:

- for a central W-SOE/C-SOE, it is up to the central W-SOE/C-SOE itself to determine which of its subsidiaries are among the 'major subsidiaries' and what transfer in such a subsidiaries constitutes a 'substantial transfer;' and
- for a local W-SOE/C-SOE, it is up to the competent local SASAC to publish a list of 'major subsidiaries' and specify the standard of 'substantial transfer'.[8]

On the other hand, if it is a transfer of the state controlling rights in the Investee Enterprises that would convert the target SOE into a company not controlled by the state or a private company, the approval power is vested in *the people's government* at the same level of the competent SASACs – State Council or local people's government above municipal level.[9]

In any event, approval of the competent authorities shall be obtained: (a) in a public transfer, before the seller can list the equity on an equity exchange to seek for potential purchasers; or (b) in a negotiated transfer, before the executed transfer agreement can go into effect. Furthermore, even after the approval of competent authorities has been obtained, if the parties intend to adjust the ratio or amount of the subject equity or there occur other substantial adjustments to the original transfer scheme, the parties shall again go through the approval procedures to obtain a new approval for the adjusted transfer.[10] In any event, if the transfer is conducted without

6. SOE Transfer Rules, Arts 25, 26.
7. *Ibid.*, Art. 26.
8. Circular No. 268, Art. II.
9. SOE Transfer Rules, Art. 25.
10. *Ibid.*, Art. 31.





approval of the competent authorities, the SASAC may halt the transfer, and, where necessary, sue the governing court to declare invalidation of the transfer.[11]

### 7.2.3 Pricing of the Transfer

Pricing of the equity transfer in SOEs shall be based on the assets valuation result issued by a qualified valuation firm (valued price). Furthermore, such a valued price that may be used as the pricing basis shall be the one approved by or filed for record with the SASAC or other authority that is competent to approving the transfer at issue (for details, see 7.6 below).[12] In intragroup transactions between W-SOEs/C-SOEs and their wholly owned subsidiaries or among such wholly owned subsidiaries of a W-SOE/C-SOE, however, the pricing may be based on audited net asset value according to the Circular (*GuoZiChanQuan* No. [2014] 95) recently issued by the SASAC in July 2014.

In a negotiated transfer by agreement, on the one hand, *the transfer price* shall be no lower than the valued price that has been approved by or filed for record with the competent approval authority.[13] In a public transfer through floor-based trading, on the other hand, there is a third concept apart from the valued price and transfer price, i.e., *listed price*. The initial listed price – the price at which the seller publicly seeks for potential purchasers by listing on an equity exchange – shall be no lower than the valued price that has been approved or filed for record. If no potential purchaser has proposed to accept the public invitation during the listing period, the seller may reinitiate the listing based on a new listed price. However, if the new listed price is lower than 90% of the valued price, then a written confirmation of such a new price by the competent approval authority shall be obtained before the listing can be reinitiated based on the new listed price.

In any event, in the public transfer, if there appears only one qualified purchaser after the listing, the transfer price shall be the listed price (either the initial listed price or the approved new listed price). On the other hand, the transfer price shall be the price resulting from public auctions or bidding if two or more qualified purchasers propose to acquire the equity for sale during the listing period. Of particular notice here is that the seller is not entitled to provide discounts or preference to such a resultant price following the floor-based trading just because the preferred purchaser has proposed an attractive payment method (e.g., payment in one lump sum or in cash).[14]

### 7.2.4 Payment

Payment of the transfer price shall comply with certain rules specified in the SOE Transfer Rules, in addition to parties' negotiation. Specifically speaking:

11. *Ibid.*, Art. 32.
12. *Ibid.*, Art. 13.
13. Circular No. 306, Art. I(3).
14. *Ibid.*, Art. V; SOE Transfer Rules, Art. 13.



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- as a rule, the payment shall be made in one lump sum; and
- in cases where the payment is of such a large amount that the purchaser does have difficulty to pay in one lump sum, the payment may be made by instalments, subject to the approval of the competent approval authority.[15]

In the former case (i.e., payment in one lump sum), however, the SOE Transfer Rules do not make clear within what time the payment shall be made. In practice, the time limit for a payment in one lump sum may be three or six months, depending on the approval of the competent SASAC. In the latter case (i.e., payment by instalments), on the other hand, the following conditions shall be additionally satisfied: (a) the initial payment shall be 30% or more of the transfer price and made within five working days of the effectiveness date of the transfer agreement; (b) the balance shall be paid up in one year of the effectiveness date; and (c) for the balance amount, the purchaser shall provide legal security or guarantee and pay interest thereof at the current interest rate on bank loans for the deferral period.[16]

## 7.3 NEGOTIATED TRANSFER BY AGREEMENT

### 7.3.1 Strict Controls over the Transfer by Agreement

China strictly limits the transfer by agreement in regard to the equity transfer in SOEs. Among other things, as compared with those discussed above in 7.2.2, the approval requirement for the transfer by agreement is stricter. Specifically speaking, the competent approval authority for a transfer by agreement shall be:

- *national SASAC*, competent to the transfer in central SOEs; or
- *provincial SASAC*, competent to the transfer in local SOEs.[17]

Of mention, in the recently issued SASAC Circular (*GuoZiChanQuan* No. [2014] 95), it states that upon consent by provincial people's government, provincial SASAC may authorizes down to local SASAC the competency for approval of negotiated transfer of an SOE below municipal level.

Furthermore, the Circular No. 306 specially stresses that, as a rule, even a transfer to foreign investors shall be conducted in a public way through listing on the equity exchange; and that, only in very exceptional circumstances where such a transfer way is of true necessity, may the parties follow the way of transfer by agreement.[18] Specifically, Circular No. 306 clearly states that only in two particular cases may the parties apply for a transfer by agreement:

- in the restructuring of state key industries or sectors where there are special and particular requirements for the qualified purchaser; or

15. SOE Transfer Rules, Art. 20.
16. *Ibid.*
17. Circular No. 306, Art. I(2).
18. *Ibid.*, Art. II(1).





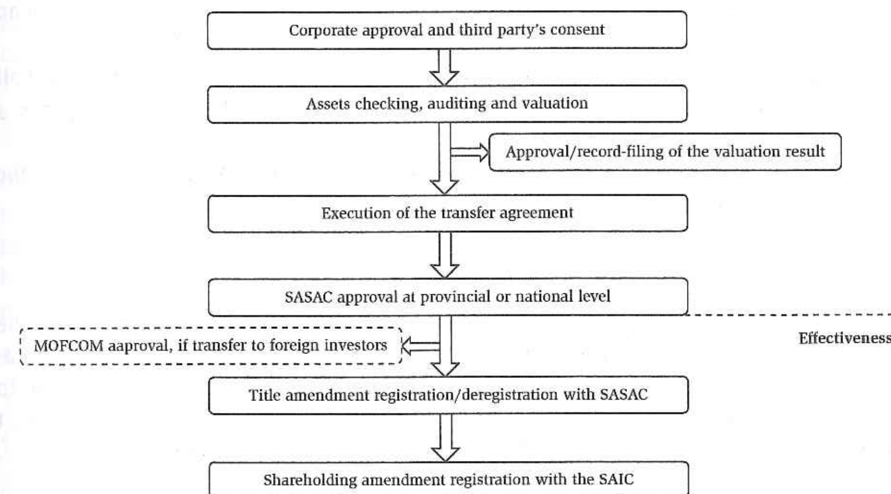
- in the group assets reorganization of the Investee Enterprises where a transfer by agreement is of true necessity.[19]

In the former case, the transfer shall satisfy the following conditions: (a) the transfer conforms to the state restructuring planning and industrial policies; (b) the proposed purchase would not contravene with the restrictions or prohibitions in respect of state economic security and would strongly promote the technology advancement or industry upgrading; and (c) if the business of the target SOE is among the state key industries or crucial sectors (see 7.5.1 below), the state capital shall remain holding absolute controlling rights (over 50%) therein after the transfer.[20] In the latter case, on the other hand, both parties to the transfer shall be among the Investee Enterprises, or the wholly owned or absolutely controlled (over 50%) subsidiaries of an Investee Enterprise.[21]

### 7.3.2 The Procedures of Negotiated Transfer

The procedures of a transfer by agreement, as contemplated under the SOE Transfer Rules and Circular No. 306 as well as in light of practice, is illustrated in Figure 7.2.

*Figure 7.2 Procedures of Negotiated Transfer*




19. *Ibid.*, Art. I; SOE Transfer Rules, Art. 30.
20. Circular No. 306, Art. I(1).
21. *Ibid.*



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Step 1: Corporate Approval and Third Party's Consent

### Corporate Approval

Above all, the proposed equity transfer shall be approved by the power organ of the target SOE. As contemplated under the SOE Transfer Rules and the Company Law, the power organ of the target SOE may be: (a) the shareholders' meeting, if the SOE is a limited liability company (LLC); (b) the shareholders' general meeting, if the SOE is a company limited by shares (CLS); (c) the board of directors, if the SOE is a W-SOE established as an LLC according to the Company Law; or (d) the staff meeting of the general manager, if the SOE is a W-SOE not established as an LLC.

As for the necessary affirmative voting at the power organ's meeting, the articles of association (AOA) or other constituent documents of the target SOE shall prevail to the extent that such constituent documents adopt a higher standard that does not contravene with the Company Law. Without such a higher standard, the general requirements under the Company Law shall apply, whereby:

- in an SOE (excluding W-SOE) of LLC nature, a confirmation is necessary that satisfies each and all of the following three conditions: (a) consent by over half of all the shareholders; (b) waiver of pre-emptive rights by all the shareholders other than the seller; and (c) resolution by more than two-thirds voting rights held by the shareholders present at the shareholders' meeting;[22]
- in an SOE of CLS nature, it is necessary to pass a resolution by more than two-thirds voting rights present at the shareholders' general meeting;[23]
- in a W-SOE of LLC nature, it is necessary to pass a resolution by more than half of the directors present at the board meeting, which meeting requires a quorum of half of all the directors; or
- in a W-SOE not of LLC nature or other SOEs, it depends on the specific procedures specified in the constituent documents of such SOEs.

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### Third Party's Consent

Consent of certain third parties, especially the consent of the creditor banks of the target company, may be required by the SASAC when reviewing the transfer application. Indeed, the concerned loan agreement usually contains a similar requirement to the effect that the debtor (i.e., the target company) shall obtain consent of, at least notify in advance, the creditor bank before it conducts an assets or equity transfer deal.

Furthermore, if a pledge has been created over the equity or shares to be transferred, then the pledgee's consent must be obtained before the transfer of such pledged equity or shares can be conducted.[24]

22. Company Law, Arts 44, 72.
23. *Ibid.*, Art. 104.
24. *PRC Property Rights Law*, Art. 226; *PRC Guarantee Law*, Art. 78.





### Waiver of Pre-emptive Rights over the Equity Targeted

If the target SOE is an LLC, the waiver by the target's shareholders other than the seller is necessary in regard to their pre-emptive rights over the equity interest to be transferred. It results from the pre-emptive rights granted to the shareholders of an LLC under the Company Law. It should be mentioned, however, that the Company Law implies that the AOA of the target company can exclude its shareholders from enjoying a pre-emptive right by an express clause to that effect.[25] In that case, the AOA prevails.

On the other hand, if it is a CLS, the shareholders are not granted such pre-emptive rights over the shares to be transferred; accordingly, the aforementioned waiver is not necessary, unless the CLS's AOA specifies otherwise.

Step 2: Assets Checking, Auditing and Valuation

As mentioned above (see 7.2.3), pricing of the equity transfer in SOEs shall be based on the assets valuation result that has been approved by or filed for record with the competent approval authority. Details in this regard will be given below in 7.6.

Before the aforementioned assets valuation can be conducted, the seller shall (a) organize an assets checking of the target SOE; and (b) appoint a PRC CPA to conduct a complete auditing of the target SOE. The said assets checking is to revaluate and confirm the profits and loss (P/L) of the state-owned assets in the target SOE, in order not to lead to any undue loss of state-owned assets as a result of the proposed transfer. To be noted, however, if it is a transfer of the state controlling rights in an Investee Enterprise that will lead to the transformation of the target SOE into a private company, then it is up to the competent SASAC to conduct such an assets checking and to appoint a CPA to conduct the auditing.[26]

Step 3: Execution of the Transfer Agreement

Upon the price fixed based on the valuation result, the parties may then execute the transfer agreement. Of particular mention here is that as required by the SASAC in practice, in an application of transfer by agreement, the transfer agreement should have clearly stated that the agreement shall become effective only upon approval by provincial or national SASAC.

Step 4: SASAC Approval at Provincial or National Level

The transfer agreement requires approval by the provincial or national SASAC. According to the SOE Transfer Rules (Articles 28, 29) and in light of the requirements in practice, to obtain such an approval, the parties shall submit, together with the transfer agreement, the documents listed in Table 7.1 to the competent SASAC for review.

25. Company Law, Art. 72.
26. SOE Transfer Rules, Art. 12.

*Table 7.1 Application Documents for the Equity Transfer in SOEs by Agreement*

| No. | File Name | Check |
|---|---|---|
| I. Documents in general | | |
| 1 | Transfer application, specifying, among other things, (a) basic identity information of the parties; and (b) key points of the transfer scheme and underlying transfer reasons | |
| 2 | Transfer scheme, specifying, among other things, (a) specific steps and methods in performing the transfer; (b) reasons underlying the transfer by agreement; (c) transfer price; (d) staff relocation arrangements; and (e) arrangements of credits, debts and claims | |
| 3 | Identity documents of the parties, such as Business License or ID card | |
| 4 | Undertaking letters respectively by the seller and target SOE that there is no mortgage, pledge or other encumbrance and litigation or seizure over the subject equity | |
| II. Documents of the target SOE | | |
| 5 | Title registration form or certificate of state-owned assets | |
| 6 | Corporate resolution by its power organ | |
| 7 | AOA and shareholders' agreement, and amendments thereto | |
| 8 | Audit reports of the most recent year and latest reporting period | |
| 9 | Staff relocation scheme, which shall have been approved by both the local labour bureau and the employees' assembly of the target SOE | |
| 10 | Arrangements for claims and debts with, or consent by, its creditors | |
| III. Documents by professionals | | |
| 11 | Assets valuation report and approval/record-filing proof thereof | |
| 12 | Legal opinion, which shall opine, among other things, on (a) legality of the establishment and changes in the target SOE; (b) legality of the transfer agreement and transferability of the subject equity; and (c) applicability to the transfer by agreement | |

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Unfortunately, however, the SOE Transfer Rules do not specify a time limit for the competent SASAC to make a decision. In practice, this SASC approval usually will take fifteen days to a month or even longer depending on the case.

Step 5: Title Amendment Registration/Deregistration with the SASAC

Within thirty days of the SASAC transfer approval but before the SAIC registration, the target SOE shall handle title registration procedures with the governing SASAC (national or local), which is to register the changes of state capital in the target SOE (title amendment registration) resulted from the transfer. If, following the transfer, the target SOE would be transformed to a private company without state capital, then the





title deregistration procedures of state-owned assets shall be handled with the competent SASAC.

The target SOE shall handle such title registration/deregistration procedures in accordance with the *Measures on Administration of the Title Registration of State-Owned Assets in Enterprises*, which were promulgated by the State Council (State Council No. [1996] 192) and became effective as of 25 January 1996, including its Implementation Rules that were promulgated and amended by the MOF (*CaiGuanZi* No. [2000] 116) and became effective (as amended) as of 6 April 2000; and the *Procedural Rules on Handling the Title Registration of State-Owned Assets in Enterprises*, which were promulgated by the SASAC (*GuoZiFaChanQuan* No. [2004] 315) and became effective as of 30 October 2004.

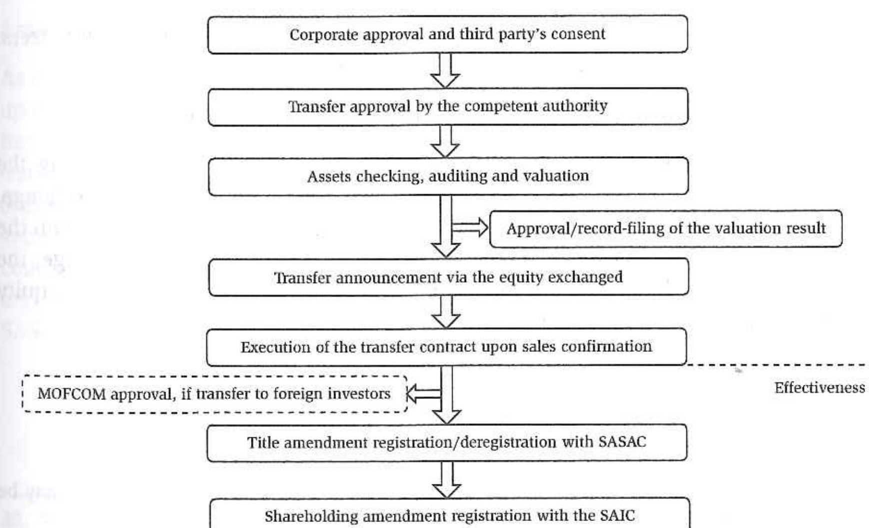
Step 6: Shareholding Amendment Registration with the SAIC

Following the title registration/deregistration of state-owned assets with the governing SASAC, the parties shall handle registration procedures of the shareholding changes with the competent SAIC, on the strength of the SASAC approval and, if applicable, the MOFCOM approval.

## 7.4 PUBLIC TRANSFER ON THE EQUITY EXCHANGE (FLOOR-BASED TRADING)

As a rule, equity transfer in SOEs shall be conducted on the equity exchange, so-called floor-based trading. The procedures of such a floor-based trading, as outlined in the SOA Public Transfer Rules, are illustrated in Figure 7.3.

*Figure 7.3 Procedures of the Transfer on the Equity Exchange*



Step 1: Corporate Approval and Third Party's Consent

See Step 1, 7.3.2 above.

Step 2: Transfer Approval by the Competent Authority

After the internal corporate approval on the proposed transfer, the seller (via the target SOE) shall obtain the approval of the competent authority, which may be the local SASAC or the W-SOE/C-SOE (for details, see 7.2.2). As for the documents to be submitted for such an approval application, they are basically the same as listed above in Table 7.1, except that the transfer agreement is not requirement at this stage.

Step 3: Assets Checking, Auditing and Valuation

After obtaining the transfer approval of the competent authority, the seller may then commence the assets checking, auditing and valuation work. For details in this regard, see Step 2, 7.3.2 above.

Step 4: Transfer Announcement via the Equity Exchange

After the assets valuation, the seller shall then entrust the equity exchange to publish a transfer announcement both on a provincially circulated newspaper and at the official website of the equity exchange. The announcement shall contain the following information:

- basic information of the subject equity;
- shareholding structure of the target SOE;
- corporate approval of the target SOE;
- information on the approval/record-filing of the assets valuation report;
- recently audited major financial indices and data of the target SOE; and
- qualification requirements for the potential purchaser.[27]

The purpose of such an announcement is to widely invite potential purchasers. The period for such an announcement is twenty days.[28]

Step 5: Execution of the Transfer Contract upon Sales Confirmation

If the public invitation results in two or more qualified purchasers following the transfer announcement, the seller shall, with assistance of the equity exchange, implement the floor-based trading through auctions or bidding in accordance with the applicable regulations. Then, upon sales confirmation with the equity exchange, the seller shall enter into the transfer contract with the preferred purchaser; and the equity exchange shall issue the sales confirmation letter to the purchaser.[29]

27. *Ibid.*, Art. 14.
28. Further details on the announcement to and registration of the potential purchasers may be found in Circular No. 268.
29. SOE Transfer Rules, Art. 17.



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On the other hand, if the public invitation results in only one qualified purchaser, then the parties may follow the approach of transfer by agreement. Details on such a transfer by agreement have been given in 7.3 above.

Step 6: Title Amendment Registration/Deregistration with the SASAC

Within thirty days of the execution of the transfer contract upon sales confirmation but before the SAIC registration, the target SOE, on the strength of the sales confirmation letter issued by the equity exchange, shall handle the title amendment registration/deregistration procedures of state-owned assets with the governing SASAC. (See Step 5, 7.3.2.)

Step 7: Shareholding Amendment Registration with the SAIC

See Step 6, 7.3.2 above.

## 7.5 SUPERVISIONS OVER THE CONTROLLING OF STATE CAPITAL

In certain particular sectors that are key or sensitive to state economy security, China implements very strict controlling by state capital. The State Council, in the *Directive Opinions on Promotion of the Adjustments to State Capital and the Restructuring of SOEs* promulgated in December 2006, requires the concerned authorities, including the SASAC, to list the specific industries and sectors that are key to the state economy and list so-called backbone SOEs in such industries.[30]

On the other hand, in sectors not requiring absolute or strong controlling by state capital, the original state controlling rights in the target SOE may be transferred. Such a transfer of state controlling rights, however, is subject to relatively strict supervisions by the SASAC. Among other things, such strict supervisions are embodied in the following aspects.

**Assets Checking by the SASAC**

As mentioned above (see Step 2, 7.3.2 above), in a common acquisition of SOEs, it is up to the seller to organize the assets checking of the target SOE. In contrast, if it is a transfer of the state controlling rights in an Investee Enterprise that will lead to the transformation of the target SOE into a private company, then it is up to the competent SASAC to conduct such an assets checking.[31] In the latter case, the target SOE shall submit the assets checking application to the competent SASAC; and the SASAC shall conduct the assets checking in accordance with the *Measures of the Assets Checking and Capital Verification in State-Owned Enterprises*, which were promulgated by the SASAC (SASAC Order No. [2003] 1) and became effective as of 9 September 2003.

30. See the interview at < www.sasac.gov.cn/gzjg/xcgz/200612180140.htm >.
31. SOE Transfer Rules, Art. 12.

**Restructuring Plan**

In cases where the seller's controlling rights in the target SOE will be transferred, the parties shall negotiate to propose, when executing the transfer agreement, a restructuring plan of the target SOE. Such a plan shall, among other things, give priority of staff placement (under same conditions) to existing employees of the target SOE.[32]

**Staff Relocation**

In cases where the seller's controlling rights in the target SOE will be transferred, the parties shall adopt a staff relocation scheme, including without limitation arrangements for the payments of (a) fees in arrears in respect of salaries and social insurance premium and (b) so-called transformation fees, which are payable to the original staff of the target SOE. Of particular mention here is that the costs and expenses incurred from such staff relocation cannot be deducted, prior to the assets valuation, from the NAV of the target SOE; nor can they be deducted from the transfer price. Furthermore, such a staff relocation scheme shall be approved by both the employees' assembly of the target SOE and the local labour bureau.[33]

**Consent Letters by Major Creditors**

In cases where the seller's controlling rights in the target SOE will be transferred, the credits/debts agreements with or consent letters by the creditor banks and other major creditors shall be submitted.[34]

## 7.6 ASSETS VALUATION AND APPROVAL/RECORD-FILING THEREOF

### 7.6.1 The Valuation Requirement and Exceptions

As a rule, pricing of the equity transfer in an SOE shall be based on the valuation result approved by or filed for record with the competent approval authority. However, in the following transfers of state-owned assets in enterprises (including FIEs with 50% or more state capital), valuation is not required:

- administrative assignment without consideration that has been approved by the competent people's government or its SASAC; or
- merger, assets swapping or administrative assignment without consideration between a W-SOE and its wholly owned subsidiary or between two or more subsidiaries wholly owned by the same W-SOE.[35]

Of additional mention here, the transfer of state-owned shares in a listed company is not subject to the valuation requirement; and, as shall be detailed in

32. *Ibid.*, Art. 19.
33. *Ibid.*, Arts 22, 29; Circular No. 306, Art. V(3); Circular No. 268, Art. IV.
34. SOE Transfer Rules, Art. 29.
35. Valuation Rules, Art. 7.



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Chapter 14, the pricing of the transfer in a listed SOE is mainly based on the average market price during a certain period.

On the other hand, in those cases that require the pricing be based on a valuation result, the target SOE shall appoint a qualified valuation firm to conduct the valuation. As for the valuation firm, it may be a firm appointed by either party or agreed between both parties, as agreed in the acquisition agreement. However, the firm shall be one that has been duly licensed by the provincial departments of the Ministry of Finance (MOF) in accordance with the *Measures on Administration of the Examination and Approval of Assets Valuation Institutions* (MOF Order No. [2005] 22, effective as of 1 June 2005), and that is qualified to conduct the valuation of state-owned assets. In practice, such firms are local ones of where the local SASAC is located. Furthermore, the qualified firm shall not be the one having economic interests with the person in charge of the target SOE; nor shall it be the one acting as the auditor for the purpose of the transfer at issue.[36]

In any event, to the extent a valuation of the state-owned assets is required for the proposed transfer, if: (a) no valuation has been conducted; (b) the valuation firm is not qualified to conduct the valuation of state-owned assets; or (c) it is found out that the valuation result has been based on false information or collusion with the valuation firm, then the SASAC may order rectification, and, where necessary, sue to the governing court to invalidate the transfer.[37]

### 7.6.2 Approval/Record-Filing of the Valuation Result

The valuation result is subject to approval by or record-filing with the competent authority. The specific level of authority and whether it suffices to go through the substantial approval or formal record-filing procedures, depend on approval requirements of the transfer itself (for details, see 7.2.2 above). As a rule (with only one exception as to be illustrated below), it is the same authority as which is competent to the approval of the transfer itself that is responsible for the approval/record-filing of the valuation result. Specifically, as contemplated under the Valuation Rules (Article 4), the requirement and responsibility authority may be:

- *approval by the competent SASAC* – if it is a transfer requiring approval by the State Council or local people's government above municipal level,[38] then the valuation result is accordingly subject to approval by the SASAC at the same level (i.e., SASAC at the municipal or higher level);
- *record-filing with the national or provincial SASAC* – if it is a transfer by agreement, which requires approval by national or provincial SASAC, then the

36. *Ibid.*, Art. 9.
37. *Ibid.*, Art. 27.
38. Specifically, the transfer of the state controlling rights in an Investee Enterprise that would convert the target SOE into a company not controlled by the state or a private company, the approval power is vested in *the people's government* at the same level of the competent SASACs – State Council or local people's government above municipal level. (SOE Transfer Rules, Art. 25).

# Chapter 17
# Substantial Asset Restructuring

## 17.1 INTRODUCTION

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A substantial asset restructuring (*SAR*) occurs when the ListCo, by itself or through its controlled subsidiaries, structures third parties' assets into it or disposes of its own assets, and such asset transaction has substantial impacts on the ListCo with regards to its main business, asset value or revenue, excluding the transactions conducted in daily business such as materials purchase or products sale.[1]

Due to its significance to the ListCo and substantial implications to the investors, the CSRC implements stringent controls over such SAR by a ListCo. In this regard, the CSRC promulgated the *Measures on Administration of the Substantial Asset Restructuring by Listed Companies* (*SAR Rules*), which were first issued in April 2008 and amended in August 2011 and are now reinstated by the version recently issued in October 2014. Apart from the SAR Rules, the CSRC issued the *Provisions on Certain Issues Concerning the Normalization of the Substantial Asset Restructuring by Listed Companies* (*SAR Provisions*) in April 2008 (CSRC Announcement [2008] No. 14) to provide for certain details in relation to the board meeting, information disclosure. In addition, the CSRC and the stock exchange have adopted lots of rules and guidelines in regard to the trading suspension and information disclosures in the SAR deal.

As compared with the 2008 version, one most significant improvement of the 2014 version SAR Rules is that, for all cash SAR deals, the precedent CSRC approval requirement is cancelled. Now, only where it is an SAR deal that involves the issue of new shares by the ListCo or otherwise constitutes a reverse takeover (*RTO*) deal, will it require the CSRC approval. In addition, such deals requiring CSRC approval must pass a review by the CSRC's Examination Committee of the Merger, Acquisition and Restructuring of Listed Companies (*Restructuring Committee*).

1. SAR Rules, Art. 2.

On the other hand, as in the case of a takeover deal, certain precedent approvals may be necessary even in a cash SAR deal. Among others, the competent provincial or national SASAC approval may become necessary under the SASAC Circular [2009] No. 124 and SASAC Circular [2009] No. 125. Significant provisions of these two Circulars have been discussed in Chapter 14. It suffices here to mention that such competent SASAC approval may be required in the SAR deal if it is a case: (a) where the counterparty is a state-owned shareholder (*SS*) injecting non-cash assets into the ListCo; or (b) where the ListCo is an SS-controlled ListCo issuing new shares to acquire assets. In addition, even in an SAR not involving new issue by the ListCo, an approval of competent local or higher level SASAC may be necessary if the subject assets to be acquired or disposed of are state-owned assets.

In addition, a competent MOFCOM approval may be required if foreign investors (other than Qualified Foreign Institutional Investor (*QFII*)) are involved. Among other things, the national MOFCOM approval is required under the Strategic Investment Rules (see Chapter 15) if a foreign investor will become the shareholder of the ListCo as a result of the latter's acquisition of the former's Foreign Invested Enterprise (*FIEs*). In such deals, local MOFCOM approval of the subject FIE's jurisdiction is additionally required for the equity transfer in such FIE under the Equity Change Rules (see Chapter 8). Even if the foreign investor will not become a shareholder of the ListCo, that is, where the ListCo pays in cash to acquire the former's FIEs, a competent local MOFCOM approval may still be required for the transfer of such FIEs to the ListCo under the Equity Change Rules. In addition, where the ListCo itself is an FIE, a competent provincial or national MOFCOM approval may be required, especially in an SAR involving new issue of the ListCo.

## 17.2 IDENTIFICATION OF THE SAR

### 17.2.1 The SAR Types

Basically, there are two types of SAR:

- the *asset purchase* deal, which usually is conducted to solve horizontal competition or otherwise enhance the ListCo's main business or asset structure; and
- the *asset disposal* deal, which usually is conducted for divesture or spin-off purpose.

Also, the ListCo is conducting an asset purchase deal in nature when it: (a) incorporates a joint venture with third parties, or subscribes for the new shares or capital increase of an existing company; (b) operates under entrustment, or rents to operate, the assets of third parties; or (c) accepts donated assets that are attached with obligations or liabilities. Correspondingly, the ListCo is indeed conducting an asset disposal deal in nature when it: (a) reduces capital in or exits from its subsidiary or





affiliate; (b) entrusts or leases its operating assets to third parties; or (c) donates its assets to third parties.[2]

Indeed, the ListCo sometimes may even conduct a complicated deal combining both purchase and disposal transactions – the asset swap deal – to change or enhance its main business or asset structure. In addition, apart from the common purchase or disposal deal, an asset deal involving the ListCo's new issue is also treated like an SAR, requiring the CSRC approval, even if such a deal does not trigger the SAR threshold (see below). This will be discussed in Chapter 18.

In any event, regardless of its specific forms or underlying purposes, once it is identified as an SAR deal, the parties shall abide by the special requirements and disclosure procedures as specified in the SAR Rules.

### 17.2.2 The SAR Thresholds

To distinguish an SAR from a notifiable or other normal transaction, the CSRC implements a 50%-threshold in terms of revenue, total asset value (*TAV*) or net asset value (*NAV*),[3] which may be illustrated below in Table 17.1.

*Table 17.1 SAR Thresholds*

| *Tests* | *50%-Threshold* | *Additional* |
|---|---|---|
| TAV | *the TAV* of the subject assets acquired or disposed of reaches or exceeds 50% of the ListCo's TAV as recorded in its consolidated audit report of the most recent accounting year; or | |
| Revenue | *the revenue* attributable to the subject assets in the most recent accounting year reaches or exceeds 50% of the revenue as recorded in the ListCo's consolidated audit report of the most recent accounting year; or | |
| NAV | *the NAV* of the subject assets reaches or exceeds 50% of the NAV as recorded in the ListCo's consolidated audit report of the most recent accounting year; | *and* the NAV of the subject assets is over RMB 50 million |

Specifically regarding the calculation of the above-listed SAR tests, it varies depending on the nature of the deal and the subject assets. In an asset purchase deal,

**Controlling Equity**

Where the subject assets that the ListCo acquires are controlling shares or equity interests that the counterparty holds in the target company:

2. *Ibid.*, Art. 15.
3. *Ibid.*, Art. 12.



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- the *TAV* of the subject assets is the higher of (i) the TAV of the target company; and (ii) the transaction value of the acquisition deal;
- the *revenue* attributable to the subject assets is the revenue of the target company; and
- the *NAV* of the subject assets is the higher of (i) the NAV of the target company; and (ii) the transaction value of the acquisition deal.[4]

**Non-controlling Equity**

Where the subject assets acquired are non-controlling shares or equity interests:

- the *TAV* of the subject assets is the higher of (i) the product of the TAV of the target company multiplied by the shareholding percentage represented by the subject assets; and (ii) the transaction value of the acquisition deal;
- the *revenue* attributable to the subject assets is the product of the revenue of the target company multiplied by the shareholding percentage represented by the subject assets; and
- the *NAV* of the subject assets is the higher of (i) the product of the NAV of the target company multiplied by the shareholding percentage represented by the subject assets; and (ii) the transaction value of the acquisition deal.[5]

**Non-equity Assets**

Where the subject assets acquired are non-equity assets:

- the *TAV* of the subject assets is the higher of (i) the book value of the subject assets; and (ii) the transaction value of the acquisition deal;
- the *NAV* of the subject assets is the higher of (i) the balance between the book value of the subject assets and that of the liabilities attached to such asset; and (ii) the transaction value of the acquisition deal;
- the *revenue* test does not apply to the acquisition of non-equity assets.[6]

On the other hand, in an asset disposal deal, similar three situations exist:

- where the subject assets that the ListCo disposes of are the controlling equity interests or shares the ListCo owns in its subsidiaries, the calculation is much simpler. The TAV of, revenue attributable to and NAV of the subject assets disposed of are respectively the TAV, revenue and NAV of the concerned subsidiary;
- where the subject assets disposed of are non-controlling shares or equity interests that the ListCo owns in its subsidiaries or affiliates, the TAV of,

4. *Ibid.*, Art. 14(1), para. 2.
5. *Ibid.*, Art. 14(1), para. 1.
6. *Ibid.*, Art. 14(2).





revenue attributable to and NAV of the subject assets disposed of are respectively the products of (a) the TAV, revenue and NAV of the concerned subsidiary or affiliate multiplied by; (b) the shareholding percentage represented by the subject assets in that subsidiary or affiliate; and
- where the subject assets are non-equity/share assets, (a) the TAV of the subject assets is the book value of the subject assets; and (b) the NAV of the subject assets is the balance between the book value of the subject assets and that of the liabilities attached to such asset.[7]

Where the ListCo both acquires and disposes of assets in a given deal, then the percentage of the assets acquired in terms of the TAV, revenue or NAV, and the percentage of the assets disposed of in terms of the TAV, revenue or NAV should be respectively calculated; and the higher percentage counts in determining whether the 50%-threshold is reached.[8] For instance, in a deal, the ListCo acquires assets that represent 30% of its TAV (not reaching the 50% threshold in terms of revenue or NAV, either); and in the same deal, the ListCo disposes of assets with a NAV of RMB 70 million, which represents 60% of the ListCo's NAV. This deal constitutes an SAR as the disposal's percentage meets the NAV threshold, although the acquisition's percentage does not meet the threshold.

Of additional notice, if the ListCo, within twelve months, continuously acquires or disposes of assets of a sort or related, the amounts will aggregate. For an aggregate calculation purpose, such subject assets will be deemed assets of a sort or related if: (a) they are owned or controlled by the same person; (b) they are operated for the same or related business purpose; or (c) where the CSRC otherwise deems necessary.[9]

### 17.2.3 Special Requirements for RTO

In the 2011 Amendments to the SAR Rules, the CSRC for the first time clarified the special requirements for an RTO deal, or so-called backdoor listing. Such requirements were followed in the 2014 version SAR Rules, which defines the RTO deal meeting the following standards:

- the deal leads to a *change of control* in the ListCo; *and*
- the *TAV test* of the acquired subject assets accounts for 100% or more of the TAV as recorded in the ListCo's consolidated audit report of the year immediately prior to the year of the change of control.[10]

To further make clear the identification of the RTO deal, the CSRC issued the *Opinions on the Application of Securities and Futures Laws No. 12 – Opinions on the Application of Articles 14 and 44 of the Measures on Administration of the Substantial Asset Restructuring by Listed Companies* (*CSRC Application Opinions No. 12*), which

7. *Ibid.*, Art. 14(1)(2).
8. *Ibid.*, Art. 14(3).
9. *Ibid.*, Art. 14(4).
10. *Ibid.*, Art. 13.



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were first issued in August 2011 and recently updated in April 2015. Among other things, the CSRC Application Opinions No. 12 sets forth two basic principles in determining an RTO deal:

- *the first-time triggering on a cumulative basis principle,* according to which an RTO deal occurs when, with effect from the change-of-control date, the TAV amount of the assets acquired by the ListCo in the SAR transactions conducted on a cumulative basis (including the transaction which exactly changes the control in the ListCo) for the first time reaches 100% or more of the period-end TAV of the ListCo's consolidated audit report of the year immediately prior to the change of its control; and
- *the expected merger principle,* according to which if the parties, as a part of the transaction, plans to further inject assets into the ListCo in future so as to resolve the competition issues and abnormal related transaction issues that have been raised by the deal, then the value of such future assets injection shall be consolidated in the calculation of whether the 100% TAV test has been triggered.

In any event, once the RTO deal occurs, more stringent requirements shall apply. In this regard, the CSRC first implemented an *IPO-similarity* standard in the year 2012, and then further elevated the standard to *IPO-equivalence* since November 2013, when the CSRC issued the Circular (*ZhengJianFa* [2013] No. 61). Such IPO-equivalence standard is now clearly followed in the 2014 version SAR Rules, according to which, in addition to the requirements generally applicable to an SAR deal, the target company to be acquired in the RTO deal (i.e., the company to be merged into, or acquired as the subsidiary of, the ListCo following the RTO deal) must be either a limited liability company or a stock limited company, and the requirements specified in the IPO Rules (see Chapter 19) shall be met. Of additional notice, a ListCo on the ChiNext is not permitted to conduct an RTO deal.

## 17.3 COMPLIANCE AND ACQUIRABILITY

### 17.3.1 The General Compliance Standards

In the Substantial Asset Restructuring Report (*SAR Report*) – the key disclosure document in an SAR deal, there is a special section of the ListCo's analysis on the compliance of the proposed SAR, which will focus on the following general aspects of the proposed transaction:

- compliance with state policy of the concerned industry and the regulations in relation to environmental protection, land administration and merger control;
- not resulting in a failure to meet the listing standards (mainly referring to the public floating requirement of at least 25% or 10%[11]);

11. Securities Law, Art. 50.





- fair and reasonable pricing of the subject assets, without prejudice to the ListCo or its shareholders;
- with clean ownership over the subject assets and following lawful procedures, without legal obstacles in the title transfer or assignment of the concerned assets;
- beneficial for the ListCo to enhance sustainable operation, not leading to the result that, post the deal, the ListCo's assets are mainly cash or have no real business (but the CSRC allows the ListCo to become a holding company if it is a deal whereby the ListCo acquires controlling rights in the target company);
- beneficial for the ListCo to maintain its independence, especially independent from its de facto controlling person in terms of business, assets, financial, staff, organization; and
- beneficial for the ListCo to maintain sound corporate governance.[12]

In analysing the above general standards, the ListCo should provide reasonable grounds and relevant supporting facts.

### 17.3.2 Conditions to Acquirable Assets

Under the general compliance standards, the subject assets must have clean ownership so that the title can be timely transferred; and, the transaction must comply with state policy of the concerned industry and the regulations in relation to environmental protection, land administration and merger control.[13]

In this regard, the CSRC further specifies the conditions qualifying the subject assets that the ListCo can acquire:

- *clean ownership*, the counterparty must have obtained clean and full ownership or rights over the subject assets and its transfer of such assets is not subject to any restriction or prohibition;
- *no defects in capital contribution and transfer procedures for equity assets*, specifically for the equity interests or shares to be acquired, they must have been duly issued, fully paid and no assessable; the other shareholders of the target company, if an LLC, must have waived their pre-emptive rights; and the procedures and conditions (if any) specified in the articles and/or shareholder agreement of the target company have been duly followed;
- *controlling rights necessary in special case*, specifically for the case where the ListCo will become a holding company post the deal, the equity or shares to be acquired should represent the controlling rights in the target company;
- *title and development conditions for land and mining rights*, specifically for the land use or mining rights to be acquired, necessary title certificates must have

12. SAR Rules, Art. 11; SAR Provisions, Art. 4.
13. SAR Rules, Art. 11.



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been duly granted; and the concerned lands or mines are under conditions fit for development or mining;

- *general compliance requirement*, for those assets requiring permits or licenses in relation to project initiation, environmental protection, market admission, land use, planning and construction, such permits or licenses (if applicable) should have been obtained before the disclosure of the ListCo's first board resolution on the SAR; and
- *generally beneficial for the ListCo*, the acquisition of the subject assets can help the ListCo to enhance the completeness of its assets structure (e.g., the assets are intellectual rights, franchise or licenses necessary for the ListCo's business), maintain its independence, cut down potential connected transaction and eliminate horizontal competition, especially against its controlling shareholder or de facto controlling person.[14]

At the first board meeting, the board should make a reasonably prudent judgment after a discussion of the acquirablity in light of the above and other relevant respects. Such discussion and judgment should be recorded in the board meeting minutes.[15]

## 17.4 PRICING OF THE SUBJECT ASSETS

### 17.4.1 Pricing Based on Auditing, Valuation and Forecast

The pricing of the subject assets acquired in the SAR deal must be fair, without prejudice to the ListCo or its shareholders.[16] To substantiate the fairness, a valuation of the subject assets is usually necessary, which follows a preceding auditing.

**Auditing**

In an SAR deal, the ListCo shall submit to the CSRC or the Stock Exchange the financial statements and audit reports of the most recent two years (or most recent three years in an RTO deal) of the subject assets to be acquired or disposed of.

Of particular notice, the execution date of the latest audit report should be within six months (at most seven months) prior to the execution date of the SAR Report. Otherwise, a new audit report must be issued. On the other hand, the ListCo needs to further provide an audit report of the latest reporting period if significant changes have occurred to the subject assets after the execution of the most recent year's audit report but before the disclosure of the SAR Report, even if such most recent year's audit report is still within the six-or-seven-month validity term.

**Asset Valuation**

Generally, there is no mandatory requirement under the SAR Rules that the pricing be based on the valuation result. However, it is usually necessary in practice for the

14. SAR Provisions, Art. 4.
15. *Ibid.*
16. SAR Rules, Art. 11(3).



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parties to do valuation, no matter from the CSRC approval-securing or parties' negotiation perspective, unless there is no need of such a valuation in light of the nature of certain particular subject assets such as cash or claims. Moreover, other applicable laws may have a mandatory valuation requirement, especially: (a) where the *subject assets* are state-owned assets (equity or non-equity); or (b) where the *consideration* is equity assets (sated-owed, foreign-invested or private).

Where an asset valuation is necessary, the ListCo shall retain a valuation firm that has been accredited by the CSRC to engage in securities-related business.[17] The firm shall adopt at least two valuation approaches.[18] In practice, the most commonly used three approaches are: (a) replacement cost; (b) income capitalization (mainly for intangible assets such as intellectual property rights); and (c) current market value (mainly for real properties).

Once the valuation work is done, the asset valuation report is to be reviewed at the ListCo's board meeting that reviews the SAR Report. At this meeting, the board, the independent directors and the IFA shall respectively issue opinions on: (a) the eligibility and independence of the valuation firm; (b) the reasonableness of the valuation presupposition; (c) the relevance between the followed valuation approach and the valuation purpose; (d) the fairness of the valuation result; and (e) the reasonableness of the valuation basis and model used for the profit and cash flow forecast and for the valuation result (if the approaches followed are based on profit forecast such as the income capitalization approach and the hypothetical development approach). In addition, where it is an SAR involving new issue, the board should analyse the fairness of the pricing of the subject assets also from the perspective of the fairness of the pricing of the consideration shares, in light of such shares' profit/equity ratio, profit/book value ratio, as well as the impacts of the new issue on the ListCo's profitability and sustainable development capacity.[19]

**Profit Forecast**

In the asset purchase SAR deal, a profit forecast report of the subject assets is additionally required, which is subject to the verification by a qualified auditor. Of mention, in the 2014 version SAR Rules, it is not required to do the forecast of the ListCo itself any more, which were required under the old rules in certain particular situations.

### 17.4.2 Disclosure of the Auditing, Valuation and Forecast Reports

The ListCo shall submit the audit reports, asset valuation report and audited profit forecast report (if necessary) to the stock exchange when applying for the disclosure of the SAR Report. After a procedural review by the stock exchange, such reports are to be disclosed, concurrently with the disclosure of the SAR Report. Of notice, before the disclosure of such reports, the ListCo cannot publish its shareholders general meeting's

17. *Ibid.*, Art. 17.
18. *Ibid.*, Art. 20.
19. *Ibid.*

(*SGM*) meeting notice.[20] In addition, apart from the disclosure of the asset valuation report itself, the ListCo should further incorporate certain valuation-related information in the SAR Report.

Moreover, where the valuation of the subject assets follows approaches based on the forecast of future profits such as the income capitalization approach and the hypothetical development approach, the ListCo needs to disclose, in future three consecutive annual reports (including the one of the consummation year of the SAR): (x) the original forecast profit, and (y) the actually realized profit attributable to the subject assets. Moreover, concurrently with or shortly after the execution of the SAR agreement, the counterparty and the ListCo shall enter into a clear and enforceable agreement to indemnify the ListCo's possible loss to the extent of the difference between (x) and (y). In case, after auditor's verification, where (y) the actually realized profit is less than 80% of (x) the original forecast profit, the ListCo and the concerned valuation firm, apart from providing and publishing reasonable explanation, need to make public apology; and, where the difference is above 50%, they may be imposed regulatory sanction by the stock exchange.[21]

## 17.5 SAR DISCLOSURE AND PRE-DISCLOSURE TRADING SUSPENSION

### 17.5.1 Disclosure Guidelines

The key disclosure document in an SAR deal is the SAR Report. Sometimes, before disclosing this SAR Report, the ListCo may have to first disclose a *Preliminary SAR Plan* if the auditing and valuation of the subject assets cannot be completed when it convenes the first board meeting for the proposed SAR.[22]

The ListCo shall prepare the Preliminary SAR Plan and SAR Report in accordance with the CSRC's *Guidelines on Contents and Formats for Information Disclosures by Companies Publicly Issuing Securities (No. 26): Application Documents for the Substantial Asset Restructuring of Listed Companies*, which were recently updated in December 2014 (*Disclosure C&F Guidelines No. 26*). These Guidelines also specify the application documents to be submitted to the CSRC for the SAR approval. In addition, the CSRC promulgated a Circular (*ZhengJianGongSiZi* [2007] No. 128) in August 2007 to deal with certain pre-disclosure matters such as confidentiality and trading suspension (*CSRC Circular No. 128*); and an *Announcement* (No. [2012] 33) in November 2012 to deal with the suspension and related matters in case of abnormal changes of the stock price.

On the other hand, the stock exchanges also promulgate detailed rules and guidelines in relation to the deal disclosure. Among them are the *Guidelines on the*

20. SAR Rules, Art. 22.
21. *Ibid.*, Arts 35, 59.
22. *Ibid.*, Art. 22.





*Information Disclosure and Suspension and Resumption of Trading in the Substantial Asset Restructuring of Listed Companies* (*Shanghai SAR Disclosure Guidelines*), which were promulgated by the Shanghai Stock Exchange in January 2015, repealing those disclosure memos in relation to the SAR (Nos 1, 3, 4, 5, 7, 8, 9 and 10) issued from the year 2008 to 2014; the *Procedural Memo No. 8 on the Information Disclosure on the Small-Medium Enterprise Board: Matters in Relation to Substantial Asset Restructuring* (*Shenzhen SAR Disclosure Memo*), which were promulgated by the Shenzhen Stock Exchange, recently updated in June 2015; and the *Procedural Memo No. 13 on the Information Disclosure on the Growth Enterprises Market: Matters in Relation to Substantial Asset Restructuring* (*ChiNext SAR Disclosure Memo*), which were promulgated by the Shenzhen Stock Exchange, recently updated in May 2015.

### 17.5.2 Pre-disclosure Trading Suspension

To suspend the trading of its stocks is usually the first step before the ListCo will disclose an SAR deal. In practice, an SAR deal usually implicates high risk of the leak of price-sensitive information and the price of the ListCo's stocks might change sharply. The CSRC and the stock exchange thus show particular concerns in this regard and scrutinize the stock trading record of six months prior to the ListCo's disclosure of the deal.

To avoid possible adverse impacts on its SAR application, the ListCo usually would or should apply for a trading suspension with the stock exchange in the following situations:

- *confidentiality difficult to keep*, where the ListCo anticipates that it is difficult to keep confidential the deal under planning; or, where information of the planned deal has been leaked;
- *unprecedented transaction to discuss*, where an unprecedented transaction with great uncertainties is being planned and the ListCo needs to consult and discuss such planning with concerned authorities to clarify certain legal ambiguities;
- *market hearsay to clarify an abnormal trading incurred*, where SAR-related (or other price-sensitive) hearsay appears on the market or in the media, and abnormal trading occurs to the ListCo's stocks; or, where such abnormal trading occurred even without any material market hearsay or leak of any price-sensitive information;
- *disclosure to follow*, where, under strict confidentiality without information leak, the ListCo has convened a board meeting for the proposed SAR and gets ready to submit the disclosure documents to the stock exchange; or



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