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Mergers and Acquisitions in China

An analysis of different ways to structure the transaction

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Summary

Title Mergers and Acquisitions in China

Course Master Thesis in Business Law, 20 Swedish credits (30 ECTS)

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Key words M&A, foreign investment, China

Abstract In the last couple of decades the number of M&A transactions in China have increased immensely. Foreign investors have recognised the Chinese market as containing a lot of potential, as the market can offer as well a great number of possible buyers, cheap work force as other incentives that makes penetrating the Chinese market a strategic investment. Due to China's history, and the underlying political ideology, foreign investment is still under strict control, although the tendency has been a movement towards less stringent monitoring from the government. Further, China's recent membership to the WTO will force the tough requirements to be loosened up as a step in the creation of a more open market where foreign and domestic investors can operate on more even terms.

However, today there are still a large number of hurdles for a foreign investor to overcome before conducting an M&A in China. Some sectors are still forbidden or tightly regulated and controlled, the legislation is unclear and to be found in several overlapping and sometimes contradicting regulations, the laws allow governmental authorities to have a large say in the approval process, due diligence is difficult and might not provide the investor with the answers wanted, the court system is unreliable and financing and valuation issues can be difficult to solve. With this being said, foreign investors still opt to enter the Chinese market. The problems are not impossible to overcome, and with the right understanding of the characteristics of the Chinese market and how to conduct business in China the possibilities for a successful M&A can outweigh the difficulties with penetrating the market.

Before conducting an M&A the investor has to be clear about what the goal with the investment is, and what timeframe he will work with. Depending on these factors there are a number of ways to structure the investment, different alternatives being best suited for the specific situation. In some cases an M&A might not even be the right way to pursue presence on the market, as alternatives like a joint venture or setting up a subsidiary can be a better call from time to time. For a foreign investors who wish to remain in full control of the investment while at the same time getting a short cut to the connections and the running operation of an already existing company, an M&A is however the answer. If not, other options should be

contemplated. A further step is to look at how to structure the M&A deal. The foreign investor has to decide upon whether a merger or an acquisition is preferred, if it is possible to keep the entire transaction abroad in order to avoid involvement by Chinese authorities, or if it is necessary to keep the transaction wholly within China or conduct it both onshore and offshore. Further, the investor has to decide upon whether to go for an asset or an equity acquisition, and also contemplate what kind of company the target should be. Economic and strategic aspects such as how well the target company fits within the existing company group, how to integrate the company and the staff etc. are further questions that must be considered.

In other words is an M&A a process consisting of several steps, each being important in its own way. Compared to M&A deals in other more developed economies, the transaction is going to take time, be much more complicated and tricky, and has to be conducted with respect for the economical and political surroundings, as the deal otherwise might come to a sudden stop when approvals are lacking or regulatory issues have not been fully taken into consideration. For a foreign investor it is therefore crucial to have patience and to be careful the entire way up to closing.

Nevertheless, conducting an M&A in China is becoming easier as the years go by seeing that the economical climate in China is causing a need to adapt and simplify foreign M&A transactions. The future of M&A in China is therefore with all likelihood going to be bright, attracting new investors and new projects.

Sammanfattning

Titel Mergers and Acquisitions in China (Översatt: Fusioner och förvärv i Kina)

Kurs Examensarbete i förmögenhetsrätt, 20 högskolepoäng (30 ECTS)

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Nyckelord M&A, utländska investeringar, Kina

Sammandrag Under de senaste årtiondena har antalet M&A transaktioner i Kina ökat stort. Utländska investerare har upptäckt Kina som en framtidsmarknad då den erbjuder fördelar i form av potentiella kunder, billig arbetskraft och andra incentiv vilka gör att en etablering på den kinesiska marknaden är en strategisk investering värd att satsa på. Som en effekt av Kinas historia och de ekonomiska och politiska konsekvenser den haft är emellertid utländska investeringar fortfarande under strikt kontroll, även om det finns en klar tendens mot allt mindre strikt reglering och kontroll från regeringens sida. Vidare så har medlemskapet i WTO för några år sedan har och kommer att innebära att regleringen luckras upp allt mer då Kina måste skapa en mer öppen marknad i vilken utländska och inhemska investerare kan verka på mer jämlika villkor.

Idag finns det således fortfarande ett antal hinder som utländska investerare måste övervinna för att kunna genomföra en M&A i Kina. Vissa sektorer är fortfarande strikt regulerade och kontrollerade, lagar och annan reglering är oklar och innehåller ofta utrymme för myndigheter att under tillståndsprocesser kunna avgöra transaktionens vara eller icke-vara, att genomföra en due diligence är svårt och kommer kanske inte att leda till att investeraren får den information som efterfrågats, domstolssystemet är inte tillförlitligt, finansierings- och värderingsproblem existerar etc. Detta till trots så väljer utländska investerare fortfarande att satsa på den kinesiska marknaden. Problemen är inte omöjliga att lösa, och med rätt förståelse för den kinesiska marknaden och hur affärer görs där är möjligheterna stora för att genomföra en framgångrik M&A.

Innan investeraren genomför transaktionen måste denne vara klar över vilka mål man har med affären och vilken tidsram man har satt för investeringen. Beroende på dessa faktorer så finns det sedan ett antal olika sätt att strukturera affären på, alternativ som passar olika bra beroende på den specifika förutsättningarna i det individuella fallet. I vissa fall är en M&A inte ens det bästa sättet att etablera sig på den kinesiska marknaden, utan andra alternativ som en joint venture eller etablering genom ett dotterbolag kan vara att föredra. För investerare som önskar vara i full kontroll över

verksamheten i Kina samtidigt som man direkt får tillgång till den verksamhet och det nätverk som ett befintligt bolag redan har, är en M&A emellertid ofta att föredra. Om inte så bör andra alternativ tittas på. Ett ytterligare steg är att sedan fundera på hur M&A transaktionen bör struktureras. Den utländska investeraren måste bestämma om en fusion eller ett förvärv är mest attraktivt, om det är möjligt att hålla hela affären utanför Kina då detta medför att tillståndsprocessen inte aktualiseras, eller om det är nödvändigt att hålla hela affären inom Kina eller både innanför och utanför gränsen. Vidare så är det nödvändigt att avgöra om transaktionen ska ske genom uppköp av tillgångarna i företaget eller genom att handla upp aktierna samt vilken typ av företag målföretaget bör vara. Även ekonomiska och strategiska aspekter som hur väl målbolaget passar in i den existerande koncernen och hur stor sannolikheten är för en väl fungerande integration av företaget och dess personal måste beaktas.

Med andra ord innebär således en M&A att investeraren måste gå igenom en process bestående av flera steg, där varje steg är viktigt på sitt sätt för en framgångsrik affär. Jämfört med en M&A i som sker i mer utvecklade jurisdiktioner så kommer transaktionen att ta tid, vara mycket mer komplicerad och måste genomföras med respekt för det ekonomiska och politiska klimatet i Kina. Annars finns en klar risk för att affären inte kommer att slutföras då tillstånd kommer att saknas eller viss del av den legala regleringen har missats. Försiktighet och tålamod är därför essentiella för att lyckas med en M&A i Kina.

Med detta i åtanke så är emellertid genomförandet av en M&A enklare nu än tidigare, och kommer att förenklas ytterligare frammöver, då de ekonomiska förutsättningarna förändras och skapar ett behov av förändring. Kina behöver ändra inställning till utländska investeringar och underlätta för dessa att verka i Kina. Framtiden för M&A i Kina kommer således med all sannolikhet att vara ljus och attrahera nya investare och nya projekt.

Abbreviations

CJV	Cooperative or Contractual Joint Venture
CLS	Company Limited by Shares
CSRC	China Securities Regulatory Commission
DD	Due Diligence
EJV	Equity Joint Venture
FDI	Foreign Direct Investment
FIE	Foreign Investment Enterprise
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
M&A	Mergers and Acquisitions; also used as the term for a merger or acquisition transaction
MOFCOM	Ministry of Commerce
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
PRC	People's Republic of China
RMB	Renmimbi; usually known as yuan (which is the principal unit)
SAAB	State Asset Administration Bureau
SAFE	State Administration of Foreign Exchange
SAIC	State Administration of Industry and Commerce
SASAC	State-Owned Assets Supervision and Administration Commission
SDRC	State Development and Reform Commission
SOEs	State Owned Enterprises
WFOE	Wholly Foreign Owned Enterprise
WTO	World Trade Organisation

1 Introduction

1.1 Background

China has come a long way since the Mao era, which ended in the late 1970s.[1] Now the country is in a period characterised by growth, reform and opportunities. This has had positive effects on various aspects of the Chinese society such as infrastructure, the overall living standard and the economy as such. It has also improved China's relations with the outside world, which is becoming an essential part of the political environment. The influence of other countries is growing and having a large impact on how the government is to act and how China is to move on issues involving foreign actors. This is to be contrasted with China being an entirely closed country merely thirty years ago.

The world has in the last two decades realised that China with its population of 1,3bn people and huge market for selling, buying and investing, is a market of huge opportunity. Foreign investment in China is in a phase of expansion, and there is no reason to believe that this is not only the beginning of a continuous trend. Today, only 22 years after the first merger and acquisition (M&A) transaction in China, the country is now one of the major M&A markets in Asia. China's ever continuing reforms and stabile growth have promoted the growth of M&A activity within the country, which today is a substantial part of China's economy. The recent membership in the WTO will probably fuel this development even further, as previous restrictions are being lifted and greater access to the market is given.[2]

Even though the number of M&A transactions has grown immensely during the last couple of years, the market is still filled with huge opportunities for those companies still considering a presence in China. As a comparison it can be mentioned that the number of M&A deals in China still are up to three and six times smaller than in Australia and Japan, respectively.[3] For those companies interested in entering the Chinese market, there is in other words still time to do so.

However, foreign investors contemplating a penetration of China's market have to be aware of the many difficulties involved in conducting a successful M&A. This paper will outline some of these problems, but also possible benefits to be made by structuring the M&A in different ways.

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[1] Lo, Vai Io and Tian, Xiaowen "Law and Investment in China – The legal and business environments after WTO accession", RoutledgeCurzon, Milton Park (2005), p. 3
[2] Webre, Edwarde "Mergers and Acquisitions in China", Deacons International (2005), found online at http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[3] Op. cit., p. 11

1.2 Problem statement and statement of purpose

With this paper the author will analysis different ways to structure an M&A in China, and look at benefits and drawbacks in regard to different factors such as the goal with the investment, time frame, type of business etc.

Several options available such as equity or asset acquisition, mergers, and direct or indirect acquisitions will be looked into and discussed from a buyer perspective in order to bring forward the optimal solution for the individual prospective investor. Depending on the aim of the establishment the outcome of the alternative strategies will be shown to differ.

With the recent accession to the WTO China's M&A environment is changing. The author will look into what effects this has had on the regulation in connection to M&A, and what the accession will mean for the future.

The author hopes that this paper will contribute to the research conducted in this area, which the author believes has not attained the attention that it should. Previous research has taken a wider perspective without looking further into M&A in China from a buyer perspective. Macro perspectives or a description of the legal framework has been done before, why the author has chosen to look at more specific establishment strategies as a complement to the work already conducted in this area. The author hopes that by writing this thesis some of the gap that today exists in this area of research will be filled.

1.3 Method and material

The method used is a traditional practical and dogmatic, with both descriptive and analytical elements. Legislation will be looked into, although no critical evaluation will be made to any greater extent of the legal framework as it stands today.

Due to the subject of this paper a majority of the sources used will be papers or articles found on the Internet. There is up until today a lack of literature written in this field of research, which has made it necessary to use alternative sources like the Internet. The rationale to the extent Internet sources have been used is the author's lack of knowledge of Mandarin or Cantonese, why English translations or descriptions of Chinese law have had to be used. As there are not any official translations of Chinese law, and the legal framework regulation M&A transactions are changing rapidly the Internet has been used to find unofficial translations. Further, the author has found it necessary to use the Internet also as a source to find material that is

up to date and as a source of complementary material to the literature found. The author is well aware of the problems involved with using these types of sources, as they might be less reliable than traditional literature. In order to minimise the risks, several sources covering overlapping subjects have been used in order to verify the material found online.

As China does not have a reporting system for decided cases, hence causing only a few cases to become known to the public and in addition, there are only a few of these that has been translated to English, court practice covering M&A transactions will not be considered. Further, arbitration awards are not made official, and the author has hence not tried to find any disputes through any arbitration institutes either as it has been considered to time consuming and difficult. The author is aware of that this is an area of great importance, but due to practical difficulties this aspects has had to be left out of this paper. It is however an area worth of further research.

1.4 Delimitations

There are various ways to penetrate a foreign market, M&A being one. Alternatives to an M&A will be mentioned briefly, although no thorough review will be made. As this paper focuses on how to structure an M&A, this delimitation has been considered necessary as the paper otherwise would have changed direction somewhat.

Important to notice is that this is a paper written from a buyer's perspective, not from a macro perspective discussing China and its stand towards foreign investment. To the extent it is important from a buyers perspective it is however going to be discussed. China from a wider economical perspective is nevertheless not going to be a subject in this paper.

The author does not lay a claim on this paper being a complete guide to M&A in China. Rather it is to be seen as an analysis of different strategies, their different benefits and drawbacks and how and when they are best to be used. Some aspects will be overlooked on only described briefly, which should be noted when reading this paper. An example is the taxation issues, which the author recognises as an important factor to consider before entering into an M&A. However, not all aspects has been deemed possible to include in the paper in order to remain focused upon the main questions. The author does not in any way by focusing upon certain issues value the importance of these and other aspects.

1.5 Disposition

Before entering into the core subject of this paper, the author sees it as essential that the reader has a basic understanding of the characteristics of

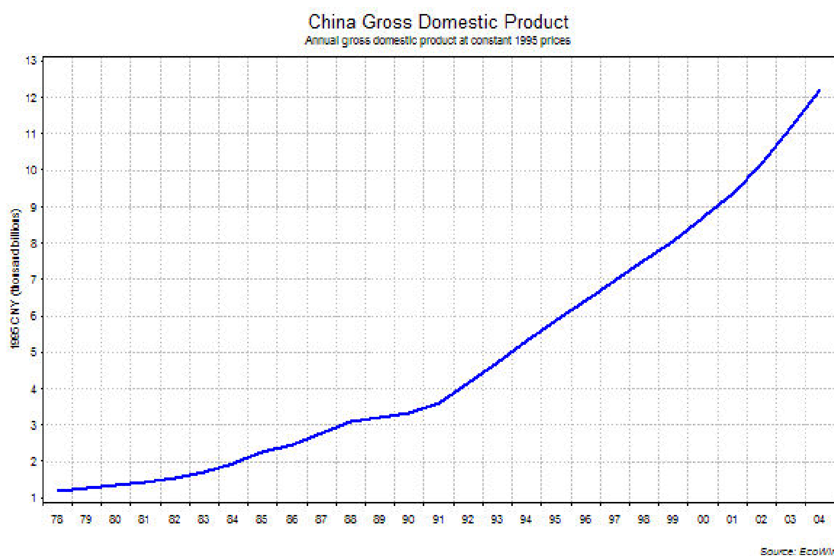
the Chinese market. Several of the divergent aspects of doing an M&A in China compared to Western countries are explained by the special historical and political rationale that underlie the regulation today. In order to operate this market and to clearly understand how to approach it some background to the present M&A market will initially be given.

This introduction will be followed by an examination of the goals of the individual company when entering the market, the legal framework, how to structure the establishment, some further practical issues and concluding remarks.

2 The playing field

2.1 History

Before 1978 China was a country closed to the surrounding world, a country troubled by the many socialist reforms that had left the economy in shambles. When the Communist Party of China came to power in 1949, its leaders' fundamental long-range goals were to transform China into a modern, powerful and socialist nation. There were fractions within the party that believed that the idea of industrialization and economic modernization were necessary tools to attain a successful socialist order, a view that was in opposite with the view held by Mao and others who believed that socialist goals should have priority over material progress.[4] When reaching power in the late 1970s Deng Xiaoping, a follower of the former approach, initiated the reformation process. The new approach, beginning in 1978, was to become successful as it motivated workers and farmers to create a larger surplus and minimized some of the economic imbalances, all resulting in a modernisation of the economy.[5]



** Diagram found at www.ecowin.com*

Since economic reform started in China, the GDP has grown with an average of 9,5 per cent.[6] The economy is now the fourth largest in the world with an economic output of US$2,68 trillion when measured by nominal

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[4] Wang, Yan "Chinese Legal Reform – The case of foreign investment law", Routledge, Milton Park (2002), p. 13
[5] Potter, Pitman B. "The Chinese Legal System – Globalization and local legal culture", Routledge, Milton Park (2001), p. 1
[6] Chow, Gregory "China's Economic Reform and Policies at the Beginning of the 21st Century" (unknown date), found online at http://www.oycf.org/Perspectives/7_083100/china.htm

GDP.[7] Chinese economic reform has, in contrast to the perestroika i.e. the economic reform in Russia, been an economic success.[8] An important part of the economic reform in China has been to stimulate foreign investment through establishment within the country, although of course also other aspects have been equally important. Examples of other important aspects are the creation of market institutions converting the economy from command economy to price driven, a sound banking system, trade with the outside world etc. Important to remember is that even though China seemingly is moving towards a capitalist system, officially the adoption of capitalist policies is in no way an abandoning of Marxism, socialism or the political regime in China. The reform has instead taken place within the political framework, as system called "Socialism with Chinese characteristics".[9] The old structures are still there, only embedded in the new regulations. The legal structures are still very much structured around a planned economy, as the government and other state authorities up until today have had a large say in various aspects of the economy, which is evident not least from the many authorisation processes required.

In regard to M&A, the gradual opening of China lead up to the very first M&A in 1985, merely seven years after Deng Xiaoping's change of the country's economic policy.[10] This M&A was between the Singaporean enterprise Hong Leong and the Chinese maker of steel drums Rheem (Far East). The purchase was made for an undisclosed sum, and has led to an expansion of the company, now owning 15 plants. For a country that for long had been closed to the outside world, and without previously allowing foreign investment, the progress was huge. However, this first transaction was only the start of an era of ever-continuing foreign interest in the Chinese M&A market.

2.2 M&A today

In 1985 M&A activity in China totalled US$124 million, which is to be contrasted with the sum of US$28,5 billion involved in these kinds of transactions during 2005.[11] It is now long ago since foreign companies wishing to invest in China were limited to merely greenfield investments,[12] instead companies now have the possibility to choose from a variety of different types of investments such as mergers, spin-offs, holding companies

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[7] Anonymous, "Economy of the People's Republic of China", Wikipedia (unknown date), found online at http://en.wikipedia.org/wiki/Economy_of_the_People's_Republic_of_China
[8] It should however be noted that Russia has been helped by its assets of oil and the increasing oil prices.
[9] See Lo and Tian, p. 1-4
[10] Bacani, Cesar and Sima, Katherine Peavy "The great buyout: M&A in China", The Economist Intelligence Unit (2006), p. 4
[11] Op. cit., p. 6. The author has not been able to find any reliable numbers for the year 2006.
[12] A greenfield investment is a start-up project such as a production plant, a refinery or a port. The name comes from the idea of building where no facilities have been before, e.g. on a "green" field. See Reuters Financial Glossery, found online at http://glossary.reuters.com/index.php/Greenfield_Investment

or a direct acquisition.[13] Today M&A transactions can be said to be a common and economically important features of China's economic landscape.

Behind the increased pace of the M&A activity is the stabile growth of China's economy and the commitment to release the constraints that previously limited the level of M&A transactions.[14] What doubts foreign investors earlier might have had about entering the Chinese market now seems to be fading away in the same pace as the Chinese government is working to promote foreign investment.

Foreign investors sees China as a "land of limitless opportunity" [15], as it is a market in which they can both sell their goods and services, produce and supply their goods, invest in companies or buy them out. Of course there are difficulties in establish oneself in China, but as foreign investment is becoming a more and more common feature in the Chinese economic environment it is obvious that foreign investors deem the possible pros being of such significance that it is worth entering into a difficult market.

Hence, it is understandable that there is such a profound interest from prospective buyers to invest in China, but what is interesting is that this interest is mirrored in local enterprises looking for investors, i.e. positive buyers. The background could of course be a need to capitalise the company or perhaps the possibility of making a great profit by selling, but one of the driving forces is also the privatisation of state owned enterprises (SOEs) presently taking place.[16] The government is giving M&A activity a big push by promoting not only transactions in more common areas of merchandise but also in fragmented sectors like steel and aviation. This has provided potential investors with a rich field of acquisition targets, as the restructuring of the state sector is high priority and there is around 50,000 SOEs that is in need for restructuring and recapitalisation.[17] The level of industry concentration in China is unusually low, which is a further inducement for investment. This will probably casue "widespread consolidation" as Chinese industries will need to restructure to remain competitive also in the future.[18]

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[13] Norton, Patrick M. and Chao, Howard "Mergers and Acquisitions in China", the China Business Review, Vol. 28, no 5 (Sept.- Oct.2001), China, found online at http://www.chinabusinessreview.com/public/0109/print/mergers.html

[14] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm

[15] Bacani et al, p. 6

[16] Woodard, Kim and Wang, Anita Qingli ""Acquisitions in China: A View of the Field", the China Business Review, China, Vol. 31, no. 6, (2004), pp. 34-38, found online at http://www.chinabusinessreview.com/public/0411/woodward.html

[17] Ibid

[18] Norton, Patrick and Chao, Howard, "Mergers and Acquisitions in China", An O'Melveny & Myers LLP Research Report, (January 2006), p. 1, found online at http://sitemaker.umich.edu/wangcheng/files/ticl_-_mergers_and_acquisitions_in_china__revised_.pdf

3 Entering the Chinese market

3.1 Benefits to be made

Before looking at how to structure a possible investment in China, it is essential for the company to determine what reason the company has for establishing oneself in China. The motive behind an M&A transaction differs depending on the investor's strategic goals and other specifics for the individual investor.[19] Different reasons are dominant in different situations, i.e. sometimes the goal with the transaction may be to increase market shares or reduce costs, while on other occasions speculation over potential underestimation of the targets assets might drive the deal as the acquirer sees a chance of later selling the target at a gain. Further, establishment in other markets or other sectors might be a way to reduce risks for the company group as a whole.[20]

When looking at what the foreign investor wishes to obtain with the investment, three basic factors emerge: resource seeking, efficiency seeking and market seeking. First, acquiring factors of production makes production more efficient than in the home country. One example of importance in China has been cheap labour, which can drive down the production cost significantly. Another aspect is less stringent environmental laws.[21] Efficiency seeking is also worth noting, although this probably is not one of the major reasons for foreign investors to enter the Chinese market. When looking for efficiency companies make investments that are believed to increase efficiency by exploiting the benefits of economies of scale and scope. The possible benefit in this aspect is again environmental laws that might allow around the clock production etc., something impossible in the home country. However, the final rationale – market seeking, is with certainty (according to the author) a major motive for companies to establish themselves in China. Creating a presence in China is important not only today, but is a strategic consideration for the future as well.

3.2 Control of FDIs

As in most underdeveloped countries, there is a need for capital from other states.[22] However, in China there is a political concern about freely allowing foreign investment, which the author sees as a result of the communist

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[19] Sevenius, Robert "Företagsförvärv", Studentlitteratur, Lund (2003), p. 43
[20] Ibid
[21] It is however possible that ethical considerations or company policy are being contrary to taking advantage of less stringent regulation. The possible contrasting goals, e.g. economic v. ethical reasons, and their influence on a company's establishment strategies will however not be discussed further here.
[22] Wang, p. 35

history but also from earlier experiences that had negative impact on the country.[23] These parts of China's history are to be considered together with the rise of Mao and the Communist Party, as the revolution was seen as a liberation from new-colonialist exploitation.[24] As a result of the cautious stance towards foreign investment China has, at the same time as foreign investment has sought to be attracted, used legal measures in order to control the investments.[25] Thus, the government hopes to supervise foreign investment and gear it in the desired direction.[26]

The legislative measures used cover both direct control over new investments and more indirect measures that affect the foreign investor´s activities. First, there is the initial screening of initial capital investments, whereupon government approval is required. By using this measure it is possible to control what kind of foreign investment is allowed to enter the Chinese market, and also to what extent. Closely connected hereto are the restrictions and ownership regulations that governs foreign investment, e.g. the Catalogue (see below chapter 5.1.1) or specific requirements on domestic capital participation.

Further, foreign exchange control exists as a controlling mechanism for the continuing operations, although China has made significant progress in the area.[27] China now meets the International Monetary Fund Guidelines for current-account convertibility, which is an important part in releasing restrictions on foreign exchange control. Other restrictions apply to ownership and exploitation of land, export requirements and restrictions on domestic sales and capitalisation requirements.[28]

However, the use of measures to control foreign investment is not solely used by China or other underdeveloped countries, but similar restrictions covering foreign investment in full or partially can be found also in many developed countries. In China the level of government control is however significantly higher. This is a negative aspect the foreign investor has to be prepared for. Every FDI is subject to government approval, and the screening is influenced by state plans and political concerns.[29] Although the policies have changed during the last couple of years, the administrative structures are the same, which creates a gap between the official line and the actual practices. In other words, it is not enough to merely look at legislation or state policy on paper, but research is necessary in order to establish how the regulation in fact is applied in the relevant area.

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[23] See Britain and the Opium Wars in 1834-43 and 1856-60, the Sino-Japanese War in 1894-95, US influence during the early 20th century etc.
[24] Wang, p. 39
[25] Wang, p. 46
[26] Wang, p. 70
[27] Wang, p. 80-81
[28] Wang, p. 82-85
[29] Wang, p. 120

4 Investment vehicles

4.1 Entering through an M&A transaction

Conducting an M&A is one way to enter the Chinese market, a route that many investors recently have chosen. During the 1980s and early 1990s joint ventures were the most prevalent foreign direct investment, which was followed by a vast number of wholly foreign-owned enterprises (WFOEs) in the late 1990s and early 21st century. Now however, acquisitions of domestic companies are booming. The well-trodden path of M&A is not surprisingly becoming a common way for a foreign company to penetrate the Chinese market, as it is a shortcut to building up presence and gaining knowledge of the specific market and "indigenous market techniques."[30] Foreign companies making a direct investment through an M&A will gain a "quantum leap in market share and broader distribution in highly fragmented already saturated markets: strong regional brands can be acquired for less than it would take to build up the same company from the ground".[31]

A global survey by the Economist Intelligence Unit shows that the major reason for companies about to conduct an M&A in China is access to China's market. Low-cost manufacturing capability and low-cost labour were also mentioned as important factors.

As M&A transactions also are covered by the general regulatory framework, the target enterprise will after the acquisition be transformed to some kind of FIE as foreign enterprises are not allowed to directly operate a business in China.[32] This will lead to new FIEs being set up or already existing FIEs being used in the transaction.

4.2 Alternatives to an M&A

Conducting an M&A is not the only option available in order to create a presence in the Chinese market. In some cases other alternatives might present a better solution to. Depending on the motive with the establishment, the time frame, initial costs etc. an M&A might be too time consuming or costly, and other solutions should be considered.

[30] Anonymous, "Doing business in China – M&A and due diligence", Grant Thornton (2002), found online at http://www.gthk.com.hk/cgi-bin/cms/upload/PageEditor/big5/insight%20China%20File%20(Autumn02).pdf
[31] Woodard and Wang , http://www.chinabusinessreview.com/public/0411/woodward.html
[32] Se below in chapter 4

4.2.1 Direct sale

Direct sale can be described as the "sale of prepackages to the ultimate consumer by the packer."[33] When using direct sale the company tries to sell the service or product directly to the consumer without using any intermediary. For a company wishing to penetrate the Chinese market this can very well, in the author's opinion, be a good first step. As it is impossible to reach a wider target group with this approach, direct sale does however have its limitations. It is both time consuming and costly, and does not reach a high number of potential consumers. Further, in order to be successful when using this approach the sales person needs to have a high understanding of Chinese culture and be able to connect with the consumers. For a company that is a new actor in the Chinese market this understanding could be lacking.

Its benefits should therefore, in the author's point of view, be seen as a potential first step to get to learn the Chinese market and its consumers and not as a long-term strategy.[34]

4.2.2 Agents

An agency can be described as the use of an agent authorised to act on behalf of the principal to create a legal relationship with a third party. Authorising agents to work on your behalf is an approach that, the author believes, is a good initial strategy. Depending on if the agent is dependent or independent there are also potential tax benefits to be made as dependent agents without mandate to sign any contracts usually is not liable to tax in the jurisdiction it operates.

Using an agent will not give the principal full control, and will only give the foreign investor a limited presence in China. For a long-term strategy the use of agents is of limited use as the agents either will work in their own name, hence not really establishing a presence per se for the principal in China, or for the principal but without authorisation to sign, thus creating a delay in time and extra costs before a contract can be signed.

4.2.3 Branches and representative offices

Setting up a branch is one way to penetrate the Chinese market. The benefit hereof is that it is comparably easy and cheap to establish, but the branch is on the other hand not a legal person which means that the parent company bears all the risks for the branch's activities.

A representative office is often, in the author's opinion, a good first way to get to know an unknown market. By looking for potential clients, surveying

[33] Elander, Jan-Erik, "Definitions of e-marketing terms", SP Technical Research Institute of Sweden (unknown date), found online at http://www.sp.se/metrology/pack/eng/edefin.htm
[34] Unless of course in sectors where a majority of the sales are linked to direct sales such as cosmetic companies like Oriflame etc.

the market and starting to make connections with local persons or companies a company can start to build up a presence in China. The problem is that a representative office cannot sign any contracts, why it later on might be necessary to establish some other investment vehicle to further build up the activities in China.

4.2.4 Joint ventures

Joint ventures can be set up either as an equity joint venture or as a contractual joint venture.[35] During the 1980s joint ventures together with a Chinese partner were the most popular way create a presence in China, which can be explained by the benefits this investment vehicle contains.

The relationship with a Chinese partner gives you direct access to knowledge of the Chinese market, help with the approval processes and finally yet importantly access to the partners connection in the industry.[36] Further, setting up an joint venture is an alternative to consider as it has the benefit of being able to operate in those sectors where it is forbidden for foreign investors to unilaterally invest directly. The negative aspects of a joint venture are that there is a split of profit, costs to protect know-how etc. against the partner, possible conflicts of interest, uncertainty of whether or not the Chinese partner will fulfil promises given during initial stages and possibly that it might be difficult to manage due to large cultural differences between the partners, perhaps due to somewhat different ways to do things or different perspectives to see things.[37]

In China, most joint ventures are equity joint ventures (EJV) although some investors use the form of a cooperative (or contractual) joint venture (CJV).[38] An EJV and a CJV are similar in several aspects such as the PRC government approval process, approval authorities, format of agreements, tax breaks, legal standing, and the means, laws, and authorities for dispute resolution are the same. Further, the general management structure and governance procedures are very much alike.[39] For example, the management structure for both a CJV or an EJV can be set up in the way preferred by the parties involved.[40]

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[35] An equity joint venture is a legal person, whereas a contractual joint venture does not have to be a legal person and instead are regulated through the parties' contract.
[36] Wei, Yingqi and Liu, Xiaming "Foreign Direct Investment in China", Edward Elgar Publishing, Cornwall (2001), p. 25
[37] Chow, Daniel "The Limited Partnership Joint Venture Model in the People's Republic of China", Law and Policy in International Business (1998), p. 25 ff.
[38] Folta, Paul H. "Cooperative Joint Ventures," The China Business Review, Vol. 32, No. 1, Jan-Feb. 2005, pp. 18-23, found online at http://www.chinabusinessreview.com/public/0501/folta.html
[39] Ibid
[40] Article 6 of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures, article 12 of Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures

An equity joint venture is considered an own legal entity after it is registered, thus being able to conclude contracts, hire labour, erect own premises etc. A contractual joint venture on the other hand does not necessarily have to be a separate legal person, although it is possible to structure the CJV in such a way. By not making it a separate legal entity the investor can benefit from lower costs, but it also means that the investor is exposed to greater liability.

An EJV and a CJV requires a contribution of at least 25 per cent of the registered capital from the foreign investor.[41] There is no limitation on how much capital a foreign investor can contribute. In a CJV the profit, control, and risks are divided according to negotiated contract terms, not in proportion to equity share as in an EJV.

4.2.5 Holding/investment companies

A holding company in China is a good alternative for many investors. By setting up a holding company, it is possible to provide administrative and management services to its FIEs in China.[42] Further, a holding company is attractive as it allows for a higher debt to equity ratio than other FIEs. The debt to equity ratio for a holding company is four to one, which compared to an FIE with the same registered capital would be three to one.[43] However, this investment vehicle is only available for investors that have shown continued commitment to invest in China. Further, foreign investors must have – in addition to good credit standing and sufficient financial capacity – either "a minimum total asset value of US$400 million in the year prior to the application, previous capital contributions in excess of US$10 million to the registered capital of already existing and approval for three further investment project proposals; or ten or more already established manufacturing or infrastructure FIEs in China, with aggregate registered capital contributions in excess of US$30 million."[44] If these requirements are not met, a holding company is not allowed to be set up. The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) ultimately gives the approval for the establishment.

It is important to remember that even though a holding company is permitted to invest directly by setting up FIEs in all sectors where foreign investment is encouraged and permitted, it is not allowed to engage in direct production or business operations. Further, the business scope is by law restricted to certain areas such as purchasing equipment and materials, sales,

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[41] Article 4 of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures
[42] Anonymous, "Principal Forms of Foreign Investment Vehicles in China", Holman Fenwick and Willan (22 September, 2002), found online at http://www.hfw.com/l3/new/newl3c028.html
[43] See MOFTEC's Provisions on Companies of an Investment Nature Established by Foreign Investors, in effect since July 10 2003
[44] Ibid

provision of after-sale services, recruitment and training of personnel, market development, consultation and logistics services. The holding company can accordingly only function as a backup to the other FIEs in China. Seeing that an investment of US$30 million also is required, a holding company is an option that only is suitable in certain situations.

Having a holding company outside China would also provide the same kinds of services. In addition, the enterprise would save the registered capital and would not have to meet the stringent requirements in Chinese law.

4.2.6 Establish a subsidiary

A further possibility is to establish a subsidiary in China. As foreign investors are forbidden to act without the establishment of a FIE, the subsidiary is usually set up as a wholly foreign owned enterprise (WFOE). A WFOE, just like many subsidiaries in other jurisdictions, takes the form of a limited liability company, which means that the subsidiary will be liable to its creditor only to the extent of its registered capital. For uncertain investments, this is a major advantage as it is possible to limit the losses from the start. As China is a complicated market, hence making it difficult to overlook all aspects of the establishment, limited liability might be one of the decisive factors when deciding upon the type of investment vehicle as it gives the investor a chance to limit possible losses.

A WFOE is an enterprise which is fully owned, i.e. 100 per cent owned, by a foreign company.[45] Today a WFOE is a popular choice for foreign investors as it allows the investor to remain the only investor, hence having complete control of the operation of the business. Being the sole investor also maximises the return as there is no split of profits. A WFOE is usually a subsidiary of a foreign parent company wanting to establish a presence in China without any Chinese participation.[46] A WFOE is commonly set up in the special economic zones in order to take advantage of beneficial tax rates, improved infrastructure and the local suppliers and services that builds their businesses around the zones. However, factors like proximity to customer base and major cities, human resource availability etc. will also affect the location decision.

A WFOE is not always the most appropriate investment vehicle, especially for a first-time investor seeking to find his way in a new and often difficult environment. The drawbacks with a WFOE is that some sectors are forbidden, i.e. not available for foreign investors, that some rules are more restrictive, complicated or restrictive than for joint ventures with Chinese partners and that it might be difficult for the foreign enterprise to establish a

[45] Anonymous "WFOEs", China-Britain Business Council (2005), found online at http://www.cbbc.org/market_intelligence/presense/wfoe.html
[46] Anonymous, "How to Set Up a Wholly Foreign-Owned Enterprise in China", China Detail (2005), found online at http://www.chinadetail.com/Business/InvestmentChinaForeignOwnedEnterprise.php

personal network on its own. Solid relationships are a key factor for a successful business in China, whether with the local authorities where the enterprise is located or along the supply chain, as China is a country where "guanxi", e.g. relationship networks, is necessary to function efficiently.

4.3 The benefits of penetrating the Chinese market through an M&A

There are certain benefits in penetrating the Chinese market through an M&A in comparison with setting up a joint venture, establish a subsidiary etc. When choosing to conduct an M&A the foreign investor gets direct asset to the market share of the domestic company, the knowledge, the employees, contractors, informal networks etc. When establishing a subsidiary, doing direct sale, using agents, branches or representative offices the foreign investor usually has to start from scratch with building up a reputation and a presence on the market. When doing business in China, personal relationships are very important, which is why taking over existing staff and their knowledge of the market and their relationships with other actors is essential. However, these benefits are also gained when setting up a joint venture, as the foreign investor then can benefit from the Chinese partners' previous experiences.

Further, an M&A is better suited for long-term investments, or when trying to reach a broader target group, than when acting through agents, direct sale or representative offices. When opting to act through these investment vehicles, it is difficult to reach a broader group why an M&A might be preferred as it possible to work from the already existing clientele and from there building up the network. Using e.g. an agent would restrict the investor to working with only a certain number of persons at a time, as the agent then would have to take care of every request on its own. When incorporated, it is easier to delegate different responsibilities as the business is run in the name of the company and not in the name of one specific person.

A joint venture does however require a split of profits and control. If the foreign investor wants to run the business only according to his own preferences, or perhaps sees the investment as a potential gold mine, this may cause problems. Further, if there emerges any differences in opinion between the parties in the future, and they no longer wish to continue to work together, there might be economic and legal difficulties that have to be solved in order to buy out the other partner. Especially when setting up a contractual joint venture, in which special regulation applies to change of partners, buy-outs, or the length of the joint venture, specific legal problems arise.

5 The legal framework

5.1 An overview of relevant regulation

The legal environment for conducting an M&A in China is, comparatively speaking, a difficult one.[47] Foreign investment in China is subject to rules and regulations limiting and controlling how, when and if the transaction is to be allowed. Even though the control imposed by the Chinese government gradually is released, the government still has strong political and economical reasons for maintaining control in certain sectors. The large state ownership and political control over large parts of the economy is one major reason for the heavy regulation, as political and social issues, such as protection of domestic industries and the jobs tied hereto, are influencing the area of foreign M&A. The accession to the WTO will certainly speed up the process of establishing an equal playing ground for foreign and domestic players, but for the next years to come the author holds it for likely that restrictions for M&A transactions, conducted by foreign investors, still will be imposed.

The legal framework covering M&A transactions is a patchwork. It is the result of laws issued in different rounds over the years, creating rules that are applicable depending on the business form of the foreign investor, (if applicable) the Chinese party etc.[48] For a foreign investor the first impression of the legal framework might therefore be that it is somewhat of a maze. However, China has tried to simplify the regulation as it today is a hurdle to the M&A activity. In 2003 the "Provisional Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors" were issued, rules that significantly clarified the M&A process.[49] Nevertheless, the legal framework is still very complex compared to most other jurisdictions.

5.1.1 The Catalogue

A first step is to look in the "Catalogue for the Guidance of Foreign Investment", as this catalogue classifies different investments as "encouraged", "permitted", "restricted" or "forbidden".[50] In the first category you find projects that

- relates to new agricultural technology, construction of energy sources, transport and raw materials for industry

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[47] Norton and Chow (2006), http://sitemaker.umich.edu/wangcheng/files/ticl_-_mergers_and_acquisitions_in_china__revised_.pdf
[48] Op. Cit.
[49] Bacani et al, p. 13
[50] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm

- uses new or advanced technology, including those that can increase product quality, save energy and raw materials, raise economic efficiency and ease shortages in the domestic market
- projects that can develop the manpower and resources of central, western and northeast China.[51]

The investor should also give some thought as to the location of the target. In case the investor has no specific preference of where in China to locate oneself, it could prove beneficial, according to the author, to try to find a target in central, western or northeast China as this is encouraged by the government and thus could be beneficial. If the project is within the group of encouraged foreign investment the investor has a huge advantage. Thus, the investor can have a high degree of certainty of that the investment will get clearance from the relevant authorities, and that no direct hurdles will have to be overcome.

The opposite can be said for projects that are forbidden. In case the project falls within this classification it is in the authors point of view not worth pursuing as the obstacles here are more or less impossible to overcome. When considering an investment the investor should therefore, in the author's point of view, consider contacting an external advisor with knowledge of this area in order to guarantee that the investment is ok according to Chinese rules. The projects mentioned in the group of forbidden projects include those that

- endanger state security or harms public interest;
- pollute the environment or endanger human health;
- occupy large tracts of farmland or endanger the security or efficient use of military resources;
- use manufacturing techniques or technologies unique to China; and
- are prohibited under state laws and administrative regulations.[52]

It is also important to take a look at what might fall into the category of restricted projects. These include projects

- with an adverse effect on the environment and energy conservation;
- involving exploring for and/or extracting rare or precious mineral resources;
- already developed in China, where the technology has already been imported and where capacity can meet market demand; and
- in industries requiring central planning by state.[53]

The classification in the Catalogue is important as it affects both the approval process and the level of allowed foreign equity holding. In some sectors a majority of Chinese equity holding is required, and in other sectors

[51] Ibid
[52] Bacani et al, p. 48
[53] Ibid

foreign investment is not permitted at all. If the foreign enterprise is considering investing in sectors classified as restricted or forbidden, this does of course require some reconsideration. Even if some level of investment is allowed, it might change the picture to such a degree that the proposed investment would be better in some other form or perhaps in another location.

The latest catalogue took effect in 2002, which was shortly after China's entry to the WTO.[54] Key sectors that previously was closed to foreign investors has now been opened up (e.g. telecommunications, gas and water) and sectors previously classified as restricted was reduced by two-thirds. The choice of target has in other words increased, which for a foreign investor can only be described as a positive development.

5.1.2 The general framework

The general legal framework governing foreign investment is applicable also to foreign related M&A deals.[55] Foreigners operating in China through FIEs are in other words bound to follow general regulations such as the PRC Company Law. In addition, the general framework for various aspects of the legal environment that affects the company such as anti-trust regulation, environmental aspects, contract law, criminal law, procedural law etc. has to be kept in mind. In the following two key regulatory frameworks – the Company Law and the Securities Law – will be highlighted.

5.1.2.1 Company law

The Company Law is of interest as it is the primary piece of legislation that governs companies in China. The new Company Law from 2006 applies to foreign investment as long as the laws and regulations governing foreign investment are silent.[56] However, if there are any inconsistencies between the regulations governing FIEs and the PRC Company law the specific regulation governing FIEs will prevail. This structure follows from Article 218 of the PRC Company Law. In other words, foreign investors looking to incorporate in China should be aware of that, although they are required to comply with the Chinese laws and regulations specific to foreign-invested companies, as a foreign investor they will also be subject to the Company Law to the extent that there is no clear stipulation in the regulations specific to foreign-invested companies.

The new Company Law, which came into effect 1 January 2006,[57] "will deliver commercial and governance improvements but are likely to create

[54] Davies, Emma "A Roadmap for China's Mergers and Acquisitions", The China Business Review, Issue 4 (Jul/Aug 2003), p. 13
[55] Bacani et al., p. 48
[56] Koh, Peter "PRCs Company Law 2005. Corporate Governance and other Major Issues", found online at http://www.civillaw.com.cn/en/article.asp?id=1013
[57] Article 219 of the Company Law

added complexities for foreign investors".[58] The author would like to describe this statement as a pointer to the lowered thresholds for incorporation, the improved corporate governance structures and minority shareholder protection, but also as a reference to that the new Company Law has left plenty of room to let the government impose higher thresholds than stated in the Company Law.

The new thresholds for incorporation has been cut by 50 per cent to RMB5 million for companies limited by shares, and for limited liabilities companies the level has been lowered to RMB30,000.[59] The Company Law further sets up regulations for the organisational structure, the board of directors and general managers, general meetings of shareholders and the board of supervisors. The Company Law further deals with how to transfer shares,[60] the qualifications and obligations of directors supervisors and senior officers,[61] company bonds,[62] financial and accounting affairs,[63] and in chapter nine to thirteen the law covers merger and divisions, increase and decrease of registered capital, dissolution and liquidation, legal liabilities and finally supplementary provisions. Important to note is the improved shareholder rights such as the right to bring action against the company, request a review of the companies books, the introduced possibility to pierce the corporate veil etc.

As this paper does not aim to give a comprehensive description of the legal environment in China, the author would like to refer to the new Company Law should the reader wish learn more about the law.

5.1.2.2 Securities law

China has come a long way since starting experimenting with a shareholder system in the mid 1980s.[64] Today there are three stock exchanges in China; in Hong Kong, Shanghai and Shenzhen, which has a total market capitalization exceeding US$3 trillion, which can be compared with the London Stock Exchange that has a total market capitalization of US$3,8 trillion.[65] The enactment of the first Securities Law in 1999, now replaced with a new Securities Law that was implemented 1 January 2006,[66] has been

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[58] Harpley, Killie "China reforms company law", Deacons, Lawyers Weekly (13 February 2006), found online at http://www.lawyersweekly.com.au/articles/08/0c03cc08.asp
[59] Article 26 and 81 of the Company Law
[60] Chapter Five of the Company Law
[61] Chapter Six of the Company Law
[62] Chapter Seven of the Company Law
[63] Chapter Eight of the Company Law
[64] Yu, Guanghua and Gu, Minkang "Laws Affecting Business Transactions in the PRC", Kluwer Law International, Hague (2001), p. 87
[65] Anonymous, "List of Stock Exchanges", Wikipedia, found online at http://en.wikipedia.org/wiki/List_of_stock_exchanges . The author would here like to make a reservation against any errors considering the source, but literary sources are not updated and the numbers received from 2001 etc. shows a totally different result.
[66] Article 240 of the Securities Law

an important achievement in the economic reform and has lead to, among others things, increased activity on the stock exchanges.[67]

The Securities Law as of today has twelve chapters – general principles, issuance of shares, trading of shares, buy-out of listed companies, securities exchanges, securities companies, institutions for share registration and clearance, securities trading service agencies, securities associations, institutions for managing and regulation securities, legal responsibilities and last supplementary articles[68] - and 240 articles that regulates activities involving shares in China. As the law is the result of a close cooperation between the US Securities and Exchange Commission and the China Securities Regulatory Commission, the Securities Law is influenced by and resemblance the US Securities Law.[69] As a result, foreign investors will probably find the Securities Law fairly easy to understand.

However, a problem is the complicated share classification system which consists of four different types of shares: state shares, legal person shares (subdivided into shares owned by states, by collective enterprises, by private enterprises, by foreign-invested enterprises and by institutional legal persons), individual shares and foreign-capital shares. Further, in the stock exchanges the shares are divided into an A- and a B share market. The difference is that B shares are denominated in Chinese currency and offered to foreign investors to trade using also foreign exchange, in comparison with A shares that originally only were available to Chinese investors and traded only in Chinese currency.[70] There are further issues that need to be dealt with in connection with the stock markets, such as corruption, unqualified employees, high governmental influence, lack of understanding for economic principles that should be underlying the markets etc.

Hence, for a foreign investor looking into the stock market, or pursuing a share transaction it is important not only to look at the Securities Law and other regulations governing securities transactions, but also to have an understanding of the practical reality in which the deal is to take place.

Although the Securities Law is a rather comprehensive legislation, there are still unresolved issues and problem areas that are in great need of attendance, such as the share classification system.

5.1.2.3 Foreign investment regulation

As has been mentioned above, a foreign company is not allowed to directly operate a business in China. Instead, the foreign investor has to operate through a FIE. Today FIEs are divided into four different types: sino-foreign equity joint ventures (EJV), sino-foreign cooperative (or contractual) joint ventures (CJV), wholly foreign-owned enterprises (WFOE) and foreign

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[67] Foreign investors should also note the internal rules in the specific stock exchange
[68] Securities Law
[69] Yu and Gu, p. 89
[70] Lo, and Tian, p. 282

investment enterprises limited by shares.[71] The most common form of direct investment is the use of a WFOE, followed by the EJV. The use of a WFOE is not only the most common form today, but is in addition constantly increasing since China's entry to the WTO and the relaxation of the regulation governing foreign investment. However, in certain sectors a WTO is not allowed, and sometimes this type of investment is not the choice best suited for the specific situation.

Foreign Direct Investment by Vehicle Type, 2004 and 2005						
	Number of Projects			**Utilized FDI Value ($ billion)**		
	2005	**2004**	**% Change**	**2005**	**2004**	**% Change**
Total FDI	44,001	43,664	0.77	$60.33	$60.63	-0.50
EJVs	10,480	11,570	-9.42	$14.61	$16.39	-10.81
CJVs	1,166	1,343	-13.18	$1.83	$3.11	-41.15
WFOEs	32,308	30,708	5.21	$42.96	$40.22	6.81
Foreign-invested shareholding ventures	47	43	9.3	$0.92	$0.78	18.21

Note: FDI=foreign direct investment; EJVs=equity joint ventures; CJVs=cooperative joint ventures; WFOEs=wholly foreign-owned enterprises
Source: PRC Ministry of Commerce

** Diagram showing the popularity of different types of FDI*

One of these FIEs has to be involved in the M&A transaction in order to acquire the shares or assets of the domestic company. By setting up a FIE the investor will have to comply with the regulations concerning the specific legal form. What has been outlined above is only a fraction of the rules that has to be followed.

The specific regulation governing foreign investment in China is as follows

[71] As both joint ventures and WFOEs have been discussed above, the author would here like to refer to chapter 4 for a description. What can be added is a brief description of the last type of FIE, a foreign investment enterprise limited by shares. This vehicle, being an enterprise limited by shares, the foreign investment enterprise limited by shares is the only FIE that are allowed to enlist on the Chinese stock exchange. For investors who later wish to go down that road, it is wise to choose this type of formation vehicle. Further, the shareholders are only liable up to the amount invested in the shares. On the other hand is the required minimum registered capital as high as RMB5 million, and the required two to two hundred promoters of the company must hold their shares for at least one year. In other words is it impossible to sell freely if you want to divert. For foreign investors looking into this alternative it is important to be sure that they are ready to stake a lot of capital and to bind capital in this investment for a certain period of time. Taken this together with the fact that approval is required for the Ministry of Commerce at the central government level, this form of FIE is less common than the other three forms. It can however be expected that this form will become more common in the years to come as previous requirements called for registered capital of RMB30 million, minimum of five promoters and promoters retaining shares for at least three years from incorporation. The less stringent demands will most likely attract investors that previously found this type of investment vehicle to bind to much capital for to long a time. See Anonymous, http://www.hfw.com/l3/new/newl3c028.html and Chen, Jie "Guide to Establishing a Subsidiary in China", Jun He Law Offices (2005), found online at http://www.junhe.com/en/law_jiaodian.htm

- The Law of the People's Republic of China on Chinese-Foreign Joint Ventures
- Procedures of the People's Republic of China for the Registration and Administration of Chinese-Foreign Joint Ventures
- Provisions of the People's Republic of China for Labor Management in Chinese-Foreign Joint ventures
- Interim Procedures for the Handling of Loans by the Bank of China to Chinese-Foreign Joint Ventures
- The Income Tax Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures
- Detailed Rules for the Implementation of the Law of the People's Republic of China on Sino-Foreign Contractual Joint Ventures
- Rules for the Administration of Employment of Foreigners in China
- Detailed Rules For The Implementation Of The Law Of The People's Republic Of China On Sino-Foreign Contractual Joint Ventures
- Rules for the Implementation of the Income Tax Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures
- The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises
- Interim Provisions of the State Council of the People's Republic of China for the Control of Resident Representative Offices of Foreign Enterprises
- The Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital
- Notice of the General Administration for Industry and Commerce of the People's Republic of China Concerning the Handling of Registration Matters by Resident Representative Offices of Foreign Enterprises
- Interim Regulations on Foreign Exchange Control of the People's Republic of China
- Provisions on the Establishment of Foreign-Funded Construction Enterprises

Depending on the type of corporate vehicle the investor has to be familiar with some of the different laws above, in addition to the general framework that applies if the specific foreign investment regulation is silent. When deciding upon what form the M&A transaction should take and how to run the business after the closing, it is essential to have a good knowledge of what rights and obligations the different legal forms have by law.

5.1.3 M&A regulation

There are a vast number of laws governing M&A transactions. There is still no integrated M&A legal regime, which has created somewhat of a maze for someone unfamiliar with Chinese legislation. The Chinese government, who is working toward creating a more integrated regime, which will govern

these kinds of transactions, has noticed the need for a clearer system. A clearer system is emerging, but it is taking time. In order to promote M&A transactions the author sees it as a necessary part to continue to work towards a simplified regulatory system.

Table 1: China's M&A Laws

Name of law	Effective Date	Issuing Authority	Type of Target Covered
Several Provisions on Changes in Equity Interest of Investors in FIEs	May 28, 1997	MOFTEC, SAIC	CJV, EJV, WFOE, and FICLS (non-listed shares only)
Provisions on Merger and Division of FIEs	November 1, 1999, revised effective November 22, 2001	MOFTEC, SAIC	CJV, EJV, WFOE, FICLS, and domestic enterprises
Interim Provisions on Domestic Investment by FIEs	September 1, 2000	MOFTEC, SAIC	LLC and CLS
Notice on Relevant Issues Regarding the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Foreign Investors	November 1, 2002	CSRC, MOF, SETC	Listed companies (non-listed shares only)
Administrative Measures on Acquisition of Listed Companies	December 1, 2002	CSRC	Listed companies
Interim Provisions on the Administration of Securities Investment in China by Qualified Foreign Institutional Investors	December 1, 2002	CSRC, PBOC	Listed companies
Interim Provisions on the Utilization of Foreign Investment to Restructure State-owned Enterprises	January 1, 2003	SETC, MOF, SAIC, SAFE	State-owned enterprises (excluding listed companies and financial enterprises)
Interim Provisions on the Acquisition of Domestic Enterprises for Foreign Investors	April 12, 2003	MOFTEC, SAT, SAIC, SAFE	Domestic enterprises (excluding transfer of equity in FIEs)

Abbreviations: CJV: Contractual joint venture; CLS: company limited by shares; CSRC: China Securities Regulatory Commission; EJV: equity joint venture; FICLS: foreign-invested company limited by shares; FIE: foreign-invested enterprises; LLC: limited liability company; MOF: Ministry of Finance; MOFTEC: Ministry of Foreign Trade and Economic Cooperation; PBOC: People's Bank of China; SAFE: State Administration for Foreign Exchange; SAIC: State Administration for Industry and Commerce; SETC: State Economic and Trade Commission; SAT: State Administration of Taxation; and WFOE: wholly foreign-owned enterprise.

SOURCE: Emma Davies

** Table from "A Roadmap for China's Mergers and Acqusitions" by Emma Davies in the China Business Review, Vol. 30, No. 4 (Jul-Aug 2003), p. 13*

During August last year (2006) China did however issue the "Regulations for Mergers with and Acquisition of Domestic Enterprises by Foreign Investors" (the "New Regulation"), which has been in force since 8 September 2006.[72] The New Regulation supplanted the "Interim Regulations on Acquisition of Domestic Enterprises by Foreign Investors" issued on 7 March 2003 (see table above). This new regulation can be seen as having "a far-reaching, if not revolutionary, impact on M&A activities by foreign investors in China".[73] The new rules cover areas such as safeguarding national economic security, antitrust review, stock-for-stock acquisitions and special-purpose entities.

Under the New Regulation acquisitions that involve domestic companies relating to "important industries", i.e. industries that may affect the national economic security, or that results in foreign investors gaining "actual control" of companies having "famous Chinese brand names" or "well-established Chinese brand names" has to be reported to the Ministry of Commerce (MOFCOM) for approval.[74] The definitions used are vague, and no explanation has been given on how to interpret the definitions. In addition, the discretion given to the central government is huge. As a result, an immense grey area has evolved. The uncertainties are, in the author's

[72] Article 61 of the New Regulation
[73]Anonymous, "China Issues New Groundbreaking M&A Regulation", Sonnenschein Nath and Rosenthal LLP, (August 18, 2006) http://www.sonnenschein.com/docs/docs_e-alert/china_m&a_regulation.pdf
[74] Article 12 of the New Regulation

point of view, obvious as the lack of precise terminology and the approval process in fact could prevent many M&A deals from being concluded. As the regulation still is new it is hard to say how it is going to be used in practise, but its potential influence should not be underestimated.

Further, the New Regulation has adopted some antitrust review regulations while awaiting the coming Chinese Anti-Monopoly Law. To sum up, in case the target company is a large company, or the sum involved is very big, antitrust clearance will be required. These regulations can be found in articles 51-54. By reaching thresholds of business volumes exceeding RMB1,5 million in the Chinese market during one year, merging more that ten domestic enterprises in one year, getting a market share for any party relating to the M&A in the Chinese market of more than 20 per cent or if the M&A leads to that the party's market share has reached 25 per cent the Ministry of Commerce and SAIC have to be notified.

Important is that the New Regulation will clear the path for share swaps. Prior stock-for-stock acquisition was lacking regulatory guidance, and was usually rejected by the relevant authorities. Even though some restrictions still apply, such as the requirement of the overseas company being legally incorporated, having a sound company legal system in the place of incorporation, the overseas company and its management have not been punished by any regulatory authority in the past three years, the shares swapped by be legally held and assignable, and not be subject to any dispute, lien or any other form of encumbrances etc., it is now possible to structure an M&A transaction around a share swap.

The New Regulation will, generally speaking, have an adverse impact on M&A by foreign companies targeting domestic companies in China as the level of uncertainty and governmental influence is high, and the antitrust review possibly will have a negative effect. Involvement by governmental authorities is unwanted as it can put a sudden end to the parties' plans, which obviously is the last thing the actors want when pursuing an M&A. As it is impossible to secure the transaction from involvement of this kind, the uncertainty of whether or not the transaction in the end will take place is impossible to overlook. Further, the regulation is, according to the author, discriminatory. Worth noticing is art. 13 of the New Regulation that requires domestic companies selling assets to any foreign company to notify creditors and publish an announcement of the transaction at least 15 days before notification to the approval authority. There is no similar requirement when selling to a domestic acquirer. This does, according to the author, create a picture of the New Regulation as being somewhat unfriendly towards foreign investors. Seeing that China should be working to create a positive climate for foreign investment as a part of the entry to the WTO the New Regulation is surprising. To the author it looks like a step backwards. The future will show if the regulation will be used as a hurdle for foreign investment or if the impact will be less extensive.

Another new regulation that came into effect during 2006 is the Provisions for Foreign Investors to Merge with Domestic Enterprises.[75] The regulation was jointly published by the Ministry of Commerce, the State-owned Assets Supervision and Administration Commission and four other government agencies. The regulation came into effect 8 September 2006, and is providing a detailed framework for mergers involving a foreign party.

The regulation requires companies to seek approval from the Ministry of Commerce and the State Administration of Industry and Commerce in certain circumstances when the parties are considering a merger. For a proposed merger when one party has annual sales of RMB1.5 billion or more and holds 20 per cent of the Chinese market, and when a party accounts for more than 25 per cent of the Chinese market or merges with 10 enterprises successively in a year, as a result of the mergers a prior approval is a necessity.[76] Further, the regulation also requires foreign investors to get Ministry of Commerce approval for bids to control companies which dominate Chinese industrial sectors, own famous brands or employ more than 2,000 people, or when the transaction could affect China's economic security. What is meant with the wording "China's economic security" is somewhat unclear, and gives leeway for governmental interference.

5.1.4 Application issues

Even though there are many gains to be made by entering the Chinese market, the risks involved should not be underestimated. Foreign investors has to battle the risks in an underdeveloped legal system, the patchwork of regulation, the reliance on guanxi, unfamiliarity with the Chinese culture, etc.

The rule of law and implementation of models of law and legal institutions have been, and are, affected by political imperatives and a different perception and reception of legal norms by the society.[77] Although there is no doubt that China has made great achievements in restructuring the legal system in order to promote the economy, more needs to be done. A commitment to the rule of law rather than the former rule of man system is a prerequisite for success.[78] Today party policies, government powers, a network of social relations (guanxi) and local protectionism often render law a secondary role, which makes the vast number of legal regulations loose its role as the determinant for what rules governs the economic environment. As the economic situation raises demand for reform, which requires legislation, strong and effective regulation is lacking due to this primacy of other sources over law – hence causing failures in reforms.

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[75] Anonymous, "China issues new regulations to standardize foreign mergers", Embassy of Israel in Beijing (Sept. 2006), found online at http://www.israeltrade.org.cn/english/2006/09/13/11.32.33/
[76] Article 10 of the New Regulation, article 55 of the Provisions on Acquisition of Domestic Enterprises by Foreign Investors
[77] Potter, p. 6
[78] Wang, p. 24

As there are a number of lawmaking authorities with conflicting interests, one outcome is inconsistencies between different regulations. There is however a clear hierarchy of legal norms in which later regulation take precedence over earlier, specified over general, Constitution over other laws etc. For a foreign investor trying to get a picture of what rules to follow, the patchwork of several overlapping regulations that sometimes are contradicting each other is nevertheless a hurdle as it is impossible to read one single piece of legislation on its own and rely upon it.

Further, the conception of law as described above has lead to implementation problems and troubles in interpreting laws and other regulations. Tensions exist between official and popular legal culture. The informal guanxi system is still significant in the PRC legal system and is today working side by side with laws and regulations, which shows a mechanism that substitutes the norms and processes associated with formal institutions.[79] Court officials and judges do in addition often lack judicial training, which causes trouble when interpreting the law – especially as China does not have a reporting system for decided cases which otherwise could provide some guidance. Independence of courts and judges are also limited as pressures from outside are hard to resist considering how wages, records and financial system results are construed.[80]

Interpretation problems are also an effect of the regulation being drafted in an unclear way. The lack of clarity is however intended, as it creates a leeway for the government to influence how to use the regulation. By choosing a wording that is up unclear the room for later influence on its practical implementation is possible.

A foreign investor does in other words have to be cautious when entering the Chinese market. Legislation is often unclear, approval and authorisation processes are many, reliance on the judicial system is not obvious etc. Should complications arise they might be hard to solve by using traditional western methods, why a knowledge and understanding of the Chinese culture is of immense importance.

[79] Potter, p. 13
[80] Wang, p. 29

6 Establishment strategies

An M&A can take a number of different forms, or at least that is the case in many jurisdictions. In the US, for example, "an acquisition could take the form of a purchase of a target company's assets with either cash or shares; a cash purchase of shares in the target; a purchase of shares in the target with the purchaser's shares; or some combination of these forms",[81] and the same applies for mergers that also can be affected with shares or cash. Depending on whether the transaction is structured as a forward merger or a reversed merger[82] either the purchaser or the target is left in place. A third option is to use a triangular merger in which the subsidiary of the purchaser is merging with the target. The preferred acquisition form depends on many factors. "For example, if a foreign investor already has a reliable business associate in China, the foreign investor may wish to consider entering into an equity acquisition with the existing entity. The advantages of an equity acquisition with a local counterpart are, among others, local knowledge and channels to penetrate the local market and the comfort of having one less competitor. Of course, consideration should also be given to factors such as the reliability of available information regarding the financial and legal status of the target, the required governmental approvals, the transferability of assets, and the tax consequence of the structure."[83] However, it is often preferred to keep the entire transaction offshore, as an equity purchase by a special purpose offshore company will not trigger any approval requirements within China.

China did previously not permit all of these M&A structures, but as its market sector matured the regulation became more accepting and is now much less restrictive. When pursuing an M&A transaction in China, there is all the traditional acquisition structures to contemplate. The deal can be conducted through an equity purchase, an asset acquisition or a statutory merger.[84] All transaction types are possible under Chinese law. What option the individual investor chooses depends on factors such as the financial condition of the target, government approvals, third party consents, transferability of assets and tax consequences to name some aspects of importance.

The first step when considering an M&A is to identify the target company. Depending on what the goal is with the acquisition different types of companies are more attractive than others. Synergies with the core business,

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[81] Capener, Cole R., "M&A in China Comes of Age", the China Business Review, Vol. 7, no. 8 (1998), pp- 14-21, found online at http://chinabusinessreview.com/public/9807/capener.html

[82] A forward merger is when the target company merges into the acquirer and it survives; it is a reversed merger if the acquirer merges into the target company and the target survives

[83] Lin, Sandy "Establishing Presence in China through Merger and Acquisition", Lehman, Lee and Xu, International Legal News, Vol. 2 Issue 2 (28 December 2005), found online at http://www.imakenews.com/iln/e_article000502963.cfm?x=b11,0,w

[84] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm

rates of return on investment, improved position in the Chinese market and low-cost manufacturing are the main reasons listed by investors, in the order named above.[85] Finding the right acquisition target is, according to the author, essential for a successful M&A. Without getting this first step right it is hard to get the wanted outcome of the investment, as it later on will require a lot of work, time and money to turn the target company around to better suit the acquirer. As has been mentioned above, for foreign investors trying to find the optimal target this has to be done with the "Catalogue" in mind, as this limits what industries or sectors, or even companies, that according to internal rules are possible for foreign investors to acquire.

Today a foreign investor can buy any type of company in China, although the purchase may be subject to government approvals, and in some cases the form of corporate vehicle has to be transformed into some other form.[86] Legal rules are now in force that allows acquisitions of an FIE, an SOE, a company limited by shares or a non-FIE domestic enterprise. However, government approval is necessary which means that the rights belonging to the foreign investor de facto could be more limited.

6.1 How to get control

The determining factor is whether the foreign investor has acquired more than 50 per cent of the equity of the target.[87] Generally, there is no maximum limit on foreign ownership which means that the foreign investor can acquire 100 per cent of the target company. However, in case the target company is in a sensitive economic sector this general rule does not apply. These sectors, set out in the catalogue (see above), include industries such as telecommunications, financial services and transportation.

When more than half of the equity has been acquired, it is possible to convert the target company into an EJV, and thereafter appoint the majority of the board of directors (which is the highest governing body).[88] As there are only a few circumstances where PRC law requires a unanimous board the foreign investor will then have the effective control. Some foreign investors are however not happy with just a majority control, seeing that they can still be vetoed against in decisions concerning mergers, dissolutions, amendments of constitutional documents etc. In such a scenario, one approach is to acquire more than two-thirds ownership in the target, where upon the company is converted into a foreign investment enterprise limited by shares. A company limited by shares (CLS) has a different corporate governance structure that enables the foreign investor to get effective control over the shareholders' general meeting and thus can pass resolutions on important decisions such as mergers, dissolutions etc.

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[85] Bacani et al., p. 38
[86] Davies, p. 13
[87] Davies, p. 16
[88] Ibid

The drawback with this structure is that MOFCOM approval is necessary, hence causing the deal to take longer time to complete. A second approach is to structure the transaction through an offshore vehicle. By first converting the target into a WFOE, making it a subsidiary of the offshore vehicle and then letting both the foreign investor and the minority shareholders buy shares in the offshore vehicle the requirement of unanimous decisions is circumvented.

6.2 Equity purchase

A foreign investor can choose between acquiring equity in the target direct or indirect. The transaction will not cause any change in the legal nature of the target, there will merely be a change in ownership.[89] An equity acquisition is usually the simplest and quickest way to complete a takeover.

PRC law allows an equity purchase to be structured either as an indirect offshore acquisition, a direct acquisition by a foreign investor or through an equity acquisition by an FIE.

Equity interests M&A transactions provide a quick way for foreign investors to establish themselves as they entail an existing operation vehicle, business, asset and skilled staff, hence making it easier to penetrate the market. Furthermore, the reputation of the target enterprise will often have a fundamental value for the investor, such as trade name, sales network, client base, market share, etc. In addition, when the deal is completed, the foreign investor will inherit the existing business including existing contracts as they often automatically come with the business.

6.2.1 Offshore transactions

The most effective way for foreign investors to avoid China's difficult and often restrictive regulation is to keep the transaction offshore, i.e. make an indirect equity acquisition. If the investment is conducted through an offshore company the foreign investor can simply buy equity in the offshore enterprise.[90] As the transaction takes place offshore, hence not changing the equity holders in the domestic company, the transaction will not have to go through the approval process. The PRC government does not purport to regulate these transactions, which results in a less burdensome transaction for the investor who then only has to comply with the rules of the country wherein the transaction takes place. However, if the offshore company owns an interest in an FIE joint venture in China consent from the joint venture partner will be required if the joint venture agreement is to be altered or the FIEs articles of association will be amended.[91]

[89] http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[90] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[91] Ibid

The offshore transaction can involve either a purely foreign seller or a Chinese partner that sets up a special purpose offshore company that holds the equity in the domestic enterprise.

This is a preferred acquisition method when the parent company of the target is a special purpose vehicle without other assets.[92] Many foreign investors maximise the benefit of this structure by setting up one offshore company for every FIE as it permits future flexibility in case of subsequent transfers. Having many offshore holding companies makes it easy to accomplish restructuring of the company group without having to be caught up in the PRC legal system.

6.2.2 Onshore-offshore transactions

In some cases, it is difficult to keep the entire transaction offshore. When the transaction involves the transfer of an equity interest in China certain regulatory restrictions apply and governmental approval is necessary.[93]

6.2.2.1 Buying equity in an FIE

As the New Regulation only applies to M&A involving a domestic company, the M&A of an FIE is excluded from its application.[94] When considering buying equity in an FIE other, less clearly, delineated, laws and regulation applies.

As the result of the transaction is that equity in the FIE will by transferred to a new foreign investor the approval requirements of EJV, CJV or WFOE laws have to be fulfilled. In addition, if the FIE is a CJV the Chinese party's consent is also a necessity and complex contractual restructuring may need to take place.

Another common FIE transaction is when a Chinese partner in a joint venture chooses to sell its interest, whatever the reason might be (e.g. the partner wishes to exit the business, a falling out between the parties etc.) For a foreign investor wanting to continue the business there might not be any other alternative but to buy the Chinese party's equity. When doing so government approvals will have to be pursued as it changes the foreign investor's ownership interest in the joint venture. Further, as the foreign investor likely will acquire full control, the joint venture becomes a WFOE. With the transformation comes a new set of problems as WFOEs in certain business sectors are more strictly regulated than a joint venture, hence causing a range of difficulties, e.g. problems obtaining the necessary approvals.

[92] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[93] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[94] Article 2 of the New Regulation

6.2.2.2 Foreign takeovers of listed companies

When pursuing an M&A of a listed company the foreign investor is not only required to follow the general M&A rules but is also subject to the recently adopted "Measures on Strategic Investments in Listed Companies by Foreign Investors". The Measures, which came into force on 31 January 2006, allowed foreign investors to acquire A-shares of PRC listed companies.[95] Previously foreign investors were only authorised to buy one category of shares known as B-shares in listed Chinese companies.[96] Even though a purchase of A-shares now is permitted there are a number of restrictions limiting the possibility for foreign investors to engage in A-share deals.

The first hurdle is the necessary MOFCOM approval. Second, PRC law permit a foreign investor to acquire a strategic investment in three ways: a private share assignment agreement, a private placement or any other method sanctioned by PRC law.[97] As the Measures do not elaborate on what these "other methods" may be, it is unclear what the legislator had in mind. It does however appear as if open market acquisitions are not sanctioned.

Further, the investment has to comply with certain principles and conditions.

- The investment has to be made with "respect for state laws and industrial policies, the protection of the lawful rights of listed companies and their shareholders, the promotion of long-and mid-term investment, the prohibition of speculation and the prevention of restrictions on competition".[98]
- The transaction has to be conducted by means of contractual assignment, private placement of new shares or other lawful means, the shares cannot be transferred within three years, if the investment is conducted in stages at least 10 per cent has to be bought through the initial investment, it has to be in accordance with the Catalogue and if the listed company is an SOE the regulations regarding state owned assets must be complied with.
- The foreign investor has to be a foreign legal person or other organisation that is established and operates lawfully, is financially stable, creditworthy and has mature management experience, has actual assets of not less than US$100 million or manages overseas actual assets of not less than US$500 million, has a sound structure of governance, a good internal control system, and standard operating rules and finally has to be free of previous serious penalties imposed by Chinese or overseas regulatory institutions in the past three years.

[95] Anonymous, "China: Foreign Strategic Investment in Listed Companies", Deacons, Hong Kong (19 June 2006), found online at http://www.hg.org/articles/article_1310.html
[96] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[97] Anonymous, http://www.hg.org/articles/article_1310.html
[98] Ibid

In addition, after the transaction has taken place there are still a number of requirements that have to be met. Upon completion of the investment, the listed company is required to obtain an approval certificate of a foreign investment enterprise and get director and shareholder approval from the target. Finally, there is a time limit, of 180 days from the preliminary approval by MOFCOM, in which the transaction must be completed.

Upon completion of the transaction, the China Securities Regulatory Commission's (CSRCs) takeover rules and disclosure requirements are necessary to abide by. The rules are quite detailed and drafted so that they will apply to a broad range of possible transaction and situations.[99] Many of the articles cover reporting and procedural requirements, which most likely will not lead to any severe difficulties (although it may be time consuming and costly), but one article is crucial to notice as it results in a compulsory offer of all the shares. Article 34, in which the requirement is to be found, states that if the holding of shares exceeds 30 per cent, a partial or a general tender offer to acquire the outstanding shares has to be made. The offer price for non-traded shares can be no less than the higher of the highest price paid by the purchaser for shares bought during the last six months or the most recently audited net asset value per share of the target company, and for traded shares the price can be no less than the higher of the price paid for such shares by the purchaser during the last six months or 90 per cent of the arithmetic mean of publicly quoted sales over the previous 30 days.

Before 2006 the foreign investor had no choice but to make a general offer to acquire all outstanding shares – partial offers was not possible. The author considers the former requirement to be very tough and restrictive in a way that cannot be justified by political or economical considerations. The freedom of negotiation between the parties becomes very restricted, and will cause agreements to be carefully negotiated before entering into force. Even though there are some exemptions,[100] these are limited and do not in any way compensate for the restrictions previously imposed. For a foreign investor it was in other words important to consider if only a minority stake of less than 30 per cent was preferred or if the investor could and wanted to buy 100 per cent of the target company. With the new possibility to make a partial tender offer, which has to be at least 5 per cent of the outstanding shares, it is much easier for the foreign investor to structure the transaction in a way that is tailored for the specific situation. When the threshold of 30 per cent is reached, it is only compulsory to make an offer to buy 5 per cent of the shares – which make a tremendous difference from buying *all* outstanding shares.

If the foreign investor acquires at least 25 per cent of the shares, the company will classify as an FIE. Often foreign investors do however only

[99] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[100] See article 49 of the Takeover Rules

acquire a smaller stake in order to establish a strategic relationship or to make a financial investment.[101]

The enactment of this new regulation has greatly increased the opportunities for foreign investment in listed companies, although acquisitions still are highly regulated and supervised. Until fairly recently, a foreign investor only had the choice between investing in the small and restricted hard currency B-share market or to acquire non-tradable legal persons or state-owned shares.[102] As the new regulation has opened up a brand new market, e.g. the A-share market, for foreign investors, and for the first time allows foreign investors to act on the stock exchange, the author sees it as very likely that there will be a surge of interest in investing in listed companies in the years to come.

6.2.2.3 Investments in listed SOEs

As the listed shares in private companies only make up a minority of the outstanding shares of listed companies in China, the possibility to buy other types of shares are of great importance. Around 95 per cent of all listed companies are SOEs, which means that the vast majority of the market for listed companies consists of state owned entities.

Foreign acquisition of shares in listed companies is regulated according to the classification of the shares in the target. When considering an acquisition of a listed SOE the governing legislation is “Notice on Relevant Issues Concerning the Transfer of Listed Company State-Owned Shares and Legal Person Shares” which became effective 1 January 2003. State-owned shares are shares owned directly by the state, whereas legal person shares are shares owned by Chinese entities typically controlled by the state.[103]

Since the shares are publicly traded, the CSRCs rules on disclosure and acquisition of controlling, or potentially controlling, interests in the shares of a publicly listed company must be followed (se section 6.2.2.2 for a more detailed description). In addition, share transfers to foreign investors are subject to the Catalogue prohibitions, which can hinder a transaction if the target company is in a specified economic sector.[104] Finally, even if the transfer is permitted, approvals from various state authorities have to be obtained. Approval from the State Economic and Trade Commission (SETC) is required if the enterprise is involved in industrial policies or enterprise restructuring, MOF is responsible for transactions of shares in enterprises involved with state-owned share management and if there is a transfer of “crucial items” the State Council – China’s highest governmental

[101] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[102] Anonymous, “Foreign stratetic investments in Chinese listed companies – China opens further”, Allen and Overy (1 January 2006), found online at http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&contentSubTypeID=7944&itemID=31337&aofeID=301&prefLangID=410
[103] Norton and Chao (2003), http://www.omm.com/webcode/webdata/content/publications/privitization.pdf
[104] Ibid

administrative authority – has to be notified.[105] As the definition "crucial items" is vague and not discussed in the state-owned shares notice the approval procedures are subject to a broad discretion in government agencies, a discretion that potentially could hinder a vast number of foreign investment in SOEs. The author hopes that the legislator will clarify the more precise meaning of the definition, as it otherwise will cause unnecessary uncertainty in these types of transactions – uncertainty that most certainly will cool off the market to some extent.

6.2.2.4 Investments in domestic companies limited by shares

Investments in domestic companies limited by shares are covered by the New Regulation, which has been discussed above in chapter 5.1.3. As most of the domestic companies still are SOEs, the practical importance of investments in domestic companies limited by shares that are not SOEs is somewhat limited. For a detailed description of the regulation that governs these transactions, the author refers to chapter 5.1.3 above.

6.2.2.5 Investments in non-listed SOEs

Investing in SOEs is becoming more and more popular among foreign investors as the restructuring of SOEs has created a huge market for these kinds of transactions. As there are a vast number of SOEs "up for grabs" by foreign investors, the option of investing in an SOE is definitely a choice to consider. What might point in another direction is that SOEs often have aging plant and equipment, heavy debt burdens and redundant workforces, problems that have made foreign investors reluctant to pursue this type of investment.[106] Before entering into this kind of transaction it is therefore of immense importance to really contemplate whether the possible gains really outweigh these hurdles.

The most important regulatory documents in relation to the issues of state-owned assets in an M&A transaction are the Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises, the Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises, the Interim Measures for the Administration of Valuation of State-owned Assets of Enterprises and the Interim Provisions on the Utilization of Foreign Investment to Restructure State-owned enterprises ("the Provisions").[107] In addition to this specific regulation governing SOE transactions, the general framework is also applicable. These regulations establish a framework for foreign investment

[105] Ibid
[106] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[107] Rongkang, Wang "Mergers and Acquistions by Foreign Investors in China (Part I of III)", King & Wood China Bulletin (August 2006), found online at http://www.kingandwood.com/Bulletin/China%20Bulletin/Issue%20August%202006/bulletin_2006_8_en_wangrongkang.htm

in state-owned enterprises and their transformation into foreign-invested enterprises.

The Provisions was introduced in 2002 as a step in the restructuring process. It provides a legal basis upon which SOE equity transactions can take place. The foreign investor can either do a partial investment or an outright acquisition as there is no limitation on how large the share stock can be.[108] However, there is the obvious problems of consummation leading to the SOE becoming a WFOE, and the complications that might bring. The SOE will become an FIE and require approval both from MOFTEC and SAIC. In addition, most transaction also require authorisation from SAFE in order to regulate its use and repatriation of foreign currency.

According to the Provisions there are five ways in which a foreign investor can restructure a SOE into a FIE:

- "acquiring all or part of the state interest in the enterprise;
- acquiring all or part of the state shareholding in the company;
- purchasing from the domestic creditors of a SOE the debt owed by that SOE;
- acquiring all of the major assets of a SOE. The resulting FIE may be owned solely by the purchasing foreign investor or jointly with the seller of the assets; or
- becoming a shareholder of a SOE following an increase in capital and/or issue of new shares."[109]

In an SOE deal the seller is "departments authorized by the state or institutions whose investment is authorized by the state, enterprises holding state-owned capital, and other economic organizations."[110] The foreign investor must have the operating credit status and technological level needed by the reorganised enterprise, good business reputation and management capacity and good financial status and economic strength.[111] What is problematic is that the Provisions does not mention on what basis these standards should be evaluated or by who, which makes the requirements somewhat vague. Further, the foreign investor has to bring forward a rearrangement program for "improving the structure of governance of the enterprise and promoting the sustainable development of the enterprise."[112] Plans for new product development, technological transformation and related investment plans, measures to strengthen the management etc. have to be included in this rearrangement program.

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[108] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[109] Rongkang, http://www.kingandwood.com/Bulletin/China%20Bulletin/Issue%20August%202006/bulletin_2006_8_en_wangrongkang.htm
[110] Article 3 of the Provisions
[111] Article 5 of the Provisions
[112] Article 5 of the Provisions

Third party's consent may also be required, as the ownership often is divided among governmental entities and other SOEs – who might have commercial and political interests clashing with the transaction.

Of a more practical importance are the employment issues involved. Employment issues are a complicated area that may have a significant impact on the value of the target and hence on the acquisition price. The Procedures state the general principle that "the employees' legitimate interests shall not be harmed" with the restructuring.[113] The foreign investor has to seek the opinions of the SOEs' employee representative,[114] make plans for the appropriate care of the employees,[115] pay overdue salaries and social security premiums, compensate terminated employees etc. To the author it is obvious that this regulation has evolved from ideological reasons and the concern for social stability. It is highly unlikely that this regulation will be less restrictive in the years to come as the concern for workers and the ambition to minimize negative effects of the privatisation are considered more significant goals than to ensure smooth foreign M&A transactions.

The Procedures are still "young", e.g. it is not long since they were implemented, and it remains to be seen exactly how the Procedures will operate in practice. However, it is clear that the Procedures will facilitate the process of SOE reform and demonstrate new openings and opportunities for foreign investors. The role of cross-border M&A in the restructuring of SOEs is explicitly recognized and welcomed by China's government, which in the author's point of view will establish a "new" playing field for foreign investors looking for targets in China and lead to a continuing interest in China's M&A market.

6.2.3 Transactions wholly within China

In the last decade there has been a huge change in the legislation governing FIEs, as FIEs until the mid 1990s were not allowed to invest in another FIE or in a domestic Chinese company. Today FIEs in China can both buy assets from existing companies or invest directly in them by undergoing a structural reorganisation.[116]

Investments by FIEs are governed by the "Interim Provisions on Domestic Investments by Foreign-Invested Enterprises" (FIE Investment Provisions).[117] With the exception of investments restricted by the Catalogue, there is no maximum or minimum investments under the FIE Investment provisions. An FIE can choose to structure its investment by

[113] Article 6 of the Provisions
[114] Article 7 of the Provisions
[115] Article 8 of the Provisions
[116] Norton and Chao (2001), http://www.chinabusinessreview.com/public/0109/print/mergers.html
[117] Norton and Chao (2003), http://www.omm.com/webcode/webdata/content/publications/privitization.pdf

setting set up or acquiring wholly-owned subsidiaries, taking minority stakes in Chinese companies or establishing "a new Chinese company to make its capital investment in the form of an asset contribution. This permits an FIE to spin off the assets of one part of its business into a new subsidiary, which can then be merged with or sold to a third party".[118] The resulting entity will however generally not qualify as an FIE, but is instead to be seen as a wholly domestic Chinese company governed by the laws regulating the activities for domestic Chinese companies.

In most cases the foreign investor prefers to create a structure in which the principal operating company is a WFOE, as it gives the investor full control over their investments in other companies.[119] The use of a joint venture will give the Chinese partner an interest in the subsidiaries that might be unwanted from as well a business standpoint as it gives veto rights etc. that can create operational and legal drawbacks when managing the operations in the subsidiary.

6.3 Asset acquisition

As in other jurisdictions the benefits to be made from an asset deal are that the transaction can be structured to pick out the good parts, and that it is possible to avoid the assumption of the target company's liabilities, also known as "cherry picking". It can provide a way out of having to take over employees and the liabilities involved. In China it is however necessary to include an employee settlement plan in the transfer papers necessary for government review.[120] In other words, there is a liability for the employees also in an asset acquisition.

The drawback with an asset acquisition is that it is complicated to complete. One example hereof is that creditors to the target company have to be notified prior to takeover, and that they can demand security for their claims. Security has to be provided alt. the liabilities should be discharged before the deal can be completed.[121]

As a foreign company is not allowed to directly operate any assets in China without the establishment of an FIE, an FIE has to be set up (if the foreign investor does not have any previous presence in China through an FIE) to purchase the assets or use the purchased assets as the registered capital to establish a new FIE.[122]

[118] Zhang, Lulu "Buying Up, Buying In", EuroBiz Magazine (unknown date), found online at http://www.sinomedia.net/eurobiz/v200507/legal0507.html
[119] Norton and Chao (2001), http://www.chinabusinessreview.com/public/0109/print/mergers.html
[120] Davies, p. 14
[121] Davies, p. 14
[122] Lin, Sandy "Establishing Presence in China through Merger and Acquisition", Lehman Lee & Xu (28/12 2005), found online at http://www.imakenews.com/iln/e_article000502963.cfm?x=b11,0,w

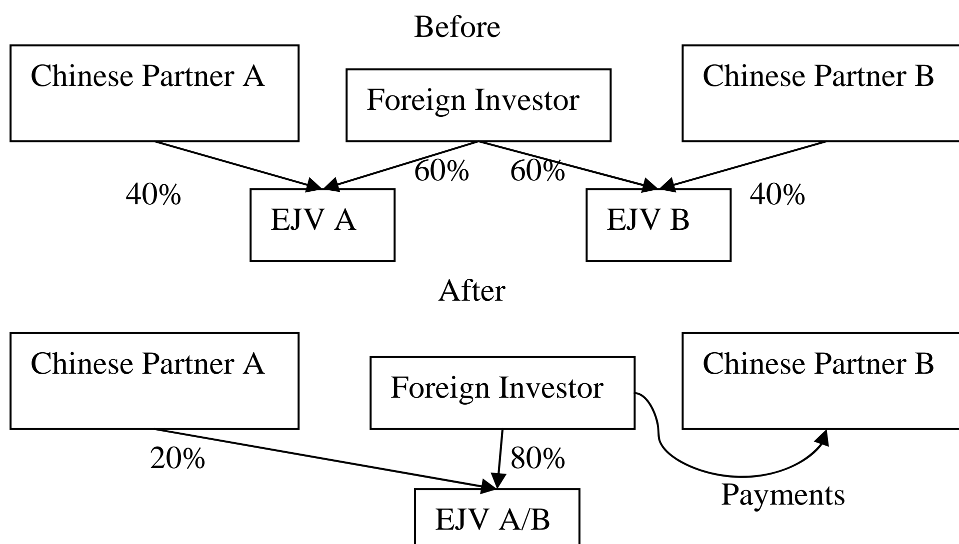
6.4 Statutory merger

In a statutory merger "the acquiring entity succeeds to all of the assets and liabilities of the target by operation of law, while the existing investor's equity is transformed into a merger consideration."[123] The Provisions on the Merger and Division of Foreign Investment Enterprises provides the basis upon which to merge FIEs and domestic enterprises.[124] Under PRC law the merger can be structured in a number of ways, e.g. the target being merged into the acquirer or a new entity being set up to absorb both entities.

6.4.1 Mergers of FIEs

A merger can provide a way for foreign investors to facilitate intra-corporate restructuring.[125] By merging existing FIEs the investor can consolidate the operations in China. Further, a merger can also be an efficient way for a foreign investor with joint ventures to structure a buyout of the Chinese partners.[126] In the case of a foreign company having two EJVs with different partners, a merger could be a solution facilitating the buy-out of the partner's interest in the process. However, if both partners are bought out it will result in the previous EJVs having to be transformed into a WFOE. This is a restructuring permitted by PRC rules.

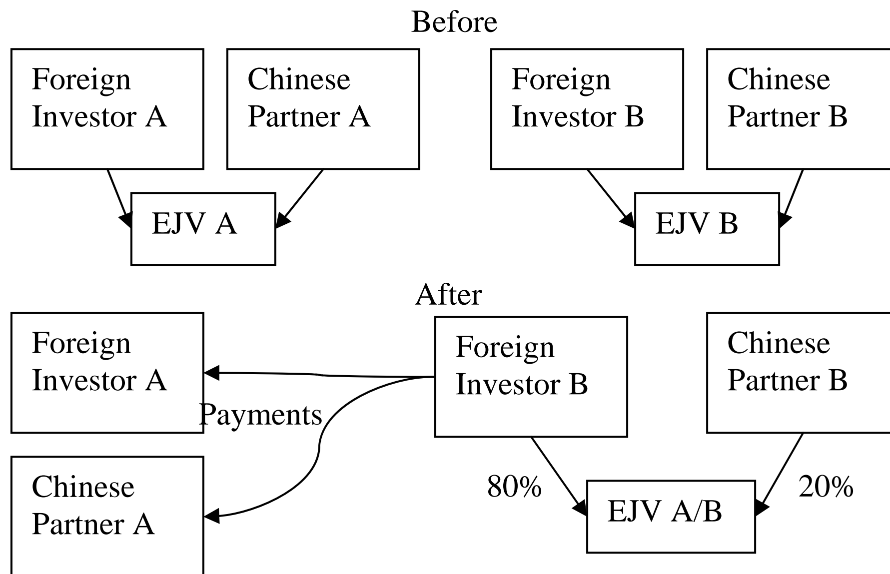
Bellow is an illustration of a buyout of one domestic partner in an EJV.



Secondly, the merger can also be conducted through an equity acquisition.[127] The surviving FIE will typically take the form of the buyer,

[123] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[124] Also before this regulation became effective mergers could take place, but then on an ad hoc basis through liaison with local approval authorities.
[125] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[126] Ibid
[127] Ibid

although the reversed also is possible. For example, you can take two WFOEs merging with each other, one of the two is bought out and the result is one single WFOE. Another alternative is to have two EJVs merging, the parties to one of the joint ventures are bought out and the resulting entity is an EJV. The similarity between the two structures is that one entity survives with its original ownership structure and its constituent documents whereas the other entity dissolves.



It is worth noting that mergers involving a CJV most likely are going to be more complicated as it is a contractual arrangement, and not a structure in which the interests are delineated by shares. In case the CJV has been set up for a certain period of time, or if the arrangements involved clauses concerning change of ownership etc. the investor will have to find out a way to work its way around these hurdles.

6.4.2 Mergers with domestic Chinese entities

The merger regulation specifically provides a legal basis for mergers with domestic entities.[128] The regulation does however not give any guidance about how the transactions are structured.

A merger of existing entities can be an effective way to establish a new joint venture with a Chinese company. One example is when the foreign investor already has an EJV with a Chinese partner and wishes to expand the business by combining the existing joint venture with the business of a Chinese company. The merger is "reasonably straightforward" under the merger regulation, and the surviving entity will continue to qualify as an FIE as long as the foreign investor still holds 25 per cent of the total equity.[129] However, a merger is subject to a multi-step approval process.[130]

[128] Article 2-4, 27-30 of the Regulation for Merger with and Acquisition of Domestic Enterprises by foreign investors.
[129] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html

As both preliminary approvals have to be attained from both the surviving and the dissolving entity's approval authorities, in addition to a final approval from the latter's approval authority, and existing subsidiaries of the merged companies have to fulfil the post-merger regulatory requirements, conducting a merger can prove to be a long and troublesome way.

Secondly, as subsidiaries of FIEs are not treated as FIEs but as domestic Chinese companies it makes it easier for foreign investors to restructure their investments as their subsidiaries can participate in mergers and divisions under the terms that are applicable for Chinese companies.

Finally, if the Chinese party to the merger is an SOE the SOE Restructuring Provisions applies.[131] The approval process is in these scenarios very complicated as approval has to be attained both from SASAC, MOFCOM and SAIC (State Administration of Industry and Commerce). Further, there are numerous of obstacles concerning the employees of the SOE. Even before initiating the approval process, the foreign investor must seek the opinions of the employee representative at the SOE. Further, the foreign investor must make plans for how to take care of the employees and needs to get the employee representative to approve of the plan. In addition, the SOE must use its current assets to pay all overdue social insurance premiums, and new contracts must be prepared for retained workers, payments must be made to terminated employees and finally a full social insurance fee for terminated employees must also be given.[132]

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[130] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[131] Tentative Provisions on the Use of Foreign Investment to Reorganize State-Owned Enterprises
[132] Norton, Patrick M. "Privatization of State-Owned Enterprises Through Foreign Investment", O'Melveny & Meyers LLP (June 2003), found online at http://www.omm.com/webcode/webdata/content/publications/privitization.pdf

7 Practical issues

7.1 Approval process

The level from which approval has to be attained depends on how the deal is structured, the target type and the transaction value.[133] The specific approval process can thus look very different from one transaction to another. Generally speaking, transactions classified as “encouraged” or “permitted” involving sums of US$100 million or more requires approval from the Ministry of Commerce and the State Development and Reform Commission (SDRC). Transactions of a value less than US$100 million do on the other hand only require approval from the Ministries’ provincial or lower branches.[134] For “restricted” investments, the same applies but for amounts of US$50 million.

Depending on what sector the industry is in, additional approvals from specialised administrative authorities may also be required. If the object of the acquisition is an SOE approval from the Ministry of Commerce, the SDRC and the State-Owned Assets Supervision and Administration Commission (SASAC) is generally a prerequisite.

It is important to keep in mind that the approval process is not just a formality, instead it can take great effort to get the necessary approvals.[135] In contrast with many other jurisdictions, authorities act beyond mere anti-trust or competition regulators. When deciding whether or not to give an approval, social concerns or policy concerns are also considered.

For foreign investors this may introduce a new element of uncertainty. In certain situations could this cause that a deal which is more or less finalised suddenly has to be abandoned. Not only would this be time consuming, but the process would also leave the company with a significant cost. In order to prevent situations like this it is therefore important to ponder the possible implications before entering into negotiations with a potential seller, and try to secure an acceptance of the transaction in an early stage.

7.2 Due diligence

As in all M&As the buyer needs to look into the target company to examine asset ownership documents, land registration and transfer contracts, business registrations, licences, certification of paid-up capital, articles of association and interest that have prior security over assets etc.[136] When

[133] Webre, http://www.deacons.com.hk/eng/knowledge/knowledge_212.htm
[134] Ibid
[135] Ibid
[136] Anonymous, http://www.gthk.com.hk/cgi-bin/cms/upload/PageEditor/big5/insight%20China%20File%20(Autumn02).pdf

doing an M&A in China it is especially problematic since public records often are unavailable or unreliable. Further, the management of the target company can often be unaccustomed to disclosure which means that the information can be hard, or even impossible to get hold of. What is important to remember is that the legislation in China is falling behind the economic development, hence leading to poor accounting standards, limited disclosure rules, etc. The regulation in these areas is still demanding very little of Chinese companies, which has caused that the information available is not as extensive as it would be in a European or a US company and the information that is accessible cannot be fully relied on. Especially in the taxation area, the foreign investor should be careful. A lack of good tax compliance is a common issue as many companies maintain inappropriate books in order to avoid or at least defer taxes.[137] The language barrier is another aspect, although the help of advisors speaking Mandarin or Cantonese can overcome this hurdle.

Some of the possible pitfalls and troubles involved are, besides inappropriate standards and quality and the language barrier, fraud and theft, incompetence and inexperience and differing agendas.[138] In order to avoid these traps it is of great help to involve advisors early on in order to get the best chances from the start to discover potential errors in the target company. It is also essential to understand that there are significant differences between conducting a due diligence (DD) in Europe and China, in order to have the right expectations of what material to find and an understanding of that additional risk areas need to be further explored.[139] In other words, the prospective investor must be prepared to go the distance. The DD is going to take time and it is going to be costly, but as lack of transparency in the DD process can hide major errors in the handling of the business, a disaster could be the result if the DD is not done with the utmost care.

The discrepancy between the economic environment and the legal system can also be seen in the court system. Often you find judges without a legal education, and without precedents or a reporting system for decided cases the outfall between two similar cases can differ a lot. For foreign investors it is crucial to keep in mind that reliance on the court system is not optimal.

Today the foreign investor has to accept that some level of risk or uncertainty is unavoidable. Cherry-picking assets through an asset acquisition, or negotiating contractual warranties or indemnities is however possible options available that can reduce these risks. Further, things are improving. "The movement from state-ownership to privatisation is

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[137] Haagmans, Stephan and Partridge, Robert "Due Diligence Factors of Success in M&A", Ernst & Young, (31/10 2005), found online at http://www.eycom.ch/publications/items/china/tas_due_diligence_20051031/en.pdf
[138] Anonymous, "More Due Diligence (and a Guide", China Business Services (16/10 2006), found online at http://www.chinabusinessservices.com/blog/?p=372
[139] Haagmans and Partridge, http://www.eycom.ch/publications/items/china/tas_due_diligence_20051031/en.pdf

improving transparency, and the Chinese system is developing fast. I have seen more changes in the past five years than in the previous 20", has David Holloway, Chief Operating Officer of International Risk at PricewaterhouseCoopers commented.[140] The author believes that the legal surroundings will improve even further quite rapidly, which in turn will result in better possibilities for a thorough DD.

Conducting Due Diligence (DD):
Europe vs. China

	Europe	**China**
Level of transparency in financial information	High	Low, if any
Normal duration of due diligence	1-8 weeks	3-12+ weeks
Preparation time required by target company before DD	Minimal	May require extensive assistance
Basis of financial statement	US GAAP or IFRS	PRC GAAP, at best
Audited financial statements	By reputable standards	Typically not reliable from a US GAAP or IFRS perspective
Extent of related party transactions	Varies, typically fully disclosed	Usually extensive; inadequate disclosure
Disclosure of contingent liabilities	Usually transparent	High risk area and rarely disclosed
Reliance on computerized accounting systems	Typical	Untested
Reliability of representations and warranties	Normally reliable	Untested
Enforceability of indemnification claims	Strong; backed by courts	Untested; may need to consider "holdbacks"

** Source: Stephan Haagmans and Robert Partridge in "Due Diligence Factors of Success in M&A", found online at http://www.eycom.ch/publications/items/china/tas_due_diligence_20051031/en.pdf*

7.3 Valuation

Generally the parties are free to agree to a price for the deal, but PRC law requires the purchase price to be based on a valuation made by a Chinese valuation firm and on internationally recognised valuation methods.[141] The

[140] Stensgaard, Anne-Birgitte "Do not forget due diligence when doing business in China", AME Info (19/3 2005), found online at http://www.ameinfo.com/55682.html
[141] Article 14 of the New Regulation

requirement is, in the author's opinion, an effect of PRC authorities seeking to protect the value of domestic assets.

The State Asset Administration Bureau (SAAB), part of the Ministry of Finance, is responsible for the asset valuation.[142] Valuations are mandatory for a range of circumstances, including setting up investment vehicles where assets will be acquired or contributed, restructuring existing enterprises, reporting for accounts purposes, asset disposals, listing on the stock exchange or in the case of liquidation. Asset valuations are carried out by local firms that are licensed to carry out the valuation of state-owned assets for reporting to the SAAB. Through the valuation a reference price for the transaction is given. A problem in this context is that the valuation process differs from the ones carried out internationally. Sometimes the independence of the firms is not observed, the qualifications and competence are varying and valuation methods are not uniform or codified. This has led to that foreign investors often raise doubts about the reasonableness and fairness of the valuation results.[143]

The standard international valuation approaches recognised by the SAAB, as mentioned above, includes comparison with the prices paid for similar assets (market comparison), calculating the present value of earnings (the income approach) and depreciating the current replacement cost (the cost approach). If the agreed price differs more than 10 per cent compared to the valuation made by SAAB the foreign investor has to provide a written explanation to the financial authorities in charge.[144] Further, the transaction is considered as forbidden. The author would therefore like to see the problem being addressed from the start by considering how to approach asset values early in negotiations or discussions. Further, carrying out a parallel asset valuation alongside the local valuation firm, is often of value in order to later discuss the values obtained and if necessary get adjusted prior to official submission, "or get both parties to jointly appoint an international valuation practice to then project manage the local valuation firm."[145]

[142] Anonymous, "Asset Valuation", China-Britain Business Council (date unknown), http://www.cbbc.org/market_intelligence/presense/asset.html
[143] Anonymous, "China Transaction Services", KPMG (2005) http://www.kpmg.com.cn/en/virtual_library/Financial_advisory_services/China_TS_brochure.pdf
[144] Anonymous, "Mergers & Acquisitions Asian Taxation Guide", PricewaterhouseCoopers (unknown date), http://www.pwchk.com/webmedia/doc/632870038811178832_m&a_asiantaxguide_2006_cn.pdf
[145] Anonymous, http://www.cbbc.org/market_intelligence/presense/asset.html

7.4 Financing

Another concern in Chinese M&A transactions is financing, whether for acquisition of a target or for operation of the target after completion of the transaction. The reason for this concern is that acquisition financing in China is limited.[146] Without guarantee from the parent company it is very difficult to get any bank loans. Today the banking system in China is burdened with a high ratio of non-performing loans, which taken together with its preference to lend to SOEs has caused financing problems for private enterprises. This issue has been addressed also by the government, who in the "Equity Change Regulations" address the prospect of a pledge of the equity investment to a lender under the Security Law of the PRC, provided all the other equity holders consent. The pledge is limited to paid-up capital only and must receive government approval. The procedures for pledging equity interests are however not fully developed, and enforcement of the interests are difficult at best, which means that bank loans are rarely given with security interests in the equity. The same applies also to registered security in other assets.[147] Of course, the problem of raising funds can be solved by using financial institutions in other countries.

A further problem is the inconvertibility of the RMB. This means that even cash payments give rise to problems, as it can be difficult to obtain the State Administration of Foreign Exchange (SAFE) approval for the conversion. If approval is given, the foreign investor will then find it difficult to later convert back the currency and repatriate as the funds will be registered in the FIEs capital account. In other words, once money has been converted and registered the foreign investor has bound the capital to the FIE and will have problems taking the funds back outside China.

Notwithstanding the availability of other financing methods, including the possibility of listing on a Chinese or foreign stock exchange, or issuing bonds, financing for the operating needs of the target typically still takes the form of foreign shareholder loans or bank loans secured by foreign investor guaranties."[148]

7.5 Closing

As the approval process is of different length for every individual transaction it is close to impossible to effect a simultaneous closing of the M&A deal with the approval (unless of course for offshore M&A transactions).[149] To try to compensate for this lack of control of timing various escrow and letter-of-credit arrangements are being used. This is all good, but as the laws governing these types of arrangements are

[146] http://chinabusinessreview.com/public/9807/capener.html
[147] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html
[148] http://chinabusinessreview.com/public/9807/capener.html
[149] Norton and Chao, http://www.chinabusinessreview.com/public/0109/print/mergers.html

underdeveloped the arrangements are not in fact really providing a compensating effect in full.

What probably will help to solve this issue to some extent is that the new SOE Restructuring Provisions and the new M&A rules allow the foreign investor to make the payment up to three months after the issuance of the new FIEs business licence.[150] In addition, with approval from the government authorities 60 per cent of the purchase price is to be paid within six months and the full amount within one year of the issuance of the licence. As these provisions permit the foreign investor to withhold payment until the deal is legally effective, it provides some safety for the investor.

[150] Ibid

8 The future of M&A in China

On 11 November 2001, after lengthy negotiations, China became a member of the WTO. As the membership set up certain commitments for China, the author sees great possibilities for the future of M&A in China as restrictions are being lifted and a more open market is being created. Foreign investors, considering a penetration of the Chinese market, should thus know what commitments China has made to the WTO and what new business opportunities that probably will emerge as a result.

Being a member of the WTO, China has to comply with certain principles such as trade without discrimination, freer trade without trade barriers, predictability, fair competition etc. For foreign investors this means that they are "granted treatments no less favourable than those granted to other individuals and enterprises in respect of the procurement of inputs and goods and services necessary for production and the conditions under which their goods are produced, marketed, or sold both in the domestic market and abroad; and the price and availability of goods and services supplied by national and sub-national authorities and public-owned or state-owned enterprises, such as transportation, energy, basic communications, and other utilities or factors of production."[151] In addition, China must also follow the rule of uniform administration, which means that China has to apply and administer all its laws in a uniform, impartial and reasonable manner no matter on what level the regulations are issued.[152]

Furthermore, China has to abide by the rule of transparency. For the future, this will probably lead to some clarifications of the present laws and regulations. An official journal dedicated to publication of laws and other regulation affecting trade and the control of foreign exchange will be probably also be published.[153] China has already been honouring their commitments to the WTO by updating the M&A regulation and easing restrictions previously imposed on foreign investment.

Some sectors will open up to foreign investors, sectors that earlier was under a state monopoly.[154] As foreign investors often will have competitive advantages in terms of efficiency, cost, technology and price compared to state-owned enterprises, the possibilities for foreign companies to successfully compete with their Chinese counterparts are good. Further, one of the more significant changes is the lifting of the prohibition against the transfer of state-owned shares of China's listed companies to foreign investors.

[151] Lo and Tian, p. 333
[152] Ibid
[153] Lo and Tian, p. 334
[154] Lo and Tian, p. 346

In the Asia-Pacific region China has become somewhat of a favourite M&A market for foreign investors, which in part is due to the WTO accession. One example is the banking sector, which now is starting to open up to foreign investors. China's financial sector is, in the author's point of view, a sector that in the close future probably will be a brisk market for M&A transactions. Today some deals have already taken place in which foreign investors has made strategic investors in Chinese banks, deals that have involved enormous amounts of money. One example is Citibank's purchase of a 5 per cent equity stake in Shanghai Pudong Development Bank which would not have been possible without the new regulations issued after the WTO entry.[155] The recent interest is however not the end of it, as these transactions only has involved minority shares and foreign investors most likely are on the look for more.

The gradual liberalisation of the foreign currency regime and the relaxation of exchange restrictions on capital accounts will also support continued M&A activity, as it facilitates cross-border activity. Finally yet importantly is the number of M&A deals driven by the present and continuing presence of a vast number of acquisition targets. Restructuring the state sector is one of the major priorities in China's economical reform, and even though the field of targets previously has been rich, there are still around 50,000 SOEs in need for restructuring – restructuring that cannot take place without foreign investors and their capital.[156]

What furthermore is interesting is that Chinese parties now are starting to conduct M&As abroad. The roles are changing, as Chinese companies are growing, becoming stronger and start looking for possibilities also outside the border. The author believes that this trend will continue, and that in a few years buyouts by Chinese investors will become a rather common feature. As this paper however focuses upon M&A *in* China, this aspect is for the purpose left aside. It would however be an interesting topic for further research, something the author would encourage.

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[155] Anonymous, "China Has Been Honouring WTO Commitments: Financial Expert", Xinhua News Agency (10 February 2003), found online at http://www.china.org.cn/english/BAT/55428.htm

[156] Woodard and Wang, http://www.chinabusinessreview.com/public/0411/woodward.html

9 Concluding remarks

China has made considerable progress in the last couple of years in the development of a regulatory framework for M&A transactions. Although these advances now have made sectors open up, and broadened the scope of permissible acquisitions, there are still a large number of issues left to be resolved. China is however looking determined to honour the commitments made to the WTO, why the author sees the future of M&A in China as positive. As the range of targets and acquisition methods have been expanded, and the regulation are becoming more structured and standardised, there is no reason to believe that the M&A activity in China today is not going to continue over the next decades. China's economy will probably follow the positive trend it has shown over the last couple of years, which means that the market in China will expand even more, and attract new foreign investors.

Although China is a promising market, a foreign investor has to be aware of the difficulties involved with penetrating the market. According to a global study by the Economist Intelligence Unit the main reason why an M&A fails is a poor understanding of the Chinese market.[157] Almost half of the respondents named this factor as crucial for success. When structuring the M&A it is thus important to remember the special characteristics of the operating environment in China every step of the way – from the start when screening the market for target companies, when doing a due diligence, in the approval process, contemplating the different perception of the rule of law and so on. Involvement of local advisors is of great importance, not only due to language barriers, but also as it gives the investor a direct access to local customs, personal networks, informal structures etc. Further, as the regulatory framework is very complicated and official translations do not exist, help to orientate through the patchwork of laws and other rules is often necessary.

There are other characteristics of the Chinese market the foreign investor needs to be aware of. China's history and the political and economical surroundings it has led to is very different from what investors may be used to. The rule of law does not apply in the same way, guanxi is important in many aspects of the running of a business, the court system is unreliable, government influence is high, laws are unclear, financing is difficult etc. An M&A cannot be conducted in the same way as it usually is done other markets as the same playing field does not exist. In the DD for example, caution is of immense importance. It is a lengthy process, filled with possible pitfalls as the structures in which a business operates is different from Western countries. Accounting standards are very poor, public records are unavailable or unreliable and theft, fraud etc. is not totally uncommon.

[157] Bacani et al, p. 9

Important to remember is that the approval process in China is of an entirely different kind compared to what the investor is used to, as the authority does not merely act as anti-trust or competition regulators. The approval process is instead a way to remain control over the M&A market, and to direct it in the wanted direction. By doing so, China can seemingly open up and ease restrictions, although the control of the M&A market is in fact not released. It is obvious that foreign investors cannot overlook this aspect, as the consequences otherwise could be severe. The author believes that it is necessary to look beyond the actual rules, and see to the practical application and play according to the more informal rules. The rule of man can in areas such as these play an essential role.

Bearing this in mind, the foreign investor should then try to find a target company that will fit with the aim of the investment. Depending on what the goal is, the preferred target type or perhaps investment vehicle will change. Hereafter the investor will have to find the way through China's complicated foreign investment- and M&A regulation. Obstacles might here occur, such as the Catalogue prohibiting some investments in certain economical sectors. Only thereafter can the investor look into different ways to structure an M&A. The preferred way is often to structure the transaction is such a way that it is kept offshore, but in case this is not possible, other alternatives have to be contemplated. The author has tried to show that there is not any best way to structure the transaction in general, but depending on a number of factors the choices available is more or less appropriate. What the investor finally chooses must however be well thought through as it will affect the future of the investment.

China is a nation that will be of ever more importance. Its economy is growing, and reforms are taking place to enable the country to adapt to the changing surroundings. Restructuring of SOEs will further fuel the M&A market, and as the opportunities for a successful investment, nevertheless the problems described above, are very good as long as the transaction is made with care, foreign investors will and should continue to try to establish themselves in China.

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Law of the People's Republic of China on Chinese-Foreign Joint Ventures

Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital

Matters by Resident Representative Offices of Foreign Enterprises

MOFTEC's Provisions on Companies of an Investment Nature Established by Foreign Investors

Notice of the General Administration for Industry and Commerce of the People's Republic of China Concerning the Handling of Registration

Notice on Relevant Issues Regarding the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Foreign Investors

Procedures of the People's Republic of China for the Registration and Administration of Chinese-Foreign Joint Ventures

Provisions for Foreign Investors to Merge with Domestic Enterprises

Provisions of the People's Republic of China for Labor Management in Chinese-Foreign Joint ventures

Provisions on Merger and Divisions of FIEs

Notice on Relevant Issues Regarding the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Foreign Investors

Provisions on the Establishment of Foreign-Funded Construction Enterprises

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