MERGERS AND ACQUISITIONS

China has a sophisticated regulatory framework for mergers and acquisitions involving foreign investors. The primary governing legislation is the Regulations on the Merger and Acquisition of Domestic Enterprises by Foreign Investors ("Foreign M&A Regulations"), which was last revised in June 2009 and is supplemented by a myriad of departmental rules governing specific industries or target groups.

General framework

Similar to the undertaking of green-field projects, foreign investors acquiring Chinese companies are subject to foreign investment restrictions, which are based on the classifications of industries into "encouraged", "permitted", "restricted" and "prohibited" categories. Such classifications, which are set forth in the Catalog for Guiding Foreign Investment (last revised in December 2011) affect the maximum percentage of foreign ownership allowed, as well as the level of Chinese government authorities from which approvals would be required. MOFCOM and the National Development and Reform Commission ("NDRC") are the major Chinese agencies in-charge for foreign investment matters.

The Foreign M&A Regulations also introduced the concepts of "industries affecting national economic security" and "companies owning well-known trademarks and old Chinese trade names", a change of control in which will require approval from central MOFCOM regardless of the transaction value. In other cases, the level of the approval authorities is determined by the transaction value or the total investment amount set for the target entity.

National security review

The State Council and MOFCOM issued regulations in 2011 fleshing out a national security review procedure already referred to in general terms in the Foreign M&A Regulations.

A joint committee led by NDRC and MOFCOM is responsible for carrying out a review to determine whether a transaction will have a major impact on national security. If that impact cannot be mitigated, the transaction will not be permitted to go forward.

The onus is on the investor to file for a national security review before seeking approval if the transaction could raise national security concerns. The approval authority may also on its own discretion decide that a national security filing is required, and suspend approval pending the results of that filing.

A filing is required if the acquisition would give a foreign investor actual control of a domestic defense enterprise, or a non-defense enterprise which (1) has a bearing on national security and (2) involves industries such as major agricultural products, major energy sources and resources, major infrastructure facilities, major transportation services, key technologies and the manufacture of major equipment.

Equity acquisitions vs. asset acquisitions

A foreign investor can acquire equity in a wholly Chinese-owned enterprise and convert it into a foreign-invested enterprise. When assets, rather than equity, are acquired, it is necessary to establish a commercial presence in the PRC in order to use the assets for operational purposes. In these circumstances, a foreign-invested enterprise may be established prior to the acquisition or, in some circumstances, may be established as part of the acquisition process.

There are certain requirements applicable to both equity and asset acquisitions. For instance, the parties are required to have the value of the equity appraised before transfer. Prices considerably lower than the appraisal result are not permitted. The transaction price and the appraisal amount may not usually differ by more than 10%.

In comparison, asset acquisitions have some advantages over equity acquisitions. The foreign investor can pick and choose which parts of the PRC target company it wishes to buy. Generally, existing obligations, liabilities or restrictions of the PRC target company will remain the sole responsibility of the PRC target company. Asset acquisitions tend to be more complex than equity acquisitions since the transaction may involve the transfer of different categories of assets and liabilities, each carrying separate statutory requirements. In addition, if a new foreign-invested enterprise is to be established for the purpose of carrying out the asset acquisition, separate approval from the Chinese authorities will be required for its establishment. Finally, there may be tax considerations for the parties in relation to the transfer of assets, as asset acquisitions are taxable in the PRC.

Other specific target groups or acquisition means

MOFCOM has, through its guidelines issued in December 2008, clarified that neither equity acquisitions of, nor assets acquisitions from, foreign-invested enterprises is subject to the Foreign M&A Regulations. While it remains unclear as to what extent acquisitions using foreign-invested enterprises have to comply with the Foreign M&A Regulations, in practice they are generally not subject to the additional requirements set forth therein.

If a purchaser wishes to acquire a foreign-invested enterprise, it may simply acquire the foreign parent of the target rather than the target itself. This form of acquisition is particularly suitable when the parent is a special purpose vehicle established for the sole purpose of holding the foreign-invested enterprise. Offshore acquisitions are in many ways simpler and more convenient than direct acquisitions because Chinese approval requirements are normally avoided. However, the PRC tax authorities have tightened their scrutiny over offshore transactions that are deemed as trying to avoid PRC capital gains tax.

State-owned equity acquisitions

The PRC Enterprise State-owned Assets Law came into effect in May 2009 to regulate, among other things, the transfer of state-owned equity interests. Under this new law, equity transfers in state-owned enterprises generally are subject to approvals by the State-owned Assets Supervision and Administration Commission (or its local counterparts). If a transfer will result in the State losing majority control, approval from the People's government at corresponding level would also be required.

The transfers of state-owned equity interests (other than shares in listed companies) have to be conducted at government-affiliated equity exchanges by means of an open bidding process. The minimum transfer price has to be determined by reference to the appraised value. A commitment to maintain employees stability is often one of the qualifying requirements for interested bidders. On the other hand, any proposal relating to redeployment of employees requires approval from the workers congress of the target.

It is worth noting that many departmental rules issued by the State-owned Assets Supervision and Administration Commission or its predecessor prior to the promulgation of the new law continue to apply.

Acquiring PRC listed companies

Since 2006, foreign investors may directly acquire tradable shares of PRC listed companies by way of transfer, private placement or other legal means for medium- to long-term investments. Where the target shares are state-owned, sellers must publish key details of potential dispositions and invite interested buyers to submit acquisition proposals for selection.

Mergers

PRC laws recognize two forms of merger: "merger by absorption" and "merger by new establishment." A "merger by absorption" involves the absorption by one company of another pursuant to which the absorbed company is dissolved and its registered capital and assets merged into the surviving entity. In a "merger by new establishment," each of the pre-merger companies is dissolved and a new company established holding an aggregate of the pre-merger companies' assets and registered capital.

Cross-border mergers are currently unavailable under PRC law, i.e. it is not possible to directly merge a foreign entity with a domestic company (including foreign-invested enterprises). As far as foreign investors are concerned, the only permissible forms of merger in China are between foreign-invested enterprises and foreign-invested enterprises, or between foreign-invested enterprises and domestic companies. In practice, however, mergers are rarely seen and acquisitions are more common.

Recent developments

There are a number of interesting regulatory developments in 2014 concerning mergers and acquisitions in China. For example, NDRC is revising the Catalog for Guiding Foreign Investment, and in a draft for comment released in November 2014, the number of restricted sectors were more than halved, and shareholding limitations were relaxed in a wide array of industries. Recent regulations of the State Administration of Foreign Exchange significantly reduced and simplified the procedures for granting and taking cross-border security, and registering a round-trip investment. Foreign invested enterprises in pilot areas are permitted to use their registered capital for making equity investments in China, a development believed to have opened a door for foreign PE funds.