

# Mergers & Acquisitions in China: Law and Practice



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**Lutz-Christian Wolff**



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# Mergers & Acquisitions in China: Law and Practice

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## Foreword

Mergers and acquisitions are gaining more and more importance on the Chinese Mainland. At the same time the legal framework governing China-related M&A transactions has become very complex. This book aims at providing a structured introduction to legal aspects of China's M&A regime. Different topics are discussed in their practical context, in particular from the viewpoint of foreign investors. Comprehensive references and bilingual versions of the most important M&A-related laws and regulations are meant to allow for an easy access to primary and secondary sources.

In many M&A-related areas, Chinese law is still unclear, incomplete and inconsistent. I have tried to flag these areas and to point to practical solutions that have been used in the past or might be available in the present and in the future. Further, Chinese law must be seen as "law in development" with many changes to be expected in the near future. This is in particular true for the rather young Chinese M&A regime. I have addressed possible future developments wherever they are already foreseeable to a satisfactory degree of certainty. However, this book is not intended to, and can by no means, replace legal advice in relation to specific M&A transactions. On the contrary, the legal situation of every practical case must be analysed based on the underlying facts and the then applicable law.

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Hong Kong, August 2006

LUTZ-CHRISTIAN WOLFF

## Abbreviations

AIC .....	Administration for Industry and Commerce
CBRC.....	China Banking Regulatory Commission <sup>1</sup>
CJV .....	Co-operative joint venture
CJV Law .....	PRC Sino-foreign Co-operative Joint Venture Law (date of effectiveness of latest version: 31 October 2000)
CJV Law Implementing Rules.....	PRC Sino-foreign Co-operative Joint Venture Law Implementing Rules (date of effectiveness of latest version: 4 September 1995)
CLP.....	China Law & Practice (Hong Kong)
COFCOM .....	Commission(s) of Commerce
CSRC .....	China Securities Regulatory Commission <sup>2</sup>
EJV .....	Equity joint venture
EJV Law .....	PRC Equity Joint Venture Law (date of effectiveness of the latest version: 15 March 2001)
EJV Law Implementing Rules.....	PRC Sino-foreign Equity Joint Venture Law Implementing Rules (date of effectiveness of the latest version: 22 July 2001)
FDI.....	Foreign direct investment
FIE .....	Foreign-invested enterprise
FII .....	Foreign indirect investment
FOREX .....	Foreign exchange
GITIC .....	Guangdong International Trust and Investment Company
GPCL .....	PRC General Principles of Civil Law (date of effectiveness: 1 January 1987)
Holding-FIEs .....	Holding companies established in Mainland China pursuant to the <i>Establishment of Companies with an Investment Nature by Foreign Investors Provisions (2nd Revision)</i>
IPO.....	Initial public offering
M&A.....	Mergers and acquisitions
MOF .....	Ministry of Finance <sup>3</sup>
MOFCOM .....	Ministry of Commerce <sup>4</sup>
MOFCOM Explanations.....	Shangwubu jiu “Waishang touzizhe binggou jingnei qiye zanzing guiding” zuochu shuoming (MOFCOM publishes Explanations of the “Acquisition of Domestic Enterprises by Foreign Investors Tentative Provisions”) (30 July 2004)
MOFTEC.....	Ministry of Foreign Trade and Economic Co- operation (now MOFCOM)
NDRC .....	National Development and Reform Commission <sup>5</sup>
NPC .....	National People’s Congress <sup>6</sup>
PBOC.....	People’s Bank of China <sup>7</sup>

PIL.....	Private International Law
PRC.....	People's Republic of China
QDII.....	Qualified Domestic Institutional Investor
QFII.....	Qualified Foreign Institutional Investor
R&D.....	Research and development
SASAC.....	State-owned Assets Supervision and Administration Commission of the State Council <sup>8</sup>
SAFE.....	State Administration of Foreign Exchange <sup>9</sup>
SAIC.....	State Administration for Industry and Commerce <sup>10</sup>
SCMP.....	South China Morning Post (Hong Kong)
SETC.....	State Economic and Trade Commission (not in existence anymore — SETC functions are partly taken over by the MOF, MOFCOM and SASAC)
SMEs.....	Small and medium-sized enterprises
SOE.....	State-owned enterprise
SPC.....	Supreme People's Court <sup>11</sup>
SPVs.....	Special Purpose Vehicles
VAT.....	Value-added tax
WFOE.....	Wholly foreign-owned enterprise
WFOE Law.....	PRC Wholly Foreign-owned Enterprise Law (date of effectiveness of latest version: 31 October 2000)
WFOE Law Implementing Rules.....	PRC Wholly Foreign-owned Enterprise Law Implementing Rules (date of effectiveness of latest version: 12 April 2001).

## Endnotes

<sup>1</sup> See [www.cbrc.gov.cn](http://www.cbrc.gov.cn) (last visited on 6 June 2006).

<sup>2</sup> See [www.csrc.gov.cn](http://www.csrc.gov.cn) (last visited on 6 June 2006).

<sup>3</sup> See [www.mof.gov.cn](http://www.mof.gov.cn) (last visited on 6 June 2006).

<sup>4</sup> See [www.mofcom.gov.cn](http://www.mofcom.gov.cn) (last visited on 6 June 2006).

<sup>5</sup> See [www.sdpc.gov.cn](http://www.sdpc.gov.cn) (last visited on 6 June 2006).

<sup>6</sup> See [www.npc.gov.cn/zgrdw/home.index.jsp](http://www.npc.gov.cn/zgrdw/home.index.jsp) (last visited on 6 June 2006).

<sup>7</sup> See [www.pbc.gov.cn](http://www.pbc.gov.cn) (last visited on 6 June 2006).

<sup>8</sup> See [www.sasac.gov.cn](http://www.sasac.gov.cn) (last visited on 6 June 2006).

<sup>9</sup> See [www.safe.gov.cn/model\\_safe/index.jsp](http://www.safe.gov.cn/model_safe/index.jsp) (last visited on 6 June 2006).

<sup>10</sup> See [www.saic.gov.cn](http://www.saic.gov.cn) (last visited on 6 June 2006).

<sup>11</sup> See [www.court.gov.cn](http://www.court.gov.cn) (last visited on 6 June 2006).



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## CHAPTER 1 INTRODUCTION

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### ¶1-100 General

In January 2006, the PRC's National Bureau of Statistics commissioner Lie Deshui announced that due to strong investments and record exports, China's economy had grown by 9.9% in the year 2005 thus overtaking Great Britain as the fourth largest economy in the world.<sup>1</sup> The People's Bank of China has forecasted that China's economy will expand 10.3% during the first six months of 2006 and the growth rate is expected to continue at 9.1% in 2007.<sup>2</sup>

China<sup>3</sup> has been regarded as a hot market in particular for foreign investments for more than 25 years now.<sup>4</sup> According to a recent survey of 1,410 CEOs of globally leading companies, 78% describe the market opportunities in China as "significant". In fact, the volume of foreign investment and non-investment related business activities with Chinese partners has increased constantly over the past years, with just a temporary slow-down in 2005. Already in 2004, China had become the second most important target country worldwide for foreign investments overtaking even the US.<sup>5</sup> In addition, China is close to replacing Japan as Asia's strongest trading nation.<sup>6</sup>

In light of these numbers and the developing global M&A market, it is surprising that M&A transactions are a rather new phenomenon in China. Before the mid nineties, the sale and purchase of Chinese business entities was only considered by foreign entities in exceptional cases.<sup>7</sup> Since then, however, M&A transactions in China have seen explosive growth rates.<sup>8</sup> In 2004, a Chinese investment official was quoted saying that M&A transactions in China will multiply tenfold over the next five years.<sup>9</sup> Credit Suisse chief regional economist Dong Tao summarised the situation in late April 2006 as follows:

"China is about to face a major wave of mergers and acquisitions. The pattern of China's FDI [foreign direct investment] is changing from setting up new factories to acquisitions."<sup>10</sup>

The legal framework governing M&A transactions has long been incomplete and extremely hard to handle.<sup>11</sup> In line with the increasing volume of China-related M&A transactions, only in recent years have more comprehensive structures been put in place. However, problems arising out of inconsistencies, unclear rules and legislative gaps continue to exist as will be shown in the following chapters.



The meaning of M&A

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¶1-200 Definition

The term “M&A” stands for mergers and acquisitions. Generally speaking, the term “merger” means the fusion of two or more partners thus creating a totally new business entity or continuing the operation of the partners “under the roof” of either of them.<sup>12</sup> In contrast, the acquisition of a business entity by another indicates that one party takes over the shares, equity interest or assets of another entity. The parties to an acquisition therefore do not appear as equal partners of the transaction.

Normally, no emphasis is laid on the distinction between mergers on the one hand and acquisitions on the other. In fact, in practice the differences between these two transaction types may be marginal. Psychological aspects could be more important in answering whether a particular transaction is communicated as a merger or an acquisition as in the case of an acquisition, the target company may give the impression of weakness.<sup>13</sup> However, as far as China is concerned the situation is different because different rules may apply depending on whether a particular transaction qualifies as a merger<sup>14</sup> or acquisition.<sup>15</sup>

¶1-210 M&A in numbers

After years of market consolidation, 2006 is expected to witness the highest volume of global M&A activity based on transaction growth over recent years. Year 2000 recorded a volume of US\$3.327 trillion. In 2005, the value of announced M&A transactions had risen by 38% year-on-year from US\$2.1 trillion in the 2004 to US\$2.9 trillion in 2005.<sup>16</sup> The average size of the deals rose from US\$147.5 million in 2004 to US\$181.7 million in 2005.<sup>17</sup> According to a survey conducted by Ernst & Young in 2005, inbound cross-border acquisitions jumped 22% to US\$31.5 billion.<sup>18</sup>

Although foreign direct investments (FDI) in China experienced a slow-down in 2005 with an actual FDI volume of US\$60.3 billion against the US\$60.6 billion recorded in 2004, foreign investors are increasingly interested in China’s M&A market.<sup>19</sup> While the number of M&A transactions fell for the first time during the first six months of 2005 and was down by 5% year-on-year to US\$26.2 billion,<sup>20</sup> from the point of target companies in global M&A activity, China ranked 9th worldwide in 2005 with 1,642 deals worth US\$63.4 billion, up 7% on a year-on-year basis.<sup>21</sup>

All in all investors are very optimistic regarding the development of China’s M&A market. China will see the biggest deals in the next two or three years according to a statement of a leveraged buyout legal expert in early 2006.<sup>22</sup> Indeed, during the first half of 2006, M&A transactions in China set a regional record with US\$41 billion in deals, up 71 % from the first half of 2005.<sup>23</sup>