

## **RECENT DEVELOPMENTS IN CHINA'S BUSINESS AND SECURITIES LAWS**

*This Note is for the purposes of providing general information on recent developments relating to Business and Securities Laws as at 18 June 2009 in China only. No responsibility is taken for the completeness and/or accuracy of the information and specific legal advice should be sought in relation to any particular situation. Charltons does not advise on PRC law.*

In the light of the global financial crisis, governments across the globe have had to quickly adapt and adopt new legislation in the hope of addressing and tackling issues created by the economic downturn. During such bleak times, China has been projected by some as a beacon for global economic recovery. Whilst its overall economy has fared better than that of other countries, the ripple effect from the U.S. and U.K. markets has affected China.

This Note summarises certain recent developments relating to legal and policy changes implemented by the Chinese Government to stimulate, protect and encourage investments.

### **Part 1 – ECONOMIC BACKGROUND**

A summary of recent economic developments in China.

### **Part 2 – CHINA'S STIMULUS PACKAGE**

A breakdown of the PRC Government's RMB 4 trillion (approx. US\$586 billion) stimulus plan which was introduced in November 2008.

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#### **Part 6 – OVERSEAS INVESTMENT BY PRC COMPANIES: NEW FOREIGN INVESTMENT MEASURES**

The Administrative Measures on Overseas Investment came into effect on 1 May 2009 and reflect a policy trend of encouraging overseas investment, particularly for smaller investments. This section looks into the application and procedural requirements.

#### **Part 7 – PRC BANKRUPTCY LAW**

The Bankruptcy Law came into effect on 1 June 2009. It provides a framework for restructuring distressed assets and protection to secured interests which were previously not recognised.

## **1 ECONOMIC BACKGROUND**

The global financial crisis has hit China's export-based economy hard. In the first quarter of 2009, annual growth in China's GDP slowed to 6.1%. This was the lowest level of growth since the keeping of quarterly records started 17 years ago. The World Bank's June 2009 quarterly report predicts GDP growth of 7.2 % for China in 2009. While this is better than the World Bank's previous China growth forecast of 6.5% made in March 2009, it still signifies a considerable slowdown given China's double-digit growth in the years 2003 to 2007 and 9% growth in 2008.

The decline in exports to the recession hit industrialized nations has reduced company profits and led to growing unemployment raising fears of social unrest. While there are no official statistics for the number of unemployed, there have been anecdotal reports of a large number of factory closures, notably in Guangdong's heavily industrialized region, the Pearl River Delta. In March, the Governor of Guangdong reported that 4,900 factories collapsed or relocated last year, including approximately 2,400 that were foreign invested<sup>1</sup>. Unofficial estimates put the total number of workers made jobless at between 20 and 40 million.

The economic downturn, coupled with generally higher labour costs following the introduction of the 2008 Labor Contract Law and higher tax bills under the Law on Enterprise Income Tax, has led to a number of foreign investors withdrawing from China. There are however specific procedures which must be followed when a foreign invested enterprise closes down its business. Very generally, shutting down a Foreign Investment Enterprise's ("FIE") investment requires it to go through the procedures for liquidation or bankruptcy. This will typically require the FIE to:

- (i) submit an application for liquidation to the relevant authorities;
- (ii) make a public announcement, and notify creditors, of the intention to liquidate; and
- (iii) form a liquidation panel responsible for the whole liquidation process including the determination of the

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<sup>1</sup> Associated Press, 19 March 2009; Wikipedia

FIE's assets and liabilities;

Once all debts have been paid, the FIE is required to submit a liquidation report to the authorities for approval. It is then only after the completion of these procedures that the FIE can apply for de-registration to the relevant authorities.

The costs and time involved in observing the specified procedures have led a number of FIEs to shut down illegally, deserting their manufacturing plants and leaving creditors and employees unpaid. In an effort to stem this practice, the "Working Guidelines on Cross-border Pursuit of Liability and Initiation of Legal Action by Relevant Interested Parties in Connection with Abnormal Withdrawal from China of Foreign Investors" were published by four central ministries in November 2008.

The Guidelines and provisions of the existing company law provide that failure to follow the proper liquidation procedures may have the following consequences:

- (i) a foreign company or individual who is the shareholder of a limited liability company, the controlling shareholder and director of a joint stock company or the actual controller of a company are personally liable for the debts of the company;
- (ii) Chinese parties can bring actions in the Chinese courts and enforce judgments in their favour against the other party's assets in China. This seems to raise the possibility that a creditor could enforce a judgment against a foreign investor's other Chinese assets (e.g. other businesses);
- (iii) Successful Chinese parties can also seek to have judgments obtained in China enforced in the home country of the investor under applicable treaties; and
- (iv) Individuals can also incur criminal liability for non-payment of taxes and the Chinese government may seek extradition in certain cases;

Most importantly perhaps, given that relevant authorities keep records of the directors, shareholders and supervisors of FIEs, if an FIE is illegally shut down, the relevant parties may find it difficult to obtain regulatory approvals if they wish to return to China in the future. This effective blacklisting may provide the most useful deterrent against improper shut downs in China.

## 2 CHINA'S STIMULUS PACKAGE

On the other hand, China has fared far better in the financial crisis than many other countries. The World Bank's March report attributes this to the following factors: (a) China is not reliant on overseas financing; (b) its banks, with little direct exposure to sub-prime related products, have been largely untouched by the global financial crisis; and (c) it has the financial reserves to implement effective stimulus measures.

New measures have been introduced to stimulate the economy and attract foreign investment to China. With asset prices falling overseas, Mainland companies are looking abroad for investment opportunities and government agencies are putting measures in place to facilitate that investment.

In November 2008, the Chinese Government announced a 10-point stimulus plan to mitigate the impact of the global financial crisis and put the tumbling Chinese economy back on track. The package includes firstly a plan to stimulate spending of RMB 4 trillion (approximately US\$586 billion) in PRC infrastructure projects and other investments over two years. The PRC Central Government will fund RMB1.18 trillion of the total with the remainder coming from local government and PRC banks. Banks are expected to fund the greatest contribution.

According to the World Bank's March 2009 China report, the central government had spent 230 billion yuan (\$33.82 billion) under its 4-trillion-yuan stimulus package: 100 billion yuan in the fourth quarter of 2008 and 130 billion yuan in the first quarter of 2009.

The money is being injected primarily into projects that will improve people's living standards, such as the health and education sectors, infrastructure, and housing for low-income earners.

### **Breakdown of Planned Spending**

Figures prepared by the government in early March 2009 show its planned breakdown of spending under the stimulus plan:

- RMB 400 billion on **public housing**, including building affordable, low-rent housing and speeding slum clearance.

- RMB 370 billion on **rural infrastructure**, including improving roads and power grids, ensuring the safety of drinking water, reinforcing reservoirs and improving water conservation in large scale irrigation areas;
- RMB 1.5 trillion on **transportation** – including expansion of the road and rail networks, building new airports and upgrading power grids
- RMB 150 billion on **health and education**, including building schools and hospitals;
- RMB 210 billion on **energy and the environment**, including construction of sewage and rubbish treatment facilities and prevention of water pollution. Green belt and natural forest planting programs will be accelerated, and support for energy conservation and pollution-control projects will be increased.
- RMB 370 billion to support **technological innovation**; and
- RMB 1 trillion on **rebuilding** in areas hit by the May 2008 earthquake.

*Source:* NDRC.

## **Other Aspects of the Stimulus Package**

### **Relaxation of Monetary Policy**

Monetary policy has been eased to encourage lending by commercial banks. Interest rates were cut four times during 2008, bank reserve requirements have been lowered and loan quotas have been removed for commercial lenders.

As a result of these reforms, new loans made by China's banks in the first quarter of 2009 amounted to RMB 4.58 trillion (US\$640 billion), which was almost as much as the total figure for new lending in 2008 and equivalent to approximately 70% of China's GDP for the first quarter<sup>2</sup>. A substantial part of this

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<sup>2</sup> Source: "China Credit Boom Spurs Concern", The Wall Street Journal, 21 April 2009

lending has been to infrastructure projects and this explosion in bank lending, has no doubt boosted consumer confidence in China.

However there have been recent reports that the China Banking Regulatory Commission (CBRC) is considering new rules to ensure that lending is to the real economy, for example to government infrastructure projects. Approximately one third of new loans in the first quarter were in the form of short-term bill financing and concerns have been raised that companies have borrowed these short-term funds in order to place them on deposit and earn interest.

## **Tax**

The government implemented a change to its value-added tax (VAT) regime for all industries from January 1, 2009. The change, a shift to a consumption-based VAT regime (from the previous production-based regime), is aimed at cutting companies' VAT liability by a total of RMB 120 billion (US\$17.57) in 2009. The VAT regime amendments will also allow companies to obtain tax deductions on fixed asset spending and encourage technological upgrading.

The amendments to the VAT regime removed the VAT exemption for imported equipment and determined that foreign-funded companies will no longer get tax rebates on purchases of domestic equipment, putting them in the same position as domestic companies.<sup>3</sup>

## **10 Sector Specific Plans**

In the first quarter of 2009, the government issued stimulus plans for 10 specific sectors. These include the automobile, steel, textile, shipbuilding, machinery, electronics, exports, non-ferrous metals and petrochemical sectors. The plans for several of these sectors include measures aimed at environmental protection and efficient use of energy, for example in the petro-chemical industry, RMB500 million will be spent in 2009-2010 on upgrading refineries and improving fuel

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<sup>3</sup> Source: China Daily

quality to cut emissions. In the car industry, the plan includes proposals for:

- a cut in the purchase tax on small cars (under 1.6 litres) from 10% to 5 percent from Jan. 20 to Dec. 31;
- the allocation of RMB 5 billion (US\$730 million) to provide subsidies for farmers to upgrade three-wheeled vehicles and low-speed trucks to new small vehicles (under 1.3 litres) from March 1 to Dec. 31; and
- in the next three years, a 10 billion RMB fund will be used to provide subsidies to auto companies to upgrade their technology and develop vehicles that use alternative energies.

### **Impact of the Stimulus Package**

The government's 10-point stimulus plan is expected to be particularly beneficial to PRC construction companies and developers and producers of cement, iron and steel. Commercial banks should gain from the abolition of loan ceilings and medium-sized and small companies are likely to benefit from preferential treatment.

The World Bank's March 2009 report stated that "In all, due to substantial policy stimulus, China's economy should continue to grow significantly in a very challenging environment".

According to China's official purchasing managers' index, China's manufacturing sector continued to expand in May for the third straight month. This has been taken by some as a sign that the stimulus package is having an affect and that the recovery is likely to broaden.

In June 2009, having revised its GDP growth forecast for China in 2009 upwards to 7.2%, the World Bank noted that growth in China should remain respectable in 2009 and 2010, although it is too early to say that there is a sustained recovery.

## **3 GLOBAL MARKETS AND IPOS**

## World Markets

The financial crisis has wreaked havoc on global stock market valuations, and China has been no exception. As shown in the following table, the valuations of the world's 10 largest stock markets by domestic market capitalization, dropped 40% or more by the end of 2008 compared to the previous year.

	<b>Stock Exchange</b>	<b>US\$bn</b>	<b>% Change 2008/2007 (in local currency)</b>
1	NYSE Euronext (US)	9,208.9	-41.2%
2	Tokyo SE Group	3,115.8	-41.4%
3	NASDAQ QMX	2,396.3	-40.3%
4	NYSE Euronext (Europe)	2,101.7	-47.8%
5	London Stock Exchange	1,868.2	-33.4%
6	<b>Shanghai Stock Exchange</b>	<b>1,425.4</b>	<b>-64%</b>
7	<b>Hong Kong Exchanges</b>	<b>1,328.8</b>	<b>-50.2%</b>
8	Deutsche Boerse	1,110.6	-44.6%
9	TSX Group	1,033.4	-41.4
10	BME Spanish Exchanges	948.4	-44.1

In fact the Chinese stock markets fared particularly badly. According to Ernst & Young's 2009 Global IPO Trends Report (the "E&Y Report"), after a period of unprecedented boom in 2006-2007, China's IPO market started to decline at the end of 2007. At the end of 2008, the Shanghai index (ranked 6<sup>th</sup> in the world by market capitalization) had fallen 64% and the Shenzhen index had fallen 58% since the beginning of the year. The Hong Kong Stock Exchange, ranked 7<sup>th</sup> by market capitalization, had fallen 50.2%. The fallout in the Mainland stock markets in particular was the result of both unreasonably inflated share valuations and widespread speculation by retail investors.

The China and Hong Kong markets have performed much better in 2009. At the end of May 2009, the domestic market capitalization of the Shanghai Stock Exchange stood at US\$2070 billion and that of the Hong Kong Exchanges was US\$1,773 billion.

## Global IPO Activity

According to the E&Y Report, the financial crisis saw 2008 global IPO market activity drop more than **61%** in number of deals and **67%** in funds raised from 2007.

During 2008, there were only 762 IPOs worldwide which raised US\$95.2 billion, down from an all-time high of 1,979 IPOs and US\$287.1 billion in funds raised in 2007.

According to the E&Y Report, global IPO activity in 2009 continues to slow, with only 50 IPOs raising US\$1.4 billion worldwide in the first quarter of 2009 compared to 251 IPOs and US\$41.2 billion in IPO funds raised in the first quarter of 2008 (although the 2008 first quarter figure includes the Visa Inc. IPO which at US\$19.7 billion, was the largest U.S. IPO ever).

There have also been record numbers of deal cancellations: more than 300 IPOs were postponed or withdrawn during 2008, and a further 37 IPOs were put on hold in the first quarter of 2009.

## China

Although emerging markets have seen a decline in IPO activity, both in terms of number of deals and funds raised, they have continued to drive activity in the IPO market. According to the E&Y Report, in 2008, emerging markets accounted for 15 of the 20 largest IPOs worldwide – including 4 from China.

Despite a dramatic decline in IPO activity, Greater China (including Hong Kong) still launched the most IPOs and ranked second in terms of funds raised in 2008, with 127 IPOs worth a total of US\$17.9 billion.

Breaking that down among the Hong Kong, Shanghai and Shenzhen Stock Exchanges, the figures are:

<b><u>Exchange</u></b>	<b><u>Number of Newly Listed Companies</u></b>	<b><u>Funds Raised</u></b>
Hong Kong	49 (inc. 18 transfers from GEM)	HK\$65.98bn (US\$8.51bn)

<b><u>Exchange</u></b>	<b><u>Number of Newly Listed Companies</u></b>	<b><u>Funds Raised</u></b>
Shanghai	6	RMB73.35bn (US\$10.73bn)
Shenzhen	71	RMB30.15 bn (US\$4.41bn)

China was home to 4 of the world's 20 largest IPOs in 2008 and 2008's second largest IPO was that of China Railway Construction Corporation Ltd which raised US\$5.7 billion in a dual listing on the Shanghai and Hong Kong Stock Exchanges in March 2008. 2008 IPO activity on the Mainland was driven largely by market privatization of state-owned enterprises – there were 22 privatizations of SOEs in 2008 which accounted for 54% of total capital raised. The Mainland's second largest IPO in 2008 after China Railway, was that of China South Locomotive & Rolling Stock Corp. Ltd. which was also dual listed on the Shanghai and Hong Kong Stock Exchanges. Most other Mainland IPOs were small due to the larger number of small IPOs on the Shenzhen Exchange: the average deal size was US\$141 million.

### **Most Mainland Issuers List Domestically**

Since the middle of 2006, active trading and high share valuations have made it increasingly attractive for Mainland companies to list locally. In order to soak up excess liquidity in the Mainland market, the Chinese regulatory authorities have also been keen to encourage local companies to list at home. In particular, during 2007 there were a number of reports that China's securities regulator, the China Securities Regulatory Commission ("the CSRC") had adopted an unofficial policy banning mainland-incorporated companies from listing overseas unless they seek to raise over US\$1 billion or they are willing to do a joint listing in the PRC.

Previously, the CSRC had followed the so-called "4-5-6 rule" in approving the overseas listing of Chinese companies. Under this rule, companies were required to have RMB 400 million of net assets, raise US\$ 50 million of funds, and have after-tax profit of not less than RMB 60 million before they could apply for listing on overseas main boards, including Hong Kong's. An increase in the amount required to be raised to US\$ 1 billion is extremely restrictive. As a result, only the largest Mainland companies have listed overseas and the trend,

certainly on the Hong Kong Stock Exchange has been for large PRC companies to conduct dual listings on the Hong Kong and Shanghai exchanges. In 2008, 78% of Mainland companies listed domestically. Shanghai was home to three large IPOs with a total value of US\$8.5 billion while there were 69 smaller listings on the Shenzhen Exchange worth US\$4.1 billion.

Overseas stock exchanges have sought to cash in on the China growth story by attracting listings of Chinese companies, and with a considerable degree of success. That looks set to decline and in 2008, there were just 31 Chinese IPOs outside China raising US\$0.9 billion.

### China: First Quarter 2009

There were 9 IPOs by Chinese companies in the first quarter of 2009 which raised US\$210.7 million. Of these 5 listed on the Hong Kong Stock Exchange and 4 listed on exchanges outside Greater China. The second largest IPO by capital raised in the first three months of 2009 was Chinese company Real Gold Mining Ltd which raised US\$133.01 million on the Hong Kong Stock Exchange.

The amount of IPO funds raised on the Hong Kong Main Board in the first quarter of 2009 fell to US\$201.4 million – down 95% from the amount of IPO funds raised in the first quarter of 2008. There are, however, a number of high quality Chinese companies ready to list when the economic situation improves.

### **Shanghai and Shenzhen**

There were no IPOs on either the Shanghai or Shenzhen Exchanges in the first quarter of 2009, the reason being that IPOs have been suspended on both exchanges since 25 September, 2008 due to concerns that new IPOs could bring about further weakening in the already battered markets.

The 9-month ban on IPOs was finally lifted on 18 June, 2009 when the CSRC gave its final approval to Guilin Sanjin Pharmaceutical Co's IPO on the SME board of the Shenzhen Stock Exchange. The lifting of the ban follows a strong rally in share prices this year: as at 18 June, the Shanghai Composite Index was up 56.74% this year.

The CSRC recently published new rules governing IPO share sales which took effect from 11 June 2009. Under the new rules, subscribers will be allowed to subscribe either online or offline: previously institutional investors enjoyed the advantage of being able to subscribe through both online and offline subscription systems while individuals were limited to the online subscription system. The amendments aim to prevent institutional investors obtaining a disproportional share of extremely profitable IPOs. .

As at the end of May 2009, 32 companies' IPO applications had passed the CSRC's review process, but they have not yet obtained final approval. Of the 32 companies, 5 are reportedly proposing to list on the Main Board of the Shanghai Stock Exchange and 27 companies are proposing to list on the SME. In addition to those 32 companies, there are apparently at least another 100 companies that have submitted proposals for listing and are awaiting CSRC approval.

Three of the largest of these companies are China State Construction Engineering Corp. which plans to raise RMB42.6 billion, China Everbright Securities Co. which plans to raise over RMB10 billion and China Merchants Securities Co. with plans for a RMB 10 billion fund raising.

It is expected however that the CSRC will control the flow of new issues carefully to avoid a sudden turnaround in market sentiment. Press reports have suggested that the small size of the Sanjin IPO (it is expected to raise up to RMB 630 million) indicates that the CSRC will allow small to medium sized companies to list first to test the market. The CSRC will also be keen to prevent any signs that the market is over-heating.

### **Secondary Offerings**

Another key trend identified by Ernst & Young is that approximately 80% of equity issues world-wide in 2008 were secondary offerings (i.e. share offerings by already listed companies). US\$554.4 billion was raised in 2,664 secondary offerings. Over half of these have been recapitalizations of financial firms.

This was also the case on the Mainland and in Hong Kong. Mainland companies carried out 123 secondary offerings worth US\$23.6 billion and Hong Kong saw 117 secondary offerings

worth US\$6.5 billion. One particular advantage of a Hong Kong listing is that it offers listed companies a particularly efficient means of subsequent fund raising. The placing and top-up mechanism allows a major shareholder to place his shares to new investors and for the issuer to then issue replacement shares to the major shareholder. This procedure can be done without shareholder approval or a circular and in practice allows capital to be raised in a matter of hours.

### **3.1 China to list foreign companies**

Chinese authorities have indicated recently that they may be prepared to allow foreign firms to list on the Mainland markets. Under existing laws, only Mainland registered firms can list on the domestic exchanges. On May 11, 2009, Chinese Vice-Premier [Wang Qishan](#) and British Chancellor of the Exchequer Alistair Darling reached an agreement during the Second China-UK Economic and Financial Summit in London paving the way for large British companies, like HSBC to sell shares in Shanghai.

Under the agreement, China will allow foreign companies meeting certain requirements to list on the A-share market by way of issuing new shares or Chinese Depositary Receipts ("CDRs"). This is thought to be an important step by China towards building an international financial market.

The move comes after the announcement made by the State Council in late March that the government had decided to build Shanghai, a financial hub, into a global financial centre to reflect the country's economic strength and the status of the RMB.

Foreign companies are likely to be attracted by the expanding pool of capital in Shanghai's stock market and the publicity that a local flotation could bring to their brands. Other companies which have expressed an interest in listing on the Mainland include Li Ka-Shing's Hutchison Whampoa.

The general view, however, appears to be that listings of foreign companies on the Mainland Exchanges, remain a long term plan. One of the most important concerns is that issues by foreign companies will pose a threat to China's foreign

exchange control system. Hu Xiaolian, Head of China's Foreign Exchange regulator, indicated in London that the country is unlikely to move quickly to free up the yuan under the capital account.

In 2007, China agreed to allow qualified foreign-invested companies float their shares on the mainland, according to a joint statement issued after the Third China-US Strategic Economic Dialogue in Beijing. The program has progressed slowly as regulators work to improve investor confidence over a stock glut.

### **Red chip return may come first**

Listing foreign companies is a challenge to the Chinese government, especially in terms of supervision. It is expected that the requirements for foreign companies will be higher than for domestic companies. At present, analysts predict that the return of red chip companies will be conducted before the listing of foreign companies.

The Shanghai listing of red chip companies was proposed in 2007, with the issue by the China Securities Regulatory Commission of the "Draft Trial Measures for Mainland Initial Public Offering by Overseas Listed Companies Controlled by Chinese Parties". The programme has however yet to be implemented. Under the draft measures, red chip companies seeking a Shanghai listing would have to meet the following requirements:

- The shares must have been listed and traded on the Hong Kong Stock Exchange for over one year;
- Market capitalization of no less than HK\$20 billion;
- Accumulated net profit for the 3 most recent accounting years of no less than HK\$2 billion
- Over 50% productive assets must be located in the Mainland, or over 50% of profits must be generated from the Mainland.

China Mobile announced recently that it will seek to list its shares domestically once the regulations are finalized. China Mobile is likely to offer CDRs in China, rather than A-shares, in order to minimize compliance work for the listing.

### **3.2 Shenzhen Growth Enterprise Board**

Another major initiative is the establishment of a Growth Enterprise Board in China to provide an additional source of financing for small but innovative enterprises with strong growth potential. The intention is to provide an alternative market to overseas growth markets such as London's Alternative Investment Market ("AIM"), New York's NASDAQ and Hong Kong's Growth Enterprise Market ("GEM"). The "Interim Measures for the Administration of the Initial Public Offering of Shares and Listing on the Growth Enterprise Board" (the "draft Measures") for China's Growth Enterprise Board ("GEB") were published on 31 March 2009 and became effective on 1 May 2009. The GEB is expected to start trading later this year.

Under the draft Measures, in order to list on GEB, a listing candidate must (among other things):

- be a company limited by shares with a continuing operating history of at least 3 years;
- either: (i) have been profitable for the past 2 consecutive years with accumulated net profits of at least RMB 10 million, or  
  
(ii) net profits in the most recent year must be at least RMB 5 million, with revenues of at least RMB 50 million and a revenue growth rate of at least 30% in the past two years;
- the minimum pre-IPO net assets must be RMB 20 million and there must be no losses that need to be made up;

- the minimum total issued share capital must be RMB 30 million;
- the core business must be focused mainly on one area;
- there must have been no material change in the applicant's main business in the previous 2 years;
- there must have been no material change in the directors, officers and actual controller of the listing candidate in the previous 2 years; and
- the capital raised on the GEB may only be used in the listing candidate's core business.

Shareholders are also regulated under the draft Measures:

- Majority shareholders or those with a controlling stake in the company are prevented from trading in the shares of the company for 3 years upon listing on GEB;
- Major shareholders that propose to increase the size of their offering during the 6 months leading up to the acceptance of the IPO application by the CSRC will be allowed to trade no more than 50% of their shares during the second year after the IPO; and
- Minority shareholders, in accordance with the current corporate law, are prevented from trading their shares for one year after the IPO.

The draft Measures provide an express delisting mechanism in three specific circumstances:

- when the company receives a "negative" audit by an accredited accounting firm;
- if the listed company registers negative net assets in its

accounting report; and

- when the company's turnover drops below 1,000,000 shares a day.

Once approval has been received, the listing candidate must issue the shares within 6 months or else the approval will expire and become invalid.

The final version of the listing regulations for GEB were issued on 5 June 2009 and are to come into effect from 1 July 2009, although it is not yet known when the GEB will be officially open.

So, what will this mean for FIEs and private equity firms?

The GEB may seem like an attractive alternative but there are a number of issues to consider:

1. Restructuring: an FIE is usually incorporated as a limited liability company, and therefore, must be converted into a foreign invested company limited by shares ("FICLS") prior to listing. It will then be subject to both PRC Company Law and will be regulated by the "Provisional Regulations on Certain Issues Concerning the Establishment of Foreign Invested Companies Limited by Shares", enacted in 1995 by Moftec (MOFCOM's predecessor). Those regulations set very high criteria for FICLS. While the requirements for profitability of a GEB listed company has been reduced to 2 years or even 1 year, under the relevant FIE regulations, an FIE cannot be converted into an FICLS unless it demonstrates its profitability over the last 3 consecutive years;
2. Further regulations: even after its conversion into an FICLS, an FIE is subject to more restrictions than non-FIEs before it can go public. In particular, there are restrictions that:
  - (i) foreign investors cannot hold more than 10% of

the total shares after the IPO; and

(ii) Chinese shareholders must maintain a specific majority shareholding in the FICLS after the IPO.

3. Lock-up Period: the draft Measures impose a 3 year lock-up period on controlling shareholders.

4. Taxation: Under the 2008 Enterprise Income Tax Law, foreign firms investing in China are treated as non-resident enterprises, hence, the dividends and/or profits from the transfer of shares in Chinese companies by such firms will be subject to a 10% income tax, unless lower rates are available in tax treaties.

## **4 M&A**

### **4.1 The Global M&A Market**

After 5 years of consecutive growth in the global M&A market, global M&A volume was US\$2,9 trillion in announced deals in 2008, a drop of 29% from the 2007 figure<sup>4</sup>. According to the E&Y report, 1,194 M&A transactions were withdrawn during 2008, the highest level since 2000.

### **4.2 The Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors**

The Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors (commonly known as the "M&A Rules") were issued by China's Ministry of Commerce (MOFCOM) and five other ministries and came into effect on 8 September, 2006. The M&A Rules have had important consequences for foreign private equity investors entering the Chinese market and Chinese businesses seeking access to overseas capital.

The M&A Rules effectively put a stop to the practice of "round-tripping" whereby ownership of a Mainland business would be transferred to an offshore company owned or controlled by the

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<sup>4</sup> M&A Review full year 2008, Dealogic, January 2009

original owners of the Mainland business. Chinese companies had used round-trip structures to convert their domestic businesses into foreign-owned businesses in order to obtain preferential tax treatment which was available to FIEs prior to the introduction of the Enterprise Income Tax Law. Another advantage for Chinese companies was that approval of the Chinese authorities would not be required for a subsequent sale of the shares of the overseas company. This was particularly advantageous in attracting overseas investors.

Round-tripping was also used by foreign private equity investors who, together with the owners of the Chinese business, would invest in the offshore company. The investors would then exit the investment either by selling their shares to another strategic investor or fund or by listing the offshore company on an overseas stock exchange.

#### MOFCOM Approval Requirement

Under the M&A Rules, the situations which require MOFCOM approval include where a domestic company, enterprise or individual intends to merge with an offshore company which is established or controlled by the domestic company, enterprise or individual (Article 11).

The M&A Rules also prevented the domestic company in this scenario from obtaining preferential treatment as an FIE before the tax treatment of foreign and domestic companies was unified under the Enterprise Income Tax law.

To ensure the efficacy of the M&A Rules, they also impose an obligation on the parties to an acquisition to declare whether they are affiliated. If two parties to a transaction are under common control, the identities of the ultimate controlling parties must be disclosed to the approving authorities, together with an explanation of the purpose of the M&A transaction and a statement as to whether the appraised value represents fair market value. The use of trusts or other arrangements to avoid this requirement is expressly prohibited. (Article 15).

Round-tripping as a means of achieving an offshore listing of a Chinese company is also effectively prevented by the M&A Rules, since MOFCOM approval at the national level is required for the establishment of the special purpose vehicle (SPV) and CSRC approval is required for the listing of the SPV on an overseas stock exchange.

### **4.3 MOFCOM Delegates Foreign Investment Approval Authority**

Any foreign investment in China must be approved by MOFCOM, either at the national level or, where approval authority has been delegated, at the provincial level.

MOFCOM has recently published a number of circulars delegating the authority to approve certain additional matters in relation to foreign investment to MOFCOM's provincial counterparts (Provincial MOFCOM). These include the Circular relating to **Further Improvement of Foreign Investment Approval Activities** (Circular No. 7) and the Circular on **Delegation of Approval Authority on the Establishment of Foreign Invested Holding Companies** (Circular No. 8) which came into effect at the beginning of March 2009. These circulars delegate to Provincial MOFCOM the authority to approve the following foreign investments:

- M&A transactions with total transaction amounts of less than US\$100 million if the target is in the "encouraged" or "permitted" sectors, or less than US\$50 million if the target is in a "restricted" sector;
- The establishment of FIEs in "encouraged" sectors which do not involve "national adjustment issues". State approval may still be required for investments of US\$500 million in the "encouraged" sectors.
- The establishment and certain changes concerning foreign- invested China holding companies with maximum registered capital of US\$100 million.
- The establishment and designated changes concerning foreign-invested joint stock companies ("FIJSCs") in "encouraged" sectors even where the registered capital of such companies exceeds US\$100 million. Previously the delegation of approval authority did not apply to FIJSCs with registered capital above that amount.

MOFCOM has also decentralised approval authorities for foreign invested venture capital enterprises with the issue of the **Notice on Approval Matters relating to Foreign Invested Venture Capital Enterprises and Foreign Invested Venture Capital Management Enterprises**, which came into effect on 5 March 2009. This delegates

approval authorities for the establishment of, and designated changes to, foreign-invested venture capital enterprises and foreign-invested venture capital management enterprises with registered capital of not more than US\$100 million, to Provincial MOFCOM and the State Economic and Technology Development Zones.

In December 2008, MOFCOM published the **Foreign Investment Examination and Approval Management Handbook** (the "Handbook") which clarifies a number of ambiguities with respect to MOFCOM's examination and approval practice for foreign direct investment and mergers and acquisitions. Although the Handbook does not have the force of law, it represents the most recent views of MOFCOM on these matters and is expected to be followed in practice.

#### Scope of Transactions Requiring Central MOFCOM Approval

Following the increase in the authority of Provincial MOFCOM to grant certain approvals, the Handbook clarifies the scope of mergers and acquisitions by foreign parties that still require approval from central MOFCOM. Approval from Central MOFCOM is still required for:

- (i) a round-trip acquisition;
- (ii) an acquisition of control of a Chinese enterprise which (a) involves a key industry; (b) may affect national economic security; or (c) may result in a change of control of a domestic enterprise that owns any well-known trademark or traditional Chinese brand name;
- (iii) the establishment or acquisition of a **special purpose vehicle** – "special purpose vehicle" is defined in the M&A Rules as an overseas company which is controlled directly or indirectly by a Chinese domestic company or individual(s) which was established or acquired as a means of achieving the overseas listing of the interests of such domestic company or individual(s) in a Chinese domestic company; or
- (iv) an acquisition where the acquisition price or the total investment in the target is more than US\$100 million if the target is in an "encouraged" or "permitted" industry, or more than US\$50 million if the target is in a "restricted" industry.

Thus with the exception of certain particularly large or high-profile foreign investment projects which still require central MOFCOM approval, most foreign investment projects will now be approved at the provincial or even at the local level.

Generally speaking, approvals are obtained more quickly from Provincial MOFCOM than they are from MOFCOM. The impact of this decentralisation of foreign investment approvals is therefore likely to be that approvals for most foreign investment projects will be obtained more quickly and easily.

#### Round-Trip Investment to Be Considered in Only Two Situations

Since the introduction of the M&A Rules, MOFCOM has not approved any round-trip investment applications, nor provided any further guidance as to the circumstances in which it would approve such an acquisition.

The Handbook states that MOFCOM will only consider the approval of a round-trip investment application in the following two situations:

- (i) the offshore acquirer is a listed company; or
- (ii) the offshore acquirer
  - (a) has been duly approved;
  - (b) has actual operations; and
  - (c) will fund the acquisition out of its own profits.

While it appears that the majority of round-trip investment will continue to be prohibited by MOFCOM, specific reference to these two situations suggests that MOFCOM might be open to considering reverse takeovers (or back-door listings), as well as consolidation or business combination acquisitions by approved offshore operating companies.

#### M&A Rules Do Not Apply to Acquisition of Foreign Investment Enterprises

The Handbook also clarifies that the M&A Rules only apply where the target company is wholly Chinese owned. In particular, the M&A Rules do not apply where a foreign investor purchases equity in an existing foreign investment enterprise ("FIE"). Nor is there any need to "make reference" to the M&A Rules (as required by Article 55 of the Rules), irrespective of whether the acquisition involves a related-party transaction or whether the purchaser is an existing shareholder or a new investor.

### **After the M&A Rules**

Now that that "round-tripping" – using an offshore company to own a Mainland business – is essentially prohibited under the M&A Rules, foreign private equity investors have had to find new ways of structuring their investments in Chinese joint ventures (JVs).

### Direct Venture Capital Investment

One obvious alternative is for foreign private equity investors to invest directly in the target company through a joint venture arrangement. This will require the following steps:

- Foreign investors first incorporate an overseas company as the investing vehicle;
- Foreign investors negotiate and enter into definitive binding transaction documents with the PRC shareholders of the target company, with a view to converting the target company into an Equity Joint Venture ("EJV");
- The relevant transaction documents must be approved by the local authorised agency of MOFCOM and other relevant authorities;

One of the principal difficulties for a foreign investor in an onshore JV, is finding a suitable method of exiting the

investment now that round-tripping is precluded under the M&A Rules.

### Listing on a Stock Exchange in China

One option being looked at by a number of funds, is listing A shares on one of the Chinese stock exchanges. The EJV must first convert to a foreign-invested company limited by shares (FICLS) which requires national level MOFCOM approval. The FICLS must then apply to the China Securities Regulatory Commission (CSRC) for listing approval.

The option is however not without drawbacks. Investors may face delays waiting for approvals to come through. Shareholders in the FICLS will also be subject to lock-ups on the sale of their shares depending on their percentage holding in the FICLS. Controlling shareholders are subject to a 3 year lock-up.

### Overseas Listing

An alternative would be for the foreign investors to make the original investment in the Chinese domestic company through a share swap. Shares of the domestic company would be swapped for shares in an offshore listed company. This is allowed under the M&A Rules but requires MOFCOM approval.

### Disadvantages of Direct Investment

One of the main disadvantages of direct investment is that in China, FIEs can only have one class of equity. This makes it difficult to provide funds with preferential rights such as preferential payment of dividends and proceeds on liquidation.

#### **4.4 SAFE Circular No. 142**

Another important development is that on August 29 2008, China's State Administration of Foreign Exchange ("SAFE") issued Circular 142, which imposes new foreign currency

capital verification requirements on foreign invested enterprises in China. The significance of Circular 142 lies in its potential impact on acquisitions and investments in China conducted through FIEs. It is one of a number of measures introduced to prevent “hot money” from flowing into China.

SAFE has delegated the authority to approve of the following matters to its local branches, effective as of 1 June 2009, namely:

- When a foreign-invested enterprise which is registered elsewhere proposes to open a capital account within the locality of the local SAFE;
- When the funds used for the purchase or redemption of QFII funds exceeds US\$50 million per month; and
- For certain guarantees that are provided to enterprises which are located abroad.

#### *FIEs' Acquisition of Chinese Domestic Enterprises*

Circular 142 affects wholly foreign-owned enterprises (“WOFEs”) and Equity or Contractual JVs. In particular:

- capital verification procedures – Article 1 specifies that before any foreign currency capital can be converted into Renminbi (“RMB”), all banks are required to request a capital verification report issued by a qualified accounting firm, in addition to certain supporting documentation stating the intended use of the RMB. The total amount of foreign currency that can be converted is limited to the amount specified in the verification report;

The Circular introduces a number of restrictions:

- **investments by FIEs in domestic enterprises** – FIEs are prohibited from using RMB converted from foreign capital to make equity investments in Chinese domestic

enterprises, unless the domestic equity investment is within the approved business scope of the FIE and has been approved by SAFE;

As to how this affects foreign-invested venture capital enterprises (FIVCEs), whose principal business is usually the purchase of minority equity interests in Chinese companies, the authorities have apparently stated off the record that FIVCEs will need to obtain SAFE approval before the making of each investment in a Chinese company.

- **the purchase of domestic real estate by FIEs** – the purchase of domestic real estate using RMB converted from foreign capital, other than for the FIE's own use is prohibited, unless the FIE is licensed as a real estate enterprise; and
- **payment of consideration to domestic individuals and institutions in M&A transactions** – The position previously was that FIEs and foreign investors were required to obtain approval from the local SAFE branch prior to converting foreign currency purchase monies into RMB. Circular 142 introduces the additional requirement that payment of foreign currency purchase monies must be effected through an exclusive foreign currency account approved by the local SAFE.

The latter requirement will have an impact on foreign investors' acquisitions of domestic companies. The M&A Rules already requires central MOFCOM approval for a foreign investor to acquire a domestic company. Following the implementation of Circular 142, foreign investors will also need to factor in the need to set up an exclusive foreign currency account for the payment of the purchase price to PRC vendors.

#### **4.5 New Tax Rules for Corporate Restructurings**

At the end of April 2009, the Ministry of Finance and the State Administration of Taxation published a notice which provides for favourable tax treatment (principally tax deferrals), for corporate restructurings meeting prescribed conditions. The notice is stated to be effective from 1 January 2008.

The types of corporate restructurings covered by the circular are:

- Debt restructurings
- Equity acquisitions
- Asset acquisitions
- Mergers
- Divisions (where an enterprise transfers part of its assets to another existing or newly formed enterprise).

In order to qualify for favourable tax treatment, the following conditions must be satisfied:

- (i) the restructuring must have a reasonable commercial purpose and must not have the reduction or deferment of tax as its principal purpose;
- (ii) there must be a transfer of at least (a) 75% of the target's equity on an equity acquisition; or (b) 75% of the transferor's assets on an asset acquisition;
- (iii) there must be no change to the original operating activities of the target for 12 months after the restructuring;
- (iv) on an equity acquisition, asset acquisition, merger or division, at least 85% of the total consideration paid must be in the form of equity of the acquirer; and
- (v) the main transferor cannot transfer equity acquired as consideration for 12 months after the restructuring.

Additional conditions must be met where the restructuring involves an overseas company. Very briefly, the following types of restructurings involving an overseas company will be eligible to elect for favourable tax treatment:

- (i) Transfers between 2 overseas companies

Where an overseas company transfers its equity interest

in a PRC company to its 100% owned overseas subsidiary, it may elect for favourable tax treatment if: (a) there is no change in the withholding tax obligation arising on the gain on any subsequent sale of the interest in the PRC company; and (b) the transferor provides a written undertaking not to transfer its equity interest in the transferee for 3 years after the transfer;

(ii) Transfer from an overseas company to a PRC company

Where an overseas company transfers its equity interest in a PRC company to its 100% owned PRC subsidiary, an election for favourable tax treatment may be made;

(iii) Transfer by a PRC company to an overseas company

Where a PRC company uses its assets or equity to invest in its 100% owned overseas subsidiary, the transfer may be eligible for favourable tax treatment, but any gain made on the transfer must be recognized over a 10-year period.

## **5 CHINA'S ANTI-MONOPOLY REGIME**

After 13 years in the making, China's anti-monopoly Law ("AML") came into effect on 1 August 2008 and provides a comprehensive framework for regulating market competition in the PRC.

Previously, the 2006 M&A Rules and the Guide for the Anti-Monopoly Declaration by a Foreign Investor in the Merger or Acquisition of a Domestic Enterprise issued by MOFCOM in March 2007 had introduced a number of anti-monopoly provisions in relation to foreign-funded M&As, including both asset and share acquisitions. The AML however covers both domestic acquisitions and transactions involving foreign investors. All investors, irrespective of nationality or of whether foreign capital is involved, are required to submit declarations for anti-monopoly clearance if their activities may potentially exclude or limit competition in the domestic market.

For foreign investors, the AML means that foreign mergers and acquisitions of domestic companies or foreign capital investing

in domestic companies in the PRC will be subject to anti-monopoly checks and potentially also to national security clearance.

Article 3 of the AML identifies three types of monopolistic conduct, namely:

- (i) monopoly agreements made between operators;
- (ii) abuse of dominant market position by operators; and
- (iii) concentration of operators – i.e. mergers and acquisitions and any other transactions giving control over a domestic entity, that may have the effect of eliminating or restricting competition.

In addition, Chapter V prohibits the abuse of administrative powers to restrict competition - a highly controversial subject during drafting of the AML.

## **5.1 Monopolistic Conduct**

### **(1) Monopoly Agreements**

Article 13 of the AML prohibits horizontal monopoly agreements between competing operators which:

- (a) fix or change the price of commodities;
- (b) restrict the output or sales volume of commodities;
- (c) divides the sales market or raw materials supply market;
- (d) restricts the purchase of new technology or new facilities, or restricts the development of new technology or new products;
- (e) joint boycotts of transactions; and
- (f) any other monopoly agreements as determined by the AMEA.

Article 14 of the AML prohibits vertical monopoly agreements between operators and their business partners which:

- (a) fix the resale price of commodities to a third party;
- (b) restrict the minimum resale price of commodities to a third party; and
- (c) any other monopoly agreements as determined by AMEA.

The term "monopoly agreement" in the AML means agreements, decisions or other concerted behaviour that eliminates or restricts competition.

## (2) Abuse of Dominant Market Position

Under Articles 17, 18 and 19 of the AML, operators with dominant market positions are prohibited from engaging in behaviour that abuses their dominant market positions, such as:

- (a) selling commodities at unfairly high prices or buying commodities at unfairly low prices;
- (b) selling commodities at prices below cost without justifiable reasons;
- (c) imposing unreasonable trading conditions or "tie-ins" to sales without justifiable reasons;
- (d) refusing to trade with partners or compelling trading partners to enter into exclusive trading arrangements; or
- (e) any other behaviour that abuses the dominant market position as determined by the AMEA, etc.

The term "dominant market position" under the AML refers to the position held by an operator in the relevant market which is capable of controlling the price, the quantity or other trading conditions, as well as the ability to block or affect the entry of other operators into the relevant market.

Furthermore, an operator is presumed to have a dominant market position if its market share accounts for 50% or more of the relevant market.

(3) "Concentrations" eliminating or restricting competition:  
M&A Control

Chapter IV of the AML requires that the Anti Monopoly Law Enforcement Agency ("AMEA") must be given prior notification of concentrations of business operators reaching certain turnover thresholds.

A "concentration of business operators" is defined in Article 20 as (i) a merger of business operators; (ii) a business operator's acquisition of control of other business operators by acquiring their shares or assets; and (iii) a business operator's acquisition of control of, or ability to exercise a decisive influence over other operators, by contract or any other means".

Notification Thresholds

The thresholds requiring prior notification are set out in the **Regulations on Notification Thresholds for Concentrations of Operators** (the "Merger Regulation") and are as follows:

- The combined worldwide turnover of all operators involved in the concentration in the last fiscal year exceeded RMB 10 billion (approximately US\$1.47 billion), and no less than two operators each had turnover in China of more than RMB 400 million (approximately US\$58.8 million) in the last fiscal year; or
- The combined China turnover in the last fiscal year of all operators involved in the concentration exceeded RMB 2 billion (approximately US\$294 million), and no less than two operators each had China turnover of more than RMB 400 million (approximately US\$58.8 million) in the last fiscal year.

The notification thresholds under the Merger Regulation removed a controversial market-share-based threshold: the objective standards of worldwide and China turnover provide greater certainty for companies and their advisers to assess whether a merger filing in China is required. The new thresholds also require at least 2 parties to have turnover in the PRC.

## Prohibition of Concentrations

A concentration will be prohibited if it will or may eliminate or restrict competition. The AMEA may however decide to approve such a concentration if the business operators can prove either that (i) the favourable impact of the concentration outweighs its adverse impact; or (ii) that the concentration is in the public interest.

## Standards for Merger Review

Article 27 lists the following factors which the AMEA will consider when reviewing mergers and acquisitions:

- (a) the parties' market share in the relevant market and controlling power in that market;
- (b) the degree of market concentration in the relevant market;
- (c) the "likelihood of elimination or restriction of competition in the relevant market as a result of the proposed concentration";
- (d) the effect on consumers and other relevant business operators (which could be read to include competitors, customers, and suppliers); and
- (e) the "effect on the development of the national economy and public interest."

## Timetable and Consequences of Non-compliance

The AML provide for an initial review period of 30 days from the date of receipt of the necessary documents. The AMEA may extend the review period up to a

maximum of 180 days in total. Concentrations can either be cleared (either with or without conditions) or prohibited.

If parties proceed with a concentration without obtaining clearance (or waiting until the review period has expired without a decision from the AMEA) they may be subject to a fine of RMB500,000 (approximately US\$72,000) and the transaction may be unwound.

### National Security Review for Foreign Investment

The AML provides for 2 levels of clearance in relation to concentrations involving foreign investment: concentration clearance and a national security review. Article 31 requires that where a foreign investor participates in a concentration of business operators and "national security" is involved, the M&A activities must pass both an anti-monopoly examination and a national security examination. This is the first time that the Chinese authorities have put such a requirement in writing. The AML is considered to increase the approval requirements for foreign investment in certain sensitive industry sectors.

The AML does not define the term "national security". The M&A Rules already require a "national economic security" review where foreign investors acquire control of a Chinese company which may affect "national economic security", involve a key industry or result in the change of ownership of certain well-known or traditional Chinese brands. It is thought that "national security" (under the AML) refers to a list published by the State Council in December 2006 of strategic sectors in which the State would retain control. The "strategic sectors" include military-related manufacturing, power production and grids, petroleum, gas and petrochemicals, telecom manufacturing, coal, civil aviation and shipping.

Nor does the AML set out the procedures to be followed for the national security review and it is expected that these will be set out in regulations.

## **5.2 Structure and Responsibilities of Enforcement Agencies**

## **under the AML**

Under the two-agency regime created by the AML, the AMEA is responsible for the actual enforcement of the AML, while the Anti-Monopoly Commission ("AMC") is in charge of formulation of competition policies and guidelines, coordination of enforcement activities, and evaluation of competition conditions in various markets.

State Administration for Industry and Commerce ("SAIC")

According to the State Council Restructuring Plan for SAIC ("SAIC Restructuring Plan"), one of the major functions of SAIC will be to assume responsibility of AML enforcement in relation to monopoly agreements, abuses of dominant market position, abuse of administrative power to restrict and eliminate competition (excluding monopolistic pricing behaviour), and investigating and penalizing unfair competition, commercial bribery, smuggling and other economic related infringements in accordance with law.

### **5.3 AML: Recent Developments**

On April 27, 2009, the Anti-Monopoly and Anti-Unfair Competition Enforcement Bureau (a newly established bureau) of the SAIC published for public consultation two draft anti-monopoly regulations:

- (i) The Provisions on Prohibiting Monopolistic Agreements, and
- (ii) The Provisions on Prohibiting Abuse of Market Dominant Positions

The draft regulations are intended to implement the AML and delegate some investigation and punishment power to provincial level counterparts of SAIC, which is responsible for enforcement of the AML's prohibition of monopoly agreements and abuse of dominant market positions.

#### **The Provisions on Prohibiting Monopolistic Agreements ("Provisions on Monopolistic Agreements")**

## Prohibited Monopolistic Agreements

The Provisions on Monopolistic Agreements provide further clarification as to the types of monopoly agreements that are prohibited. For example, the AML prohibit horizontal monopoly agreements which divide the sales or raw materials supply market. The Provisions on Monopolistic Agreements clarify that this will include dividing product distribution areas, sales targets, types of products for sale, and raw material procurement areas and suppliers.

## Monopolistic Agreements in the Bidding Process

Monopolistic agreements in the bidding process are dealt with in the new Provisions for the first time. The Provisions prohibit, as a form of horizontal agreement, colluding in bidding, including mutual agreements between bidders, taking turns to win the bid and colluding on matters other than the quotation. Monopolistic agreements between bidders and persons soliciting bids are also among the categories of prohibited vertical agreements.

### **1.1.**

#### Involvement of Industry Associations in Monopolistic Agreements

### **1.2.**

Industry associations are generally prohibited under the AML from being engaged in monopolistic agreements. The Provisions on Monopolistic Agreements further elaborate on how industry associations are prohibited from organizing the entering into of monopolistic agreements by business operators within their industries by means of:

- making and issuing rules, decisions, or circulars that eliminate or restrict competition;
- calling its members to discuss and make agreements, resolutions, meeting minutes, or memoranda; or
- facilitating business operators to communicate, discuss, or collaborate in reaching a monopolistic agreement.

## Leniency for Whistle Blowers

The draft Provisions on Monopolistic Agreements also provide further details of the leniency regime mentioned in the AML under which the first company to voluntarily report a monopolistic agreement and provide substantial evidence can receive full immunity. The second company to voluntarily report receives a 50 per cent reduction in penalties, and the third receives a reduction of 30 per cent. However, the immunity and reduction regime does not apply to parties organizing or initiating a monopolistic agreement. Nor does it apply to any business operator that coerced others to participate in a monopolistic agreement.

### **The Provisions on Prohibiting Abuse of Market Dominant Positions (“Abuse of Market Dominance Provisions”)**

#### Definition of “Dominant Market Position”

The Abuse of Market Dominance Provisions defines a “dominant market position” as a market position held by business operators that have the ability to:

- (i) control the prices or quantities of commodities or other trading conditions in the relevant market; or
- (ii) block or affect the entry of other business operators into the relevant market.

This is a clearer definition than that provided in the AML. The Provisions also specify that “other trading conditions” include commodity grades, terms of payment, methods of delivery, after-sale services etc.

#### Determination of factors on market dominance position

The AML provides a list of factors that will be taken into account in determining whether there is a dominant market position. These include the business operator’s market share and its competitive status in the relevant market and the business operator’s ability to control the sales market or the raw material supply market.

The Abuse of Market Dominance Provisions provides clarification as to the meaning of these factors. For example, the Provisions specify that "market share" refers to a business operator's sales revenue or sales volume of a specific product in the relevant market.

#### Rebuttal of Presumptions of Dominant Market Positions

The AML provides that a business operator may be presumed to have a dominant market position if:

- (i) Its market share accounts for half or more of the relevant market;
- (ii) The total market share of two business operators accounts for two-thirds or more of the relevant market; or
- (iii) The total market share of three business operators accounts for three-quarters or more of the relevant market.

A business operator with a market share of less than one tenth, will not however be presumed to have a dominant market position under paragraphs (ii) or (iii) above.

The new Abuse of Market Dominance Provisions repeat these provisions but provide that a business operator can rebut the presumptions if it can prove that:

- (i) It is relatively easy for other business operators to enter the relevant market;
- (ii) Competition in the relevant market is relatively sufficient; or
- (iii) The business operator has no ability to control the price and quantity of products or other trading conditions, or to obstruct or affect the entry of other business operators into the relevant market.

## Prohibited Abusive Acts of Market Dominance

The AML prohibits some of the more common forms of unjustifiable abuse of market dominant positions. The Abuse of Market Dominance Provisions provides clarification as to the scope of prohibited conduct.

For example, the AML provide that a business operator with a market dominant position is prohibited from refusing to trade with any party, without justifiable cause. The AML provide no guidance as to when a refusal will be "without justifiable cause". The Abuse of Market Dominance Provisions clarify that if, under equivalent trading conditions, a business operator refuses, restricts or discontinues trade with other parties, the business operator will be deemed to do so "without justifiable cause".

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

The carving out of "monopolistic pricing behaviors" from the SAIC Restructuring Plan suggests that pricing-related violations under the AML will be supervised by NDRC, which is already responsible for industrial policy and price control in China.

## MOFCOM

In contrast to the jurisdictions of SAIC and NDRC, MOFCOM's role within the AML is relatively clear. It is responsible for conducting merger reviews.

MOFCOM has been enforcing the merger review rules under the *Regulation on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors* since 2003, and has developed a team of staff who are familiar with the legal and economic issues that arise in merger reviews.

The new *Anti-Monopoly* Bureau within MOFCOM has been established to perform the functions of AML enforcement.

## **5.4 Recent Decisions under the Anti Monopoly Law:**

### **(1) InBev/Anheuser-Busch**

On 18 November 2008, MOFCOM published its decision to clear InBev NV/SA's ("InBev") proposed US\$52bn acquisition of Anheuser-Busch Companies Inc. ("AB"), subject to conditions. This was the first merger decision under the new AML to have been published and also the first time that the merging parties had to comply with affirmative conditions to a merger in order to obtain clearance under the new AML.

#### The review process

MOFCOM's review period lasted just more than two months after InBev's submission of a merger notification on 10 September 2008. It was required to make further submissions to MOFCOM on 17 and 23 October before the review period started formally. The 'phase 1' review period appears to have lasted for 21 days (out of a maximum possible of 30 days) after MOFCOM was satisfied with the information received.

#### Conditions Imposed

It was found that the proposed acquisition would not eliminate or restrict competition in China's beer market.

However, given the size of the acquisition and the market share and market position of the combined group, the following conditions were imposed to minimise the acquisition's potentially adverse effects on China's beer market in the future:

- (i) There can be no increase in AB's existing 27% stake in Tsingdao Brewery;
- (ii) InBev is required to notify MOFCOM of any changes to its controlling shareholders, or to the shareholders of such controlling shareholders, in a timely manner;

- (iii) InBev should not increase its existing 28.56% stake in Zhujiang Brewery; and
- (iv) InBev should not hold any stake in China Resources Snow Breweries or Beijing Yanjing Brewery, two other major Chinese breweries.

InBev is required to give MOFCOM prior notification of its intention to take any of the above steps and it must obtain MOFCOM's prior approval.

It is an international practice to approve an M&A transaction with restrictive conditions, and this option has only recently become available to MOFCOM under the AML.

## **(2) Coca-Cola / Huiyuan**

On 18 March 2009, MOFCOM announced its decision to prohibit Coca-Cola's proposed US\$2.4 billion acquisition of China Huiyuan Juice Group Limited ("Huiyuan"), a Hong Kong-listed company. Huiyuan is China's largest juice manufacturer, holding over 40% share of China's pure fruit juices market and 10% of its fruit and vegetable market. China is reportedly Coca-Cola's fourth largest market and in 2008, Coca-Cola reportedly controlled 52.5% of China's carbonated drinks market and 12% of the fruit and vegetable juice market. If the acquisition had gone ahead, it would have been China's largest overseas acquisition. This is MOFCOM's first decision to prohibit an acquisition under the AML.

### The Review Process

Coca-Cola submitted its merger notification under the AML on 18 September, 2008. Following the submission of additional materials required under the AML, MOFCOM commenced its preliminary review on 20 November. On 20 December, MOFCOM decided to conduct a further review which it completed on 18 March, 2009.

According to the announcement of its decision, MOFCOM conducted an extensive review which involved consulting the parties to the acquisition, relevant government authorities, industry associations, fruit juice suppliers, juice concentrate suppliers, juice distributors, the Chinese partners of Coca-Cola as well as experts on law, economics and agriculture. MOFCOM adhered strictly to the timelines under Articles 25 and 26 of the AML.

### The Decision

MOFCOM's decision was that the Coca-Cola acquisition would eliminate or restrict competition in the China fruit juice market.

In an attempt to reduce the adverse impact on competition, substantive negotiations were held between MOFCOM and Coca-Cola on the inclusion of restrictive conditions to the acquisition, as in the Inbev/Anheuser Busch case. Coca-Cola was requested to provide solutions to the competition issue, but MOFCOM determined that the proposals put forward by Coca-Cola could not effectively reduce the adverse impact on competition. MOFCOM's announcement did not disclose the specific proposals, but it was reported in the media that MOFCOM wanted Coca-Cola to agree that the locally famous Huiyuan brand would not be included in the acquisition – something which was not acceptable to Coca-Cola.

In its announcement, MOFCOM gave three reasons for its decision. It then elaborated on those reasons in a Q&A session with the media, a record of which was posted on its website on 25 March 2009. The reasons were:

- (i) That after the Huiyuan acquisition, Coca-Cola would be able to pass on its dominant position in the carbonated soft drinks market to the fruit juice market and that this would eliminate or restrict competition**

**between other fruit juice suppliers, which would in turn harm the interests of consumers.**

In the Q&A session, MOFCOM set out its reasoning that:

- (a) Coca-Cola, with a 60% share of the carbonated soft drinks market and strength in branding and distribution capability, is dominant in China's carbonated soft drinks markets; and
  - (b) The carbonated soft drinks and fruit juice markets are closely related. The acquisition could result in Coca-Cola increasing its influence in the fruit juice markets as it would be able to sell its carbonated drinks and fruit juices as a combined product or impose restrictive conditions on purchasers.
- (ii) **Branding was considered to be a key factor affecting competition in the drinks market. MOFCOM found that Coca-Cola's control over the juice market would be strengthened by its control of two well known brands in the market: Huiyuan and the "Minute Maid" brand already owned by Coca-Cola.** Together with Coca-Cola's already dominant position in the carbonated soft drinks market, control of two well-known brands was considered to make it significantly more difficult for potential competitors to enter the market. It was considered that the barriers to entering the fruit juice market are high, due to the presence of existing brand names, and strong branding carries a great deal of value and meaning to Chinese consumers in this sector. The threat posed by potential new entrants is therefore low.

In the Q&A, it was emphasized that MOFCOM's decision had not been motivated by any intention to protect the Huiyuan brand – i.e. it was not protectionism. Consideration of the Huiyuan brand had been focused solely on the

issue of competition.

- (iii) **Small and medium-sized domestic fruit juice companies would find it difficult to compete and could be squeezed out of the market. Domestic companies would find it difficult to participate in China's fruit juice market and the acquisition would hamper innovation by other fruit juice companies.**

The acquisition would therefore have led to less choice for consumers in the juice market and higher prices. Article 27 of the AML allows MOFCOM to consider the effects on individual competitors and other affected companies (such as suppliers or customers) in a proposed acquisition.

Until the Coca-Cola acquisition was barred, MOFCOM had accepted all merger applications reviewed under the AML. In the Q&A session, a MOFCOM representative confirmed that the decision should be viewed as a one-off and that it did not indicate any change in China's policy on foreign investment.

### **(3) Mitsubishi Rayon/Lucite International**

On 24 April 2009, MOFCOM announced its decision to grant conditional clearance for the US\$1.6 billion acquisition of Lucite International Group Limited ("Lucite") by Mitsubishi Rayon Co. Ltd. ("Mitsubishi Rayon") under the AML. Unlike the previous decisions, this transaction involved a Japanese purchaser and a British target, both leading methyl methacrylate ("MMA") manufacturers with plants in China.

#### **The Review Process**

MOFCOM conducted extensive reviews with the relevant industry manufacturers, producers and parties to the transaction. It was estimated that the merged entity would ultimately be supplying to 64 per cent of the MMA market which would place Mitsubishi Rayon in a dominant market position, significantly greater than

that of Jilin Petrochemical and Heilongjiang Longxin Company, the second and third largest suppliers in China respectively.

In addition to Mitsubishi Rayon's market dominance, it has business activities in two other MMA-related products, thus the merged entity would be capable of effecting vertical and horizontal restrictions to its competition. MOFCOM extended its review into phase 2 and invited Mitsubishi Rayon to propose restrictive conditions to address the anti-competitive concerns raised by MOFCOM.

### The Conditions

The following conditions were proposed and adopted:

#### (i) Divestiture

- Partial – within six months of completing the transaction, Lucite China must sell, in a one-off transaction, 50 per cent of its annual MMA production to one or more independent third party purchasers over a period of five years at production cost without any profit margin. An independent auditor must verify the cost figures; or
- Full – if Lucite China does not sell 50 per cent within six months (or any extension granted by MOFCOM), it is agreed that MOFCOM may appoint an independent trustee to oversee the sale of 100 per cent equity interest of Lucite China to an independent third party.\

#### (ii) Operational restrictions for Lucite China from the completion of the transaction to the divestiture (the "divestment period")

During the divestment period, Lucite China must operate independently from Mitsubishi Rayon. Both parties must have separate management teams and boards of directors and compete with one another in the MMA market. Both parties are prohibited from sharing any pricing information, customer information or information that is competition sensitive. Infringement of this condition may incur fines of RMB 250,000 to RMB 500,000.

(iii) Restrictions on expansion in China for the next five years

The merged entity must not, except with MOFCOM's prior approval, expand its MMA monomer, PMMA polymer or cast sheet production in China either by acquisition or by establishing new plants.

## **Conclusion**

This application highlighted the importance of the negotiations with MOFCOM during the review process, particularly in addressing areas where MOFCOM has raised concerns. However, there appears to be a lack of transparency during the negotiation period and this may be a concern when an applicant is trying to determine whether the proposed remedies will satisfy MOFCOM's concerns. There is very little information available and neither the AML nor its implementation rules provide guidance on this issue.

## **6 OVERSEAS INVESTMENT BY PRC COMPANIES: NEW FOREIGN INVESTMENT MEASURES**

More interesting, in my view, is the recent trend of overseas acquisitions by PRC companies. The Chinese government has been encouraging overseas investment in certain sectors as a means of employing China's extensive foreign exchange reserves and securing natural resources. Since the on-set of the financial crisis, the Government has also been encouraging companies to take advantage of the depressed valuations of companies in developed economies.

## **The Administrative Measures on Overseas Investment**

MOFCOM published new rules governing overseas investment by Chinese companies on 16 March 2009 - the **Administrative Measures on Overseas Investment** - which came into effect on 1 May, 2009.

The new Measures generally reflect a policy trend of encouraging overseas investment by shortening the approval process for all types of overseas investments, but particularly for smaller investments. It is estimated that once the Measures have been fully implemented, 85% of overseas investment applications will be handled by MOFCOM's provincial departments. This should generally make the approval process both easier and quicker for the vast majority of overseas investment projects.

The Measures have however created additional approval requirements for larger investments and overseas investments in the energy and mining sector. This suggests that the Chinese government intends to maintain strict control of significant overseas investments.

### Scope of the Measures

The Measures apply to enterprises incorporated in China (including FIEs) that propose to establish, or acquire interests in, overseas non-financial enterprises. The measures do not regulate investments in financial institutions which are subject to approval by other regulatory bodies.

The Measures set out three categories of review based on the size and type of the overseas investment. Different documentary requirements and approval processes apply to each category.

### **Category (a) - The following overseas investments must be approved by MOFCOM at national level:**

- investment in a country which does not have an established diplomatic relationship with China;

- investment in specific countries or regions (the list of such countries or regions is to be prepared by MOFCOM in conjunction with the Ministry of Foreign Affairs and other relevant departments);
- investment by a Chinese party of US\$ 100 million or more;
- investment which involves the interests of multiple countries or regions; or
- investment involving the setting-up of an offshore special purposes vehicle.

A “special purpose vehicle” is defined as an overseas company that is controlled directly or indirectly by a domestic enterprise for the purpose of achieving an overseas listing of interests in the domestic company. An offshore investment vehicle established by a Chinese investor for purely offshore investments should not, theoretically, fall within the scope of this definition. This is, however, waiting to be confirmed in practice. The existing restrictions on establishing special purpose vehicles for “round-tripping” continue to apply and are governed by the *Interim Measures on the Takeover of Domestic Enterprises by Foreign Investors* (No. 10) published on 8 September 2006.

The time limit for MOFCOM approval at the national level (excluding the period for Chinese Embassy review) is 30 working days from the receipt of complete application documentation. MOFCOM must consult the relevant Chinese Embassy or Consulate in the target country to determine its security conditions and the impact the proposed investment may have on the political and economic relationship. The Embassy is required to provide an opinion within 10 working days of receiving the request.

In addition, when reviewing an overseas investment in the energy or mineral sectors, MOFCOM must consult with the relevant domestic industrial association or chamber of commerce. No time limit is set on the period of consultation

which may result in the review process being delayed.

Once MOFCOM has completed its review, it will issue either a certificate approving the investment or a written notice of disapproval to the Chinese investor.

**Category (b) - The following overseas investments must be approved by MOFCOM at the provincial level:**

- investments of between US\$10 million and US\$100 million;
- investments in the energy and mineral sectors; or
- investments that need to attract other domestic investors.

Provincial MOFCOM is required to consult the Chinese embassy or consulate in the relevant country if it considers it appropriate. If the investment involves the energy or mineral sectors, provincial MOFCOM is also required to consult the relevant industrial association or chamber of commerce.

The time limit for provincial MOFCOM approval is 20 working days, excluding the time for consulting the relevant PRC embassy or consulate if applicable.

**Category (c) - Overseas investments not falling within categories (a) and (b)**

The Measures greatly simplify the approval procedures for overseas investments of under US\$10 million that do not fall within the above- mentioned categories.

For investments that do not require national or provincial MOFCOM approval, it will only be necessary to submit a one-page application form to provincial MOFCOM. The review of such applications should be completed within three working days, which is a significant improvement on the previous timescale for approving small investments.

## Grant of Approval

Once MOFCOM has completed its review, it will either issue a certificate of approval or a written notice rejecting the application. A rejection notice must set out the reasons why the investment was not approved and the applicant's right to re-apply or bring an administrative lawsuit to challenge the decision.

When approval is granted, the investment must be made within two years or the certificate of approval will lapse.

### Restriction on Entering Contracts before Grant of Approval

The Measures also provide that domestic enterprises must obtain relevant government approvals before contracts or agreements in relation to overseas investment come into effect. If a Chinese party enters into such an agreement without first obtaining the required approval from authorities such as the NDRC or MOFCOM, it may affect the effectiveness of the document or contract in China. If the governing law of another jurisdiction upholds the effectiveness of the document, the Chinese party may find itself in breach of contract if approval has not been obtained from the Chinese government (as an approval certificate is required by the foreign exchange, bank, customs and foreign affairs).

### Prohibited Overseas Investments

The Measures list four categories of overseas investments that will not be approved by either national or provincial MOFCOM:

- overseas investments that threaten the PRC's national sovereignty, security or public interest, or violate PRC laws or regulations;
- overseas investments that will harm the relationship between China and other countries (or regions);

- overseas investments that might lead to the violation of international conventions to which the PRC is a contracting party; and
- overseas investments involving technology or commodities that are prohibited from exportation.

#### Documents required

Investments that fall within category (a) and category (b) are required to submit following documents:

- an application form, which should provide information such as the name, registered capital, amount of investment, scope of business and duration of business of the overseas enterprise, an explanation of sources of investment capital, the specific contents of the investment, the equity structure, the analysis and assessment of the investment environment, and a statement that the proposed investment is compatible with national sovereignty, security, public interests, PRC laws, state-to-state relationships, international treaties. In addition, a further statement that the investment does not involve technology or commodities that are prohibited from exportation;
- a photocopy of the business license(s) of the domestic enterprise(s);
- the articles of association of the overseas enterprise and the relevant agreement(s) or contract(s) of the overseas enterprise(s);
- the approval or filing documents issued by the relevant authorities;
- a preliminary report on the Overseas Merger or Acquisition if it is an overseas merger and acquisition investment; and

- other documents as specified by the competent authorities.
- The Measures do not clearly state if there is a requirement for submitting a review opinion issued by the foreign exchange department on the source of investment capital, which is required under the 2004 Regulations..

If it is a merger and acquisition investment, MOFCOM will require further information to be provided, including a risk management evaluation and plan. The documents at (1) – (6) were not required under the 2004 Regulations. These extra requirements provide MOFCOM with more discretionary power than before and represent a shift of responsibility for certain matters from the National Development and Reform Commission to MOFCOM.

### **NDRC Review**

The MOFCOM and the National Development and Reform Commission (NDRC) are the two key regulators in the review and approval of PRC companies' outbound investment.

The NDRC is reportedly revising its regulatory framework in order to be consistent with the new Measures.

### **Guidance on Risk Management of Merger Loans Provided by Commercial Banks**

Another measure introduced by the Chinese Government which is likely to encourage overseas investment by PRC entities is **the Guidance on Risk Management of Merger Loans Provided by Commercial Banks** (the "Guidance") which was issued on 6 December 2008 by the China Banking Regulatory Commission ("CBRC").

The Guidance removes the prohibition on PRC banks advancing loans to Chinese enterprises for the purpose of funding M&A investments.

It therefore provides Chinese companies with an additional financing channel for overseas investment besides loans provided by the China Development Bank and National Export-Import Bank.

### **SAFE's Relaxation of Overseas Funding Rules**

On 9 June 2009, SAFE announced its relaxation of restrictions on Chinese companies lending to their overseas subsidiaries. The revised rules will come into effect on 1 August and will allow Chinese companies to use their foreign exchange reserves or to purchase foreign exchange to fund their overseas subsidiaries. Under the revised rules, the maximum amount which a Chinese parent company can lend to its overseas subsidiaries cannot exceed 30 per cent of the Chinese parent's equity.

These measures are aimed at supporting the overseas subsidiaries of Chinese companies which have faced difficulties in raising capital abroad due to the credit crunch. It is also hoped that more Chinese companies will be encouraged to expand into profitable markets overseas. According to estimates by SAFE, the revised rules could see up to US\$30 billion in new lending.

Companies still need SAFE approval to use foreign exchange in overseas investments although SAFE is proposing to simplify the approval procedures for outbound investment.

### **Overseas Investment: Recent Developments**

On 18 May 2009, MOFCOM announced that in the light of the financial crisis, it was optimal for PRC companies to make overseas investments now. Despite earlier warnings and cautions from Premier Wen Jiabao and other members of the delegation regarding overseas investment, the impact of the financial crisis has created many global investment opportunities for Chinese firms.

Among the more high profile recent acquisition proposals are:

- Aluminum Corp of China's US\$19.5 billion deal to acquire Rio Tinto's convertible bonds and mining assets – this deal was cancelled on 5 June 2009; and
- China Minmetals Non-ferrous Metals Corp.'s proposed US\$1.2 billion acquisition of mining assets from OZ Minerals which has received the approval of China's National Development and Reform Commission but still needs the approvals of other regulatory bodies, including MOFCOM and SAFE. The acquisition has been cleared by the Australian regulatory bodies.

Municipal governments are also reportedly looking overseas for assets. This year, the National Social Security Fund ("NSSF"), the national pension fund also sought approval to invest in foreign private equity funds. The NSSF aims apparently to invest about US\$ 8 billion, approximately 10 per cent of its total assets, in both domestic and global private equity funds.

## **7 PRC BANKRUPTCY LAW**

On 1 June 2007 the Enterprise Bankruptcy Law of the PRC (the "Bankruptcy Law") came into effect. In the light of the recent global financial crisis and the inadequacies of the previous bankruptcy legislation, significant attention has been paid to the Bankruptcy Law.

Prior to the Bankruptcy Law, the only available Chinese laws and regulations governing insolvency were fragmented and primarily addressed the insolvency of State-Owned Enterprises ("SOEs"). There was no framework to restructure distressed companies. In addition, the previous legislation did not provide sufficient protection to investors as bankrupt companies had to make payments according to the following priority: liquidation expenses, employee claims and taxes, debts of the company and lastly the shareholders or capital contributors. There was limited recognition given to secured interests.

### **Features of the Enterprise Bankruptcy Law**

#### **7.1 APPLICABLE ENTITY**

According to Article 2 of the Bankruptcy Law, where an enterprise fails to pay off its debts as they fall due, and it does not have sufficient assets or if it is obviously incapable of settling its debts, it may be liquidated under the provisions of the Bankruptcy Law. The definition of an "enterprise" includes SOEs, foreign-invested enterprises ("FIEs"), listed/non-listed enterprises, limited liability companies, and the limited liability by shares companies.

The Bankruptcy Law does not cover bankruptcies of individuals, sole proprietors or partnerships.

The application may be made by a debtor or a creditor, applying on the grounds as set out above. The court will have 15 days to determine whether to accept the application.

## **7.2 BANKRUPTCY ADMINISTRATOR**

An independent bankruptcy administrator will be appointed by the PRC Court. The new Bankruptcy Law aims to reflect existing international practice.

### Composition of and Qualification on the Bankruptcy Administrator

Chapter Three of the Bankruptcy Law stipulates the requirements for the bankruptcy administrator. The position of bankruptcy administrator may be assumed by a liquidation group or by social intermediary agencies that have been established according to the law, such as a law firm, an accounting firm or a bankruptcy liquidation firm.

Under Article 25, the functions of the bankruptcy administrator include:

- Taking over the assets, seals, the account books and documents of the debtor;
- Investigating the financial status of the debtor and preparing the financial statements;

- Deciding the internal management of the debtor;
- Deciding the daily expenditure and other necessary expenditures of the debtor;
- Deciding, before the first creditors' meeting is held, to continue or suspend the debtor's business, subject to the approval of the PRC Court;
- Managing and disposing of the debtor's assets;
- Participating in actions, arbitrations or any other legal procedures on behalf of the debtor;
- Proposing to hold creditors' meetings; and
- Upon approval of the PRC Court, employing the relevant work staff as necessary.

### **7.3 LIQUIDATION EXPENSES AND COMMUNITY LIABILITIES**

Any liquidation expenses and community liabilities arising after the court accepts the application may be paid from the debtor's assets at any time. Where the debtor's assets are insufficient to settle all the liquidation expenses and community liabilities, the liquidation expenses shall be settled first. If there are insufficient assets to settle these, the liquidation will be conducted on a pro rata basis. Where there are insufficient assets to settle the liquidation expenses, the bankruptcy administrator should apply to the PRC Court to conclude the procedures for liquidation.

Liquidation Expenses include:

- Costs of action in bankruptcy cases;
- Expenses of the administration, conversion and distribution of the debtor's assets; and

- Expenses of the bankruptcy administrator's performance of its functions and duties, its remuneration and the expenses of recruitment of employees.

### **1.3. Community Liabilities include:**

- The liabilities arising under a contract, the performance of which both parties fail to fulfil when requested to do so by the bankruptcy administrator or which the other party fails to perform when requested to do so by the debtor;
- The liabilities arising from the negotiorum gestio of the debtor's assets;
- The liabilities arising from "ill-gotten gains";
- The labour cost for the continuance of business operations, social insurance premiums and other liabilities incurred in relation thereto;
- The liabilities arising from loss sustained in the performance of the functions and duties of a bankruptcy administrator or other relevant personnel; and
- The liabilities arising from any damage to the debtor's assets.

## **7.4 THE CREDITORS' MEETINGS AND THE CREDITORS' COMMITTEE**

### The Creditors' Meeting

A creditor who declares its creditor's right according to the Bankruptcy Law has the right to attend the creditors' meeting and is eligible to vote.

Any creditor whose debt is secured on assets of the debtor, who has not given up the right to be repaid in priority, will not be entitled to vote on any matters set out in item (g) or (j)

below.

The creditors' meeting may:

- (a) Examine the creditors' rights;
- (b) Apply to the PRC Court to change the bankruptcy administrator and examine the expenses and remuneration of the bankruptcy administrator;
- (c) Supervise the bankruptcy administrator;
- (d) Select and change the members of the creditors' meeting;
- (e) Decide whether to continue or stop the debtor's business operations;
- (f) Decide whether to adopt a revival plan;
- (g) Decide whether to adopt a settlement;
- (h) Decide whether to adopt a management plan of the debtor's assets;
- (i) Decide whether to adopt a conversion plan of the insolvent assets;
- (j) Decide whether to adopt a distribution plan of the insolvent assets; and
- (k) Exercise any other functions and powers that the PRC Court deems that the creditors' meeting may exercise.

#### The Creditors' Committee

The creditors' meeting may decide to establish a creditors' committee, which will be made up of creditor representatives selected at the creditors' meeting as well as an employee representative of the relevant debtor or a representative of the labour union. The creditors' committee should have no more than 9 members. The members of the creditors' committee are required to be confirmed by the PRC Court.

The creditors' committee may:

- Supervise the management and disposal of the debtor's assets;
- Supervise the distribution of the insolvent assets;
- Propose to hold a creditors' meeting; and
- Perform the other functions and duties as entrusted at the creditors meeting.

Under the Bankruptcy Law, the bankruptcy administrator may not distribute dividends or dispose of particular types of assets without obtaining approval from the creditors' committee.

## **7.5 RESTRUCTURING & RECONCILIATION**

### **Restructuring**

The Bankruptcy Law provides an alternative procedure to liquidation, where a debtor, creditor or shareholder holding more than 10% of the debtor's capital may apply to the court for restructuring once a petition to bankrupt the debtor has been filed, but before the bankruptcy declaration has been issued. This procedure is supervised by the Court and allows a compromise to be reached between the debtor, its creditors and its shareholders. The threshold for a restructuring application is lower than for liquidation as the debtor, creditor or shareholder is only required to prove the likelihood of the debtor's incapability to repay its debts. The restructuring period commences as soon as the court's approval is obtained. During the restructuring period, a debtor may, after obtaining an approval from the PRC Court, manage its assets and business operation under the supervision of its bankruptcy administrator. Secured creditors cannot seize or dispose of the debtor's secured assets during this time. This provides the debtor with an opportunity to negotiate a reorganization of debt with its creditors without any creditors interrupting its operations.

The bankruptcy administrator or the debtor must submit a

restructuring plan within 6 months of the Court's ruling in favour of a restructuring, or apply for an extension for a further 3 months. The plan must be approved by a majority of the creditors of each class representing two-thirds of the amount of confirmed claims in that class. Once approved, the plan may be submitted to the court for sanctioning.

#### Business operation during the restructuring period:

1. During the restructuring period, a debtor may manage its assets and business operation under the supervision of its bankruptcy administrator.
2. Where the bankruptcy administrator takes charge of the assets and business operations, it may employ the business managers of the debtor to take care of the business operations.
3. During restructuring, creditors whose claims are secured on the assets of the debtor are not allowed to be repaid. However, in the case of possible damage or significant depreciation in the value of the assets, which may be detrimental to the creditor's rights, the creditor may apply to the court.
4. If the debtor or bankruptcy administrator borrows money to carry on the business operation, it may provide security for the loan.
5. No capital contributor of a debtor may request distribution of any investment proceeds.
6. No director, supervisor or senior manager of the debtor may transfer the equity it holds to a third party, except with the approval of the court.

#### Restructuring Procedure

1. The debtor or bankruptcy administrator is required to submit a draft of the restructuring plan to the court and the creditors' meeting within 6 months (or 9 months if an extension has been sought and granted) from the

date of the court order.

2. The court should organize a creditors' meeting to vote on the draft.
3. Relevant creditors will be divided into groups according to their rights (creditors with security over assets of the debtor; employees whose wages, welfare and compensation are unpaid; agencies claiming unpaid taxes; and ordinary creditors) when voting on the draft restructuring plan.
4. If the creditors' meetings reject the plan, the company or the administrator may apply to the PRC Court to have the plan approved.
  - Approval may be granted if it meets certain criteria;
  - If the plan is rejected by the court, the restructuring will be terminated and the debtor will be declared bankrupt.
5. If the plan is accepted at the creditors' meetings and by the court, the company will be able to implement it and this will be carried out under the supervision of the administrator.

#### **1.4. The approved restructuring plan**

- Once the restructuring plan is approved by the court, it should be implemented by the debtor, subject to the administrator's supervision, within the prescribed supervision period.
- A restructuring plan, once approved by the court, binds the debtor and all creditors. If a creditor fails to present his claim in accordance with the provisions of the Law, he is precluded

from exercising any other rights during the implementation period.

- The rights of a creditor against the guarantor of a debtor company, and other obligors bearing joint and several liability with the debtor, will not be affected by the plan.

## **Reconciliation**

This is an alternative form of debt restructuring. The debtor can apply for reconciliation after the presentation of a bankruptcy petition but before a declaration of bankruptcy is made.

### Application

The debtor applies to the court to obtain a ruling on debt reconciliation with its unsecured creditors. Whilst no statutory time limit is imposed for the preparation or agreement of the reconciliation agreement, it must be agreed by at least 50% of the unsecured creditors present at the meeting representing 2/3 of the amount of outstanding unsecured debt. The agreement must also be approved by the court.

Secured creditors are not involved in the reconciliation process and may continue to seize and dispose of the debtor's secured assets during the process.

## **7.6 INSOLVENCY LIQUIDATION**

If there is a failure to reach an agreement on either restructuring or reconciliation, the PRC Court will declare the debtor as bankrupt and begin the insolvency liquidation procedure.

### Priority of claims

Secured claims have priority during the insolvency liquidation procedures. Previously, employees' rights ranked first and secured assets were applied to pay employees' claims ahead

of the claims of secured creditors. However, the Bankruptcy Law reflects China's desire to foster a market-oriented economy and also aims to protect the interests of lenders. The problems of redundant workers are expected to be solved by the social security system.

The order of priority of claims is as follows:

- secured claims to the extent of the value of the secured assets;
- bankruptcy expenses and common claims;
- wages, basic welfare of employees and compensations prescribed by law;
- other social insurance premiums and taxes; and
- unsecured claims (including shareholders' claims).

### **Cross-border insolvency regulations**

The Bankruptcy Law includes specific provisions in relation to cross-border bankruptcies.

It requires a bankruptcy administrator to seek the recovery of overseas assets of a bankrupt enterprise.

The Bankruptcy law further provides for the recognition of a foreign court judgment or ruling and its enforcement against a debtor's assets in the PRC provided that the following conditions are met:

- the jurisdiction of the bankrupt estate has a reciprocal treaty with the PRC;
- the bankruptcy proceedings outside the PRC do not violate PRC state sovereignty, national security and social public interest; and

- the bankruptcy proceedings outside the PRC do not impair the legitimate rights and interests of Chinese creditors.

## **Issues**

There are two main issues which the creditor of a non-PRC bankrupt company will face if it does seek a bankruptcy judgment:

### **1. Reciprocity**

The creditor will need to establish that the jurisdiction of the bankrupt company has a treaty with the PRC or will reciprocate the enforcement of a PRC ruling.

### **2. Discretion by the PRC Court**

The creditor will need to convince the PRC court that enforcement of the foreign bankruptcy judgment or ruling will not harm the interest and rights of anyone in the PRC. The requirements under Article 5 are onerous and the PRC court has substantial discretion to interpret the conditions when deciding whether to recognize a foreign court's ruling.