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CAPITAL MARKETS

China-based Companies Accessing the U.S. Capital Markets
Paul W. Boltz and Robert Woll, *Morrison & Foerster LLP*

Regulators Building Investor Confidence: Chinese Style
Joseph R. Tiano, Jr., *Thelen, Reid & Priest LLP*

CORPORATE GOVERNANCE

So You've Set the Tone at the Top — Now What? Practical Considerations in Implementing Good Corporate Governance at the Middle Management and Staff Levels in Your China Operations
Paul W. Boltz, *Morrison & Foerster LLP*

DISPUTE RESOLUTION

Enhanced Flexibility for Arbitrations Involving China and Remaining Obstacles to Party Autonomy
Jeffrey P. Layman, *Fulbright & Jaworski LLP*

New Attack on Arbitration in China
Owen Nee, *Orrick, Herrington & Sutcliffe LLP*

ENERGY

Regulatory Developments in China Encourage Growth of Renewable Energy Sector
Jeffrey Layman and Jeffrey Blount, *Fulbright & Jaworski LLP*

FINANCE

Securitization: China as an Emerging Market
Alvin Leong, *Milbank, Tweed, Hadley & McCloy LLP*

Opening the Door to Fund Management in China
Effie Vasilopoulos, *Sidley Austin LLP*

Strategic Investments by Foreign Investors in PRC Listed Companies
Jean-Marc Deschandol, Charles Desmeules and Steven Towell, *Norton Rose*

Structuring Private Equity Investments in China—The State of Play Post—SAFE Notice 75
John Lange, *Paul, Weiss, Rifkind, Wharton & Garrison LLP*

STRUCTURING PRIVATE EQUITY INVESTMENTS IN CHINA—THE STATE OF PLAY POST—SAFE NOTICE 75

By John E. Lange*

Over the past four years, the private equity industry in China has matured at startling speed. For close to a decade after its emergence in the early 1990s, foreign private equity in the PRC suffered through many fits and starts and justly earned a reputation for unachieved exits and poor returns. Beginning in 2003-2004, however, a string of eye-catching deals began to show that skillful and persistent private equity investors could make real money in China.

Among the reasons for this turnaround were the equally startling development of Chinese private sector activity generally, and the evolution of transaction structures that facilitated exits. China Mengniu Dairy Company Limited, which completed an IPO on the Stock Exchange of Hong Kong in June 2004, became a quintessential success story. Mengniu's business, founded in Inner Mongolia in 1999 by a group of former managers of a state-owned dairy company, was reorganized several years later to accept investment from private equity funds through a Cayman Islands holding company, in which the founders retained a controlling interest. Since the IPO, the foreign private equity investors, led by Morgan Stanley and CDH, have sold shares at a substantial profit.

The offshore holding company structure exemplified by Mengniu is the one that foreign private equity and venture capital (VC) investors, in almost all cases, would prefer. In this structure, the offshore holding company owns all of, or at least a controlling interest in, the equity of the PRC operating company. The operating company itself must be an entity organized under PRC law and would be designated as a "foreign invested enterprise" (FIE) – typically, either a wholly foreign owned enterprises (WFOE) or a Chinese-foreign joint venture company.

The principal alternative for private equity and VC investors to investing through an offshore holding company is investing directly in a

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joint venture company. This also creates an FIE, but without the interests of the various equity holders flowing through an offshore holding company that controls the FIE. The economic and governance arrangements agreed among the investors operate at the level of the FIE, rather than through a holding company established outside of China.

There are several reasons for the preference to invest through an offshore holding company. The most important relate to exit. China's domestic stock markets, for all practical purposes, have been closed to FIEs. An FIE seeking to conduct an IPO on an exchange outside of China must go through an arduous governmental approval process. Even if the company succeeds in completing such an "H Share" listing (a listing on a foreign exchange – most typically in Hong Kong – by a company organized in the PRC), the private equity investors will require separate governmental approvals to sell their shares on the market, and may be subject to lengthy lockups. An IPO by a foreign company that controls a business in the PRC is a much simpler process, and the investors' shares will become immediately tradeable following expiration of any contractually agreed lock-up (and, in the US, any required SEC registration).

Trade sales are likewise easier to accomplish through an offshore holding company structure. While sales of direct interests in an FIE require Chinese governmental approval and attract PRC capital gains tax, transfers by foreign investors of shares in a non-PRC holding company requires no government approval, and is not taxable, in China.

Other reasons to prefer the offshore holding company structure are the greater flexibility and enforceability of the shareholder arrangements that are possible through such a structure. PRC corporate law allows a very limited range of capital structures and is not well suited to the type of convertible preferred stock and convertible debt instruments typically used for private equity investments. Highly customized governance arrangements, including extensive minority protections for private equity investors, are also easier to design – and are generally thought more likely to be enforced – through offshore arrangements.

For the foreign investors to get these benefits of an offshore structure in full, all of the owners of the PRC business must own their interests through the offshore holding company. In any event, to get the key advantages, at least a controlling interest must reside in the offshore holding company; otherwise exit through an offshore listing or trade sale would not be practicable. Because foreign private equity and venture capital investment in China almost invariably involves the acquisition of minority stakes by the foreign investors – with the majority remaining in the hands of the management and other existing domestic investors – setting up an offshore holding company structure usually requires a substantial "migration" offshore of domestic investment. It is the ability to accomplish this migration that has been the overwhelming preoccupation of the past year for private equity and venture capital professionals operating in China.

The migration of domestic investment required to establish an offshore holding company is accomplished through mechanisms, such as an exchange of equity in or assets of a domestic enterprise for shares of an offshore company, or sale of equity or assets of a domestic enterprise for cash and investment of that cash in an offshore company, that involve overseas investment by PRC persons. Overseas investment by PRC companies has long required various governmental approvals, including approval of the Ministry of Commerce (MOFCOM). However, before 2005 overseas investment by individuals was not similarly restricted. So long as he or she had a lawful source of foreign exchange funds, a PRC national could invest them outside the PRC without MOFCOM or other special governmental approval.

That all changed after a series of successful IPOs of private equity-backed offshore companies started to make a number of Chinese entrepreneurs very wealthy. This was yet another sign of the natural and healthy development of China's private sector, but it had the effect of crystallizing a diverse set of policy concerns within the PRC government. The result was the double bombshell of State Administration of Foreign Exchange (SAFE) Notices 11 and 29, issued in January and April 2005.

Notices 11 and 29 said, in essence, that if one or more PRC companies or individuals wanted to acquire shares of an offshore company that would own an interest in a PRC business, they would be required to obtain the approval both of MOFCOM, and of SAFE at the central government level. The new requirement for MOFCOM approval of this type of offshore investment by PRC individuals was very daunting — particularly given that it was not accompanied by any application procedures or approval criteria. And like all requirements for approval at the central government level (rather than at the local level, where investors find a friendlier and more responsive attitude), the SAFE approval requirement sent shivers down the spine of the foreign investment community. Notices 11 and 29 amounted to an indefinite moratorium on restructurings to create offshore investment holding company structures, and threw foreign private equity and venture capital investment in China into a tailspin.

What are the policy concerns that so animated SAFE as to bring forth Notices 11 and 29? This has never been articulated in any systematic fashion, and different explanations have been given by different officials at different times. However, the predominant concern seems to be the loss of control in two highly sensitive areas: taxes and the plundering state assets.

Regarding taxes, concern has been expressed that "round trip" investment by PRC nationals allows them to abuse the system of foreign investment incentives by effectively turning domestic investment into foreign investment thereby taking advantage of tax holidays and reductions available only to FIEs. This is, in fact, a legitimate policy concern, but very unconvincing as an explanation of Notices 11 and 29. The "phony joint

venture" problem could have been addressed through a much more focused set of regulations that, by definition, would not have affected transactions involving real foreign investment. The more cogent tax consideration (and certainly the more emotional, since it involves the creation of great individual fortunes rather than the fairly routine gaming of the tax system practiced by a wide range of PRC companies — state-owned enterprises not excluded) is the transfer of assets out of the PRC in a manner that makes it impossible, as a practical matter, to track and tax the proceeds of those assets. Whether profits from overseas share sales or dividends received by PRC nationals from overseas companies are taxed by the PRC has nothing to do with the approval process for overseas investment, but information and control are what make the system work in the real world.

Likewise, the problem of safeguarding state assets goes way beyond the issues addressed in Notices 11 and 29. For reasons ranging from corruption to the fundamentally flawed concepts of valuation that pervade the PRC bureaucracy, state-owned assets regularly pass into private hands for compensation well below their fair value. PRC authorities have not found a way to solve this politically charged problem, but they do not want to exacerbate it by allowing Chinese nationals to move the nominal ownership of assets abroad in a way that makes them even more difficult to track and monitor.

There are other policy concerns as well: the potential drain on foreign exchange from Chinese nationals transferring business profits abroad; money laundering; and the prevention of illegal capital outflows and "hot money" inflows. For the most part, the government's interest seems to be not in stopping "round trip" investment by PRC nationals, but in collecting sufficient information about it to enable tax and other laws to be enforced.

This fact helped when Notices 11 and 29 provoked a storm of criticism. SAFE showed an unusual willingness for a government agency in the PRC (or anywhere else, for that matter) to admit that it had not gotten the recipe quite right, and entered into a constructive dialog with the private equity and venture capital community. The China Venture Capital Association in particular took an active role in educating officials about the industry's concerns and suggesting alternative approaches. In October 2005, SAFE came out with a new notice, Notice 75, which repealed Notices 11 and 29 and laid out a new set of rules that are far less onerous.

Notice 75 governs the establishment or control of offshore "special purpose companies" by PRC residents and the making of "round trip" investments by such companies. A special purpose company (SPC) is defined as an offshore enterprise directly established or indirectly controlled by a domestic resident for purposes of conducting offshore equity or convertible debt financing using the assets or shares of a domestic enterprise.

A round trip investment is defined as direct investment in China by a domestic resident via an SPC. A domestic resident is either a domestic resident legal person (*i.e.*, a company or other organization established under PRC law) or a domestic resident natural person (which includes for purposes of the Notice both PRC citizens and persons "normally resident in China due to economic interests."

"Control," which is an important concept for determining whether an offshore company is an SPC, is defined very broadly as the possession by domestic residents of the right to operate, to receive revenues or to decide the policies of an SPC or domestic enterprise, whether through acquisition, trust, beneficial ownership, voting rights, repurchase rights, convertible bonds or other means. The language could be read to mean that the mere possession by any domestic resident of the right to receive any revenues from an offshore company is sufficient for that company to be considered "controlled" by domestic residents, but such an expansive reach is probably not intended.

Notice 75 has five core provisions. First, it requires that, before a domestic resident may establish or take control of an SPC, the resident must carry out registration procedures at the SAFE branch where he, she or it is located. In connection with these registration procedures, certain information must be provided concerning the SPC, the intended offshore financing, the source of foreign exchange and, where applicable, other required government approvals. The registration must be amended to reflect any material change in the capital of the SPC. The crucial differences between this provision and the requirements of Notices 11 and 29 are that only registration with, not approval by, SAFE is required; for natural persons, MOFCOM approval is not required; and SAFE registration is done at the local level rather than the central level.

Second, Notice 75 requires that when a domestic resident injects assets or equity of a domestic enterprise into an SPC, or when the SPC conducts an offshore financing after such an asset or equity injection, the domestic resident must carry out procedures to amend the SAFE registration. Certain relevant materials must be submitted to SAFE, including information the method of pricing the assets or equity of the domestic enterprise and the SPC and, if state-owned assets are involved, a document from the state-owned assets administrative department confirming the value of the domestic enterprise's assets or equity.

Third, Notice 75 also requires a domestic enterprise that receives a round trip investment or loan from an SPC to carry out foreign exchange registration procedures for that investment, in connection with which the registrations previously made in relation to the SPC will be examined. Failure to carry out these procedures, or defects in the SPC-related registrations, may prevent the SPC from being able to receive foreign exchange distributions or loan repayments from the domestic enterprise.

Fourth, Notice 75 provides that an SPC may keep proceeds of its offshore financing onshore or offshore for use in accordance with its bus-

iness plan, but the profits, dividends, and foreign exchange revenues derived from changes in capital that are received by a domestic resident must be remitted back to the PRC within 180 days.

Finally, Notice 75 provides that if a domestic resident established or took control of an SPC and completed a round trip investment prior to the implementation of the notice, the resident must carry out registration procedures in accordance with the Notice 75 by March 31, 2006. It is not clear how far back into history this provision is supposed to stretch, and many PRC nationals with existing investments will be tempted to ignore it. However, a failure to comply with this requirement may affect the ability of an existing offshore company to conduct an IPO or trade sale in the future.

Private equity and VC processionals can agree on two things about Notice 75: it is a whole lot better than Notices 11 and 29; and we would be happier without any of them. Offshore restructurings in connection with private equity and VC investments are henceforth going to have to flow through SAFE, and we do not yet know what kinds of obstructions they may encounter along the way. Although the distinction between an approval requirement and a registration requirement is quite clear in principle, the two tend to shade into each other in PRC administrative practice. Documentation requirements, procedural delays, even refusals to register on substantive grounds that are nowhere stated in law, may turn a registration process into a proxy for discretionary approval.

It is too early to tell whether this will happen under Notice 75. It takes a while for government agencies to get themselves set up and oriented to handle new procedures like this, and few if any transactions seem to have worked their way through the registration process in the first several months after Notice 75 was promulgated. Some key provisions of Notice 75 are obscure in very important ways, and it is uncertain whether SAFE will adopt a narrow or a broad construction. Clearly, there are valid reasons for the creation of offshore structures, and a strong lobby to champion them, so we can hope for the best.