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Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

Executive Summary

The Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, issued by the former Ministry of Foreign Trade and Economic Cooperation and other agencies on March 7, 2003, broadens the scope of M&A transactions by foreign investors and foreign-invested enterprises in China. They newly legitimize acquisitions of registered capital in limited liability companies, allow acquisitions with shares, allow the capitalization of new FIEs with assets acquired from domestic enterprises, and begin to solve China's "registered capital trap".

The Provisions also establish an anti-monopoly review process for M&A transactions that are perceived to have a potential anti-competitive or market concentration effect. Such review places an additional burden on foreign investors contemplating such transactions, including offshore transactions that fall within the scope of the Provisions, as no comparable review process presently exists for M&A transactions without the presence of foreign investment.

New regulations substantially broaden the scope and clarify procedures governing foreign investment in the People's Republic of China ("China" or the "PRC") through mergers and acquisitions ("M&A"), as opposed to greenfield investments, but also present substantial burdens for foreign investors and foreign companies with extensive business interests in China that contemplate M&A. On March 7, 2003, the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "Provisions") were issued by the former Ministry of Foreign Trade and Economic Cooperation ("MOFTEC"), State Administration of Taxation ("SAT"), State

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Administration for Industry and Commerce ("SAIC") and State Administration of Foreign Exchange ("SAFE"). The Provisions, to take effect on April 12, 2003, broaden the scope of M&A with respect to transactions ("Transactions") in which foreign investors (including foreign-invested holding companies established in China) (a) purchase equity interests in domestic enterprises that are not foreign-invested enterprises ("Domestic Companies"), either from existing shareholders or by purchasing newly issued shares, with the result that the Domestic Company becomes a foreign-invested enterprise ("FIE"); (b) establish FIEs that purchase assets from domestic enterprises;[1] or (c) contribute cash to a new FIE to purchase assets directly from domestic enterprises (apparently including FIEs).

The Provisions do not apply to Transactions with existing FIEs except under (b) above, and thus are intended generally to regulate the creation of FIEs through M&A and asset Transactions only. By contrast, the acquisition by foreign investors of registered capital interests in existing FIEs continues to be governed by the Several Provisions on Changes in Equity Interests of Investors in Foreign Invested (the "Equity Change Provisions") issued by MOFTEC and SAIC on May 28, 1997, and the purchase of equity by foreign investors in companies limited by shares ("CLS") is governed by the Provisional Regulations on Several Issues Concerning the Establishment of Foreign-Invested Companies Limited by Shares (the "FICLS Regulations") issued by MOFTEC on January 10, 1995. However, the Provisions subject Transactions, and transactions covered by the Equity Change Provisions and FICLS Regulations, with a potential impact on competition in China to additional scrutiny. The Provisions also affect overseas M&A transactions that would otherwise have no nexus to China if the foreign parties have investments and/or operations in China that reach specified monetary or market share thresholds.

Background

The Provisions are the latest in a recent series of regulations issued by Chinese government departments that provide a framework for the acquisition by foreigners of interests in existing

[1] As discussed below, the use of the broader term "domestic enterprise" (*jingnei qiye*), which would include FIEs, rather than the defined term "Domestic Company" (*jingnei gongsi*), which excludes them, appears to be deliberate.

Chinese enterprises of various kinds. In September of 2002, the China Securities Regulatory Commission ("CSRC") issued the Measures for the Administration of the Acquisition of Listed Companies, and in November of 2002, the CSRC and the People's Bank of China ("PBOC") jointly issued the Interim Measures on the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors ("QFII Measures"), setting forth for the first time the conditions under which foreign parties may purchase "A" shares. "A" shares are the main type of equity listed on China's stock exchanges, and their purchase had previously been restricted to Chinese nationals.

On November 1, 2002, the CSRC, Ministry of Finance ("MOF") and State Economic and Trade Commission ("SETC"), with State Council approval, issued the Notice Regarding the Transfer to Foreign Investors of State-Owned Shares and Legal Person Shares of Listed Companies. This Notice reversed a 1995 moratorium on such transfers and was a necessary complement to the QFII Measures which applied only to "A" shares that constitute only about 30% of the share capital of listed companies, whereas almost all the rest is in the form of restricted-circulation state-owned and legal person shares.

On November 8, 2002, SETC, MOF, SAIC and SAFE issued the Interim Provisions on Utilizing Foreign Investment to Reorganize State-Owned Enterprises, which for the first time provided a legal basis for the purchase by foreign parties of registered capital interests in an existing domestic limited liability company (*youxian zeren gongsi*). These rules also provided a basis for the direct purchase by foreign investors of the assets of a state-owned enterprise ("SOE") for subsequent injection into an FIE as the foreign party's capital contribution. Prior to the issuance of these rules, while it had been relatively simple for an SOE to contribute its assets into a joint venture with a foreign party in exchange for a registered capital interest, it had been difficult to sell the assets directly for cash.

Finally, in December of 2002, MOFTEC, SAT, SAIC and SAFE jointly issued the Notice on Relevant Issues for Strengthening Management of FIE Approval, Registration, Foreign Exchange and Tax Collection (the "Notice"). The Notice for the first time ruled that enterprises with less than 25% foreign equity interest are nevertheless classified as FIEs requiring approval by the foreign

investment authorities (*i.e.*, MOFTEC and its local counterparts), albeit without eligibility for FIE tax and other preferences. This rule is repeated in Article 5 of the Provisions.

Analysis of the Provisions

In many ways, the Provisions serve as a convenient summary of existing rules regarding the purchase by foreign parties of the assets or equity of domestic entities. They repeat the established rules that Transactions must not result in a violation of the Guidance Catalog for Foreign Investment, and that aggregate foreign investment of less than 25% must still be approved by the foreign investment authorities. They do, however, add significant new content in the form of anti-monopoly measures that may block Transactions likely to impair competition.

Covered Transactions

As noted above, the Provisions apply to the purchase of equity interests as well as asset purchases by foreign investors. Although the Provisions are not clear on this point, an official explanation clarified that the Provisions apply to any target company organized under the Company Law (*i.e.*, limited liability companies ("LLCs") and CLS, including SOEs organized as LLCs or CLS).[2] This appears to be the first official authorization for foreign investment in the economy at large through acquisitions of registered capital in LLCs, although there are many examples of such Transactions. Indeed, the China Insurance Regulatory Commission ("CIRC") and PBOC have approved such Transactions within the insurance and banking industries, respectively.[3]

Article 2 expressly authorizes the capitalization of new FIEs with assets acquired from domestic enterprises, avoiding the need to joint venture with the selling enterprise to acquire or obtain control over the assets.

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2 A news report dated March 25, 2003 indicated that this is indeed the interpretation of the Ministry of Commerce ("MOC"), the successor to MOFTEC and SETC under China's recent government reorganization.

3 CIRC, CSRC and PBOC rather than MOFTEC separately regulate foreign investment in many bank and non-bank financial institutions.

Article 9 par. 5 for the first time allows foreign investors to conduct Transactions through the use of shares as consideration, subject to the approval of the foreign exchange administration department. As such Transactions constitute overseas investments from the perspective of the merged or selling enterprise (*i.e.*, a PRC-domiciled entity will come to own securities in an overseas-domiciled issuer), Transactions involving shares as consideration may also require the approval of the State Development and Reform Commission and State Council.

Creditors' Rights

In accordance with M&A convention, Article 7 provides that an equity Transaction does not affect the debts and creditors' rights of a domestic enterprise, *i.e.*, such debts and creditors' rights remain with the enterprise after conversion to an FIE. By contrast, the selling domestic enterprise retains its debts and creditors' rights under an asset purchase Transaction, *i.e.*, the FIE does not assume such obligations or rights.

The parties to the Transaction, creditors and other unspecified parties are nevertheless authorized to enter into separate contractual arrangements regarding the disposition of the obligations and creditors' rights of the merged or acquired domestic enterprise. To enable creditors to exercise such rights, the seller of assets must provide notice to creditors of the Transaction within 10 days, and creditors then have an additional 10 days to request that the seller provide appropriate security. This rule applies even if the selling enterprise is not in bankruptcy proceedings or the value of the sale is not material to the selling enterprise. Intended to prevent harm to creditors from Transactions,[4] most likely asset-stripping by the management of the selling enterprise, Article 7 grants creditors a right to demand security which they may not have originally negotiated. This threatens to impose a substantial procedural and financial impediment to asset acquisitions by foreign investors and FIEs.

[4] No. 7 of a set of question and answers published on March 31, 2003 explains this purpose.

Pricing

Article 8 provides that all Transactions *must* be priced on the basis of an appraisal by an asset appraisal agency in accordance with an internationally recognized appraisal method, and prices "clearly lower" than appraised value are prohibited. It is unclear how flexible the appraised value may be relative to the value of registered capital, but the appraisal requirement is intended to prevent offshore side payments in contravention of foreign exchange controls. It is noteworthy that the parties "may", but seemingly need not, use a certified Chinese asset approval agency. However, any Transaction involving state-owned assets remains subject to a state-owned assets appraisal process which may become even more uniform and rigorous following the recent creation of the State Asset Management Commission.

Timing of Payments and Capital Contributions

Article 9 addresses the timing of purchase price payments and capital contributions but is by no means easy to understand. The general rule for purchases of equity or of assets is that the purchaser must pay the seller within three months after issuance of the business license of the FIE created as part of the equity or asset purchase Transaction. An extension may be granted with approval; if so, 60% of the total consideration must be paid within six months after issuance of the business license, and the full amount within one year. The Provisions mimic an earlier regulation[5] in providing that profits shall be distributed in accordance with actual, not promised, contribution ratios, but drop the earlier regulation's unworkable rule that purchasers of a controlling interest could not exercise control consistent with the subscribed-for or contracted-for equity interest until the full purchase price was paid.

When the Transaction involves an equity purchase with a subsequent contribution of additional capital into the purchased enterprise (now transformed into an FIE) by the foreign investor, such capital contribution must be made within six months after issuance of the FIE's business license if it is to be in a single lump-sum payment. When the additional capital

contribution is to be in installments, the first installment must be made within three months after issuance of the FIE's business license, and must be at least 15% of the total planned increase. These rules mimic those for original capital contributions to joint ventures set forth in the Several Provisions on Contributions of Capital by Parties to Chinese-Foreign Equity Joint Ventures (the "Contribution Provisions").[6] Like the Contribution Provisions, the Provisions seem to overlook the issue of deadlines for subsequent installments. Apparently this is a matter for the parties to settle by contract.

When an FIE is created by M&A but aggregate foreign investment is less than 25%, investments must be contributed in full within three months if in cash and six months if in kind.

When the Transaction involves an asset purchase, the purchaser must contribute an amount equal to the price of the assets into the FIE within the standard three-month period (subject to the possible extension discussed above).[7] Any additional capitalization of the FIE in such circumstances is treated like a capital increase following an equity Transaction (discussed in the preceding paragraph).

Registered Capital Share

Chinese foreign investment laws and regulations have for some time presented what is known as the "registered capital trap." Such laws and regulations require that profits be distributed in accordance with the investor's share of registered capital (equivalent to the GAAP concept of stated capital), but require at the same time that every dollar or yuan of registered capital have an equal value, regardless of when contributed or what the actual value of the company was on the date of contribution. Thus, if a Chinese-foreign equity joint venture was originally capitalized at US$10 million, with US$5 million contributed by each of a Chinese party and a foreign party, a further US$5 million capital contribution ten years later is entitled to a one-third share of the equity

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5 The Supplementary Rules to the Several Provisions on Contributions of Capital by Parties to Chinese-Foreign Equity Joint Ventures, issued by MOFTEC and SAIC in November 1997.

6 Issued by MOFTEC and SAIC in 1988.

7 No. 9 of the March 31, 2003 set of questions and answers.

and profits even if the going concern value of the joint venture is much higher, no matter what the parties might otherwise wish to agree.

The "trap" impedes capital formation and disadvantages early investors. Investors often escape this trap with respect to equity Transactions through buyout clauses, but such clauses are not necessarily easy to negotiate.

Article 10 deals with this obstacle by providing that while further capital contributions shall simply be added to existing registered capital on a dollar-for-dollar basis, the share of all investors in the registered capital – in other words, simply their equity share in the company – shall be adjusted on the basis of the appraised value of the company's assets. Although the meaning of the clause is not absolutely clear, the intention seems to be to allow the parties to negotiate the value of their respective equity shares, instead of having the law impose an unrealistic solution.

Ratio of Registered Capital to Total Investment

Article 11 sets forth permissible ratios of registered capital to total investment. This Article mimics in principle the Interim Provisions on the Ratio Between Registered Capital and Total Amount of Investment in Chinese-Foreign Equity Joint Ventures (the "Ratio Provisions")[8] although the amounts in question have been lowered (in other words, the permissible amount of leverage has increased). The rules are as follows:

(1) if registered capital is US$2.1 million or less,[9] the total amount of investment shall not exceed 10/7 of registered capital;

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[8] Issued by SAIC in 1987.

[9] The Provisions, and Chinese legal discourse in general, are still unfortunately bedeviled by the frequent use of the ambiguous terms "*yishang*" (sometimes "at least" and sometimes "greater than") and "*yixia*" (sometimes "… and under" and sometimes "less than"). "*Yishang*", used frequently in Article 11, usually means "at least" and includes the relevant number. Chinese legal scholars often point to Article 155 of the General Principles of Civil Law ("GPCL") as the source of this principle, even though that Article by its terms applies only to the GPCL and to no other piece of legislation. Here, however, we believe that "*yishang*" does *not* include the relevant number and is appropriately translated as "more than". The structure of Article 11 duplicates that of the 1987 Ratio Provisions, which were worded slightly differently so as to be unambiguous on this particular issue. While the absolute value of the thresholds may have changed, there is no reason to think that the way of understanding the thresholds has changed.

(2) if registered capital is greater than US$2.1 million and not greater than US$5 million, the total amount of investment shall not exceed two times registered capital;

(3) if registered capital is greater than US$5 million but not greater than US$12 million, the total amount of investment shall not exceed 2½ times registered capital; and

(4) if registered capital is greater than US$12 million, the total amount of investment shall not exceed three times registered capital.

Application, Examination and Approval Procedures

Articles 12-18 specify the application, examination and approval procedures for Transactions. Articles 12(9) and 15(8) require resettlement plans for employees of the merged or selling enterprise, which indicates that the acquirer has an obligation with respect to employees of the acquiree. Article 17 specifies that the examination and approval authority must decide whether to approve an application within 30 days after submission of a complete application. Such 30-day period begins after the creditors' notice and action periods for asset purchase Transactions discussed above. The 30-day period is shorter than the 45-day period for ordinary *de novo* FIEs. However, Transactions with potential anti-competitive effects are subject to much more stringent examination as discussed below.

Anti-Monopoly Implications

Article 3 states that Transactions must not "cause excessive concentration, eliminate or restrict competition, disrupt the social and economic order or damage the interests of society and the public". In addition to the standard examination and approval procedures for all Transactions, Article 19 requires that a foreign investor report to MOFTEC and SAIC if a Transaction implicates any of the following circumstances:

(1) a party to the Transaction has operational revenues of more than RMB1.5 billion in the "China market" during that year;

(2) the aggregate number of domestic enterprises subject to a Transaction in the related industry in a year is more than ten;

(3) the market share in China of a party to the Transaction has reached 20%; or

(4) the market share in China of a party to the Transaction reaches 25% as a result of such Transaction.

Article 19 expressly provides that the term "party" to a Transaction includes a foreign investor's affiliates. It is unclear whether a "party" also includes Chinese parties to the Transaction and/or the target itself, but that appears to be so.

Even if a transaction does not implicate any of the above four sets of circumstances, it may still be subject to anti-monopoly review. If MOFTEC or SAIC believe that a Transaction implicated by Article 19 may result in excessive market concentration, harm to legitimate competition or damage to consumer interests, they have the discretion within 90 days under Article 20 to call hearings involving relevant departments, institutions, enterprises and other interested parties, and may disapprove the Transaction on the basis of such hearings.

The review process lacks any clear grounding in market analysis beyond treating market share as tantamount to market power. It is aggravated by the absence of any criteria to define "market". It appears to treat China as a unified market rather than an assemblage of regional markets, and ignores potential substitution effects. In addition, the length of the review process alone may be sufficient to discourage investors from engaging in many Transactions.

The value criterion in (1) and the number of Transactions criterion in (2) are even more problematic because they are only indirectly related to market concentration. Indeed, neither (1) nor (2) differentiates between parties with a single product or operating in a single product industry from parties with multiple products or operating in multiple industries.

Especially noteworthy is the requirement in Article 21 that a party to an *overseas* M&A transaction (*i.e.*, a merger or acquisition not involving domestic enterprises or assets) implicating

any of the following circumstances must submit the transaction plan to MOFTEC and SAIC for approval prior to publicly announcing the transaction, or concurrently with submission to the competent authority in the country where the transaction will take place:

(1) a party to the overseas transaction owns assets inside China of RMB3 billion or more;

(2) a party to the overseas transaction has operational revenues in the Chinese market of RMB1.5 billion or more for that year;

(3) the market share in China of a party to the overseas transaction together with its affiliates has reached 20%;

(4) the market share in China of a party to the overseas transaction together with its affiliates reaches 25% as a result of such overseas transaction; or

(5) the overseas transaction will cause a party to participate, directly or indirectly, in the equity of more than 15 FIEs in the same domestic industry.

The value criteria in (1) and (2) and the number of FIEs criterion in (5) are particularly problematic, like their counterparts in Article 19, because they appear to be directed solely at size and amount of business rather than market concentration.

Waivers are available under Article 22 if a party can demonstrate that a Transaction or overseas M&A transaction will improve market competition conditions, restructure a deficit-ridden enterprise and ensure employment, introduce advanced technology and managerial talent and enhance the enterprise's international competitiveness, or has the potential to improve the environment. However, regardless of whether a waiver is available, the burden of the application process may discourage investors from engaging in Transactions or overseas M&A transactions.

Because most financial institutions fall outside MOFTEC's jurisdiction, it is unlikely that the Provisions will govern such industries. The Provisions are, however, sweeping in their scope, and foreign investors contemplating M&A transactions in industries governed by the Provisions,

regardless of whether such transactions take place within the PRC or overseas – will need to assess carefully the impact of the Provisions' anti-monopoly measures. Additional anti-monopoly legislation, especially the Anti-Monopoly Law of the PRC, is reportedly of high priority and is expected to become law in the near future.

Conclusion

The Provisions broaden the scope and clarify M&A procedures for foreign investors in China. They legitimize Transactions involving LLCs, authorize the use of shares as consideration, authorize the capitalization of new FIEs with assets acquired from domestic enterprises, and set tight examination and approval time limits in most instances. However, the additional rights provided to creditors may impede asset purchase Transactions.

The anti-monopoly provisions are most problematic. In particular, for the purpose of combating market concentration, they threaten to burden foreign investors contemplating Transactions in China, and even to reach overseas M&A transactions by companies with extensive business interests in China. This creates a disproportionate impact on foreign companies who may be subjected to lengthy and vague review processes. The timing of promulgation is particularly curious as the Provisions precede a proposed Anti-Monopoly Law of general application, which is still in draft and is expected to authorize creation of a specialized anti-monopoly body with authority over all transactions that may affect market concentration, including those without foreign investment. This creates a potential conflict between the review process established under the Provisions with that to be created under the Anti-Monopoly Law.

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Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

Order of the Ministry of Foreign Trade and Economic Cooperation, the State Administration of Taxation, the State Administration for Industry and Commerce and the State Administration of Foreign Exchange

Order No. 3 of 2003

The Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors were examined and adopted at the first ministerial meeting of the Ministry of Foreign Trade and Economic Cooperation of the People's Republic of China on January 2, 2003. The Provisions are hereby promulgated and shall be implemented as of April 12, 2003.

Ministry of Foreign Trade and Economic Cooperation
State Administration of Taxation
State Administration for Industry and Commerce
State Administration of Foreign Exchange

March 7, 2003

Article 1. In accordance with laws and administrative regulations on foreign invested enterprises and other relevant laws and administrative regulations, these Provisions are formulated to promote and standardize investment in China by foreign investors, introduce advanced foreign technology and management experience, improve the utilization of foreign investment, implement the rational allocation of resources, ensure employment, and safeguard fair competition and the safety of the national economy.

Article 2. For the purposes of these Provisions "mergers and acquisitions of domestic enterprises by foreign investors" refers to the agreed purchase by foreign investors of equity interests from shareholders of non-foreign invested enterprises ("Domestic Companies") or subscription by foreign investors for increased capital of Domestic Companies, with the result that such Domestic Companies become foreign invested enterprises ("Equity Mergers and Acquisitions"); or the agreed purchase and operation of assets of domestic enterprises[1] by foreign invested enterprises established by foreign investors, or the agreed purchase of assets of domestic enterprises by foreign investors who use such assets to invest in the establishment of a foreign invested enterprise which operates such assets ("Asset Mergers and Acquisitions").

Article 3. When merging with or acquiring domestic enterprises, foreign investors shall comply with the laws, administrative regulations and departmental rules of the PRC

[1] Translation note: it is assumed that the use of the term "domestic enterprises" (*guonei qiye*) rather than "Domestic Companies" (*guonei gongsi*), which is defined earlier in the sentence, is deliberate.

and adhere to the principles of fairness, reasonableness, compensation for equal value and honesty and good faith, and they shall not cause excessive concentration, eliminate or restrict competition, disrupt the social and economic order or damage the interests of society and the public.

Article 4. When merging with or acquiring domestic enterprises, foreign investors shall comply with the requirements regarding the qualifications of investors and industrial policies as set forth in the laws, administrative regulations and departmental rules of the PRC.

With respect to those industries for which wholly foreign investment is prohibited under the Catalogue Guiding Foreign Investment in Industries, mergers and acquisitions shall not result in the ownership of all of an enterprise's equity interests by foreign investors. With respect to those industries for which the Chinese parties are required to hold the controlling position or the equivalent to the controlling position, Chinese parties shall maintain the controlling position or such equivalent to the controlling position following mergers or acquisitions of enterprises in such industries. With respect to those industries in which foreign investors are prohibited from operating, foreign investors must not merge with or acquire enterprises in such industries.

Article 5. When foreign investors establish foreign invested enterprises through the merger or acquisition of domestic enterprises, they shall obtain the approval of the examination and approval authority and handle the registration of the conversion or establishment with the registration administration authority in accordance with these Provisions. The proportion of registered capital contributed by foreign investors in a foreign invested enterprise established following a merger or acquisition shall generally not be less than 25%. Except as otherwise provided by laws and administrative regulations, if the proportion contributed by foreign investors is less than 25%, examination, approval and registration shall be handled in accordance with the current examination, approval and registration procedures for establishing foreign invested enterprises. When issuing the foreign invested enterprise approval certificates, the examination and approval authority shall add a notation that "the proportion of foreign investment is less than 25%". When issuing the foreign invested enterprise business licenses, the registration administration authority shall add a notation that "the proportion of foreign investment is less than 25%."

Article 6. The examination and approval authority referred to in these Provisions is the Ministry of Foreign Trade and Economic Cooperation of the People's Republic of China ("MOFTEC") or the competent province-level authority for foreign trade and economic cooperation ("Provincial COFTEC"), and the registration administration authority is the State Administration for Industry and Commerce ("SAIC") or the local administrative authority for industry and commerce authorized by SAIC.

If, in accordance with the provisions of laws, administrative regulations and departmental rules, a foreign invested enterprise established after a merger or acquisition falls into a specific category or industry for which foreign invested enterprises must be examined and approved by MOFTEC, Provincial COFTEC shall submit the application documents to MOFTEC, and MOFTEC shall approve or disapprove the application in accordance with the law.

Article 7. For Equity Mergers and Acquisitions conducted by foreign investors, foreign invested enterprises established after the merger or acquisition shall succeed to the obligations and creditors' rights of the merged or acquired Domestic Company.

For Asset Mergers and Acquisitions conducted by foreign investors, the domestic enterprises selling the assets shall bear their original obligations and creditors' rights.

The foreign investor, domestic enterprise being merged or acquired, creditors and other parties may enter into separate agreements regarding the disposition of obligations and creditors' rights of the domestic enterprise that is being merged or acquired. However, such agreements must not harm the interests of any third parties, society or the public. Agreements regarding the disposition of obligations and creditors' rights shall be filed with the examination and approval authority.

A domestic enterprise that is selling assets shall notify its creditors within 10 days after it has made the decision to sell the assets, and issue a public announcement in nationally-circulated newspapers at the province level or above. Creditors shall have the right for 10 days from the date of receipt of such notice or the publication of such public announcement to request that the domestic enterprise that is selling the assets provide relevant guarantees.

Article 8. Parties to a merger or acquisition shall use the results of an asset appraisal agency's appraisal of the value of the equity interests to be transferred or the assets to be sold as the basis for determining the transaction price. The parties to the merger or acquisition may agree on an asset appraisal agency established in China in accordance with the law. The assets shall be appraised by adopting an internationally recognized appraisal method.

Where the merger or acquisition of a domestic enterprise by a foreign investor will lead to a change in an equity interest for which the form of investment comprises State-owned assets or a transfer of State-owned property rights, appraisal shall be carried out and the transaction price determined in accordance with the relevant provisions on the administration of State-owned assets.

It is prohibited to transfer equity interests or sell assets at prices clearly lower than the appraisal results, as this is a disguised transfer of capital out of China.

Article 9. With respect to a foreign investor's establishment of a foreign invested enterprise through the merger or acquisition of a domestic enterprise, the foreign investor shall, within three months from the date of issuance of the foreign invested enterprise business license, pay consideration in full to the shareholders transferring equity interests or the domestic enterprise selling assets. Where an extension is required due to special circumstances, upon the approval of the examination and approval authority, 60% or more of the total consideration shall be paid within six months from the date of issuance of the foreign invested enterprise business license, with full consideration to be paid within one year, and distributions of profits shall be made in proportion to the actual contribution ratios.

Where a foreign investor conducts an Equity Merger and Acquisition in which the foreign invested enterprise established after the merger and acquisition increases its investment, the investor shall set out the deadlines for contribution of investment in the contract and articles of association of the proposed converted foreign invested enterprise. If it is stipulated that the contribution shall be fully paid in one lump sum, the investor shall make the contribution in full within six months from the date of issuance of the foreign invested enterprise business license. If it is stipulated that the contribution shall be made in installments, the investors' first contribution installment shall not be less than 15% of their respective subscribed amounts of contribution, and

shall be paid in full within three months from the date of issuance of the foreign invested enterprise business license.

Where a foreign investor conducts an Asset Merger and Acquisition, the investor shall set out the deadlines for contribution of investment in the contract and articles of association of the proposed foreign invested enterprise. Where a foreign invested enterprise is established, and agreement is reached regarding the purchase and operation of the assets of a domestic enterprise through such foreign invested enterprise, the investors shall, within the deadlines for payment of consideration specified in the first paragraph of this Article, contribute that portion of the investment which is equivalent to the price of the assets. The deadline for contribution of the remaining investment shall be agreed in accordance with the method specified in the second paragraph of this Article.

Where foreign investors establish foreign invested enterprises through the merger or acquisition of domestic enterprises, if the proportion of investment contributed by foreign investors is less than 25% and the contributions are made in the form of cash, the investors shall contribute their investments in full within three months from the date of issuance of the foreign invested enterprise business license. If investors contribute in-kind, industrial property rights, etc. investments, they shall contribute their investments in full within six months from the date of issuance of the foreign invested enterprise business license.

The methods for payment of consideration shall comply with the relevant laws and administrative laws and regulations of the State. Foreign investors who use as their method of payment shares for which they possess the right of disposition or Renminbi assets which they legally possess must go through examination and approval by the foreign exchange administrative department.

Article 10. Where a foreign investor agrees to purchase the equity interest of a shareholder of a Domestic Company, after the Domestic Company has been converted into and established as a foreign invested enterprise, the registered capital of such foreign invested enterprise shall be the same as that of the former Domestic Company, and the foreign investor's investment proportion shall be the proportion that the equity interest it has purchased bears to the original registered capital. Where there is a concurrent increase in investment of a Domestic Company that is being merged or acquired, the registered capital of the post-merger and acquisition foreign invested enterprise shall be the sum of the registered capital of the former Domestic Company plus the increased investment. On the basis of an appraisal of the Domestic Company's assets, the foreign investor and the other original investors of the Domestic Company being merged or acquired shall determine their respective investment ratios with respect to the registered capital of the foreign invested enterprise.

If a foreign investor subscribes for increased investment in a Domestic Company and the Domestic Company is converted into and established as a foreign invested enterprise, the registered capital of such foreign invested enterprise shall be the sum of the registered capital of the former Domestic Company plus the increased investment. On the basis of an appraisal of the Domestic Company's assets, the foreign investor and the other original investors of the Domestic Company being merged or acquired shall determine their respective investment ratios with respect to the registered capital of the foreign invested enterprise.

For Equity Mergers and Acquisitions of Domestic Companies, Chinese natural persons who are shareholders in the former company and have enjoyed shareholder status for one year or more may, with approval, continue to be Chinese party investors in the foreign invested enterprise established following the conversion.

Article 11. Where there are Equity Mergers and Acquisitions by foreign investors, the ceiling for the total amount of investment of a foreign invested enterprise established following a merger and acquisition shall be determined in accordance with the following proportions:

(1) if registered capital is US$2.1 million or less,[2] the total amount of investment shall not exceed 10/7 of the registered capital;

(2) if registered capital is greater than US$2.1 million but not greater than US$5 million, the total amount of investment shall not exceed two times the registered capital;

(3) if registered capital is greater than US$5 million but not greater than US$12 million, the total amount of investment shall not exceed 2½ times the registered capital;

(4) if registered capital is greater than US$12 million, the total amount of investment shall not exceed three times the registered capital.

Article 12. Where there are Equity Mergers and Acquisitions by foreign investors, the investors shall, based on the total amount of investment of the foreign invested enterprise to be established following the merger and acquisition, submit the following documents to the examination and approval authority of corresponding competence:

(1) for domestic limited liability companies which are being merged or acquired, a shareholders resolution unanimously approving the Equity Merger and Acquisition by foreign investors, or for domestic companies limited by shares which are being merged or acquired, a resolution adopted in a shareholders' general meeting approving the Equity Merger and Acquisition by foreign investors;

(2) application of the Domestic Company being merged or acquired to lawfully convert into and be established as a foreign invested enterprise;

(3) contract and articles of association of the foreign invested enterprise to be established following the merger and acquisition;

(4) agreement for the purchase of shareholders' equity interests or subscription for increased capital of the Domestic Company by the foreign investor;

(5) financial audit reports for the most recent fiscal year of the Domestic Company being merged or acquired;

(6) documents evidencing the investor's identity and commencement of business, and establishing its creditworthiness;

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[2] Translation note: the term "*yixia*" is ambiguous here – it may be interpreted as "US$2.1 million or less" (*i.e.,* including US$2.1 million) or "less than US$2.1 million" (*i.e.,* excluding US$2.1 million). Similar ambiguity is presented by the term "*yishang*", which is used in clauses (2), (3) and (4) of Article 11, and may be interpreted as "XX or more" (*i.e.,* including XX) or "more than XX" (*i.e.,* excluding XX). This translation reflects our assessment of the drafters' intentions, based on previous similar regulations.

(7) explanation of the situation regarding invested enterprises of the Domestic Company being merged or acquired;

(8) business licenses (duplicates) of the Domestic Company being merged or acquired and its invested enterprises;

(9) resettlement plan for staff and workers of the Domestic Company being merged or acquired;

(10) documents required to be submitted under Articles 7 and 19 of these Provisions.

If the business scope, scale or acquisition of land use rights of the foreign invested enterprise to be established following a merger and acquisition are implicated by permits from other relevant government authorities, documents relating to such permits shall also be submitted.

The business scope of original invested enterprises of Domestic Companies undergoing merger or acquisition shall comply with the requirements of the relevant policies of foreign investment in industries. Any non-compliance shall be adjusted.

Article 13. Equity interest purchase agreements and agreements for increased capital of a Domestic Company as stipulated in Article 12 shall be governed by Chinese law, and shall include the following major particulars:

(1) information regarding the parties to the agreement, including their names and domiciles, names, titles and nationality of legal representatives, etc.;

(2) portions and prices of the equity being purchased or the increased investment being subscribed;

(3) agreement term and method of performance;

(4) rights and obligations of the parties to the agreement;

(5) liability for breach of contract, settlement of disputes;

(6) time and location of execution of the agreement.

Article 14. Where there are Asset Mergers and Acquisitions by foreign investors, the total amount of investment of the foreign invested enterprise proposed to be established shall be determined based on the transaction price of the assets to be purchased and the scale of actual production and operations. The proportion of registered capital to total amount of investment of the foreign invested enterprise to be established shall comply with relevant regulations.

Article 15. Where there are Asset Mergers and Acquisitions by foreign investors, the investors shall, in accordance with the provisions of laws, administrative regulations and departmental rules related to the establishment of foreign invested enterprises, submit the following documents to the examination and approval authority of corresponding competence, with reference to the total amount of investment, type of enterprise and industry of the foreign invested enterprise to be established:

(1) resolution of titleholders to the property rights of the domestic enterprise or of the agency of authority approving the sale of assets;

(2) application to establish a foreign invested enterprise;

(3) contract and articles of association of the foreign invested enterprise to be established;

(4) asset purchase agreement executed by the foreign invested enterprise to be established and the domestic enterprise, or asset purchase agreement executed by the foreign investor and the domestic enterprise;

(5) articles of association and business license (duplicate) of the domestic enterprise being merged or acquired;

(6) evidence that the domestic enterprise being merged or acquired has notified and made announcements to creditors;

(7) documents evidencing the investor's identity and commencement of business, and establishing its creditworthiness;

(8) resettlement plan for staff and workers of the domestic enterprise being merged or acquired;

(9) documents required to be submitted under Articles 7 and 19 of these Provisions.

If the business scope, scale or acquisition of land use rights of the foreign invested enterprise to be established following a merger and acquisition are implicated by permits from other relevant government authorities, documents relating to such permits shall also be submitted.

If, in accordance with the preceding clause, the purchase and operation of assets of the domestic enterprise are implicated by permits from other relevant government authorities, documents relating to such permits shall also be submitted.

Where foreign investors agree to purchase the assets of domestic enterprises and use such assets to invest in the establishment of foreign invested enterprises, such assets shall not be used to carry out operational activities prior to the establishment of the foreign invested enterprises.

Article 16. Asset purchase agreements as stipulated in Article 15 shall be governed by Chinese law, and shall include the following major particulars:

(1) natural status of the parties to the agreements, including names and domiciles, names, titles and nationality of legal representatives, etc.;

(2) inventory and price of the assets to be purchased;

(3) agreement term and method of performance;

(4) rights and obligations of the parties to the agreement;

(5) liability for breach of contract, settlement of disputes;

(6) time and location of execution of the agreement.

Article 17. Except as otherwise provided in Article 20 hereof, where foreign investors establish foreign invested enterprises through mergers and acquisitions of domestic enterprises, the examination and approval authority shall determine whether to approve or disapprove the application in accordance with law within thirty days from the date of receipt of all documents required to be submitted. If approval is granted, the examination and approval authority shall issue a foreign invested enterprise approval certificate.

Where a foreign investor agrees to purchase shareholder interests in a Domestic Company and the examination and approval authority decides to grant the approval, the examination and approval authority shall concurrently copy the relevant approval documents to the foreign exchange administration authorities of the places where the parties transferring the shareholder interests and the Domestic Company are located. The foreign exchange administration authority of the place where a party transferring a shareholder interest is located shall handle the foreign investment and foreign exchange registration procedures related to the receipt of foreign exchange by such transferor and issue a foreign investment and foreign exchange registration certificate certifying the full payment of consideration for the Equity Merger and Acquisition by a foreign investor.

Article 18. Where there are Asset Mergers and Acquisitions by foreign investors, within thirty days after the date of receipt of the approval certificate for foreign invested enterprises, the investors shall apply to the registration administration authority for registration and obtain a foreign invested enterprise business license.

Where there are Equity Mergers and Acquisitions by foreign investors, the Domestic Company being merged or acquired shall, in accordance with these Provisions, apply to the original registration administration authority to change its registration and obtain a foreign invested enterprise business license. If the original registration administration authority does not have registration jurisdiction, it shall, within ten days from the date of receipt of the application documents, transfer to the registration administration authority with jurisdiction the application documents, attaching the registration file of the Domestic Company. When a Domestic Company being merged or acquired applies to change its registration, it shall submit the following documents, and shall be responsible for their truthfulness and validity:

(1) application for the change of registration;

(2) shareholders' meeting (general meeting) resolution regarding the equity transfer or increase in capital adopted by the Domestic Company in accordance with the Company Law of the People's Republic of China and the Articles of Association;

(3) agreement for a foreign investor's purchase of shareholders' interests in a Domestic Company or subscription for increased capital in a Domestic Company;

(4) amended company articles of association or an agreement to amend the original articles of association, and foreign invested enterprise contract required to be submitted in accordance with law;

(5) approval certificate for foreign invested enterprises;

(6) documents evidencing the foreign investor's identity and commencement of business, and establishing its creditworthiness;

(7) amended list of directors, documents setting forth the names and residences of new directors and documents appointing new directors;

(8) other relevant documents and certificates as stipulated by SAIC.

For transfers of State-owned equity interests or subscriptions by foreign investors for increased capital in companies having State-owned equity interests, approval documents from the competent economic and trade departments shall also be submitted.

Within thirty days from the date of issuance of the foreign invested enterprise business license, the investors shall handle registration procedures with the relevant authorities, such as tax, customs, land administration, foreign exchange control, etc.

Article 19. Where the merger or acquisition of a domestic enterprise by a foreign investor implicates any of the following circumstances, the investor shall report such circumstances to MOFTEC and SAIC:

(1) a party to the merger or acquisition has operational revenues in excess of RMB1.5 billion in the China market for that year;

(2) the aggregate number of domestic enterprises being merged or acquired in the related industry in one year exceeds ten;

(3) the market share in China of a party to the merger or acquisition has reached 20%; or

(4) the market share in China of a party to a merger or acquisition reaches 25% as a result of such merger or acquisition.

In the absence of any of the conditions set forth in the preceding paragraph, a foreign investor may be required to make a report upon the request of competitive domestic enterprises, relevant departments or industrial associations, or if MOFTEC or SAIC believes that the merger or acquisition by the foreign investor involves a significant market share, or if other important factors exist which seriously impact market competition, the national economy and people's livelihood or State economic security, etc.

A party to a merger and acquisition includes a foreign investor's affiliates.

Article 20. Where the merger or acquisition of a domestic enterprise by a foreign investor involves one of the circumstances described in Article 19, if MOFTEC and SAIC believe that this could result in excessive market concentration, harm to legitimate competition or damage to consumer interests, they shall jointly or, after consultation, individually call relevant departments, institutions, enterprises and other interested parties for hearings within ninety days from the date of receipt of all documents required to be submitted and make a decision of approval or disapproval in accordance with laws.

Article 21. Where one of the following circumstances is implicated by overseas mergers or acquisitions, a party to the merger or acquisition shall file the transaction plan with MOFTEC and SAIC prior to publicly announcing the merger or acquisition or concurrently with submission to the competent authority in the relevant country. MOFTEC and SAIC shall examine whether circumstances exist which would cause excessive concentration in the domestic

market, harm to domestic legitimate competition or damage to domestic consumer interests, and decide whether or not to approve.

(1) A party to the overseas merger or acquisition owns assets inside China of RMB3 billion or more;

(2) a party to the overseas merger or acquisition has operational revenues in the Chinese market of RMB1.5 billion or more for that year;

(3) the market share in China of a party to the overseas merger or acquisition together with its affiliates has reached 20%;

(4) the market share in China of a party to the overseas merger or acquisition together with its affiliates reaches 25% as a result of such overseas merger or acquisition;

(5) the overseas merger or acquisition will cause a party to participate, directly or indirectly, in the equity of more than fifteen foreign invested enterprises in the same domestic industry.

Article 22. Where a merger or acquisition implicates one of the following circumstances, a party to the merger or acquisition may apply to MOFTEC and SAIC for exemption from examination and approval:

(1) it may improve conditions for fair market competition;

(2) restructure a failing enterprise and ensure employment;

(3) introduce advanced technology and management talent, and improve an enterprise's international competitive edge;

(4) it may improve the environment.

Article 23. When submitting documents, an investor shall categorize the documents as required and attach a document index. All documents required to be submitted shall be written in Chinese.

Article 24. These Provisions shall govern mergers and acquisitions of domestic enterprises by companies of an investment nature lawfully established by foreign investors in the PRC.

Equity Mergers and Acquisitions of domestic foreign invested enterprises by foreign investors shall be governed by current laws and administrative regulations on foreign invested enterprises and the Several Provisions on Changes in Equity Interests of Investors in Foreign Invested Enterprises; matters not covered therein shall be handled in accordance with these Provisions.

Article 25. Mergers and acquisitions of enterprises in other regions [of China] by investors from the Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan region shall be handled with reference to these Provisions.

Article 26. These Provisions shall come into force as of April 12, 2003.