COUNTRY COMPARATIVE GUIDES 2021

The Legal 500 Country Comparative Guides

China

PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in China.

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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

In 2019, Chinese market remained to be a popular destination for investment of financial sponsors. The M&A 2019 Review from PwC shows that the aggregate deal value of financial sponsors reached US$ 208.9 billion in the year of 2019, which involved 4,134 deals . That means, 46.55% of all M&A transactions (constituting 41.60% of the aggregate deal value of the M&A transactions in 2019) were closed by financial sponsors and the remaining 53.45% of all M&A transactions (constituting 58.40% of the aggregate deal value of the M&A transactions in 2019) were closed by strategic buyers. In 2020, due to the COVID-19 pandemic and the economic and market uncertainty caused thereby, the global deal market has been turbulent, but according to the statistical analysis from White & Case, the second quarter of 2020 has already witnessed a remarkable recovery for M&A transactions of financial sponsors in China.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

One of the main differences between a financial sponsor and a trade seller is the degree of participation in the target company's operation, where the trade seller (or the founder) is relatively much more active in operating the company. Therefore, when a purchaser purchases shares from, for example, a founder of the target company, it would expect the founder to make broad representations and warranties related to the target company's business and operation. Such representations and warranties on the operation of the target company would normally include due authorization and capacity, the full, complete and accurate disclosure of the legal, business and financial due diligence materials, compliance with applicable law, and timely payment of relevant taxes, etc. On the other hand, financial sponsors, who normally don't participate in the daily operation of the company, are usually willing to make only limited representations and warranties, e.g., their capacity to enter into the deal, and clean title to the shares to be sold. Correspondingly, the indemnification obligation and liability cap that a financial sponsor is willing to bear thereunder is also much more limited than a trade seller. Financial sponsors are less likely to commit to an indemnity obligation for a long time because, for example, a fund has a life of 8 to 10 years only. Moreover, where a trade seller has more than one businesses and some of which are horizontally related (for example, on the different levels of the same supply chain), the M&A terms may also address the business relationships among the related companies, given the change of the ownership and control of one of them.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The transfer of shares by foreign investors will become effective once parties register with the State Administration for Market Regulation ("SAMR") and report the relevant changes via the local enterprise registration system, as long as the target business does not fall under a list specified in the Special Administrative Measures for Foreign Investment Access by the Ministry of Commerce ("MOFCOM") and the National Development and Reform Commission (as amended from time to time, the " Negative List"). Otherwise, pre-approval or special permit from the MOFCOM shall be obtained before any transaction taking place. On the other hand, acquiring shares from public listed company through secondary market involves registration with the China Securities Depository and Clearing Corporation. After the completion of private company's share transfer, parties will submit the agreements to the Chinese tax authority and pay applicable taxes in accordance with Chinese tax law. The most relevant taxes relating to the transfer of shares are income taxes and stamp duties. Stamp duties need to be paid by both parties upon execution of the legal documents. Income taxes are determined based on the type of sellers in the transaction. If the seller is a PRC corporate tax payer, 25% income tax on profits are payable and such tax could apply to worldwide profits in connection with the company pursuant to the Enterprise Income Tax Law of the PRC. Special rates may apply to small-scale enterprises engaging in encouraged business activities including but not limited to high-technology companies. If the seller is an individual, 20% tax rate applies to income such as interest, dividends and transfers of property that derives from such individual investor. In addition, none PRC tax resident is subject to 10% or lower withholding tax on capital gains arising from the transfer. Moreover, value added tax applies when acquiring shares from a public listed company.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

First, in transactions where the purchasers are prestigious financial sponsors with extensive financial resources, the sellers might agree to sign an agreement with the special purpose vehicle without obtaining any comfort from the parent fund. On the other hand, if the sellers have much more negotiation leverage, the purchasers might have to provide comfort to the sellers. Such comfort can be provided in forms such as equity commitment letters, debt commitment letters, signing escrow, etc. On or prior to the singing of the purchase agreement, the purchasers can provide to the seller equity commitment letters (signed between the parent fund and the purchasing entity) and/or debt commitment letters (signed between the borrower and the lender) evidencing that the purchasing entities will have access to sufficient funds to make the acquisitions. The sellers in some cases might also request the buyer's parent to provide its financial statement, although such request will usually face great resistance from the purchaser for confidentiality reasons. Signing escrow is another mechanism for providing comfort to the seller. The purchaser may agree to put the signature pages in the seller's or the seller legal counsel's hand prior to the expected date of signing for escrow, and such signature pages shall only be released upon the purchaser's subsequent authorization. Under this arrangement, no official contract will be signed until closing (i.e., simultaneous signing and closing).

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

The two commonly used pricing mechanisms in M&A (and private equity) deals in China are locked box approach and completion accounts approach. When applying the locked box approach, the purchase price agreed upon by both parties is a fixed price. On the other hand, in the completion accounts approach, the purchase price will be adjusted after the closing in accordance with the financial statement of the target company immediately prior to the closing. Currently, they are both widely used in China. Generally speaking, the locked box approach is more preferred by the sellers because the purchasers have to rely on the financial statements prepared by the sellers as of the dates mutually agreed upon by both parties prior to the signing to determine the enterprise value of the target companies. After signing the agreement, the risk of the value decrease of the target companies prior to the closing is borne by the purchasers. Therefore, the purchasers will usually want very strict representations and warranties and covenants with respect to the operation and financial conditions of the target companies between the financial statement date and date of closing. Moreover, it is also less complex than the completion accounts approach and involves less transaction costs. Hence, comparatively speaking, locked box approach is more ordinarily seen in seller's market where the sellers usually have more negotiating leverage than the purchasers (for example, when the sale is conducted through an auction and the seller can receive bids from various purchasers) and/or small transactions where both parties want to keep the transaction process simple.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

Risk allocation between a purchaser and a seller involves various aspects of the deal. For example, in a private M&A deal the purchasers usually conduct a thorough due diligence. However, in recent years, some large M&A projects were conducted through a public bidding process, and the sellers would control the process of due diligence, which would expedite the process and enhance the efficiency but increase the purchaser's risk exposure. The two pricing mechanisms discussed in Question 5 also demonstrate different degree of risk allocation, with the locked boxed approach being riskier to the purchaser because it has to bear the risk of enterprise value decrease between the date of singing and date of closing. Regarding the transaction agreements, the sections of representations and warranties will significantly affect the risk allocation between the parties. A broader scope of the representations and warranties will impose more risks on the seller, and using the terms such as "Material Adverse Effect" and "to the best knowledge of the seller" will limit the scope of the representations and warranties and thereby reducing seller's risks.

7. How prevalent is the use of W&I insurance in your transactions?

W&I insurance has been introduced to China market for more than 10 years, and are increasingly popular among the parties to M&A (and private equity) transactions for the following reasons we observed: (i) a transaction involves auction process which makes it almost impossible for the purchaser to have a thorough due diligence investigation due to its limited access to seller data and the given time pressure; (ii) the W&I insurance can cover the losses of a purchaser above the seller's liability cap (if any) agreed upon in the transaction documents; (iii) many sellers, especially the financial sponsors, wish to realize a clean exit from the transaction, as they need to be certain about the sales proceeds distributable to their investors, without bearing contingent liability arising from a purchaser claim; and (iv) some purchasers may be reluctant to claim against the seller, aiming to maintain good relationship with the seller or seller's parent. In contrast with a purely domestic transaction in China where both parties are Chinese entities who are familiar with the legal and policy risks under the Chinese law, W&I insurances are more often used in cross-border transactions, in particular the outbound investments made by Chinese purchasers. A regulation promulgated by the State-owned Assets Supervision and Administration Commission in 2017 even highly recommends that all state-owned or controlled enterprises at the central government level utilize insurance tools for risk avoidance purpose when they make outbound investment.

8. How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?

Financial sponsors are always playing an active role in acquiring shares of Chinese listed companies. However, in publicly disclosed cases of recent years where controlling stake of a listed company is acquired, more than half of such deals are driven or successfully consummated by state-owned or backed investors. Typical ways for acquiring shares in Chinese listed companies include: (i) privately negotiated transaction, (ii) secondary market trading, (iii) tender offer, and (iv) indirect deal structure devised to acquire shares in the controlling shareholder of the listed companies. Thanks to the set-up and booming of Sci-Tech innovation board (SSE STAR Market) which provides a test field for China's innovation in the securities market since 2018 as well as recent regulatory developments along the direction of marketization in the QFII/RQFII system and refinancing rules for listed companies in 2019 and 2020 respectively, the below trends are observed: (i) financial sponsors are seeking earlier stage deal opportunities (e.g., pre-IPO financing) for private companies who have the potential to go public in China, (ii) the QFII system and RQFII system are largely used by foreign financial sponsors to participate in minority investment in Chinese listed companies, and (iii) regulations are loosened to offer more opportunities to financial sponsors for their participation in private placement by Chinese listed companies. .. Although state-owned or backed entities have long played a dominant role in the infrastructure market, "social capitals" including financial sponsors are recently encouraged by the Chinese government to participate in large-size PPP projects by forming a special purpose fund or running a joint venture with other qualified market players.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

There are no governmental consents or control procedures which target to, deliberately or discriminately, govern or restrict foreign investment by financial sponsors. Apart from the anti-trust review and industry-specific approvals, government consents or control procedures for foreign investment include: (i) filing with the National Development and Reform Commission (including its competent local counterparts, the "NDRC") and MOFCOM, or approval by NDRC and MOFCOM if the investment sector falls within the scope of the Negative List, (ii) national security review ("NSR") conducted by a joint committee led by MOFCOM and NDRC, where the foreign investments involve elements of national defense security (military industry, location adjacent to military facilities, etc.) or aim to acquire an effective control over targets engaged in key industries (e.g., agricultural products, energy and resources, infrastructure, transportation services or key technologies or important manufacturing of equipment and machinery having a bearing on national security), and (iii) foreign exchange control imposed by the State

Administration of Foreign Exchange on capital inflow and outflow relating to foreign investment/divestment and remittance abroad of realized proceeds. On January 1, 2020, the first uniform Foreign Investment Law ("FIL") in China took effect, thereby further deregulating the market access to foreign investors and the related foreign exchange control. Against this backdrop, however, apart from China's NSR which is envisioned to become an increasingly important regulatory tool for government to oversee foreign participation in the nation's economy and can inevitably be leveraged as a counteraction in response to the strengthening by U.S. and EU of their prohibitive or restrictive measures against China's overseas investments in these jurisdictions, it becomes vague and uncertainty may increase as to whether or not a variable interest entity ("VIE") arrangement typically employed by foreign financial sponsors for their indirect investment in China could be regulated by FIL in the future, as the definition of "foreign investment" under the FIL is meant to cover various direct and indirect investment activities carried out by foreign investors within the PRC territory, including foreign investors acquiring shares, equity interests, shares of property or "other similar interest" in a Chinese target.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Acquisition of a minority stake in a target by financial sponsors may still trigger the acquiring party's obligation of declaring to SAMR for merger clearance review, if the acquiring party gains control over the target through the transaction and any statutory threshold is satisfied. According to the relevant guiding opinions from SAMR, the test for "control" should take into account various legal and factual factors, including, among others, voting mechanism of shareholders' or board meetings. Thus, if a financial sponsor who acquired minority interest is granted under the shareholders' agreement and/or articles of associations of the target a right to veto on certain significant operational matters of the target (e.g., business plan, budget, appointment and removal of CEO and CFO, branch/subsidiary setup and closedown), whether at the shareholder level or board level, it may be viewed as acquiring de facto control over the target, alone or in concert with others. To manage the risk of triggering merger clearance, the acquiring party should think carefully to narrow down the scope of "veto" matters so as to avoid being regarded as taking control of the target's daily operation. Where substantial risk of failure to obtain merger clearance exists with a particular transaction, an acquiring party may consider: (i) making the receipt of merger clearance a condition precedent for it to close the deal and asking for a breakup fee from the selling party/target, and (ii) requiring the selling party/target to redeem the purchased shares of the acquiring party with agreed annual return if the transaction is invalidated or unwound by order of SAMR after the closing. In the past, the merger declaration involving a VIE arrangement has never been formally recognized by SAMR or MOFCOM which was the authority in charge of merger review for quite a long time, however, this practice has changed since 2020. In two cases released publicly by SAMR in April 2020 and November 2020 respectively, one of the transacting parties has a VIE structure, the SAMR's reviewing and making decision on the foregoing cases may signal a turning point that the VIE arrangement can obtain formal recognition from the regulatory authorities (or at least from SAMR) and will no longer constitute an obstacle to the making of merger clearance review. The said change was also evidenced by a new anti-trust guideline for platform economy industry (draft for public comments) promulgated by SAMR on November 10, 2020, where a merger involving VIE structure shall fall within the scope of merger clearance review, and such merger, when triggering the declaration thresholds, cannot be carried out without first obtaining a clearance from SAMR.

11. Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?

In a typical private equity or venture capital deal, financial sponsors usually make investment for acquiring a minority stake in the target. This is because: (i) the overly high valuation of China-based companies these years has increased the risk of financial sponsors (e.g., down-round and lack of liquidity), (ii) the founding shareholder(s) want to retain their control over the target after the transaction, and (iii) in certain industrial sectors, the shareholding percentage of a target is restricted for participation by foreign investors or "social capitals". In onshore transactions, acquisition of minority interest is more often structured as equity investments than as debt-like investments, largely due to the regulatory restrictions and potential dispute arising from the uncertain nature of such debt-like investments; while in offshore China-related transactions, debt-like investments (convertible bond or debt-to-equity bridge loan) are commonly seen as a tool to fund the working capital needed by the target before or even after the closing. Minority protection mechanism (e.g., veto right, drag-along right, pre-emptive right, right of first refusal and co-sale right of a financial sponsor) now is widely adopted in the market practice of China, and on top of that, valuation-adjustment mechanism or performance-based triggering event for redemption which are rarely seen in other markets are frequently considered by Chinese investors.

12. How are management incentive schemes typically structured?

For a target company incorporated in China, the management team is usually incentivized indirectly through granting thereto of options to purchase the "shares" of a limited liability partnership, which will hold the equity interest or shares of the target company. The founder(s) of the target company will usually act as the general partner of the limited liability partnership, while the incentivized management team members, upon exercising the vested options, will become the limited partners of the limited liability partnership. For a target company not incorporated in China (usually in an offshore jurisdiction, e.g., Cayman Islands and British Virgin Islands), the management incentive plan is usually similar to that in most other developed common law countries in terms of reservation, granting, vesting, and exercising of options/ordinary shares. We do note that since China still maintains a foreign exchange control regime, the Chinese participants so incentivized will face PRC foreign exchange control barrier to exercise their vested options unless they complete relevant PRC exchange control registrations.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

Generally, the employees so incentivized will be subject to individual income tax at the time of exercise as ordinary incomes subject to progressive individual income tax rates. Chinese tax rules do provide that if certain criteria are met, the incentivized employee may defer the tax payment till the time of disposal, and the gains so generated will be taxed as capital gains (usually lower than regular income taxed at the progressive individual income tax rates). Such criteria include, without limitation, (i) proper authorization of the incentive plan through the company's resolutions, (ii) qualifications and number of the incentivized employees, (iii) length of the holding period after the granting date (and after the exercise date for options), (iv) the length of the exercise period, and (v) the sector of business the company engages in.

14. Are senior managers subject to non-competes and if so what is the general duration?

Yes. Senior managers are subject to a statutory non-compete obligation during their employment. After the termination of employment, if expressly agreed in the labor contract or a separate non-compete agreement, the company may subject the senior managers to additional contractual non-compete obligation for an agreed term no more than two (2) years. In exchange for senior managers' observance of such post-employment non-compete obligation, the company must pay economic compensation to such senior managers in the amount agreed under such employee's labor contract or the separate non-compete agreement. If the labor contract or the separate non-compete agreement is silent on the compensation amount, relevant legal interpretations provide that the compensation amount shall not be lower than 30% of the employee's average monthly salary in the twelve (12) months before the employment termination, or the local minimum wage, whichever is higher. If a senior manager is also a shareholder of the company, then he or she might be subject to a non-compete obligation with a longer period if so contractually required, such as under the shareholders agreement.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

A financial sponsor typically achieves its control over its portfolio company's material business decisions through (i) proper design of the company's corporate governance, e.g., shareholders meeting, board and executive team composition, and selection of the company's legal representative, and (ii) voting arrangements, e.g., the financial sponsor's veto right under certain matters, exercised directly or through the director designated by it. The typical documents regulating the governance of the portfolio company include the shareholders agreement or a joint venture contract, the articles of association, or other constitutional documents of the portfolio company.

16. Is it common to use management

pooling vehicles where there are a large number of employee shareholders?

Yes. If a large number of employees participate in the company's incentive scheme, a platform, usually in the form of a limited liability partnership, will be formed by founder(s) or the majority shareholder(s) as a management pooling vehicle to hold the shares or equity interest issued to the incentivized employees under such scheme. Since the founder(s) or the majority shareholder(s), or their respective designee, will usually act as the general partner, while the incentivized employees acting as limited partners, this arrangement can achieve a balance between employee incentivization and operational efficiency. Multiple platforms might be necessary due to the statutory limit on the number of partners (50 partners) of a limited liability partnership.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

In terms of debt finance capital structures, it is normally referred to as debt financing instruments. The commonly used types of debt financing instruments are as follows: i) loans from non-financial institutions, commonly used in debt financing with a small amount and flexible terms; ii) loans from financial institutions, such as bank loans and trust loans, with a medium amount and boilerplate clauses; iii) bonds, issued by a company pursuant to statutory procedures and for which face value and interest payment are agreed to be made by a specific deadline and at a fixed rate, mainly for a large amount. According to our experience, PRC companies do not generally have the ability to provide credit guarantee to a lender through offshore debt financing, thus, commercial bank loans are most commonly used in onshore debt financings. With regard to the capital structure, the borrowers usually would give creditors security interests over their assets (including but not limited to shares and real properties) to secure repayment of the debt. According to PRC law, private equity funds are not allowed to invest in the area of the debt financing directly. Please refer to Q21 for details.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

In general, the concept of financial assistance refers to the situation where a company provides financial support such as gift, loan, guarantee, exemption from obligations, etc., to a person who has acquired or is to acquire that company's shares or bonds ("investor"). So far, financial assistance is not definitely prohibited in the PRC Company Law. However, according to relevant regulations, public company stock issuers and public or private corporate bond issuers are prohibited from using their own resources to provide any form of financial assistance to their investors. For example, Article 38 of the Administrative Measures on Issuance and Trading of Corporate Bonds, which was promulgated by China Securities Regulatory Commission and became effective on January 15, 2015, provides that issuers and underwriters shall not provide financial assistance to investors participating in subscription directly or through any other stakeholders. The reason for this provision is that if investors are "lured" to subscribe for the bonds with other financial interests, the coupon rate cannot accurately reflect the risk and value of the bonds, which will disrupt the free market, and it is unfair to other small or individual investors who do not have access to these "lures".

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

In terms of the typical debt financing, such as loans from financial institutions, usually a standard form of credit agreement will be provided by the financial institutions. But provisions, including but not limited to, the loan amount, loan term, interest rate of the credit agreement are still negotiable between lenders and borrowers. As a result, negotiations on these provisions of credit agreements between parties become vital. As for the bonds, there will be a standard form of credit agreement (normally referred to as "indenture") stipulated by the bond issuers of which all terms are determined by the issuers and third-party agencies, such as bond rating agencies who are responsible for the credit rating of the bonds. The issuers and investors will not negotiate any provisions of the indenture. The only thing investors shall decide is whether to subscribe or not.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

The key areas of negotiation between borrowers and lenders include, inter alia, the loan amount, loan term, interest rate, calculation and settlement of the loan, guarantee, interest on late payments, fees, remedies, etc. As credit default of the corporate bonds occurred more frequently in recent two years, lenders tend to pay more attention on the terms of guarantee and remedies. According to Wind, a Chinese financial database, the number of credit default of corporate bonds is 309, and the accumulated amount of which is about RMB 270.4 billion from January 1, 2018 to December 31, 2019, approximately four times of the sum of the credit default amount from 2016 to 2017.

However, even with adequate guarantee and remedies, investors could still suffer damages from debt defaults with currently highly inflated bond ratings. Based on the data from Wind, the number of credit default of corporate bonds from January 1, 2020 to November 6, 2020 is 106, and the accumulated amount of which is about RMB 124.1 billion. According to this trend, credit default of corporate bonds is mitigated compared with the last two years. However, since October 2020, Brilliance Auto and Yongcheng Coal & Electricity Holding Group Co. Ltd. (hereinafter referred to as “Yongcheng Holding”), which are two bond issuers rated AAA in the bond market, have both defaulted. These two issuers are both state-owned enterprises as well. The impact of these two defaults was immediately observed in the bond market like an earthquake. On November 10, 2020, after Yongcheng Holding’s bond defaulted, bonds of several issuers plunged, which attracted the attention of bond market investors. This incident suggests that the market rating of corporate bonds is not highly differentiated, the market is flooded with AAA rated enterprises, and market rating does not give sufficient indications on credit risks. Investors should be aware of this problem and pay extra attention to bonds screening.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

According to relevant regulations, private fund managers shall comply with the specialized operation principle which means that the private fund managers shall only be involved in one of the three areas, namely, private equity funds, private securities funds and other private funds. According to relevant regulations, the private equity fund is not allowed to invest in the area of debt financing. Hence, the so-called “private equity credit funds” are not allowed to be incorporated in the PRC. We also notice that, in practice, some private equity funds are trying to participate in debt financing by using the instrument of convertible note. The arrangement is mainly as follows: private equity investment fund first provides a loan to the target company and agrees that private equity investment fund has the right to choose to convert the debt in such form of loan into the equity of the target company or require the target company to return the principal and interest of the loan when due. At present, China’s laws and regulations on whether convertible note is part of the “loan” business for private equity funds is not clear. For the nature of convertible note, we need to do specific analysis for the terms and provisions of specific notes.

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