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A Legal Update from Dechert LLP

Key Considerations for Inbound Mergers and Acquisitions (M&A) in China

Since China's accession to the World Trade Organization (WTO) in 2002, China has seen a rapid increase in the volume of inbound M&A consummated by foreign investors. What follows is a high-level overview of the primary issues for foreign investors to consider when contemplating inbound M&A transactions in mainland China. These issues are: (I) market entry; (II) players; (III) regulatory approval and examination process; (IV) defenses to a hostile takeover and (V) other special issues (foreign exchange control and local law and governmental requirements).

I. Market Entry

Market entry should be the starting point for a foreign investor contemplating an M&A transaction in China. After China acceded to the WTO, the government substantially revised a policy regarding foreign investment in China, opening certain industries to foreign investors and restricting or prohibiting foreign investment in other industries, in line with its WTO commitments. The policy is updated every three or four years. There is no single concern that determines which industries are open and which are restricted or prohibited; rather, a host of issues specific to each industry are considered. This policy applies to all foreign investment and does not permit case-by-case analysis.

Once the foreign investor determines that foreign investment is allowed in a target industry, it must carefully examine market entry requirements for foreign investment in that industry under Chinese law. Especially important are a) any restrictions on the shareholding percentage of foreign shareholders in a China-based company; b) qualification requirements for foreign investors and c) the level of regulation of the target industry. Examples of highly regulated industries open to foreign investment include banking, insurance, securities and funds. In these industries, foreign investors must receive approval from the appropriate regulatory authority, in addition to complying with standard approval and registration procedures applicable in any sector. Obtaining approval from regulatory authorities in such highly regulated industries generally is difficult and time consuming.

II. Key Players – Target and Acquirer

A foreign acquirer must consider the corporate form of its target because different PRC laws and regulations apply and different problems can arise depending on the type of enterprise being acquired.

A notable difference between acquiring an existing foreign invested company and an existing domestically-owned company is that market entry requirements are likely easier to satisfy in the former case because any issues were dealt with at the time of the initial foreign investment. In contrast, the acquisition of an existing domestic company involves conversion of the domestic company into a foreign invested company.

The acquisition of a listed company also raises special issues. For example, for historical reasons, there are listed companies with a portion of shares that are not available for exchange trading; acquiring these shares by agreement is the best way to accomplish an acquisition. Freely-traded shares, which are more common, can be acquired via any of the following transactions: purchase on the open market, tender offer, purchase agreement with one or more current shareholders, targeted offering, indirect acquisition (acquiring the listed company's parent), proxy contest and merger.

Unlike most jurisdictions worldwide, acquisitions of state-owned enterprises/assets are common in China. There are specific regulations governing the acquisition of state-owned enterprises/assets and any acquisition must be approved by the State-Owned Enterprises and Assets Supervisory Bureau. The acquisition of state-owned companies or assets can be frustrated by national security concerns and brand protectionism if the target owns the rights to a well-known industry trademark.

Foreign investors can acquire Chinese companies directly or through subsidiaries in China. The decision of whether to use a foreign or domestic acquirer entity depends on the purpose, structure, tax concerns and foreign exchange aspects of the deal, in addition to the interaction between Chinese laws and the laws of the investor's home jurisdiction. A foreign investor may use one of its Chinese subsidiaries to acquire another target company in the same or similar industry, or may invest through an investment company or an equity investment enterprise that invests in various sectors.

III. Regulatory Approval Process

The regulatory approval process differs for each deal depending on many factors, including the key players and the financing source. Key steps in the general regulatory process are as follows:

1. Every foreign investment transaction is subject to the approval or supervision of the competent office of the Ministry of Commerce of the PRC ("MOFCOM").
2. The target company must register changes to its corporate information with the competent office of the State Administration for Industry and Commerce ("AIC").
3. Post-AIC registrations with various PRC authorities are required. The most important post-AIC step is to obtain approval from or register with the foreign exchange bureau.

Under certain circumstances, there will be other approvals required prior to seeking MOFCOM approval. For example, obtaining the approval of the China Securities Regulatory Commission is a crucial step when acquiring a listed company. As reflected above, the acquisition of state-owned enterprises/assets is subject to the approval of the State-Owned Enterprises and Assets Supervisory Bureau and acquiring companies in certain regulated industries (e.g., banking, insurance, securities and funds) involves various approvals in addition to a MOFCOM approval.

IV. Hostile Takeover Defenses?

Hostile takeovers are uncommon in China so an acquirer is unlikely to face takeover defenses. Some forms of defense common in other jurisdictions are either legally or practically impossible in China. For example, the poison pill does not exist in China because Chinese listed companies may issue only common shares under the Chinese Company Law and Securities Law. Practically speaking, without the target company's cooperation, it may be difficult to complete all of the regulatory approval and registration processes.

V. Other Specific Issues

There are other issues to consider, in particular China's tight control over foreign exchange. For example, when making a cash purchase of shares from a Chinese shareholder, the payment must occur in China and the foreign exchange bureau will oversee the funds transfer.

Unlike in the U.S., where state law determines requirements for corporate formation and transactions, the local laws of provinces and cities in China are not an important aspect of M&A. Local laws may not establish different or additional requirements from those under national law, e.g., the Chinese Company Law and the Securities Law. However, foreign acquirers still must comply with administrative requirements of local governments.

Due to the complexity of the laws, regulations and practices relating to inbound M&A in China, it is essential that investors carefully consider each of these aspects and retain experienced advisors. Retaining counsel with local knowledge and expertise is indispensible for the successful completion of an M&A project in China.

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