



Private Equity

Fund formation and transactions
in 42 jurisdictions worldwide

2009

Contributing editor: Casey Cogut



Published by
GETTING THE DEAL THROUGH
in association with:

Advokatfirman Delphi
Appleby
Batalla Abogados
Blake, Cassels & Graydon LLP
Bowman Gilfillan
Carey Olsen
CHSH Cerha Hempel Spiegelfeld Hlawati
Dillon Eustace
Esinlsmen
G Breuer
Gide Loyrette Nouel
Hamelink & Van den Tooren NV
Hernández & Cía Abogados
HJM Asia Law & Co LLC
Homburger
Jones Day
Kennedy Van der Laan NV
Kromann Reumert
Latournerie Wolfrom & Associés
Lee & Ko
Lepik & Luhaäär LAWIN
Loyens & Loeff, Luxembourg
Lydian
Moussas & Tsibris
Mundie e Advogados
Navarro Abogados
Nishith Desai Associates
P+P Pöllath + Partners
Proskauer Rose LLP
Rodés & Sala
SAI Consultores, SC
Salomon Partners
Simpson Thacher & Bartlett LLP
Slaughter and May
Smaliukas, Juodka, Beniusis & Partners
Stoica & Asociatii – Attorneys at Law
Wiesner & Asociados Ltda, Abogados
WongPartnership LLP
Yangming Partners



Private Equity 2009

Contributing editor

Casey Cogut
Simpson Thacher & Bartlett LLP

Business development manager

Joseph Samuel

Marketing managers

Alan Lee
Dan Brennan
George Ingledew
Edward Perugia
Robyn Hetherington
Dan White
Tamzin Mahmoud
Elle Miller

Marketing assistant

Ellie Notley

Subscriptions manager

Nadine Radcliffe
Subscriptions@
GettingTheDealThrough.com

Assistant editor

Adam Myers

Editorial assistants

Nick Drummond-Roe
Charlotte North

Senior production editor

Jonathan Cowie

Subeditors

Jonathan Allen
Laura Zúñiga
Kathryn Smuland
Sara Davies
Ariana Frampton
Sarah Dookhun

Editor-in-chief

Callum Campbell

Publisher

Richard Davey

Private Equity 2009

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 7908 1188
Fax: +44 20 7229 6910
© Law Business Research Ltd
2009

No photocopying: copyright
licences do not apply.

ISSN 1746-5524

The information provided in this publication is general and may not apply in a specific situation. Legal advice should always be sought before taking any legal action based on the information provided. This information is not intended to create, nor does receipt of it constitute, a lawyer-client relationship. The publishers and authors accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as of February 2009, be advised that this is a developing area.

Printed and distributed by
Encompass Print Solutions.
Tel: 0870 897 3239

Law

Business

Research

Global Overview Casey Cogut, William Curbow and Kathryn King Sudol <i>Simpson Thacher & Bartlett LLP</i>	3
FUND FORMATION	
Bermuda Sarah Moule <i>Appleby</i>	6
British Virgin Islands Valerie Georges-Thomas <i>Appleby</i>	13
Canada J Rob Collins and Frank P Arnone <i>Blake, Cassels & Graydon LLP</i>	19
Cayman Islands Bryan Hunter and André Ebanks <i>Appleby</i>	23
China Caroline Berube, Linford Liu, Patrick Pu, Ivy Yang and James Yule <i>HJM Asia Law & Co LLC</i>	29
Denmark Vagn Thorup and Lisa Bo Larsen <i>Kromann Reumert</i>	35
England & Wales Timothy Drake <i>Proskauer Rose LLP</i>	40
Germany Amos Veith <i>P+P Pöllath + Partners</i>	48
Guernsey Ben Morgan, Geoff Ward-Marshall and Emma Penney <i>Carey Olsen</i>	54
India Vikram Shroff and Richie Sancheti <i>Nishith Desai Associates</i>	60
Ireland Andrew Lawless and Sean Murray <i>Dillon Eustace</i>	66
Italy Bruno Castellini, Stefano Crosio and Velislava Popova <i>Jones Day</i>	73
Jersey Andrew Weaver and Mark Lewis <i>Appleby</i>	80
Luxembourg Gilles Dusemon and Marc Meyers <i>Loyens & Loeff, Luxembourg</i>	85
Mauritius Malcolm Moller <i>Appleby</i>	92
Netherlands Louis Bouchez, Floor Veltman and Maurits Bos <i>Kennedy Van der Laan NV</i> Jan van den Tooren and Reinier Noort <i>Hamelink & Van den Tooren NV</i>	99
Singapore Low Kah Keong <i>WongPartnership LLP</i>	106
Spain Carlos de Cardenas, Victor Domenech, Alejandra Font, Javier Morera and Julio Veloso <i>Rodés & Sala</i>	111
Sweden Anders Lindström, Anders Björk and Peter Utterström <i>Advokatfirman Delphi</i>	118
United States Thomas H Bell, Barrie B Covit, Jason A Herman, Glenn R Sarno and Michael W Wolitzer <i>Simpson Thacher & Bartlett LLP</i>	124
TRANSACTIONS	
Argentina Diego Fissore <i>G Breuer</i>	131
Austria Albert Birkner and Hasan Inetas <i>CHSH Cerha Hempel Spiegelfeld Hlawati</i>	137
Belgium Peter De Ryck <i>Lydian</i>	143
Brazil Arthur R Viñau and Ricardo P C Villela <i>Mundie e Advogados</i>	149
Canada J Rob Collins and Frank P Arnone <i>Blake, Cassels & Graydon LLP</i>	155
Cayman Islands Stephen James and Simon Raftopoulos <i>Appleby</i>	160
China James Yule, Ivy Yang, Patrick Pu and Caroline Berube <i>HJM Asia Law & Co LLC</i>	164
Colombia Mauricio Rodríguez A and Eduardo A Wiesner <i>Wiesner & Asociados Ltda, Abogados</i>	171
Costa Rica Rodrigo Zelaya <i>Batalla Abogados</i>	176
Denmark Vagn Thorup and Bent Kemplar <i>Kromann Reumert</i>	180
England & Wales Timothy Drake <i>Proskauer Rose LLP</i>	185
Estonia Gerli Kilusk <i>Lepik & Luhaäär LAWIN</i>	191
France Pierre Lafarge, Claire Langelier and Nicolas Duboille <i>Latourmerie Wolfrom & Associés</i>	196
Germany Andres Schollmeier <i>P+P Pöllath + Partners</i>	202
Greece Michael Tsibris <i>Moussas & Tsibris</i>	207
Hong Kong Benita Yu and Risen Tan <i>Slaughter and May</i>	211
India Archana Rajaram and Amrita Singh Nishith Desai Associates	217
Ireland Andrew Lawless and Sean Murray Dillon Eustace	223
Italy Bruno Castellini, Stefano Crosio and Velislava Popova <i>Jones Day</i>	227
Korea Wonkyu Han and Je Won Lee <i>Lee & Ko</i>	232
Lithuania Robert Juodka, Inga Martinkute, Tomas Venckus, Vaida Pacenkaite, Arunas Kasparas, Ramunas Svencionis and Mindaugas Rimkus <i>Smaliukas, Juodka, Beniusis & Partners</i>	238
Mexico Juan Pablo Martínez Velasco and Luis Alberto Aziz Checa <i>SAI Consultores, SC</i>	244
Netherlands Louis Bouchez, Floor Veltman and Maurits Bos <i>Kennedy Van der Laan NV</i> Jan van den Tooren and Reinier Noort <i>Hamelink & Van den Tooren NV</i>	248
Peru Juan Luis Hernández, Alfredo Filomeno and Alvaro del Valle <i>Hernández & Cía Abogados</i>	255
Romania Cristiana I Stoica <i>Stoica & Asociatii – Attorneys at Law</i>	260
Russia Anton Klyachin and Igor Kuznets <i>Salomon Partners</i>	264
Singapore Ng Wai King and Dawn Law <i>WongPartnership LLP</i>	269
South Africa David Anderson and Shahid Sulaiman <i>Bowman Gifflin</i>	275
Spain Julio Veloso, Javier Morera and Victor Domenech <i>Rodés & Sala</i>	283
Sweden David Aversten, Clas Romander, Peter Sjögren and Michael Juhlin <i>Advokatfirman Delphi</i>	289
Switzerland Dieter Gericke, Reto Heuberger and Jürg Frick <i>Homburger</i>	295
Taiwan Robert C Lee and Claire Wang <i>Yangming Partners</i>	301
Turkey Ismail Esin and Arzum Gunalcin <i>Esinlsmen</i>	306
Ukraine Karl Hepp de Sevelinges and Ilyia Tkachuk <i>Gide Loyrette Nouel</i>	310
United States William Curbow and Kathryn King Sudol <i>Simpson Thacher & Bartlett LLP</i>	315
Uruguay Alfredo Navarro Castex and Alfredo H Navarro <i>Navarro Abogados</i>	322

China

James Yule, Ivy Yang, Patrick Pu and Caroline Berube

HJM Asia Law & Co LLC

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

In practice, there are various types of private equity transactions occurring in China, such as leveraged buyouts, venture capital, mezzanine capital and growth capital transactions, angel investments, and private investment in public equity (commonly referred to as PIPE).

In China, there is also a special type of fund that could be called a form of private equity fund – the Industry Investment Fund (the IIF). IIFs are similar to most private equity funds in the sense that they can only purchase shares in non-listed companies. IIFs are the only form of private equity funds that are directly referenced in Chinese legislation. There is currently no legislation that refers specifically to either private equity funds or transactions in general or to other individual types of private equity funds or transactions. However, the People's Republic of China (PRC) central government has drafted a regulation on the administration of private equity funds that is expected to come into force in 2009.

IIFs are usually funded by certain 'institutional investors' who are state-owned or state-controlled enterprises. For example, the Bohai Industry Investment Fund is jointly sponsored by the National Social Security Fund, the China Development Bank, the Postal Savings Bank of China and five other state-owned enterprises. IIFs can also be funded by large Chinese commercial banks, and private insurance and security companies.

While leveraged buyout funds may play an important role in the global private equity transactions market, they do not currently play a major role in China, as the majority shareholders of Chinese enterprises, whether state or privately owned, are generally reluctant to give up their position as majority shareholders.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

In China, many private equity transactions are not conducted with the view of the investing company exiting through the use of an IPO. This is due to the strict corporate governance rules on public companies in general and in particular the conducting of an initial public offering (an IPO). Further to this, all IPO activity has been temporarily suspended in China as of September 2008.

Private equity transactions are commonly conducted through foreign companies in order to escape the scrutiny of the Chinese authorities, even though there were specific reporting regulations issued in 2006 by the Chinese authorities relating to foreign companies that

are set up in order to purchase the equity of the target Chinese companies. These companies are commonly referred to as special purpose vehicles (SPVs). The stipulations regarding share swaps in these regulations made SPVs (and other foreign companies) become subject to Chinese merger and acquisition regulations – previously, these laws were able to be avoided.

The central government also periodically issues a Chinese-language 'Guidance on Foreign Investment' (most recently in 2007). This guideline is in reality a set of legally binding rules which classifies industries into three different categories which indicate a foreign company's (including an SPV's) ability to invest in it: the restricted, the encouraged and the prohibited.

Often private equity transactions are conducted with the view to eventually making private the listed company in question. This is because, again, once a company is no longer public it no longer has to deal with the onerous obligations imposed on it, especially the obligations in relation to disclosure.

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where management members of the board are participating in the transaction?

In China, as in most parts of the world, the board of directors of a public company is the key part of the company's management. According to the Chinese-language Rules of Corporate Governance of Public Companies, the board of directors will establish, according to the resolutions made at the shareholders' meetings, special committees such as a strategy committee, an auditing committee, a nomination committee and remuneration and assessing committee, among others. These committees will consist only of directors, and every special committee has its own functions and responsibilities. The strategy committee shall, for instance, carry out research on the long-term strategies, including major investment decisions that the company should take, and will submit proposals on their findings to the company. Every member shall fulfil its fiduciary duties as prescribed in the Chinese Company Law or other related laws and regulations.

The Chinese company law places restrictions on a board of directors' ratification of 'vested-interest' transactions. Directors (or the board of directors as a whole) who have personal interests in the transaction cannot ratify on such transactions, nor can they represent other directors (in relation to the other directors' voting rights) on such transactions.

With regard to the acquiring of a public company in China, an independent qualified accountant must be hired according to Chinese regulations on the acquisition of a public company as such

transactions are closely related to the shareholders of the target company's interests and the board of directors of the target company might damage the interests of the shareholders for their own personal benefit, which is discussed further in question 7. The China Securities Regulatory Commission and the Ministry of Commerce must give their initial approval to the acquisition and furthermore are able to closely supervise the acquisition process.

Going private, of course, brings major changes to a company. In China, being public does not only bring financial power from the public stock market, it is also a symbol of a company's reputation and strength, especially when viewed in light of the lengthy and selective process that Chinese companies need to complete to go public in the first place. Thus, until now, most of public companies in China have been reluctant to go private, but this trend may rapidly change in 2009, with the global financial crisis hitting China.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

The Chinese-language Regulation on Mergers and Acquisition of a Public Company, issued by the China Securities Regulatory Commission and effective as of 1 September 2006, heightened the disclosure requirements regarding mergers and acquisitions of public companies. In China, disclosure requirements differ depending on the ratio of shares being purchased in the target company.

If the investor or other individuals or companies acting in concert obtain between 5 per cent and 20 per cent (inclusive) of total shares issued by the target company, through a stock exchange purchase or share transfer, the acquiring parties only need to submit a share change report to both the China Securities Regulatory Commission and the relevant Chinese stock exchange (there are two in China, the Shanghai Stock Exchange and the Shenzhen Stock Exchange) within three days upon transfer of the shares. The report must also be published in the relevant stock exchange's bulletin. This report must include the name and domicile of each acquiring party (ie, the investor), the purpose of the acquisition, the investor's intention in relation to its newly-purchased shares for the coming 12 months, and the name, types, volume and ratio of the newly-purchased shares of the target company (public company), as well as the date and method of obtainment.

If the acquired share ratio is between 20 per cent and 30 per cent (inclusive) of the total shares issued by the target company, a more detailed share changes report must be submitted by the acquiring party. Besides the information mentioned above, the report must include details on the share structure of the acquiring company, the price of the purchased shares, the amount of the required capital of the acquiring party that was used in the transaction, and a list of the transactions between the acquiring party and the target public company in the past 24 months. The report should also state whether this is a vested-interest transaction. If the acquiring party obtains more than 30 per cent of shares of the target company through a stock exchange purchase, it is legally required to make a tender offer to the target company if it still wishes to increase its shareholdings in the target public company.

In the event that after such transactions, the equity structure of the target company does not fulfil the relevant requirements on public companies, the stock exchange will issue a caution to the public regarding the stock transactions of the target public company, which is also called the 'Exit Stock Market Caution'. This caution is to remind the public that the listed company may go private due to either a private equity transaction or through failure to fulfil the relevant official requirements.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Actual time considerations vary from case to case; under Chinese laws and regulations, the following rules apply where the acquiring party acquires over 30 per cent of the share ratio.

- Article 37 of the Chinese-language 'Regulation on Acquiring Public Companies' stipulates that the period stated in the tender offer given by the acquiring party or parties shall be between 30 and 60 days (inclusive), unless there are other competitive tender offers whereby the timing limits do not apply.
- If there is any substantial change to the fundamental terms of the tender offer, the acquiring company is required to submit a written report regarding the amendments within two days upon the occurrence of change to the China Securities Regulatory Commission, and the report shall also be copied to the bulletin of the relevant stock exchange.
- In the event that the acquirer is foreign-based, the Chinese target company or the acquirer shall submit certain documentation to the Ministry of Commerce in relation to the proposed offer, which shall issue its preliminary approval within 30 days upon their receipt of the above documents. The Ministry of Commerce's official approval is usually valid for 180 days.
- The acquirer must open a specific foreign currency bank account within 15 days upon its receipt of the Ministry of Commerce's approval, and the money to be used for the acquisition shall be remitted into the bank account according to the foreign exchange administration laws and regulations of the PRC.
- Once the tender offer is accepted, the acquirer shall start its strategic acquisition within 15 days upon the completion of the settlement of the foreign currency and, in general, the acquisition process shall be completed within the 180-day validity period of the official approval mentioned above.

The following rules apply once any foreign company has purchased shares in a Chinese public company:

- the target company shall obtain a new certificate of approval in relation to its amended status as a foreign-invested enterprise, as issued by the relevant bureau of commerce at different levels within 10 days upon the completion of the acquisition;
- where the target company has become private, it shall file for the amendment of type of company (from a public company into a non public company) with the relevant administration for industry and commerce (the Chinese business registry) within 30 days upon its receipt of the approval from the relevant bureau of commerce; and
- also where the target company has become private, the target company shall proceed with the related formalities with the tax bureau, customs office, and the administration of foreign exchange within 30 days upon the completion of the administrative formalities with the Chinese registry.

6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

Below is a list of the main clauses that are either specific to, or should be contained in, purchase agreements that deal with Chinese private equity transactions.

Prerequisites

The first and most important prerequisite is the consent of the shareholder's meetings of both the acquirer (if it is a company) and the target company. Also, warranties need to be included regarding the effective

completion of the many complex administrative procedures which must be completed through various Chinese authorities for private equity transactions, especially if the target company is a public company or a state-owned public company. Obviously, these administrative approvals will sometimes affect the validity of the purchase agreement. Further, warranties need to be included confirming the validity of the transaction in light of any agreements between the main parties and third parties.

Evaluation of equity

This is equivalent to the 'price term' of a common purchase agreement. In common cases, the acquirer and the target company can negotiate with each other the value of equity purchased. However, if the acquirer is a foreign company and the target is a Chinese company, the value of equity under the purchase agreement shall be evaluated and approved by a qualified third-party evaluation agency. If a state-owned enterprise is to be acquired, the equity value shall be evaluated by one of the specific State-owned asset evaluation agencies accredited by the Chinese State-owned Assets Supervision and Administration Commission of the State Council.

Management and profit distribution

After the transaction, if the acquirer is a foreign entity and obtains all of the shares in the target company, the target company will become a wholly owned foreign enterprise (commonly referred to as a WOFE), which is still a separate Chinese legal entity under Chinese company law. However, if the acquirer obtains only part of the shares of the target company, the target company will become a joint-venture company. Such classification affects the distribution of profits and corporate structure of the new entity and thus should be taken into account in the purchase agreement. The management rights and profit distribution shall be decided in accordance with the shareholding amount each party owns in the company after the transaction. The 'Guidance on Foreign Investment' as mentioned in previous questions might periodically influence the choice of target companies and the shareholding level allowed by the foreign private equity purchaser.

Employment

Mergers and acquisitions of a company will not influence the current employment relationship between the acquired company and its employees. If the new shareholder wishes to terminate the employment relationship with the employees, severance pays shall be paid in accordance with the related labour laws and regulations. Employment issues, especially the compensation of senior managers of the target company, are important issues to be addressed in the purchase agreement, and sometimes influence the cost of the whole transaction;

Financing

Successful financing plays an important role in deciding the success of the whole transaction. A clause in a purchase agreement usually requires that the acquirer shall have a good credit history and financial reputation. Such a clause is especially important given the current worldwide capital market.

Penalty clause

In most cases, the acquirer seeks to get a break-up fee from the target company if the transaction is terminated owing to the default of, or abandonment of the deal by, the target company. It is regarded as a kind of guarantee in the event that the target company reneges on its acceptance after it has already accepted the offer. Reverse break-up fees require the acquirer to pay a fee to the target company (or seller) if the deal fails to conclude because of any breaches by the acquirer of the financing clause (or any other reason as stipulated in the agreement).

7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

The Chinese Company Law sets forth that if a public company wants to sell (or purchase) its major assets that represent more than 30 per cent of its total capital, the resolution shall be ratified by more than two-thirds of the shareholders with voting rights. Therefore, going private is regarded as a crucial decision for public companies. In practice, such a resolution is submitted through the management and presented at the shareholder meeting, and under the current corporate governance stipulations, the management gets involved in the private equity transaction from the very beginning.

The management of the target company can be given the rights to purchase the equity, options, and restricted stocks of the target company, or it can be offered a 'golden parachute' (which refers to high compensation payouts given to the current management of the target company to get them to leave after the transaction). These dispositions aim at encouraging the management to get involved in the transaction, and ensure that senior managers will protect the interests of the target company – as well as their own interests. However, the management may also persuade the shareholders to accept unfavourable transactions owing to protecting their own interests as covered in question 3.

To prevent the management of the target company from damaging the overall interests of the target company and its shareholders during transaction, the China Securities Regulatory Commission issued the Regulation on Mergers and Acquisition of a Public Company as mentioned in question 4. This regulation provides that the board of directors of the target company must make due diligence research on the qualifications, credit, reputation and intentions of the acquirer, and make an in-depth analysis and give suggestions to the shareholders as to the terms and conditions of the tender offer rendered by the acquirer. More importantly, the law requires the board of directors of the target company to hire third-party independent consultants so as to ensure the authenticity of the report, which shall also be submitted at the shareholder meeting.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

The stamp tax of the share transfer agreement shall apply to both contracting parties. Use of the company seal on an agreement shall be subject to a 0.05 per cent stamp tax, calculated on the amount stipulated in the agreement. The shareholders of the target company shall also be subject to income tax, whether individual or enterprise, based on the incomes obtained from the transaction; however none of the parties shall pay any business tax.

Under Chinese tax law, share acquisition is more tax-effective than assets acquisition. For example, for tangible assets, value-added tax (or VAT) shall apply to the purchasing party according to the tax rate applicable to each type of assets. As for transfer of the ownership of real estate or intangible assets, the target company shall be subject to a 5 per cent business tax and 3 per cent to 5 per cent deed tax if the assets involve land use rights or property titles.

The payment method further influences the tax payable in a private equity transaction. In the event that the acquirer pays by cash, the cash received by the shareholder of the target company shall be subject to income tax. If the acquirer pays with unconvertible bonds, the interest earned on the bonds received by the shareholder shall

also be subject to income tax, but the interest paid by the acquirer shall be deducted prior to taxation. If the acquirer pays with convertible bonds, the acquirer can defer the process of converting the bonds to shares. By doing so, the interest paid by the acquirer shall be deducted from the taxable amount and the tax on capital gains from the conversion shall be deferred too, which is beneficial to the acquirer.

Furthermore, if the private equity transaction was carried out through the swapping of shares, it shall be exempted from income tax, as no actual monetary income was earned as a result of the transaction.

Finally, some preferential tax policies apply regarding the level of employees retained after the transaction. For example, According to a recent notice issued by the Ministry of Finance of the PRC on 29 December 2008 regarding deed tax incurred during the restructuring of enterprises, if the acquiring party or parties can keep more than 30 per cent of the employees of the target company and enter into labour contracts with a term of more than three years with these employees, the deed tax involved in any transfer of land use rights and property title in relation to the transaction shall be halved. If the acquiring party or parties can keep all the employees and enter into labour contracts with a term of more than three years with the employees, deed tax related to the transaction shall not apply.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How are these issues resolved?

In a share purchase, the existing indebtedness of the target company will not be affected by the transaction. Obviously, the equity value of the target company is closely related to its net-assets. If there is any existing hidden indebtedness when evaluating the equity of the target company, the real value of the equity will certainly be depreciated after the transaction, especially when the assets of the target company are seized, detained or auctioned.

There could be some potential or future indebtedness issues, for example the target company may lack some required official permit or credentials to legally conduct its activities, which will certainly bring potential legal and financial risks to the acquirer after the transaction (for example, in the form of fines).

Therefore, an effective and in-depth due diligence plays an important role in choosing the potential target company. Apart from the due diligence, the inclusion of a warranty clause is common. For example, the acquirer could require the target company to disclose its existing indebtedness clearly in writing in the purchase agreement, and it shall be liable for the indebtedness not listed in the acquiring agreement. More importantly, the acquirer shall have the rights of recourse if there is any loss caused by such hidden indebtedness.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions?

In China, the LBO process has not been commonly accepted in acquisition practices, largely owing to a lack of relevant laws and regulations and a mature capital market, as well as the control issues as noted in question 1. Also, In China, traditionally, the main source of capital is commercial banks, however, under the current banking laws and regulations, the Chinese commercial banks are reluctant to lend money to those companies unable to offer any guarantee, even if there is the prospect of high returns on the investment. The social insurance fund and securities investment fund in China are under strict supervision and can only invest in certain IIF accredited by the

National Development and Reform Council and are thus not yet used for LBO financing purposes.

In practice, some big companies and enterprises do lend each other money, but under the current financial laws, financing between two commercial companies is also restricted – only legally recognised financial institutions such as banks are able to lend money.

According to one recent regulation, the Directions on Risk Management of Loans for Acquisition issued by the Chinese Banking Regulatory Commission on 6 December 2008, it is legally allowed for qualified commercial banks to offer loans for acquisition projects, but the term of the loan shall be five years or less, and the loan shall not be over 50 per cent of the total value of the acquiring transaction. As LBOs in acquisitions are still new financial products for Chinese commercial banks, most of them are still very cautious and will probably wait for further detailed implementation rules as given proscribed by the Chinese authorities.

The Chinese government is still cautious about acquisition transactions in China. There are various reasons for this (including a perceived lack of experience, talent, and legal support), but the most important is certainly for the wish to prevent state-owned assets from ‘leaking’ during the acquisitions, as many target companies are state-owned enterprises which play an important role in the China’s economy. For example, China Stegy Investment Co (Hong Kong) acquired 196 Chinese enterprises during 1992 and 1993 and most of the target companies were state-owned enterprises. The large-scale buyout handled by China Stegy Investment Co raised the attention of the Chinese government and made the Chinese government reconsider the use of foreign investment in LBOs especially since there is a lack of relevant supervision mechanisms.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

The LBO market is closely related to the subordinated debts market especially the high yield bond market. As discussed in question 10, the Chinese capital market is not as mature as that of western countries yet, and thus, debt or equity financing (especially in going-private transactions) are not popular. On the other hand, being public in China is, as mentioned in question 3, very highly regarded and therefore, public companies are usually very reluctant to go private.

12 Fraudulent conveyance issues

Do private equity transactions involving leverage raise ‘fraudulent conveyance’ issues? How are these issues typically handled in a going-private transaction?

In accordance with the Regulation on the Strategical Acquiring of Public Companies by the Foreign Investors (issued jointly by the Ministry of Commerce, the Securities Regulatory Commission, State (ie, Federal) Administration of Taxation and the State Administration of Industry and Commerce and State Administration of Foreign Exchange in 2006), there are strict requirements as to the qualifications of the acquiring party (capital levels, corporate governance, credit, etc). This aims to lessen the risk of the transaction. Apart from this, the resolution shall be ratified by the board of directors and shareholders of the target company, according to the Chinese Company Law and the target company’s articles of association. Further, elements of the transaction, including but not limited to the transaction plan, share transfer agreement and the qualifications of the acquirer, shall be firstly reviewed and approved by the Ministry of Commerce and then, by the Chinese securities industry watchdog and the Securities Regulatory Commission. The strict scrutiny pre-

vents, to some extent, fraudulent conveyance. Further, the acquirer often requires the target company to provide consent letters issued by the creditors of the target company to indicate that the creditor's consent on the transactions to be carried out.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

One important exit mechanism for a private equity sponsor is the share transfer. In order to ensure that a public company can operate smoothly at the beginning stage of post-public and prevent the shareholders from engaging in illegal speculation of securities, under the Chinese Company Law the shares issued before the initial public offering shall not be transferred within one year of the date shares go public.

With regard to foreign acquirers, in accordance with the company law and related foreign-invested enterprise laws and regulations, the share transfer made by foreign investors shall also be restricted, especially where the foreign party in a joint venture wishes to sell its shares as part of an acquisition in the joint venture company. This share transfer shall be approved by the Ministry of Commerce or its affiliated bureau and, if the target company is a public company, the share transfer shall be also approved by the Chinese Securities Regulatory Commission. In practice, the target company must also include the transfer restriction clause in the purchase agreement or the shareholder's agreement stating that the shareholder is restricted from transferring their shares to competitors.

Most of the minority shareholders can not have directors representing their benefits, owing to their small shareholdings. In practice, majority shareholders have had the final say about major decisions, even if some decisions may be disadvantageous to minority shareholders. Under the Company Law, the minority shareholders of a limited liability company are entitled to apply to a court to exit the company (by forcing the company to purchase back their shares) if they object to some major resolutions. This is because they cannot technically prevent a resolution from being ratified by the board of directors of the company.

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

In China, private equity sponsors and private equity transactions are still limited so far, owing to the lack of related laws and regulations, but not the actual size of the transactions.

In accordance with article 166 of the Security Law, the investor who wishes to carry out securities transaction shall open a brokerage account with his ID card or the certificate of incorporation for legal person. Most of the private equity sponsors are not legal persons which will usually take the legal form of limited partnership or trust form. As foreign entities are not allowed to open brokerage accounts and there is no national equity exchange in China (except in some trial cities), such provision indeed limit the participation of international private equity sponsors to carry out the private equity transaction while influence their exit mechanism.

With regard to the registry of private equity sponsors, and although the Partnership Law of the PRC also includes the legal form of limited partnership, limited liability partnerships can not register under the current registry system (there are some exceptions for some cities carrying out financial innovation trial programs, such as Tianjin, Shanghai and Beijing).

Apart from private investment in public equity, private equity

sponsor mostly choose to invest in non-public company, operate it and then refund profits through the IPO of the target company or share transfer. However, the IPO procedures in China takes long time and shall proceed with complex procedures.

In the latest issued regulation, 'Direction on Risk Management of Chinese Commercial Banks Dealing with Loans for Mergers and Acquisitions' issued by the Chinese Banking Regulatory Committee on 9 December 2008, the loan issued by a Chinese commercial bank shall not be above 50 per cent of the total capital to be used in the acquisition.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

There are several types of exit strategies for private equity used in China, such as the shares buyback, IPO and liquidation.

Under the Company Law, there are mandatory requirements for the shares buyback that can be only carried out under certain circumstances. (for example, a stock company shall purchase back some of its shares if it decreases its registered capital, merges with the company that has shareholdings of the target company, gives stock options to the employees or if the minority shareholder of the company opposes to the resolution of merger and split of the company).

IPO of a Chinese company can be initiated either abroad or in the Chinese stock markets. IPO in China can a long and complicated process, so foreign private equity firms prefer going public abroad, where there is looser foreign exchange control policy and lower requirements for an IPO. However, there is an 'indirect' alternative that can allow the private equity sponsor conduct the IPO and exit shortly afterwards. The Chinese target company will incorporate a company in BVI or another tax-free place to be used as the SPV. The SPV will use capital from the private equity transaction to purchase all the shares of the Chinese target company. The Chinese target company will then become a 100 per cent subsidiary of the SPV. The private equity sponsor will help the SPV (or another company that swaps its shares with the SPV), go public in the foreign stock market to realise its exit.

Domestic private equity firms usually choose the IPO in China as they are not restricted by foreign currency controls and are more familiar with the procedures of the IPO in China. However, as mentioned in question 1, IPOs are currently not being issued in China.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

There are no accounting principles unique to a private equity transaction in China. The Accounting Standard for Business Enterprises No. 2 – Long-term Equity Investment, and No. 20 – Business Combinations shall apply to a private equity transaction.

For a business combination involving enterprises under common control (where the acquiring party and the target company are controlled by the same controlling company) the initial investment cost of the long-term equity investment shall be the absorbing party's share of the owner's equity of the party being absorbed at the combination date. The difference between the purchase price and the initial investment cost shall be adjusted to capital reserve.

For a business combination not involving enterprises under common control, the initial investment cost of the long-term equity investment shall be the fair values of the assets given, liabilities incurred or assumed and equity securities issued by the acquirer at the acquisition date. If the cost of long-term investment exceeds the acquirer's

interest in the fair value of the acquirer's identifiable net assets, the difference shall be recognised as goodwill; if the cost of long-term investment is less than the acquirer's interest in the fair value of the acquirer's identifiable net assets, the acquirer shall recognise the difference in profit and loss for current period.

Initial investment cost in long-term equity investment acquired otherwise than through a business combination shall be determined as follows:

- where a long-term equity investment is acquired by paying cash, the initial investment cost shall be the actual purchase price paid;
- where a long-term equity investment is acquired by the issue of equity securities, the initial investment cost shall be the fair value of the securities issued;
- where a long-term equity investment is contributed by an investor, the initial investment cost shall be the value stipulated in the investment contract or agreement, unless the value stipulated in the contract or agreement is not fair;
- where a long-term equity investment is acquired through an exchange of non-Monetary assets, the initial investment cost shall be determined in accordance with the Accounting Standard for Business Enterprises No. 7 – Exchange of Non-Monetary Assets;
- where a long-term equity investment is acquired through a debt restructuring transaction, the initial investment cost shall be determined in accordance with the Accounting Standard for Business Enterprises No. 12 – Debt Restructurings.
- the long-term equity investments shall be accounted for using the cost method if either the investing enterprise can exercise control over the target company, or the investing enterprise does not have joint control or significant influence over the target company, the investment is not quoted in an active market and its fair value cannot be reliably measured; and
- where an investing enterprise can exercise joint control or significant influence over the target company, a long-term equity investment shall be accounted for using the equity method.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years?

Recently, the typical going-private transactions in China mainly targeted big state-owned enterprises that are publicly listed in the Hong Kong Stock Exchange and involved in the natural resource and agricultural industries such as China Petrol, China Pec Group, Aluminum Corporation of China and China Food Corporation. Strictly speaking, it shall not be regarded as the going-private transaction in China mainland because most of them went public in Hong Kong. Going-private transactions of these companies are mainly for restructuring purposes as they may have more than one listed subsidiary. According to the latest statistics report issued by China Venture Investment Consulting Co, Ltd in 2008, the most popular targets for the international private equity sponsors in China are in the IT and manufacturing industries. The medical and healthcare industry and retail chain store companies are also popular targets.

Strictly speaking, there have been very few going-private transactions in China (excluding the Hong Kong stock market). Again, the status of being a public company in China is regarded as a precious asset unless the listed company wants to sell its 'shell' to another company that wishes to go public.

18 Industry-specific regulatory schemes

Do industry-specific regulatory schemes limit the potential targets of private equity firms?

One of the most important industry-specific regulatory schemes in China is the above-mentioned Guidance on Foreign Investment in China, which indicates the Chinese government's attitudes in directing foreign investment. Industries have been classified into three different categories: encouraged, restricted and forbidden.

These relate categories reflect how much of foreign shareholdings can occur in the company, and variations can occur within these categories. For example, foreign shareholdings in a life insurance company shall not be over 50 per cent, and those in a securities company shall not be over one third of the total shares and the Chinese shareholder shall be the majority shareholder of a joint-venture security company (both industries, however, fall under the 'restricted' category). These are real limits on potential targets, and affect investment strategies, as exit strategies are more difficult to implement when one is not the majority shareholder.

19 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

As mentioned in questions 2 and 18, foreign investors are restricted. Thus, verifying market entry into the industry that the target company is engaged in is one of the key issues for the cross-border private equity transaction, which will also decide how much the foreign investor can really invest in the target company. For some restricted industries, the foreign shareholder can not be the majority shareholder.

China has been adopting a looser (but still strict in foreign terms) foreign currency control policy and this will definitely bring complexity and difficulties to private equity transaction if the target company is a Chinese public company. As discussed in question 5, the foreign acquiring party shall file for the approval of opening a bank account in foreign currency to receive capital for private equity transaction with the local Administration of Foreign Exchange where the listed company is located within 15 days upon its receipt of the official approval from the Ministry of Commerce of the PRC. All transactions must generally be completed within 180 days upon the receipt of the official approval. If the foreign acquiring party fails to complete the whole transaction within the above time limit, the official approval will become invalid automatically. The foreign acquiring party shall, upon the approval from the Chinese administration of foreign exchange, purchase foreign currency and remit the capital abroad.

If the target company is a state-owned public company, more issues must be considered. Firstly, the consideration of the share transfer shall be evaluated by the state-run Assets Administration and Supervision Committee. Secondly, if the acquiring involves a key industry, or has some influence on the national economic security, or would lead to the transfer of control of a well-known Chinese brand owned by the target company, the contracting parties must file for approval of the transaction with the Ministry of Commerce otherwise they can terminate the transaction. Thirdly, since the state-owned enterprises are large-scale companies employing many people, the arrangements for employees after the transaction shall be another key issue. Lastly, the equity transfer must be handled through an accredited Chinese equity exchange (a stipulation that is otherwise rarely required).

Update and trends

Recently, private equity sponsors began to pay more attention to public companies in China to look for the chance of carrying out a PIPE. Compared with investment in private companies, PIPEs require more capital but the risk is less than investment in a private company during its growth period. From the recent cases, we have found that the transactions mainly target the natural resource, real estate and finance industries.

Compared with sourcing funds from the stock market or financial institutions, private equity is often more suitable for small and medium-sized enterprises (SMEs) in China. Most SMEs are not public companies (and do not have the means to become such) nor do they get loans from financial institutions, often due to the strict approval process of issuing the loans. More importantly, the rules and preferences of private equity transactions are different from loans, which pay more attention to the scale of the company instead of the company's efficiency and growth potential. The participation of private equity (especially foreign private equity) may bring much-needed new management practices, technology, and marketing skills to Chinese companies. As mentioned above, the Chinese Banking Regulatory

Commission issued a specific regulation regarding mergers and acquisitions in December 2008, and we believe that private equity transactions in China will be stimulated by the new policies.

On the other hand, the global economic crisis will certainly make some investors keen to hold onto their money, which could lead to financing difficulties for the acquirer. Suspension of IPOs in the Chinese mainland market has become another obstacle for the expansion of private equity transactions as the private equity sponsors have lost one of the major exit methods under Chinese law.

Private equity became the next hot topic after real estate and share trading in China in 2007. The development of the Chinese capital market, update of industry structure and the legal framework will help lay a good foundation for the development of private equity transactions in China. In terms of key issues of private equity transactions, we are of the opinion that the choice of target company (and its industry), the protection of the benefits for the private equity sponsor, the exit mechanism and the management and operation of the target company after the transaction would be, both presently and in the future, the key issues of private equity transactions in China.

20 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Different equity firms will have different criteria in choosing the target company and different ways to realise their exits from the target company. This will inevitably bring complexity and conflicts to the transaction. Furthermore, as we discussed in question 12, there are certain requirements for the acquiring party when acquiring a Chinese company (such as financing ability). Every participant must meet the above requirements. Though the fund used in the LBOs are mainly from outside sources, the financier (such as the bank) will still often request that the acquiring party invest more of their own capital, which suggests more attention is put by the acquiring party on the acquiring projects. It also may mean the acquiring party will not sell its shares in the target company in a short period instead of opting for a more long-term strategy.

21 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking? What specific changes to transaction terms have you seen and do you expect in the future?

The global economic crisis has also affected China's economy. The downturn of the stock market makes it even harder for Chinese public companies to source funds from the stock market and the value of their equity is depreciating. Private equity sponsors seem to be more cautious, and they have slowed down their investments in China. According to the statistics provided by the China Venture Investment Consulting Ltd, the total value of the private equity transaction deals in the third quarter of 2008 is nearly US\$2.1 billion, down by 17.1 per cent when compared with that of the second quarter of 2008. Owing to the recent economic policy taken by the Chinese government to stimulate domestic market, real estate companies are facing a big challenge. Lack of capital resources is one of the main issues for them, which may attract private equity sponsors from both China and abroad to invest in them.

HJM
ASIA
LAW & CO LLC

恒即名
亚洲
法律
事务所

Caroline Berube

cberube@hjmasialaw.com

46, Office 104
Shamian Main Street
Li Wan District
Guangzhou
510 133 Guangdong
China

Tel: +86 20 8121 6605
Fax: +86 20 8121 6505
www.hjmasialaw.com

