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Private Equity Investments In China:

Impact Of Recent Legal Reforms

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Since acceding to the World Trade Organization (WTO)[1] in December 2001, China has undertaken a series of broad legal reforms required by the WTO accession commitments, among others. Many of such reforms materially affect foreign private equity investments in China, which have grown substantially over the same period.[2] This article discusses the implications for foreign private equity investors of certain key recent legal developments in the context of China's existing foreign investment regime.

Foreign Investment Regime

Between the declaration of the People's Republic of China by Mao Zedong in 1949 and the end of the Cultural Revolution in the late 1970s, foreign investment in China was essentially prohibited. In 1979, as Deng Xiaoping ushered the country into an era of economic reform with his famous "To get rich is glorious" aphorism, China adopted the *Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures,* which opened up a

1 China's accession to the WTO was based on the *Decision: Accession of the People's Republic of China* dated November 10, 2002 and the terms and conditions contained in the *Protocol on the Accession of the People's Republic of China* (the "Protocol"), which were accepted by China on November 11, 2001 and became effective on December 11, 2001.

2 According to AVCJ Group Ltd., during the three-year period from 2002 to 2005, capital raised (not including real estate and global funds) for private equity investments in China has grown over six-fold to $2.2 billion and private equity capital invested (not including real estate investments) has grown over five-fold to $8.8 billion. During the first half of 2006, new capital raised for China private equity investments was already at $1.9 billion and $4.7 billion of private equity capital was invested.

limited number of industries (primarily manufacturing) for foreign investment. Since then, China's foreign investment regime has evolved significantly. To date, most foreign investments in China have comprised a direct investment in a "greenfield" project, typically in the form of an equity joint venture, a cooperative joint venture, a wholly foreign-owned enterprise, or a foreign-invested joint stock company limited by shares (FIJSC). The laws, regulations and rules which govern the formation and operation of such entities, collectively referred to as "foreign invested enterprises" or FIEs, are different from those applicable to domestic Chinese entities. Largely in response to recent increases in merger and acquisition activity by foreign investors involving domestic Chinese companies, however, China has issued a series of new regulations specifically governing such transactions, to most of which the existing FIE regime remains relevant because they involve FIEs formed as onshore acquisition or operating vehicles.

Challenges to Private Equity Investing

In the context of China's foreign investment regime, foreign private equity investors in China face numerous challenges to undertaking transactions in a manner to which they are accustomed in other markets. Below is a brief discussion of certain key challenges of particular relevance to such investors, based on their typical investment goals and practices.

Due Diligence

Social, economic and legal circumstances in China can pose unusual challenges to the standard due diligence exercise conducted in other markets. For example, because government involvement in the economy at various levels is extensive and weak corporate record keeping can obscure ownership of equity capital and other assets, it is often advisable to conduct a much more comprehensive investigation into the identity of the counterparties and the nature of their interests than might be considered reasonable in the U.S. or Western Europe in order to avoid additional, and sometimes surprising, stakeholders being discovered during later stages of a transaction. Other areas that merit special attention in due diligence of Chinese target companies include affiliate transactions, employee benefits and labor issues, financial reporting, intellectual property, land use rights and tax. In light thereof, it is important to involve at an early stage experienced advisors, including legal counsel and accountants, who speak Mandarin Chinese and understand local culture and business practices. In addition, because even with such advice satisfactory due diligence on certain aspects of a Chinese target company's business may not always be possible or practical, a foreign private equity investor may consider whether to seek more extensive seller representations and warranties than usual, and to obtain security for the seller's obligations in the form of an escrow, holdback or similar provision. Resistance to such provisions should be expected from Chinese companies, most of which are not accustomed to undertaking such detailed obligations in a sale and purchase agreement.

Government Approvals

Onshore acquisitions of Chinese businesses by foreign investors and establishment of related onshore acquisition vehicles are subject to a multi-step, multi-agency government approval process. The nature and level of approvals required generally depends on the ownership of the target (e.g., state-owned, private or publicly listed), type of transaction, amount invested and industry involved. Special approvals are required from the State-Owned Assets Supervision and Administration Commission, for example, to consummate a foreign investment in a state-owned enterprise, in addition to the other approvals required for any acquisition transaction. If Chinese residents acquire equity interests of an offshore entity in connection with the acquisition of an onshore Chinese company by utilizing such offshore entity, registration with the State Administration of Foreign Exchange (SAFE) is also required. Such and many similar notice, approval and registration requirements incur additional costs, protract the transaction, divert management attention and increase uncertainties.[3]

3 Perhaps the most prominent example of the potential impact of such issues is the Carlyle Group's original agreement to acquire an 85% stake in Xugong Group Construction Machinery Co., Ltd., China's largest construction machinery manufacturer and distributor, for $375 million, which, although signed October 25, 2005, had not received approval. It has recently been reported that Carlyle has agreed to scale down it's proposed investment in Xugong to a 50% stake for about $220 million in order to obtain the government approval.

Control

Acquiring control of a Chinese target company is not simply a matter of contract as in many other jurisdictions. All acquisitions in China by foreign investors are subject to the foreign ownership restrictions periodically published in the *Catalogue for the Guidance for Foreign Investment Industries,* which categorizes foreign investment in Chinese industry sectors as "encouraged," "restricted" or "prohibited" (unlisted industry sectors are deemed to fall into the "permitted" category). While 100% foreign ownership is allowed for investments in most industry sectors in the "encouraged" or "permitted" categories, investments in the restricted sectors generally require Chinese joint venture partners and, in some cases, that such Chinese partners retain a majority interest. For example, a foreign investment in a telecommunications service provider, which is in a "restricted" sector, cannot exceed a 50% stake. Furthermore, the *Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment* provides that certain important corporate acts of any such joint venture company must be unanimously approved by the board, including (i) any amendment to the articles of association, (ii) liquidation or dissolution, (iii) any increase or decrease of the registered capital and (iv) merger or division. As a result, even where majority foreign ownership is legally permitted, in a joint venture a majority foreign partner cannot obtain complete control because the minority Chinese partner has a statutory veto over these fundamental corporate acts through its representative(s) on the board of the joint venture company.

Debt Financing

Several substantial hurdles exist to the debt financing of Chinese acquisitions by foreign private equity investors. First, an FIE, often required to be established or used as the acquisition vehicle, is subject to a maximum leverage ratio (ranging from approximately 0.43:1.00 to 2.00:1.00 of debt to equity, depending on the amount of the registered capital of such FIE), which effectively caps its borrowing capacity (in the case of an existing FIE as the acquisition vehicle, some or all of which may have already been used). Second, compared to other jurisdictions such as the U.S. or some Western European countries, the procedures for creating and perfecting security interests in assets (particularly personal and intangible property) have not been fully developed in China,[4] and the enforcement of such security interests is often difficult. Hence, foreign lenders are reluctant to lend funds for a Chinese acquisition on the same basis they would in buyout transactions elsewhere. Third, China's evolving but still strict foreign exchange control regime (i.e., the lack of free convertibility of renminbi) means that a foreign party is usually reluctant to bring funds into China (as opposed to into an offshore vehicle) to finance an acquisition because it is often difficult to convert such funds back into foreign currency and repatriate them upon a liquidity event. Finally, although there is no law expressly prohibiting (or permitting) the debt financing of acquisitions in China, the authors are unaware of any instance in which the Ministry of Commerce (MOFCOM) has approved an acquisition transaction in which debt financing was secured by the Chinese target company's assets.

Management Equity

There is no clear regime under Chinese law recognizing typical private equity management incentives in domestic companies. Historically, it was therefore common for foreign investors acquiring a Chinese company (particularly in the private equity context) to offer Chinese management an opportunity to own equity interests in the offshore holding company established to make the acquisition. To receive such equity incentives from an offshore holding company, the Chinese management must meet certain registration and disclosure requirements under *Circular 75* issued by SAFE, effective on November 1, 2005 ("Circular 75"). Circular 75 applies to any inbound and outbound investments made utilizing an offshore special purpose vehicle (SPV) directly formed or indirectly controlled by any "Domestic Resident," defined as any legal entity established under Chinese law or natural person with

4 China began to develop a security collateral registration system with the adoption of the Security Law in 1995.

Continued on page 31

Some industry organizations are campaigning against the proposed application of the new liability regime to AIM companies, and it remains to be seen if this will actually be brought into force and if so, what effect it will have on the attractiveness of AIM.

Can AIM Compete with Nasdaq?

Through the collapse of other junior markets in Europe, the widening of its potential investor base and increased liquidity, AIM has become the primary market in Europe for growth companies, and has positioned itself as a potential alternative for companies that would previously have considered Nasdaq as a natural home. However, if AIM is to establish itself as a true competitor to Nasdaq for growth companies it faces the challenge over the coming years of ensuring that it retains its attractiveness in light of the increasing pressure on the European Union to impose stricter regulation and disclosure requirements on its markets, such as the Transparency Directive. Whether or not this happens, more and more US high-growth companies are now looking to AIM as a serious alternative to Nasdaq. ◎

Private Equity Investments in China

Continued from page 9

a Chinese identity card or passport or who habitually resides in China because of economic interests. Circular 75 defines "control" broadly (without any qualification) to include the right to operate, *to benefit from*, or to decide the policies of an SPV or a Chinese company. In addition, Chinese management has an ongoing obligation under Circular 75 to disclose any material corporate transactions completed at the offshore holding company level. A violation of any of these rules may not only subject a Chinese management member to a penalty by SAFE for foreign exchange evasion, but may also potentially hamper the onshore operating company's remittances of dividends to the offshore SPV.

Exit

As in all other private equity markets, a private equity investor in China must carefully consider and employ the most flexible and efficient structure for various possible exit scenarios from the commencement of an investment transaction. In light of extensive government involvement (i.e., required approvals) and the potentially applicable taxes (e.g., 10% capital gains tax on the sale of shares of a Chinese company), however, such consideration is even more critical in Chinese private equity deals. Typically, this requires forming an offshore investment structure prior to making the Chinese investment. Such a structure usually involves formation of one or more holding companies in a tax haven (such as the Cayman Islands or British Virgin Islands) or in a jurisdiction with a favorable tax treaty with China (such as Barbados or Mauritius) to acquire and hold the Chinese target company. Although such a structure entails some additional administrative burdens, they do not exceed those typically incurred by foreign private equity funds investing in other jurisdictions (e.g., U.S. private equity investors investing in European target companies via structures involving holding companies in the Cayman Islands and Luxembourg). Because in such a structure either a trade sale or an initial public offering exit occurs at the holding company level, it does not attract Chinese capital gains tax. Moreover, because such a transaction is not subject to the typical Chinese government approvals, it facilitates a much more rapid transfer of ownership than might be possible in a Chinese company.

Recent Regulatory Changes

While the challenges described above remain, the recent legal reforms discussed below, among others, are likely to have, in most cases, a positive impact on foreign private equity activity in China.

WTO Liberalizes China's Foreign Investment Control System

All acquisitions by foreign investors in China are subject to the restrictions on foreign investment set forth in the *Catalogue* (as described above). However, as a result of China's implementation of its WTO accession commitments, restrictions in respect of most industrial and service sectors will have been removed by the end of 2007.[5] This liberalization will provide foreign investors opportunities to acquire controlling stakes in many more Chinese companies.

New M&A Rules Provide a Legal Framework for Acquisitions

On August 8, 2006, six Chinese government agencies jointly issued *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the "2006 M&A Rules"), substantially amending and expanding the *Provisional Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* issued in 2003 (the "2003 M&A Rules"). The 2006 M&A Rules became effective on September 8, 2006. They establish a general legal framework in which foreign investors can acquire either equity or assets of a Chinese company in exchange for cash or, in the case of an acquisition of equity, stock of the foreign acquirer, subject to, among other things, approval by one or more Chinese government agencies.

At least the following three changes introduced by the 2006 M&A Rules are likely to have an immediate impact on acquisition transactions by foreign private equity investors in China:

National Economic Security Review. The 2006 M&A Rules require foreign investors to notify MOFCOM if a proposed acquisition results in foreign investors controlling any Chinese company that involves or affects: (i) a key domestic industry; (ii) national economic security; or (iii) well-known or traditional trademarks or brand names. If MOFCOM is not properly notified, it may require termination of the transaction, divestment of equity interests or assets, or any other action required to dissipate negative effects to national economic security resulting from the transaction. This new provision is both broad and vague regarding which industries are "key," when "national economic security" is affected, and what trademarks and brand names are "well-known or traditional." The new rules also place the onus on the parties to determine whether a transaction triggers the notification requirement. Moreover, it is uncertain whether under the new rules MOFCOM has the power to block a transaction in respect of which advance notice has been filed. The timing of adoption of this provision is notable in light of the status of several high profile acquisition transactions pending regulatory approval, including the Xugong deal noted in footnote 3.

Share Exchange Transactions Permitted. Unlike under the 2003 M&A Rules, under the 2006 M&A Rules the use of a foreign publicly listed company's shares as consideration for the exchange of Chinese equity securities in connection with an acquisition transaction is (for the first time) expressly permitted and regulated. Two requirements, among others, for such a share exchange transaction are that: (i) the foreign shares used as consideration must be traded on a public stock market (i.e., not traded over the counter or privately held) and must have a "stable" share price over the previous 12 months, and (ii) the foreign listed company (and its management) must not have been subject to any "sanction"[6] by a relevant regulatory authority

5 *See* the *Schedule CLII - People's Republic of China* to the Protocol.

6 The new rules do not define "sanction." Further clarification may be provided in subsequent implementing rules and the actual implementation of the rules by the regulators.

within the past three years. The new rules also impose a multi-step government approval process on such a share exchange transaction. This aspect of the new rules provides greater structuring flexibility for Chinese acquisitions.

Strengthened Regulation of Round-Trip Investments. The 2006 M&A Rules introduce a new provision regulating so-called "round-trip" investments by Chinese persons through offshore companies, which was the focus of Circular 75 discussed above. The new provision requires approval by MOFCOM of any acquisition by an offshore company formed or controlled by any Chinese domestic person (i.e., any domestic company, enterprise or individual) affiliated with the Chinese target company, in addition to the registration process already required by SAFE in Circular 75 regulating similar transactions (as described above). The 2006 M&A Rules provide neither any detail regarding such approval process nor any definition or explanation for the terms "controlled" and "affiliated" used therein. As such, absent further legislative clarifications, in any given transaction an investor should consider seeking guidance from relevant government authorities regarding the scope of such provision, as well as its implementing procedures. In addition, it is unclear how this new provision will be applied in relation to Circular 75, which covers similar transactions and requires registration with SAFE.

Regulatory Reforms Open Market for Acquisitions of Listed Domestic Companies

Chinese corporate investors and the state own a substantial portion of the issued shares of most Chinese listed companies, which are thus known as state-owned enterprises (SOEs). Those so-called "legal person shares" and "state-owned shares" were owned prior to listing and, until recently, were not freely tradable. There are two other types of shares issued by such companies that are tradable, however, namely A shares and B shares. Until recently, A shares, the most commonly traded shares on Chinese stock exchanges, were permitted to be sold only to Chinese investors. Foreign investors, on the other hand, were allowed to acquire only B shares, which are issued by a small percentage of Chinese listed companies. Thus, Chinese publicly traded companies were largely inaccessible to foreign investors. Recent regulatory changes, including those described below, however, appear intended to gradually encourage foreign investment in listed Chinese companies and seem likely to have a positive impact on foreign private equity activity.

Share Liquidity Reform Converts Non-Tradable into Tradable Shares. Since April 2005, the China Securities Regulatory Commission (CSRC) has promoted a share liquidity program in which listed companies are being restructured to convert almost all non-tradable legal person shares and state-owned shares into freely tradable A shares within two years. To date, more than 85% of China's listed companies have completed this program.

New Accounting Standards for Listed Companies. On February 15, 2006, China's Ministry of Finance issued a series of new and revised *Accounting Standards for Business Enterprises* (the "New Accounting Standards"), which will become effective on January 1, 2007, for listed companies. Most of the New Accounting Standards reflect the approaches and principles of the International Financial Reporting Standards (IFRS). For example, the New Accounting Standards provide formal accounting standards and comprehensive and detailed guidelines applicable to business combinations and consolidated financial statements akin to those established by the IFRS. By aligning Chinese accounting standards with a widely accepted international standard, these changes enhance the likelihood that foreign private equity investors will be able to conduct more meaningful and customary financial due diligence than in the past, initially on listed Chinese companies and potentially over time on private companies adopting as best practices such listed company standards.

FSI Rules Permit a Broader Group of Foreign Investors to Acquire Listed Shares. The *Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors* (the "FSI Rules"), which became effective on January 31, 2006, allow foreign investors to purchase A shares traded on China's stock exchanges as "mid- or long-term strategic acquisition investments." The FSI Rules apply to acquisitions of A shares of listed companies that have completed their own share liquidity reform measures and of companies that are listed after the completion of CSRC's overall share liquidity reform. For purposes of the FSI Rules, foreign strategic investors are those that either own at least $100 million of offshore assets or manage at least $500 million of offshore assets and are "financially sound, credible foreign legal persons or other entities with significant management experience." It thus appears that large foreign private equity funds will qualify. Compared to the QFII Rules,[7] the FSI Rules have a lower eligibility threshold for foreign investors and also do not impose any specific ownership caps, although shares acquired under the FSI Rules are subject to a three-year lockup period after the acquisition. The FSI Rules also allow a foreign strategic investor to acquire A shares with an offshore subsidiary, provided that the parent[8] agrees to be jointly and severally liable for the investment of the subsidiary and submits to MOFCOM an irrevocable letter of undertaking to that effect. Many observers expect that the FSI Rules will significantly open up the market for acquisitions of Chinese listed companies by foreign investors.

Tender Offer Rules Apply to Acquisitions of Listed Shares by Foreign Investors. Historically, acquisitions of Chinese listed shares by foreign investors were subject to compulsory offer rules familiar to private equity investors in European companies. The *Administrative Measures on the Takeover of Listed Companies* issued by the CSRC on September 28, 2002 (the "2002 Takeover Measures") required a foreign investor that purchased 30% or more of the outstanding shares of a Chinese listed company to make a "general offer" to all shareholders of the listed company to purchase all of their shares. This requirement could be waived by the CSRC under certain conditions. The compulsory regime no longer applies. On July 31, 2006, CSRC issued its new *Administrative Measures on the Takeover of Listed Companies* (the "2006 Takeover Measures"), which became effective September 1, 2006. Under the new measures, when a foreign investor purchases 30% or more of the outstanding shares of a Chinese listed company, the investor, instead of being required to make a general offer for all shares of the listed company, may make a general offer to purchase any amount of shares, provided that the aggregate amount of shares proposed to be purchased through such general offer shall not be less than 5% of all issued shares of the listed company. The relaxation of the previously mandatory tender offer requirements provides potential foreign private equity investors in Chinese public companies with more flexible and less costly access to controlling equity stakes.

New VC Rules Encourage Formation of Onshore Funds by Foreign Sponsors

The predominant majority of the China-focused private equity funds formed by foreign sponsors has been formed in offshore jurisdictions such as the Cayman Islands or the British Virgin Islands. In an attempt to encourage foreign sponsors to form funds within China, in 2001 and 2003 China issued rules[9] (the "2001 and 2003 Rules") permitting and regulating foreign-invested onshore venture capital (VC) enterprises. However, the 2001 and 2003 Rules contained many non-market restrictions on fund formation and operation and failed to attract many foreign financial sponsors to establish onshore investment vehicles. In November 2005, 10 Chinese government agencies jointly issued the *Provisional Measures on the Administration of Venture Capital Enterprises* (the "2005 VC Rules"), effective as of March 1, 2006, in an attempt to streamline the regulation of domestic VC enterprises, encourage the

7 On November 5, 2002, CSRC and the People's Bank of China (PBOC) issued the *Provisional Administrative Measures on the Investment in Domestic Securities by Qualified Foreign Institutional Investors*, which was recently superseded by the *Administrative Measures on the Investment in Domestic Securities by Qualified Foreign Institutional Investor*, issued by CSRC, PBOC and SAFE on August 24, 2006 (the "QFII Rules"). The QFII Rules permit qualified foreign institutional investors ("QFIIs") to acquire A shares of Chinese listed companies under a quota system. A QFII and/or its underlying offshore investors, however, must satisfy stringent eligibility criteria and are subject to certain ownership caps on investment in a Chinese listed company.

8 While the FSI Rules are not entirely clear on this point, the literal language requires the foreign investor to be wholly owned by its parent in order for it to rely on its parent's undertaking. The term "parent" is not defined under the FSI Rules but presumably does not include an affiliate, i.e., an entity under common control with the foreign investor.

9 The *Provisional Regulations on the Formation of Foreign-Invested Venture Capital Enterprises* issued on August 28, 2001 and effective as of September 1, 2001 and The *Regulations on the Administration of Foreign-Invested Venture Capital Enterprises* issued on October 31, 2002 and effective as of March 1, 2003.

formation of onshore investment funds by foreign sponsors and level the playing field for domestic and foreign-invested VC enterprises. An important feature of the 2005 VC Rules is that, instead of creating a mandatory regime, they lay out a voluntary registration regime under which both domestic and foreign-invested VC enterprises that meet the requirements with respect to the paid-in capital, number of investors and staffing as set forth in the 2005 VC Rules may choose to register, and thus become subject to, and entitled to the benefits (including tax benefits) provided by, the 2005 VC Rules. While the 2005 VC Rules represent a significant step forward, it remains to be seen whether the 2005 VC Rules will achieve the goal of attracting foreign sponsors to form onshore funds.

New Company Law Provides More Structuring Flexibility

China's new Company Law, which became effective on January 1, 2006, contains many revisions which may improve structuring flexibility for foreign private equity investors and operational efficiency of Chinese portfolio companies. The new Company Law applies to (i) limited liability companies (LLCs), (ii) joint stock companies limited by shares (JSCs) and (iii) FIEs, except where laws and regulations that specifically govern FIEs provide otherwise. On April 24, 2006, several Chinese authorities jointly issued the *Implementing Opinions on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign-Invested Companies* (the "Opinion") to confirm and clarify the application of certain revisions in the new Company Law to FIEs. Key revisions relevant to foreign private equity investments include those discussed below.

Flexibility in Voting Rights and Profit Distribution. The new Company Law introduces greater flexibility for shareholders in determining their voting and profit distribution rights in an LLC and JSC. The new Company Law provides that, with the unanimous consent of all shareholders of a company, profits may be distributed to a shareholder in a proportion different from such shareholder's equity ownership percentage. This would also suggest that a company may issue different classes of shares (as the new Company Law provides that the same class of shares must have the same rights and interest) even though the new Company Law does not expressly provide so, which would introduce further structuring flexibility. Because all of such flexibility also extends to an FIJSC, the corporate governance rules applicable to which are generally regulated under the new Company Law, foreign investors may now consider forming a FIJSC, instead of other types of FIEs, in order to retain greater flexibility when determining the capital structure.

Restrictions on Reinvestment Eliminated. Previously, the aggregate amount of a company's investment in other companies was limited to 50% of its net assets. The new Company Law eliminates this limit and allows a company to freely invest in other companies as long as such company does not assume any joint and several liabilities for the debts of other invested companies. This change in law, which the Opinion confirms also applies to FIEs, creates another potential source of increased M&A activity for private equity investors in China.

New Corporate Governance Provisions. The new Company Law contains provisions on corporate governance of companies, which the Opinion confirms apply to FIEs, and the duties and liabilities of their directors and officers. It explicitly imposes a new duty of care and duty of loyalty on directors, supervisors and the senior management of companies. However, the new Company Law does not enunciate a business judgment rule a pillar of fiduciary duties law in other jurisdictions, and does not provide specific guidance for directors and officers regarding how to comply with their new fiduciary duties.

China's New Enterprise Bankruptcy Law

In a move that marked a milestone in China's protracted efforts at creating an effective bankruptcy law, President Hu Jintao of China signed into law China's new *Enterprise Bankruptcy Law* on August 27, 2006, which will become effective on June 1, 2007. In contrast to the old regime, under which liquidation is the sole bankruptcy mechanism, the new law, for the first time, shifts its focus to corporate reorganization and introduces many concepts primarily borrowed from

Chapter 11 of the U.S. Bankruptcy Code. The new law clarifies many provisions of the 1986 *Interim Enterprise Bankruptcy Law* and appears likely to provide creditors and investors with more transparency regarding process and certainty or results during a restructuring. Among other notable changes discussed below, perhaps the most significant change created by the new law for foreign private equity investors is that, theoretically, the Chinese government will no longer play the leading role in a bankruptcy case.

Nature of Debtors. Under the new law, any Chinese enterprise now may be a debtor, regardless of whether the entity is an SOE, or a private domestic or foreign invested company. Although the 1986 *Interim Enterprise Bankruptcy Law* did not establish procedures governing the bankruptcy of, among other things, financial institutions (including commercial banks, insurance companies and securities companies), for example, they are covered by the new law, which clearly facilitates greater certainty for private equity investors interested in this sector.

Priority of Secured Creditors. Historically, displaced workers' compensation claims were often paid ahead of secured claims in liquidation scenarios. The new law reverses this practice and expressly provides that secured creditors are entitled to distributions to the extent of the value of their collateral prior to any payments to employees for wages, medical insurance and other benefits other than those that arose prior to the promulgation of the new law on August 27, 2006.

Debtor-in-Possession. The new law introduces the concept of debtor-in-possession in a reorganization proceeding. Under the new law, a debtor or a creditor may apply directly to the court to commence a reorganization. A debtor-in-possession may manage the assets and operate the business of the debtor under the supervision of the administrator, or the administrator may operate the business and administer the assets by engaging the existing management. Only the debtor-in-possession or the administrator can propose a plan of reorganization, the exclusivity period applicable to which is six months (which may be extended by three) after the reorganization application is accepted by the court. If exclusivity expires and no plan of reorganization is proposed by either the debtor-in-possession or the administrator, the court shall terminate the reorganization proceeding and declare the enterprise bankrupt.

Enforcement of Foreign Bankruptcy Judgments. The new law allows Chinese courts to recognize and enforce orders and judgments issued by a foreign court sitting in a bankruptcy proceeding to the extent that such orders or judgments may be enforced or recognized by a Chinese court pursuant to any existing treaties or international convention or based on principles of comity.

Conclusion

Foreign private equity investments in China remain subject to substantial uncertainty and risks associated with the rapidly evolving regulatory regime, governmental involvement including burdensome approval processes and undue political influence, as well as inconsistent interpretation and enforcement of laws, which together create a challenging transactional environment. As described above, however, numerous recent regulatory reforms are reshaping, and in many cases, improving, the country's legal environment for private equity activity, including new, more sophisticated types of transactions than were permitted under China's pre-existing legal framework.

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