KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

August 30, 2010

RMB Funds – An Emerging Opportunity

PENpoints

Recent favorable regulatory developments may enhance opportunities for non-Chinese sponsors seeking to enter the China market by raising RMB-denominated funds.

As non-Chinese private equity sponsors have increasingly focused on investments in China, the possibility of raising a Chinese-oriented fund denominated in Renminbi ("RMB") has generated significant interest. Recent favorable regulatory developments may enhance opportunities for non-Chinese sponsors seeking to enter the China market by raising RMB-denominated funds.

Recent Developments

Effective March 1, 2010, a non-Chinese sponsor and/or investor is allowed to participate directly in a Chinese limited partnership (known as a foreign invested partnership or "FIP"—commonly pronounced a "fip" rather than an "F-I-P"). A FIP is a Chinese vehicle with characteristics familiar to U.S. and European sponsors and investors, including limited liability, tax transparency and flexibility. Previously, a Chinese limited partnership was open only to Chinese individuals and entities.[1]

Long-awaited national regulations governing the Chinese private equity industry remain pending. In the past 18 months, however, the local governments of Beijing, Shanghai, Tianjin, Suzhou, Shenzhen and Chongqing have announced new rules permitting a non-Chinese sponsor to establish an investment management enterprise to manage RMB funds in their respective regions, viewed as a signal of their intent to promote private equity in their regions.

Key Issues

Despite these positive developments, several key issues still require careful consideration.

- **Tax.** No specific tax rules relating to a FIP have been announced. While tax authorities have confirmed that a limited partnership is generally regarded as a tax flow-through, it is unclear whether a non-Chinese investor or sponsor who invests in a FIP managed or advised in China will be deemed to have a permanent establishment, in which case such an investor/sponsor would be subject to 25% Chinese tax on capital gain as opposed to 0% – 10% tax withholding (depending on double tax treaties) if such FIP is not viewed as a permanent establishment.

  While there are compelling arguments against permanent establishment treatment, some Chinese local tax authorities have expressed contrary views.

  Although certain non-Chinese investors or sponsors may be able to claim tax credits on their home country tax returns for China taxes paid, this remains a significant issue for a tax-exempt investor.

- **Regulatory Approval.** One significant barrier faced by a non-Chinese investor is the requirement of regulatory approval from the Ministry of Commerce ("MOFCOM") for each investment in China, which usually takes two to three months. While it is now generally accepted that a FIP also requires MOFCOM approval for each of its Chinese investments, criteria and procedures for such approval remain unclear. It is anticipated that there will be a fast-track approval process for a FIP investment in a "permitted" or "encouraged" industry as identified in China's foreign investment guidelines.

  A Chinese limited partnership whose direct and indirect owners are exclusively Chinese nationals generally is not required to obtain regulatory approval for its investments; thus, a FIP's need for regulatory approval is a significant disadvantage vis-à-vis such a competitor. For a non-Chinese sponsor experienced in China, a key consideration in deciding whether to establish an RMB fund is the ability to compete with a Chinese sponsor on an equal footing.

INSIDE KIRKLANDPEN

- **Capital Sources.** There are limited sources of Chinese capital for RMB funds, particularly from institutional investors. One source is China's National Social Security Fund ("NSSF"), which has made several significant commitments to RMB funds. With limited exceptions, the NSSF has not been approved to invest in an RMB fund with a non-Chinese sponsor.

  State-Owned Enterprises ("SOEs") also have become increasingly active in private equity over the past year and may become a significant source of capital. However, an SOE must comply with complicated rules governing state-owned assets in China, requiring careful consideration in the context of a private equity fund.

  Chinese insurance companies are expected to become another source of capital for Chinese private equity funds, particularly following recent administrative measures announced by the China Insurance Regulatory Commission permitting Chinese insurance companies to invest in RMB funds, subject to certain limits (although detailed implementation rules remain pending).

- **Currency Conversion.** China maintains strict foreign exchange controls. However, in April 2010, it was speculated that the local Shanghai government would announce a trial program to allow a private equity fund to convert non-Chinese currency at the fund level up to a specified quota (the "Qualified Foreign Limited Partner" or "QFLP" program). If approved by the Chinese central government, this program should provide non-Chinese sponsors with more flexibility for structuring transactions and greater certainty of being able to convert dollars or euros into RMB and vice versa.[2]

- **Regulation.** Chinese national rules regulating the private equity industry in China are pending. It remains unclear which Chinese government agency (e.g., the National Development and Reform Commission and the China Securities Regulatory Commission) will assume responsibility for the industry. Chinese national regulation may affect the recently promulgated local government rules, and is expected to further clarify the rules governing other types of Chinese institutions investing in private equity, such as SOEs and insurance companies.

Next Steps

Given lingering uncertainties, few non-Chinese financial sponsors have set up an RMB fund. Carlyle's announcement of the first closing of its Beijing RMB fund, with commitments of RMB 2.4 billion (approximately US$350 million) and a target of RMB 5 billion (approximately US$740 million), and announcements of planned RMB funds from TPG and Blackstone, may signal a change in the pace of formations, although the focus so far remains on raising capital from Chinese investors to mitigate some of the issues described above. Other sponsors have adopted a more low-key approach, negotiating with local governments to determine the preferable Chinese region in which to establish a fund.

While these developments present an exciting prospect for non-Chinese sponsors seeking to establish a Chinese presence, sponsors should carefully weigh the risks associated with the remaining uncertainties against the potential upside of being one of the early entrants with an RMB fund.

1 Some local governments have agreed to register a Chinese limited partnership with a non-Chinese-owned general partner. While this structure potentially allows foreign sponsors to raise capital from Chinese investors, the regulatory treatment of such structure remains unclear. A private equity fund may also be formed as a foreign invested venture capital investment enterprise ("FIVCIE") pursuant to the 2003 FIVCIE Measures. However, a FIVCIE is subject to various restrictions, e.g., a FIVCIE may invest only in "high and new technologies."

2 Under the FIVCIE rules, a non-Chinese sponsor can convert non-Chinese currency into RMB but the conversion must be undertaken on a deal-by-deal basis and capital must be registered and converted by the target company rather than at the fund level.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

David Patrick Eich
http://www.kirkland.com/deich
+852 3761 3333

Justin Dolling
http://www.kirkland.com/jdolling
+852 3761 3363

Carol G. Liu
http://www.kirkland.com/cliu
+852 3761 3378

Letters of Intent – Say What You Mean and Mean What You Say

PENpoints

A recent decision by the Georgia Court of Appeals upholding a jury verdict awarding millions to a spurned prospective buyer shows that even careful drafting of "non-binding" language in a letter of intent may not be effective in avoiding unanticipated binding obligations.

In many acquisitions, the prospective buyer and seller enter into a non-binding letter of intent ("LOI"), which often gives the buyer the exclusive right to investigate and negotiate the transaction with the seller for a certain period of time. A recent decision by the Georgia Court of Appeals upholding a jury verdict awarding $281 million to a spurned prospective buyer shows that even careful drafting of "non-binding" language in an LOI may not be effective in avoiding unanticipated binding obligations if the parties' conduct is inconsistent with those provisions.[1]

An Unexpected Contract

In the Georgia case, David McDavid entered into an LOI providing him a 45-day exclusivity period to negotiate the acquisition of the Atlanta Hawks and Atlanta Thrashers professional sports franchises from Turner Broadcasting. The LOI stated that "neither party ... [would] be bound ... unless and until such party ... has executed the Definitive Agreements" and that "[n]o such binding agreement shall exist ... unless and until the parties have negotiated, executed and delivered ... Definitive Agreements." When the LOI expired at the end of the 45-day period (according to its terms), Turner did not agree to extend exclusivity, noting that the parties were "very, very close to a deal." Negotiations on final terms and documents continued for several months (without exclusivity) with multiple indications from Turner that the parties "have a deal" and the "deal is done," even to the point of preparing for a joint sale announcement. At the very end of the process, a second prospective buyer appeared and Turner engineered a quick sale of the teams to this suitor, signing the agreements as McDavid was flying to Atlanta for the sale announcement. McDavid sued Turner for breach of oral contract and won, with the jury awarding him $281 million in damages.

On appeal, Turner argued that the LOI clearly provided that the parties would not be bound to a sale unless written definitive agreements were signed. However, the court noted that since Turner had elected to allow the LOI to expire, it no longer benefitted from the protection of the "non-binding" provisions. As a result, the court judged Turner's conduct during the ensuing months (including the assurances to McDavid and the preparations for the sale announcement) as evidence of Turner's intent to be bound to a deal.

Lessons

When pursuing a deal involving an LOI, parties should not only include language specifying which provisions are intended to be legally binding, but they should also provide that the "non-binding" language will survive the termination of the LOI and/or the expiration of any exclusivity or negotiation period. Otherwise, parties who continue to work on a deal after a LOI expires could lose the benefit of its protective "non-binding" provisions, with the risk that they become unwittingly bound to an agreement based on their post-termination statements and conduct.

It is likely that the jury in this case was swayed by the extreme facts, and it bears noting that the appellate court's review was limited. However, the Georgia case serves as a reminder that words and actions can, after the fact, be interpreted as evidence of a binding agreement, even if definitive documents have not been signed, so parties should be careful about what they do and say during any negotiation period.

1 See our recent *M&A Update* discussing the importance of careful drafting of binding and non-binding provisions of LOIs.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

David Fox
http://www.kirkland.com/dfox
+1 212-446-4994

Daniel E. Wolf
http://www.kirkland.com/dwolf
+1 212-446-4884

PENbriefs

Gift and Generation-Skipping Taxes: 2010 Window of Opportunity to Expire Soon

A law passed in 2001 eliminated the federal estate tax and generation-skipping tax and decreased the gift tax rate to 35% for 2010. To learn how to take advantage of the 2010 decrease in the gift tax rate and the repeal of the generation-skipping tax, please see our recent *Kirkland Alert*.

PENnotes

Kirkland & Ellis & Houlihan Lokey Seminar: India: Opportunities & Challenges

Having emerged relatively unscathed from the financial downturn, India has emerged as an attractive investment destination. More recently, Indian companies have been active acquirers as they seek to accelerate their growth and establish international businesses, with many of these transactions squarely in the U.S. mid-market M&A range. Join panelists, including Kirkland partners Srinivas Kaushik and Abrar A. Hussain; Kushal Kapadia, Houlihan Lokey's director of corporate finance; Ashish Karandikar, partner at Apax Partners; Nick Nash, vice-president at General Atlantic; Sushma Rajagopalan, head of global strategy & corporate development at L&T Infotech; Ashwath Rau, partner at Amarchand & Mangaldas & Suresh A. Shroff & Co., and Haneef Sheikh, vice-president of North American operations at Glodyne Technoserve Limited, as they discuss how to source and execute investments in India, key terms for sponsors and Indian promoters and key considerations for Indian acquirers in the United States. This event will take place in Kirkland's New York office on September 28, 2010. For more information, or to register for this event, please visit www.kirkland.com/India2010.

Kirkland & Ellis Private Fund Manager Advisers Act Registration Seminars
Chicago, Illinois - September 14, 2010
New York, New York - September 21, 2010
London, UK - September 28 - 29, 2010
San Francisco, California - October 5, 2010

Join Kirkland & Ellis at one of our Private Fund Manager Advisers Act Registration Seminars, chaired by partner Scott A. Moehrke, P.C. Panelists at the seminars will focus on how the Private Fund Investment Advisers Registration Act of 2010 will affect private fund managers and the steps private fund sponsors need to take to plan for SEC registration and operate as a registered adviser. The seminars will allow interactive dialogue with our panels and are designed to give practical, hands-on advice for private fund managers. For more information, or to register for this event, please visit www.kirkland.com/pfmaar.

Kirkland & Ellis 5th Annual Real Estate Private Equity Symposium
New York, New York
September 23, 2010

Kirkland & Ellis' 5th Annual Real Estate Private Equity Symposium will discuss the state of the real estate funds business. Panelists include Alan Bear, managing director, Alvarez & Marsal Capital Real Estate LLC; Ed Casal, chief investment officer, global real estate multi-manager group, Aviva Investors; Jim Hime, principal, The Lionstone Group; Charles Purse, senior managing director and co-founder, Park Hill Real Estate Group, and Kirkland partners Gary E. Axelrod, P.C., Paul M. Basta, Nathaniel M. Marrs, P.C., Todd F. Maynes, P.C. and Stephen G. Tomlinson, P.C. For more information, or to register for this conference, please visit: www.kirkland.com/repe2010.

The Practising Law Institute's Mergers and Acquisitions 2010: What You Need to Know Now
Chicago, Illinois - September 23-24, 2010
San Francisco, California - October 7-8, 2010

These PLI seminars will focus on the continuing effects of instability in the credit and equity markets, the current market for acquisition financing and trends in going-private transactions. Kirkland partner R. Scott Falk, P.C., is co-chair of both events and will be a panelist in a discussion on "The Current M&A Landscape" in Chicago and San Francisco. During the Chicago event, partner Jon A. Ballis, P.C., will participate in a panel discussion on "Hot Button Issues in Private M&A Agreements." Partner Stephen D. Oetgen will participate in this panel during the San Francisco event.

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
Kirkland & Ellis LLP
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2009 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS LLP

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please e-mail
kirklandpen@kirkland.com
+1 (312) 862-2894

www.kirkland.com