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Private Equity Investment in China – Selected Considerations

U.S. Private Equity is Investing in China

An increasing number of private equity funds ("PEFs") are investing in companies with significant operations in China. While some of these investments are direct acquisitions of control or non-control interests in Chinese companies by larger funds with dedicated Asian investment teams, frequently they are being made by U.S.-based middle market portfolio companies doing bolt-on acquisitions, green field projects, or joint ventures. This investment activity reflects China's growing presence as one of the world's most important workshops and markets.

Favorable Tax and Other Policies for Foreign Investors

Under current Chinese law and policies, foreign investors can enjoy favorable tax treatment and other benefits if they come to own at least a 25% ownership interest in a China-based company. This investment can take the form of a joint venture or, more typically, a wholly foreign owned enterprise or "WFOE." As the name implies, a WFOE is wholly foreign owned and, under current Chinese law, may not have any ownership by Chinese "Domestic Residents" ("CDRs"). The tax benefits inuring to such a foreign invested enterprise or "FIE" can include a 100% corporate income tax holiday for the first two years of profitable operation and a 50% tax holiday for the next three years. Another benefit available to FIEs is the ability to import manufacturing equipment on a duty-free basis under certain circumstances.

Direct China vs. Offshore Holding Company Structure

The simplest and most straight forward FIE structure is direct ownership of the FIE by the foreign investor. There may, however, be advantages in making the investment in the FIE through an offshore holding company (which, from a Chinese regulatory perspective, could be an entity formed in the U.S. or in any other jurisdiction outside of mainland China, including Hong Kong). These advantages include: (1) if there are one or more co-investors, the opportunity to have some aspects of the legal and business relationship among the investors governed by the law of a country other than China, thereby providing greater certainty as to enforceability of the parties' respective rights and obligations; (2) greater flexibility in terms of follow-on financing at the holding company level; and (3) greater ease in transferring ownership of the investment at the holding company level (including in the form of an IPO) without the need for Chinese governmental involvement in most cases.

Ownership Interest of CDRs in FIEs Before Circular 75

In many instances it may be necessary or desirable for CDRs to obtain or retain an ownership interest in the FIE. Sometimes this will be the case because the current CDR owner of a business (whether an individual or an entity) which a PEF or other buyer wishes to acquire will sell only if the owner retains an equity interest. Other times, the buyer will want the former owner or a key existing or new manager to co-invest ("have skin in the game") in order to help ensure a better alignment of economic interests. The ability of a PEF to require a minority co-investor to deliver 100% ownership to a future buyer can be dealt with by providing for transfer restrictions and drag-along rights in a shareholder or similar agreement (although such rights may be more reliably and more readily enforceable in an offshore holding company structure governed by other than Chinese law).

In addition to the laws and regulations governing the formation of FIEs,

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applicable laws and regulations relating to the ability of a CDR to legally invest in an offshore holding company (or special purpose vehicle ("SPV")) that owns an FIE have been undergoing significant changes. The reason for this is the legitimate interest of the Chinese government to ensure that money transferred out of China by CDRs has been taxed when it was earned in China, and also to ensure that the special favorable laws and policies designed to attract foreign investment are not inappropriately taken advantage of by CDR investors (who such laws and policies were not intended to benefit). China has focused on the formation of, and investment in SPVs by CDRs in a process that has come to be known as making "Roundtrip Investments." Specifically, in January and April of 2005, Chinese governmental agencies issued so-called Circulars 11 and 29, with the stated aim of curtailing corruption in the disposition of state-owed assets and strengthening the enforcement of China's personal income tax laws.

However, Circulars 11 and 29 created the unintended consequence of putting a de facto freeze on the legitimate fundraising activities of numerous private enterprises in China in which many SPVs were legitimately being used by CDRs to obtain financing to acquire businesses and assets in China and to expand the operation of Chinese companies.

Chinese Ownership Interest in FIEs Since Circular 75

In order to redress these unintended consequences and encourage domestic private enterprise, China's State Administration of Foreign Exchange or "SAFE" issued Circular 75 on October 21, 2005, thereby effectively overruling Circulars 11 and 29. Prior to the issuance of Circular 75, Circular 11 required any CDRs who directly or indirectly established or obtained control of an offshore holding company to first obtain SAFE's approval. SAFE's approval was also required for any CDR to exchange domestic assets or equity interests for the stock or assets of a foreign company. In contrast, Circular 75 only requires CDRs to register with SAFE rather than obtain SAFE's approval.

Chinese Government Transactional Approvals

Even though Circular 75 changed the requirement for establishing an offshore holding company from obtaining an "approval" from SAFE to undergoing "registration" with SAFE, other governmental approvals related to offshore holding company transactions still apply. For example, Circular 75 requires that, prior to the registration of an offshore holding company with SAFE, a CDR must apply for and obtain a "Certificate of Overseas Investment" from the Ministry of Commerce ("MOFCOM") or the applicable provincial Department of Commerce depending on the size of the overseas investment. In addition, after obtaining the "Certificate of Overseas Investment," a CDR must apply for and obtain a "Foreign Exchange Registration Certificate for Offshore Investment" from the appropriate Chinese foreign exchange authority.

Applicability of Circular 75 to U.S. and Other Foreign Private Equity Investments

Even though the Circular 75 regime applies only to CDRs and their SPVs, if a CDR co-invests with a U.S. or other foreign investor, the benefits and requirements of Circular 75 affect the overall investment. As previously mentioned, there are many instances in which it is necessary or desirable to have CDRs co-invest with U.S. or other foreign investors. One needs to be careful, however, to not be ethnocentric about who needs or desires whom as co-investors. Private equity investment by domestic Chinese PEFs is already taking place and can be expected to expand. It may be, with increasing frequency, that domestic Chinese PEFs will be bringing U.S. or other foreign private equity investors into transactions – and not the other way around – given the domestic Chinese PEFs' greater overall access to target companies in China.

Certain Circular 75 Requirements

Circular 75 requires detailed disclosure of information by the parties involved in the SPV financing transactions, including information about the non-Chinese investor as well as the Chinese investor. Circular 75 also requires updates whenever certain material events or changes occur that affect the capital structure of the SPV. In addition, any profits, dividends, and foreign exchange revenue received by the CDR from the SPV must be remitted back into China in accordance with the fund use arrangement set forth in the business plan required to be filed as part of the initial SAFE registration. Furthermore, the Chinese company receiving capital from the SPV is required to complete registration of certain changes in its equity structure and the foreign capital infusion with SAFE. Non-compliance with these requirements or the business plan filed with SAFE may undermine the SPV's future ability to infuse capital into targeted Chinese companies, receive equity interests, profits, dividends, liquidation proceeds, or capital reduction proceeds from targeted Chinese companies, and conduct other offshore financing activities. In light of the significant problems that can arise, it is becoming standard practice for the parties to obtain an opinion from competent legal counsel on Circular 75 compliance issues.

Due Diligence and the Stages of a Chinese Private Equity Investment

For those new to doing business in China, we repeat here, an often quoted maxim – the "Six Ds" of investing in China – due diligence, due diligence, due diligence. The importance of due diligence in any investment, anywhere in the world is axiomatic; however, the role of diligence in China, where reliance on the enforceability of indemnification obligations is often less certain than in other jurisdictions which have more experience enforcing legal rights in transactional settings and where the ability to collect on a judgment may be problematic, cannot be overstated.

Investments in China require careful business and legal diligence at every stage, starting with background investigations of the principals and confirmation that the proposed transaction is permitted under applicable law and ultimately including careful examination of, among other things, (1) ownership and title issues, (2) labor, employment and social benefit obligations, (3) real estate and environmental compliance, and (4) financial, accounting and tax matters.

A typical scenario (albeit subject to many possible variations of course) for a U.S.-based PEF or a portfolio company making an investment in, or an acquisition of, a China-based company (or for establishing a green field operation) using an offshore holding company in which a CDR will be a co-investor might involve the following stages:

1. Pre-signing:
   a. enter into a mutual, non-disclosure agreement with the target company and the co-investor;
   b. enter into a non-binding letter of intent outlining the proposed transaction and providing for a period of exclusivity; and
   c. negotiate and prepare agreements and other documents needed to form and license the SPV and FIE, effect the acquisition, and govern the business relationship among the co-investors.

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Charlene Lee Joins China Group

Benesch is pleased to announce that **Charlene Lee** has joined the firm as Of Counsel in the Corporate & Securities Practice Group and the China Group.

Ms. Lee has more than 20 years of experience comprised of both corporate and private practice in the United States as well as government experience in China. She focuses her practice on Asian, European, and Latin American international commercial transactions; global expansion; mergers and acquisitions; corporate governance and compliance; and contract drafting and negotiations.

Most recently, Ms. Lee served as senior counsel in corporate international for Briggs & Stratton Corporation, a $2.6 billion publicly held manufacturer of gasoline engine and power products. She was responsible for managing global legal affairs, foreign investment, global expansion, commercial transactions, and contract issues.

Ms. Lee received her J.D. from Marquette University, and her LL.M. in International Commercial Transactions and Corporate Laws from the University of Illinois College of Law. She received her LL.B. (Chinese degree in law) from Beijing University of International Economy and Trade. She is fluent in Mandarin.

Prior to practicing in the U.S., Ms. Lee was admitted to practice in China. She is currently licensed to practice law in Illinois, and her admission to the Ohio Bar is pending.

Co-Chair of the China Practice Group, Allan Goldner, stated, "Charlene brings a great depth of experience to the firm. She will be an asset to our China, international, and Corporate practice areas, and we are very excited to have her on board."

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2. At signing: execute and deliver the agreements and other documents needed to form and license the SPV and FIE, effect the acquisition, and govern the business relationship among the co-investors (subject to a due diligence out, if possible).
3. Prior to closing:
   a. form the SPV and FIE entities; and
   b. apply for and obtain a business license and other Chinese governmental approvals (including compliance with Circular 75).
4. At closing:
   a. foreign sourced capital is contributed into the offshore SPV;
   b. the offshore SPV uses the capital to purchase the assets of, or swap for the equity interests held by the CDRs in the Chinese domestic enterprise, thereby transforming it into an FIE (subject to Chinese governmental approval); and
   c. the SPV may contribute capital into the FIE (thereby increasing its registered capital).

Unanswered Questions About Circular 75

Though Circular 75 provides fairly detailed definitions for SPVs, "Roundtrip Investment", CDRs, and "Control," it does leave some ambiguity. For example, "Domestic Residents" include both a resident with a PRC passport/ identification card, and an individual who does not have a resident status in the PRC, but who, because of his/her economic attachment to China, "habitually" resides in the PRC. But there is no certainty as to the point at which a non-China resident will be deemed to habitually reside in the PRC. It is clear, however, that PRC citizens residing outside of China are "Domestic Residents" for the purpose of Circular 75.

Another unanswered question arises from the fact that, even though Circular 75 requires that the capital infusion from an offshore holding company to a domestic Chinese company must be registered with SAFE, it does not address whether such domestic Chinese company is automatically converted to FIE status as a result of the capital infusion.

[T]he need to carefully plan an appropriate FIE structure and to proceed with due care in implementing the structure is critical.

It is not clear whether the FIE must still go through the normal approval procedures with MOFCOM. This is an issue that is being discussed and studied (or rather "negotiated") by MOFCOM and SAFE. Both administrations seem to be in agreement with the general trend to relax the "approval" procedures for FIEs, and any changes in this regard will likely favor encouraging and facilitating foreign investment rather than setting up obstacles. At this point however, a CDR that receives foreign capital still needs to apply for approval from MOFTEC or its local agencies to convert itself into an FIE in order to enjoy FIE benefits and privileges.

As is often the case, newly promulgated laws and regulations such as Circular 75 are subject to further interpretation over time as well as to some local variations in interpretation and enforcement. Accordingly, further refinement of Circular 75 in the coming months or years is certain.

The Future of Investing Private Equity in China

As a result of continuing manufacturing advantages over most of the world and the tremendous market opportunities within China and much of neighboring Asia, there will undoubtedly be significant amounts of additional PEF capital invested in China in the coming years. However, the opportunities in China are coupled with significant complexity and risk, so the need to carefully plan an appropriate FIE structure and to proceed with due care in implementing the structure is critical. Looking forward, while Circular 75 can be regarded as a favorable development for U.S.-based and other foreign PEFs as well as CDRs, additional favorable developments which may further enhance the landscape for foreign investment in China may be on the horizon. PEFs and other investors with an interest in China and its impact on the global marketplace should continue to monitor these developments.

For more information on this topic, please contact Allan Goldner at agoldner@bfca.com or 216.363.4623; Charlene Lee at clee@bfca.com or 216.363.4635; Peter Shelton at pshelton@bfca.com or 216.363.4169; or Yanping Wang at ywang@bfca.com or 216.363.4664.

Benesch Lawyers Travel to China Again

In April, Allan Goldner, Yanping Wang, and Peter Shelton completed a two week trip to China. While there, the three China Group attorneys traveled extensively on behalf of clients and in furtherance of the firm's strategic objectives in China. China Group Co-Chair Allan Goldner notes that "[T]he amount of work requiring the presence of Benesch lawyers on the ground in China – for diligence as well as face-to-face meetings and negotiations – continues to grow. We are very pleased with the growth we have seen in this practice and gratified to be able to help so many clients with China-based needs."

[W]e were able to accomplish a great deal on behalf of our clients, as well as continue our mission of expanding our relationships with other service providers with whom we work closely.

Allan and Yanping spent their first two full days in Qingdao, in eastern Shandong Province, in connection with the acquisition of a manufacturing business that will ultimately be a wholly foreign-owned enterprise (WFOE) of a joint venture controlled by the firm's Tennessee-based client. From Qingdao, Allan and Yanping traveled to Guangzhou, in southern China's Guangdong Province, to meet with representatives of a client in the rubber compounding business that is negotiating a joint venture with a Japanese partner. Yanping, Allan and our client toured the proposed factory that will be the foundation of the joint venture's operations and attended a dinner with representatives of the Japanese partner. Concurrently, Peter traveled to Hong Kong for meetings with colleagues at a local law firm that is providing assistance on behalf of several clients with Hong Kong-based holding companies and/or operations. While in Hong Kong, Peter also met with a number of business associates and service providers.

The three Benesch lawyers, along with Joanna Liao, head of Benesch Pacific's representative office in Shanghai, reunited in Dongguan for a meal together before Peter and Joanna flew three hours west to Chengdu, in Sichuan Province. Peter and Joanna spent a day and a half there, meeting with a client that is building a factory to make medical equipment for distribution throughout Asia. Meanwhile, Allan and Yanping continued their work on behalf of several other clients with projects in Shenzhen and elsewhere in Guangdong Province. From Shenzhen, Allan and Yanping traveled to Shanghai, where they caught up with Peter and Joanna upon their return from Chengdu.

While in Shanghai, the Benesch lawyers spent a significant amount of time working with a Cleveland-based manufacturing client with significant operations in China in connection with a proposed merger with a Chinese manufacturer in a complimentary industry. Allan, Peter, and Yanping met with the firm's client and the Chinese investment banker that brought the parties together to discuss the structure of the proposed transaction as well as the terms of a proposed equity investment by a leading Asian financial institution. The three lawyers also spent time in Shanghai with a number of business associates and other service providers with whom members of the China Group frequently work. The group also met with local representatives of the Ministry of Justice to discuss Benesch's application to open a legal representative office (i.e., a law office) in Shanghai.

From Shanghai, Peter and Yanping traveled to Shenyang, in northeastern Liaoning Province, for two days of discussions between an Akron-based client and its Chinese joint venture partner. The planned venture will be a leading manufacturer of molds for the tire industry in China. Meanwhile, Allan remained in Shanghai for additional client meetings. Allan and Peter reunited in Beijing for the return flight to the US, while Yanping stayed on in Beijing for several additional days in order to attend to client matters. China Group Co-Chair Peter Shelton reflected on the trip, noting that "[I]t was a lot of travel to compress in to two weeks, but we were able to accomplish a great deal on behalf of our clients, as well as continue our mission of expanding our relationships with other service providers with whom we work closely."

Benesch Lawyers Visit the White House

China Group members Allan Goldner, Peter Shelton and Yanping Wang were fortunate to be among those invited to attend the welcoming ceremony for President Hu Jintao and Madam Liu Yongqing on April 20. The ceremony, held on the South Lawn of the White House, included extensive remarks from both heads of state, as well as quite a bit of pageantry including military honor guards. The US delegation to the ceremony included both President and Mrs. Bush, as well as the Vice President and Secretaries of State and Defense. However, President Hu's day of meetings at the White House did not result in any breakthroughs or meaningful immediate developments on the significant issues (e.g., the U.S. trade deficit, devaluation of the RMB, intellectual property rights, human rights) discussed.

Events

On May 23rd, Yanping Wang spoke on **Practical Advice on IPR Protection in China** at "China: Risk, Reward & How to Win" put on by the U.S. Department of Commerce. This conference was geared to American businesses serious about developing their market in China, and aimed to provide attendees with the tools, marketing intelligence and resources needed to thrive in China, from Shanghai to Hong Kong.

Benesch's annual private equity summit will take place this year on June 21st at the Ritz Carlton in Cleveland. This year's theme is **Doing the Deal: M&A Beyond Our Borders**. Our keynote address on "Doing Business in China – Strategy Before Structure" will be given by Steven Ganster, Managing Director of Technomic Asia. Two panel discussions, "Investing Overseas - Sourcing and Significant Investments in and on the Ground" and "Due Diligence, Intellectual Property and Other Challenges" will follow.

How We Work With Clients

We help U.S. companies as they: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally-related legal issues in China; (5) source components or products from China, and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We also help Chinese companies with respect to U.S. legal and business considerations as they: (1) establish U.S.-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish subsidiaries and other business operations in the U.S.; and (3) acquire the shares or assets of U.S. companies.

We help clients as they structure, negotiate and document China-related transactions; and provide consult with clients with respect to capital structure, operating control, governance, due diligence, and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers (including Chinese licensed lawyers with whom we work when our clients' needs require advice on Chinese laws) enable us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost effective manner.

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