Structures for International Private Equity Investment in the PRC

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Over the last several years, a number of emerging trends have increased the attractiveness of utilizing onshore RMB-denominated investment vehicles to international private equity investors operating in China. While the regulatory framework remains opaque and less than fully formed, the Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises and Individuals, which became effective in March 2010, has clearly changed the landscape for the formation of onshore private equity investment structures and RMB-denominated investment funds and, moreover, indicates a growing maturation and clarification of regulatory support in this important area of the Chinese economy.

For international private equity investors seeking opportunities in China, the challenges have not been limited only to the identification of investable local targets. The inconvertibility of the Renminbi ("RMB"), the unreliability of the legal system, and the preference for a foreign public listing as an exit event had all been among the numerous reasons that most foreign private equity investments in Chinese companies were done indirectly as investments in offshore holding companies, typically formed in the British Virgin Islands, Hong Kong or the Cayman Islands, under which the target Chinese companies were held. These structures operated to convert white label domestic companies into Wholly Foreign Owned Enterprises ("WFOEs") by virtue of their ownership being transferred from local owners to an offshore holding company in which the Chinese transferees were then issued shares, a transaction termed a "return" or "round trip" investment by the Chinese authorities. While such so-called "red chip" structures facilitated capital inflows to small and medium PRC enterprises and allowed them to list on foreign bourses, such as NASDAQ, AMEX, US OTCBB, London AIM and the Hong Kong and Singapore exchanges, the Chinese government effectively blocked this approach over concerns, inter alia, that such structures were being abused to enable Chinese companies and their owners to avoid domestic taxation and foreign exchange controls.

In August 2006, the Regulations on Mergers and Acquisitions of Domestic Companies by Foreign Investors ("M&A Rules"), sometimes referred to as Circular 10, were jointly promulgated by the Ministry of Commerce ("MOFCOM"), the State-Owned Assets Supervision and Administrative Commission of the State Council, the State Administration of Taxation ("SAT"), the State Administration for Industry and Commerce ("SAIC"), the China Securities Regulatory Commission ("CSRC") and the State Administration of Foreign Exchange ("SAFE") becoming effective the following month.

The M&A Rules imposed strict restrictions on onshore-offshore restructurings, the use of offshore special purpose vehicles for private equity investments, and overseas public listings of Chinese companies by requiring approval from the MOFCOM central office in Beijing, as opposed to the local Commission of Foreign Trade and Economic
Cooperation (“COFTEC”) office in the province or municipality relevant to the transaction. In practice, such central approval has proven to be near impossible to obtain.

The M&A Rules were followed by the release of SAFE Implementation Notice 106 in May 2007. These implementation rules were issued pursuant to SAFE Circular 75 (November 2005) that had liberalized the regulation of offshore structures for foreign investment in Chinese companies. However, Notice 106 went beyond clarifying the earlier more liberal rules and further constrained offshore financing structures by introducing additional regulation.

In response to the new barriers to the offshore holding company structure, a number of international private equity investments and foreign listings (including reverse merger and Special Purpose Acquisition Company (“SPAC”) deals) have been structured on a Variable Interest Entity (“VIE”) model known as the “Sina structure”. The Sina structure takes its name from Sina Corporation (NASDAQ: SINA) and was originally adopted to avoid Chinese government restrictions on foreign investment in companies engaged in business in restricted economic sectors. The structure involves the establishment of an offshore holding company with a subsidiary WFOE that enters into a series of agreements with the target Chinese operating company (“captive company”) and its shareholders to transfer the economic interests of the captive company to the WFOE. This type of structure is also referred to as a “triangular” or “China-China-foreign” structure.

Despite the fact that a strict reading of the applicable regulations would indicate its apparent impropriety, the absence of equity ownership that categorizes the Sina structure has allowed foreign investors to acquire controlling interests in restricted industries and has been often employed to avoid the MOFCOM approval process under the M&A Rules and Notice 106. Even without regard to its technical legality, the risk to investors that such a structure based on contractual rather than direct equity ownership rights represents, especially in the China context, makes this type of VIE model much less than ideal.

While the structure has not recently faced any major challenge despite its use in high profile listings like Sohu (NASDAQ: SOHU) and Shanda (NASDAQ: SNDA), China Unicom (HKSE: 0762; NYSE: CHU) still presents a cautionary tale for Sina structure investors. In 2000, the China Unicom Hong Kong IPO was the biggest IPO of the year in Asia ex-Japan. The company also listed ADRs on the New York Stock Exchange. However, the year previous to the successful offering, the Ministry of Information Industry (“MII”) had made a determination, widely reported in the press, that Unicom’s then existing VIE arrangements were “irregular” and instructed Unicom to dissolve them. A China Unicom company press release from 6 February 2001 explains:

*The success of China Unicom's IPO was mainly attributed to the Company's restructuring and appropriate settlement of 43 "China-China-Foreign" contracts. The approval from the Regulatory Bureau [MII] in China prior to the IPO to allow China Unicom to provide integrated telecommunication services was also a favorable decision to China Unicom.*

Another less than ideal work-around to the M&A Rules and Notice 106 is the so-called “slow walk” structure. In this structure a China operating company is wholly acquired by an offshore company and converted into a subsidiary WFOE with the intent to revert partial ownership back to Chinese shareholders post-transaction. While approvals for the acquisition are required, most often from COFTEC, obtaining such is comparatively easy as with removal of all Chinese owners the round trip investment issue is averted.
The reversion of ownership to the operating company’s original Chinese shareholders, usually top management, is accomplished by earn-out agreements through which they are eventually issued shares in the offshore holding company. The main operative issues with this structure are that entrepreneurs are very often loath to give up their ownership, even temporarily, and that the structure complicates deal valuation (which is an item of MOFCOM/COFTEC review). The main legal issue is, again, a strict reading of the relevant law indicates that the slow walk structure should not be sufficient to remove the investment from the purview of the M&A Rules and Notice 106 especially if a determination were to be made that the purpose of the structure is to circumvent the regulatory authorities rather than to achieve a legitimate commercial purpose. This structure has, however, like the Sina structure, been used, so far with success, in numerous deals, an example of which was the US listing via reverse take over of Orient Paper (AMEX: ONP; formerly OTCBB: OPAI).

At the same time a changing regulatory environment created difficulties for investments in Chinese companies made utilizing an offshore structure, the increasing attractiveness of on-shore RMB-denominated investments to foreign investors has also been driven by the development of a number of factors including the general perceived desirability of exposure to RMB-denominated assets, the emergence of local exit event option of GEM listings in Shenzhen and relaxation of listing restrictions for foreign owned companies on PRC bourses, the availability of investment incentives from provincial and municipal level governments, and better access to the growing pool of domestic capital.

One way of structuring an onshore China investment is through a Sino-foreign joint venture under the foreign-invested enterprise (“FIE”) laws. This structure has long been a mainstay of foreign investments in China. However, there are a number of drawbacks to this approach for private equity investors stemming largely from the fact that the FIE laws were implemented to accommodate long term strategic investments, primarily in greenfield projects, and therefore lack the sophistication and flexibility afforded by the company laws of jurisdictions such as, for example, the British Virgin Islands, Hong Kong or Delaware.

Capital structures available for FIE formation are limited. The most common FIEs, the equity joint venture (“EJV”), the co-operative joint venture (“CJV”) and the WFOE, are not organized by shares, as utilized in most familiar international jurisdictions, but rather the equity interest is evidenced by verification of the actual pay-in of the investor’s equity contribution as registered with SAIC. Thus equity ownership interest is a reflection of the individual shareholder’s contribution as a percentage of the enterprise’s registered (“paid in”) capital. The overall funding required by the FIE, as declared at its formation, is “total investment”. The difference between total investment and registered capital represents the FIE’s legal borrowing capacity. Any increase in total investment requires prior governmental approval. There are also practical limitations to the sale of FIE ownership interests as a pre-condition to such are unanimous board action as well as governmental approval.

An EJV is the most inflexible FIE structure as there are legal requirements for board representation and capital distributions to shareholders to reflect registered equity ownership percentages. The CJV offers a little more flexibility as distributions may be made pursuant to shareholder agreement, but such a right is not absolute. A WFOE generally has the greatest flexibility of the common FIE structures, but by definition may not include PRC domestic shareholders. Moreover, none of these structures provide for a preferred share class, convertible debt or options mechanisms. While these and other common private equity investment terms can be contractually stipulated, enforcement is uncertain.
A less common FIE structure, and a much more flexible one than the two forms of joint venture, is the foreign company limited by shares (“FICLS”). This structure has been described as a marriage between an international corporate structure and an EJV. However, it has been infrequently used due to the strict review requirements by MOFCOM. Significantly, the FICLS is the only form of FIE which currently may be publically listed in the PRC. Other forms of FIE may be converted into a FICLS upon the meeting of a set of strict requirements, including three years of profitability, and the approval of MOFCOM. As domestic exits increase in feasibility and popularity, this structure is likely to become more common and more detailed regulation regarding the formation and governance of FICLS is likely to be forthcoming. The FICLS structure remains in the focus of the investment community.

Although China has undertaken a continuing series of broad legal reforms since its entry into the WTO in 2002, the legal framework of the PRC still lacks the consistency, transparency, and reliability of familiar international incorporation jurisdictions. This, together with the wide latitude of discretion exercised by various governmental authorities, subjects international private equity investments, especially those structured as joint ventures, to a substantial degree of uncertainty which may only become evident at a late stage in the investment transaction process. Incidents where the governmental authorities have denied approval of a proposed CJV investment transaction structure on the basis that the terms are in violation of the principle of shareholder equality and mutual benefit enshrined in PRC company law have been widely decried. Another encountered problem which causes international investors in China using FIE structures to lose sleep has been being prevented from exercising a preference right due to the denial of government approval post-closing of the investment transaction, such as the denial of the reduction of registered capital of a joint venture upon exercise of a redemption right granted under contract outside the company formation documents.

In 2001, MOFCOM together with the Ministry of Science and Technology (“MOST”) and other concerned authorities promulgated a set of regulations which allowed foreign investors to set up foreign-invested venture capital investment enterprises (“FIVCIE”) and to pool funds with domestic capital in certain high tech investments. These rules, and their later amendments, provided the first means for the establishment of onshore foreign-invested investment funds in the PRC.

Once established on approval by MOFCOM and MOST, a FIVCIE is allowed to make equity investments in certain private companies falling within the scope of permitted investment without prior government review or approval. The onshore FIVCIE structure has a number of strong advantages. Foreign exchange can be more easily processed and capital can be redeployed onshore in RMB. Investment transactions made through the FIVCIE can be completed much more quickly because of the streamlined approval and foreign exchange allowances and it allows foreign fund managers to have a legal structure to raise RMB capital onshore from Chinese institutions such as securities firms, insurance companies and government industrial investment funds. The greatest limitation to the use of the structure is the fact that allowable investments are limited to a narrow range of emerging technology enterprises.

In December 2009, the Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises and Individuals (“FIPE Measures”) were promulgated. This followed the adoption of the PRC Partnership Law in 2007 and appears to represent a potential sea change for the structuring of international private equity investments and the establishment of onshore foreign-invested investment funds in China. The FIPE Measures, which went into effect in March 2010, provide, for the first time, the regulatory basis for foreign investors to form a PRC partnership.
One key advantage of a FIPE structure over FIEs is that it is not necessary to obtain MOFCOM approval for the establishment of a FIPE. Registration is made with SAIC. Under the Measures, FIPEs are generally subject to the same terms and conditions as domestic partnerships under the Partnership Law. However, FIPEs are not completely recognized as a domestic enterprise and must comply with the Foreign Investment Industrial Guidance Catalogue and so are unable to invest in legally prohibited economic sectors and may also not directly invest in regulated investments where the use of a JV vehicle is legally mandated.

The promulgation of the FIPE Measures marks a significant change in China’s foreign investment regime, and is likely to largely replace the use of FIEs, especially the CJV, in international private equity investments in the PRC as the partnership structure will provide a number of benefits to investors. Like a partnership, a CJV need not be an independent legal person under the law; however, in such case the investors will bear unlimited liability. PRC law provides for both general and limited liability partnership enterprises. In a general partnership, the partners have unlimited joint and several liability for the partnership’s obligations. A limited liability partnership ("LLP") has two classes of partners: general and limited. The general partner is held to unlimited liability while limited partners are liable only up to the amount of their capital contribution.

Similar to, but more flexible than the stipulation of unequal profit sharing in a CJV structure, the partners of a partnership enterprise are entitled to profits as memorialized in the partnership agreement. Profit and loss sharing ratios are not required to correspond to capital contributions, as in an EJV, and these and other unequal, or preferred, rights should be more enforceable under the partnership than FIE model as there is no legal concept of stake holder equality enshrined in the Partnership Law or FIPE Measures.

The FIPE Measures do not stipulate or expressly limit the forms of capital contributions for FIPEs. Assuming then that the capital contribution provisions of the Partnership Law are also applicable to FIPEs, in addition to cash, land-use rights, and/or IP or other property rights, general partners will be able to make a capital contribution in a partnership through the provision of services. This type of capital contribution has not been traditionally allowed in the FIE context. A number of questions regarding FIPE capital contributions remain unanswered including any maximum percentage for non-cash contributions by any individual partner or as a total percentage of paid-in capital, the applicability of debt to equity ratio limitations, time limits on capital pay in, and issues regarding the process for the increase or decrease of registered capital.

Despite some significant remaining obstacles, including the inability to legally provide debt financing to portfolio companies, a 25% tax rate on carried interest and management fee payments, an incomplete regulatory framework, and foreign exchange issues, the FIPE Measures have increased the momentum for international private equity firms to form domestic RMB funds in China. It must be noted in particular that Article 14 of the Measures mandates that FIPEs with a business scope including investment must comply with further rules, but such further rules are yet to be promulgated. Moreover, the Measures do not relieve FIPEs from the necessity of complying with other regulations including SAFE Circular 142, issued in October of 2008, which severely restricts the conversion and repatriation of foreign currency. However, local governments, including Beijing, Shanghai and Tianjin, have moved to issue more detailed regulation of foreign-invested private equity funds based on the Partnership Law and FIPE Measures and are actively seeking incentive policies from the central government to attempt to resolve some of the obstacles and allow FIPES to be effectively used in the formation of investment funds. The successful formation of the FIPE RMB fund by Carlyle and Chinese partner Fosun in Shanghai closely following the effective date of the Partnership
Measures seems to indicate that SAIC will allow local Administration of Industry and Commerce (AIC) offices to register private equity funds formed as FIPEs despite the fact that the additional rules referred to in Article 14 of the Measures have yet to be implemented.

While many issues remain unsettled, it is clear that the FIPE Measures are a big step toward satisfying the demand to make partnership enterprises, as established in the Partnership Act, available to international private equity investors and to allow the structure of international investments and investment management activities in China to be executed after a form more in keeping with global standards than is possible under the existing FIE regime. However, the Measures still fall short of giving international investors the ability to establish, invest in and operate an RMB-denominated fund recognized nationally as a PRC domestic entity free to invest on an equal basis with non-foreign invested domestic funds and, moreover, as noted, fail to resolve the chilling restrictions of SAFE Circular 142.

The appetite of international investors to participate in the economy of China, now the second largest in the world, continues unabated despite the ongoing lack of a fully formed, reliable, and clear regulatory system to support foreign investment activities. The Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises and Individuals and other regulatory changes, including steps to liberalize the domestic public listing of foreign invested enterprises, are encouraging signs for international private equity firms active in the PRC and herald the beginning of a new stage in China private equity marked by the dominance of domestic-based RMB-denominated investment structures open to the meaningful participation of foreign players. While further regulatory clarity and progress are sorely needed, especially in the area of foreign exchange controls, the promise that the future holds for increased flexibility in investment structures, enhanced investor rights, and the ability to operate foreign-invested funds as domestic entities is an exciting and realistic prospect for international investment in China.

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Origo Partners PLC (LSE: OPP) is a London AIM-listed private equity firm active in investing in both private companies in China and international companies involved in the Chinese economy.