



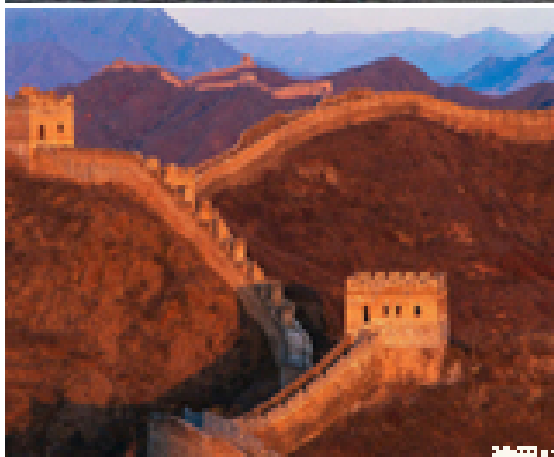
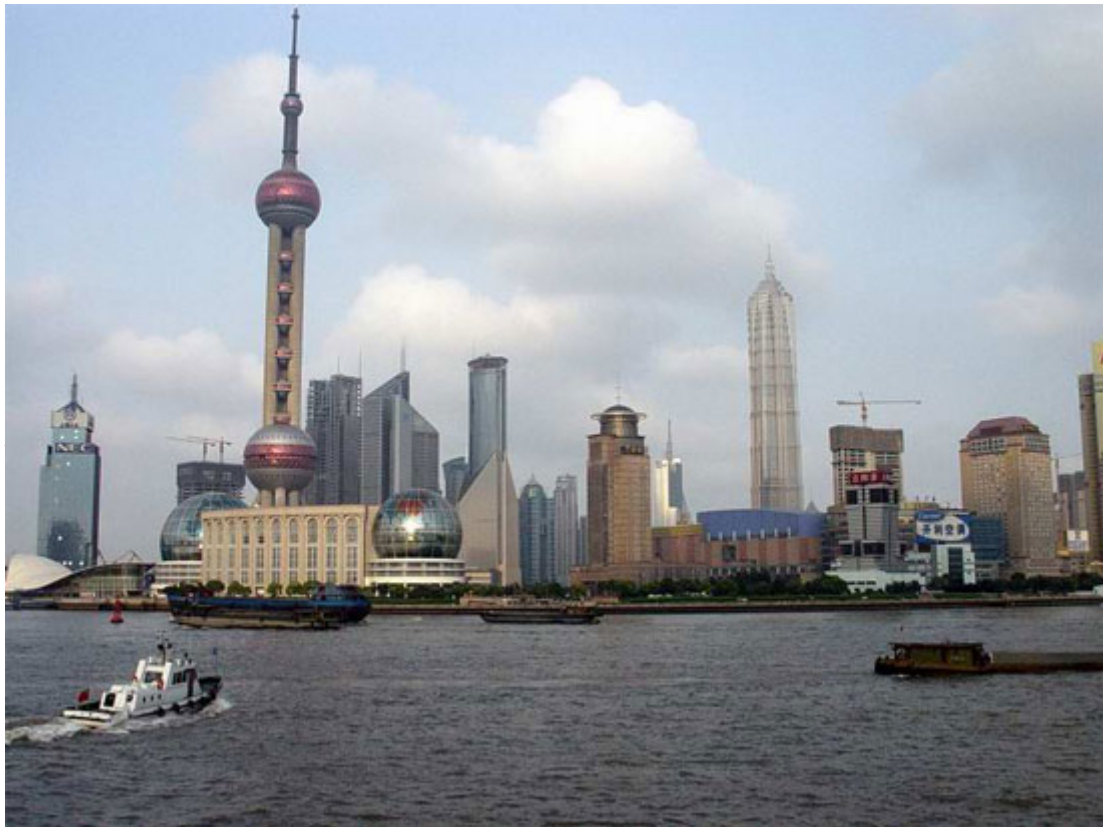
CHINA SUNBOW & ASSOCIATES
ADVISORS ON CHINESE IP & COMMERCIAL LAWS

GUIDANCE ON CHINESE FDI, M&A PRACTICE

BRIEF GUIDANCE TO FOREIGN DIRECT INVESTMENT, MERGERS AND ACQUISITIONS IN CHINA

PROCEDURES AND COMMENTS ON ESTABLISHING JOINT VENTURES,
WHOLLY FOREIGN OWNED ENTERPRISES, REPRESENTATIVE OFFICES AS
WELL AS MERGERS AND ACQUISITIONS PRACTICE IN CHINA

BY BILL H. ZHANG IN MARCH, 2009





INTRODUCTION

China Sunbow & Associates, Advisors on Chinese IP & Commercial Laws, is pleased to provide this *Guidance on Chinese FDI, M&A Practice*, as a basic introductory guide for companies from other countries and regions who may be interested in making foreign direct investment or merging with and acquiring enterprises in the People's Republic of China ("PRC" or "China"). China is one of the world's fastest-growing economies with stable political and social environment, providing unparalleled opportunities for both foreign and local investors. More and more foreign investors are desirous to make investment or merger with and acquire enterprises in China from their global business strategies. Nevertheless, numerous cultural, legal and governmental regulatory issues separate foreign investors from opportunities to make investment or merger with and acquire enterprise in China without acquainting themselves with Chinese legal regime and practice. To have a basic knowledge on Chinese FDI and M&A related legal regulatory frame is quite important to assure your business operation in China successful. For this purpose, we have prepared this Guidance for our foreign clients. We hope this Guidance will be of some assistance to your business decisions and strategies for the relevant legal issues concerning the China market entry and operation of your business in China.

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FOREIGN DIRECT INVESTMENT



WFOE

- **Establishment of a Wholly Foreign Owned Enterprise (“WFOE”) in China**

The Procedures for the Establishment

Generally speaking, when establishing a WFOE in China, though it may possibly vary from one place to another within China, it shall normally go through the following procedures:

- ▼ Name pre-registration with the competent administration for industry and commerce (AIC)
- ▼ Approval of the feasibility study report by the competent commercial authority
- ▼ Environmental impacts evaluation by the relevant environmental protection bureau (if any)
- ▼ Approval of the articles of associations and issuance of the approval certificate by the competent AIC

- ▼ Issuance of Business License by the competent AIC
- ▼ Carving chops of the WFOE at the relevant public security bureau (PSB)
- ▼ Handling enterprise organizational code certificate with the relevant technical supervision bureau (TSB)
- ▼ Opening RMB bank account
- ▼ Registration with the State Administration of Foreign Exchange (SAFE)
- ▼ SAFE approval
- ▼ Open foreign capital bank account
- ▼ Inject capital
- ▼ Capital verification
- ▼ Renewal of Business License with the competent AIC
- ▼ Tax registration and issuance of tax registration certificate
- ▼ Customs registration and recordal
- ▼ Commodity inspection registration with commodity inspection bureau
- ▼ Application for general tax payer status

Time Estimation for the Establishment

If it is a straight forwarding case for applying for various governmental permissions and licenses, it will



normally take about three to six months to complete all the above steps to establish a WFOE in China. As we have already mentioned that this may possibly vary among different local places, so the time schedule for such establishment really depends on the local governmental practice.

Document Lists Required for the Establishment

The following documents shall be submitted to the relevant Chinese governmental authorities for applying for various permissions, licenses and approvals for the establishment of a WFOE:

- Articles of Associations;
- Feasibility Study Report;
- Application Letter;
- Approval Letter;
- Investors' Certificate of Incorporation;
- Letter of Creditworthiness issued by the investors' opening bank;
- Identity Certification of the Investors' Legal Representative;
- Lists of the Members of the Board of Directors of the WFOE;
- Appointment Letter for the Members of the Board of Directors of the WFOE;
- Premises Lease Agreement or Real Estate Ownership Certificate;
- Lists of Import and Export Goods (only required for wholly foreign owned commercial enterprises); and
- Power of Attorney

FICE



► **Establishment of a foreign invested commercial enterprise (FICE)**

Is FICE allowed in China?

According to the Measures on the Administration of Foreign Investment in Commercial Fields promulgated by the Ministry of Commerce in June, 2004, China has opened its distribution and retail industry to foreign investors. As of June 1, 2004, foreign investors have been permitted to establish a commercial company by means of Sino-foreign joint venture and wholly foreign owned commercial companies are further allowed to be established by a foreign investor from December 11, 2004.

A FICE is allowed to engage in retail and distribution business to sell their goods domestically made to Chinese individual persons from its fixed location or through TV, telephones, mail order, internet or vending machines.

However some strict conditions are still imposed on some special commodities for foreign investment in the means of FICE.

The Procedures for the Establishment

The procedures for establishing a FICE is quite similar to the establishing procedures for a WFOE, please refer to the details of the procedures for establishing a WFOE.

Time Estimation for the Establishment

In case it is a straight forwarding case for applying for governmental permissions and licenses, it normally takes about three to six months to complete the whole procedures for establishing a FICE in China. Please also be noted that it varies regionally within China, depending on the complexities and local governmental practice.

Document Lists for the Establishment

According to the Guiding Manual for Foreign Invested Commercial (Distribution) Enterprises promulgated by the Ministry of Commerce in September, 2005, when establishing a foreign invested commercial (distribution) enterprise, the following documents shall be submitted to the competent commercial authorities:

- Application Letter;
- Feasibility Study Report;
- Joint Venture Contract, if any, and Articles of Associations;
- Letter of Creditworthiness of the Investors;
- Certification of Incorporation of the Investors;
- Identity Certification of the Legal Representative of the Investors;

- Latest Audit Report of the Investors;
- Lists of the Import and Export Commodities;
- Lists of the Members of the Board of Directors;
- Appointment Letter for the Members of the Board of Directors; and
- Land Use Rights Certificate or Premise Lease Agreement.

JV



► Establishment of a Joint Venture Enterprise (“JV”) in China

Why JV?

If you do not want to take a long time to develop Chinese markets and deal with the complicated local governmental relations when newly coming to China, establishing an enterprise by choosing the entry vehicle of joint venture with an existing Chinese partner can facilitate your market entrance and speed up your business operation in China. More importantly, when you intend to establish a business in a certain area, however such area is strictly controlled or restricted for pure foreign investment, then a JV is an ideal choice for starting your business in China.



Both foreign investors and Chinese partners may benefit from the establishment of a JV. Some Chinese enterprises need to develop a foreign partner to help their products go beyond the country and sold overseas and they need to seek for advanced technology and management experience from a foreign partner, while some foreign

enterprises, hungering for the Chinese massive markets and also the cheap Chinese labor and land costs, also need a Chinese partner to accomplish their objectives in China. Therefore JV is widely used by Chinese and foreign enterprises to cooperatively operating business in China

Two Types of JVs

In China there are two types of JV, one being the equity joint venture (EJV), the other being the cooperative joint venture or so called contractual joint venture (CJV). The main differences of these two JVs are highlighted as follows:

Items	EJV	CJV
Governing Law	PRC Law on the Sino-foreign Equity Joint Venture and the Implementations	PRC Law on the Sino-foreign Cooperative Joint Venture and the Implementations
Legal Status	Having the status of Chinese legal person and it shall be established as a limited liability company.	Optional for operating it either as a limited liability company, thus having the status of Chinese legal person, or as an enterprise other than having legal person status.
Governance Structure	EJV shall at least have a Board of Directors and a contractually appointed management board consisting of a GM and Vice GMs.	CJV can only either have a Board of Directors if it is a limited liability company having the status of legal person, or a joint management committee if it is not a limited liability company and not having the status of legal person.
Capital Contribution	Contribution to the registered capital of the EJV in the form of non cash, such as building, machinery or know-how shall be strictly evaluated so as to ensure that the items identified are not higher than the prevailing international market prices.	CJV parties may choose the methods and conditions for determining their contributions, leaving their investment conditions for cooperation to be priced or evaluated by their mutual agreements. For CJV, there is no ratio restrictions on how much the foreign party shall contribute to the registered capitals,



For EJV, foreign party shall contribute at least more than 25% of the registered capital to the EJV.

For EJV, the foreign parties are not allowed to recover their investments to the JV before the expiration of the JV.

For CJV, the foreign parties are allowed to recover their investments to the JV in an accelerated repayment structure before the expiration of the JV. For such arrangement, the Chinese party has the title to the assets of the CJV after expiration.

Document Lists for Establishment

Document Lists for Establishing an EJV

When establishing an EJV, according to the PRC Law on the Sino-foreign Equity Joint Venture and the Implementations, normally the following documents are required and shall be drafted in Chinese language:

- Application Letter;
- Feasibility Study Report;
- Joint Venture Contract;
- Articles of Associations;
- Certification of Incorporation of the Foreign Investors;
- Identity Certification of the Legal Representative of the Foreign Investors;
- ID Card of the Legal Representative of the Chinese Party;
- Duplicate of the Business Licenses of the Chinese Party;
- Letter of Creditworthiness issued by the Opening Bank of the Foreign Investor;
- Lists of the Chairman, Vice Chairman and Members of the Board of Directors;

- Appointment Letter for Board Directors; and
- Other documents required by the examining and approving authority.

Document Lists for Establishing a CJV

When establishing a CJV, according to the PRC Law on the Sino-foreign Cooperative Joint Venture and the Implementations, normally the following documents are required and shall be drafted in Chinese language:

- Application Letter;
- Project Proposal Letter and the Approval Letter by the Competent Authorities;
- Feasibility Study Report and the Approval Letter by the Competent Authorities;
- Joint Venture Contract;
- Articles of Associations;
- Certification of Incorporation of the Foreign Investors;
- Identity Certification of the Legal Representative of the Foreign Investors;
- ID Card of the Legal Representative of the Chinese Party;



- Duplicate of the Business Licenses of the Chinese Party;
- Letter of Creditworthiness issued by the Opening Bank of the Foreign Investor;
- Lists of the Chairman, Vice Chairman and Members of the Board of Directors or the Joint Management Committee;
- Appointment Letter for Board Directors; and
- Other documents required by the examining and approving authority.

help you to find the right Chinese business partner to establish a JV.

What Can a RO Do?

A RO can conduct the following activities in China:

- market research;
- liaison with Chinese governmental authorities;
- marketing and sales administration for the sales between China and the parent company; and
- administrating domestic purchasing activities.

RO



► Establishment of a Representative Office (“RO”) in China

Why RO?

Instead of establishing a JV or WFOE, if you have not decided to invest so much, establishing a RO can satisfy your requirements and present your company in China. Establishing a RO is not so expensive, reducing the risk for the initially entering into Chinese market. Establishing a RO and operating it for some time can make you be familiar with Chinese business and legal environments by taking little risks. Also firstly establishing a RO in China can

Procedures for the Establishment

The establishment of a RO in China will normally include the following procedures:

- ▼ Name pre-registration with the relevant administration for industry and commerce (AIC)
- ▼ Approval by the foreign economic and trade commission (COFTEC) at a municipal level
- ▼ Issuance of registration certificate by the relevant AIC
- ▼ Carving chops by the public security bureau (PSB)
- ▼ Applying for organizational code certificate with the technical supervision bureau (TSB)
- ▼ Registration with the competent administration of foreign exchange



- ▼ Open RMB bank account and foreign exchange settlement bank account
- ▼ Tax registration with the State and local tax bureaus

Document Lists for the Establishment

When establishing a RO in China, the following documents shall be submitted in Chinese:

- Certificate of incorporation of its parent company;
- Articles of Association of its parent company;
- Application letter for establishing the RO;
- Appointment letter for the chief representative;
- Salary certification of the chief representative; and
- Bank reference of the parent company.

According to the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors jointly promulgated by the Ministry of Commerce, the State Assets Supervision and Administration Commission under the State Council, the State Administration of Taxation, the State Administration for Industry and Commerce, the China Securities Regulatory Commission and the State Administration of Foreign Exchange on August 8, 2006, there are two types of modes for foreign investors to merge and acquire Chinese domestic enterprises, namely “Share Equity Acquisition” and “Asset Acquisition”.

“*Share Equity Acquisition*” refers that foreign investors purchase by agreement the equities of the shareholders of a domestic non-foreign-funded enterprise (“domestic company”) or subscribe to the increased capital of a domestic company, and thus change the domestic company into a foreign-funded enterprise.

“*Asset Acquisition*” refers that a foreign investor establishes a foreign-funded enterprise, and through which it purchases by agreement the assets of a domestic enterprise and operates its assets, or, a foreign investor purchases by agreement the assets of a domestic enterprise, and then invest such assets to establish a foreign-funded enterprise and operate the assets.

MERGERS & ACQUISITIONS



Basic Information on M & A

- ▶ **Modes Available in China for Foreign Investors to Merge and Acquire Domestic Enterprises**

- ▶ **Basic Rules Foreign Investors Shall Obey When Merging and Acquiring Domestic Enterprises**



When foreign investors merge and acquire domestic enterprises, they shall obey the following requirements and principles:

- *Satisfying the requirements of China's industrial policies on utilization of foreign investment*

The legal consequences of either share equity acquisition or assets acquisition will finally lead to the establishment of foreign invested enterprises, the essence of which is the entry of foreign capital into China. Therefore, foreign invested merger and acquisition shall, as newly established foreign invested enterprises, satisfy the requirements of China's industrial policies on utilization of foreign investment.

It is clearly specified in Article 4 of the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors that for the industries where solely foreign-owned operation is not permitted by the "Catalog of Industries for the Guidance of Foreign Investment", the acquisition shall not lead to the consequence of a foreign investor's holding all the equity shares of the enterprise; for the industries where it is required for a Chinese party to control or relatively control the shares, the Chinese party shall, after an enterprise in such industries is acquired, still control or relatively control the shares of the enterprise; for the industries where foreign investors are prohibited from operation, no foreign investors shall merge and acquire any enterprise in such industries.

The business scope of any enterprise invested by the domestic enterprise prior to the acquisition shall satisfy the requirements in the industrial policies on foreign investments. If it does not, adjustment shall be made. The enterprises with investment from the merged target companies may adjust their business scope in advance or at the same time with the merger and acquisition or the target companies may carry out restructuring with their invested companies.

- *Non-violation of relevant laws, administrative regulations and departmental rules*

For some special industries, the relevant laws, administrative regulations and departmental rules shall be observed. The basic principles of the civil law, such as equality, fairness, equal price and compensation and good faith, shall be observed in the equity transfer or asset purchase agreements, contracts of foreign invested enterprises, and undertakings of other civil activities relating to the merger and acquisition. Excessive concentration shall not occur, competition shall not be eliminated or restricted, the social market economic orders shall not be disturbed and public interests shall not be damaged as a result of the merger and acquisition.

It is further specified in Article 12 of the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors that where a foreign investor intends to obtain the actual controlling power of a domestic enterprise it plans to acquire, and if any important industry is concerned, or if it has an impact on or



may have an impact on the national economic security, or it will lead to the transfer of the actual controlling power of a domestic enterprise which holds a famous trademark or China Time-honored Brand, the parties concerned shall file an application with the Ministry of Commerce (“MOFCOM”). If the parties concerned fail to do so, but its acquisition has had or may have a serious impact on the national economic security, the MOFCOM may, jointly with the relevant departments, demand the parties concerned to terminate the transaction or transfer the relevant equities / assets or take other effective measures to eliminate the acquisition impact on the national economic security.

Due Diligence



➤ Legal Due Diligence Before Merging and Acquiring A Chinese Domestic Company

When you intend to merge and acquire a domestic Chinese company, an effective legal due diligence is quite necessary and critical. Through a thorough legal due diligence by fully checking and verifying all the legal documents of the target company can help you to know the real legal status of the assets and equities of the domestic Chinese company you are going to merge and

acquire and to assure that what you are getting is actually what you are buying.

Generally speaking, you had better collect a thorough and true information in the following aspects of the domestic Chinese company to be merged and acquired:

• LEGAL STATUS OF THE DOMESTIC COMPANY

You should firstly know whether the establishment procedures, the qualifications and conditions, etc. of the domestic company comply with the then-current laws and regulations or not, otherwise you have to bear the legal risk of acquiring a company not in line with the current laws.

- Establishment

You shall learn and check the approval documents, business license, Articles of Associations of the domestic company and go to the competent administration for industry and commerce (“AIC”) where the domestic company is registered to verify its establishment procedures, their former consolidation and dissolutions and the registration of such changes at the competent AIC, the results of the annual examination by the competent AIC, so as to make a correct judgment on the legality for its incorporation and existence of the domestic company.

- Legality on Shares Transfer, Total Shares Amounts and Shareholders’ Structure



You shall check the approval documents, capital verification, shareholders' equities certificate, lists of the shareholders and the registration for the change with the competent AIC for its shares transfer every time. You shall further check the total shares amounts and the shareholders' structure of the domestic company being changed or not after the shares transfer.

- *Capital Contribution by Shareholders*

You shall know before the acquisition whether the shareholders had fully contributed the amounts of the registered capital they subscribed to the domestic company and whether their contribution methods complied with the then-current laws and regulations or not by checking the capital verification report issued by a qualified certified public accountant firm registered within China. In case the contribution was made in the form of non-cash, such as in kinds, industrial rights, non-patentable know-how and land use rights, etc. you shall further check the assets evaluation reports so as to know whether these assets are overevaluated or not.

- *Assets Restructuring*

Has the domestic company undergone any consolidations, dissolutions and assets exchanges so as to importantly affect its operation scale? If so, check the decisions of the shareholders' meeting or its Board of Directors and the registration for such changes at the competent AIC. Did the procedures for calling on such shareholders' meeting or meeting of the Board of Directors

comply with the then-current laws and regulations as well as its Articles of Association?

- *Restrictions on the Equity Shares*

Has any restrictions existed on the transfer of the equity shares of the domestic company, such as mortgage, pledge, encumbrances, liens or any other third-party rights and liabilities, etc.? If so, you have to bear some adverse effects after acquiring the equity shares of the domestic company.

• *MAIN ASSETS AND PROPRIETARY RIGHTS*

- *Land Use Rights and Real Estates*

There are two types of land use rights in China, namely granted land use rights and allocated land use rights. Granted land use rights can be directly transferred while in case the land use rights is obtained through allocation, complex procedures and formalities have to be undergone before you really get its land use rights. So you shall firstly know the nature of the land use rights of the target company to be acquired. The relevant land use rights certificate and the ownership certificate of the premises on the land had better be double checked. In China, the land use rights certificate and the premise ownership certificate are closely related with each other and normally shall be owned by the same legal entity. You had better go to the relevant land administrative authority and real estate administrative authority to check whether any restrictions exist on the land use rights and the transfer of the



real estate or the premise and whether any guarantees have been created on them.

- *Intellectual Property Rights and other Proprietary Rights*

Has the target company registered any patents and trademarks? Does the company enjoy any other proprietary rights, such as domain names, know-how and trade secret, etc.? Have their patents or trademarks been licensed, exclusively or nonexclusively, or even transferred to any others? If so, you had better check the registration certificate to learn the legal status of those patents and trademarks, especially for their valid term and the information about their renewals. More importantly you shall also analyse the previous transactions and other relevant agreements which may affect what can be done with those patents and trademarks. Further you had better consulted with relevant Chinese intellectual property authorities to see whether any restrictions, such as mortgage, pledge or guarantees, etc. have been created on those intellectual property rights and other proprietary rights.

- *Main Equipments Owned or Leased*

You shall know the main equipments that the target company is using for its production and operation. Are those equipments owned or leased by the target company? If owned, check the relevant ownership certificate and transaction contracts for those equipments. You had better consulted with the competent AIC to confirm whether those equipments are

mortgaged or pledged or used as a guarantee so as to know the latest legal status of those equipments.

• *PRODUCTION AND OPERATION OF THE DOMESTIC COMPANY*

- *Production and Operative Licenses*

Generally speaking, after obtaining the Business License, a domestic company may conduct its business activities within the business scope stipulated in its Business License. However for some special fields and some special programs, only obtaining special production or operative licenses from various governmental authorities, apart from the Business License, can the company conduct its business activities according to those special licenses. So you shall first check whether special licenses, apart from Business License, are required for the operation of the domestic company. If so, has the target company gotten such licenses?

- *Creditor's Rights and Obligations*

You shall check out all the important contracts, such as lease contract, mortgage contract, loan contract and guarantee contract, etc. which are currently being performed, or will be performed soon or have already been performed but potential disputes for the target company may possibly arise. You shall clearly know the performance of those contracts and what effects such performance will cause or have already caused to the target company. What rights can the target company enjoy and what obligations shall the target company bear from such performance?

You had better know what the payable accounts and receivable accounts are. You shall also importantly check whether the Directors or managers have used the assets of the target company to provide securities or guarantees to the personal obligations of the shareholders or the Directors or managers of the target company.

- *Litigations, Arbitrations and Administrative Proceedings*

Any potential, predictable or pending litigations, arbitrations or any administrative proceedings against the target company or the target company will or have already brought forth will be of great importance for your acquiring the domestic company. Some of those proceedings will cause some adverse effects to the new company after the acquisition. According to Chinese Company Law, in case a company is completely consolidated or acquired by another company so that it does not exist any more, then all the rights and obligations of the former company shall be enjoyed or borne by the new company after the acquisitions respectively. Therefore those proceedings are very important for your decisions to acquire the target company under such proceedings.

- *Tax, Environmental Protection and Product Quality*

The domestic target company may possibly be granted some tax preferable policies and incentives, even some financial subsidies by the local government. However you shall check whether those incentives or subsidies are

in line with the current laws and regulations.

Another important aspect you shall also draw attention to is that whether the production and operation as well as the investment projects comply with the relevant requirements on environmental protection and whether the products of the target company comply with the relevant standards on product quality and technical supervisions. An acquisition of a domestic company complying with the requirements on environmental protection, product quality standard and technical supervisions will bring you less trouble after the completion of the acquisitions.

Thanks for your interesting in our guidance on Chinese commercial laws practice. We are happy and eager to work with you soon and assist you managing your business in China.



ABOUT THE AUTHOR

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with corporate and commercial matters, such as mergers and acquisitions, direct investment in China, joint venture, intellectual property, technology license and transfer, international trade, corporate governance and compliance, restructuring and reorganization, labor and employment, and dispute resolutions. He has represented many multi-national companies to merge and acquire Chinese enterprises, make investment, register and enforce various trademarks, patents and copyrights, resolve commercial disputes in China. He has also counseled many foreign invested enterprises on their daily operations in China.

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