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Private Equity

China: Law & Practive

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Law and Practice

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Contents

1. Trends p.3
1.1 M&A Transactions and Deals p.3
1.2 Market Activity p.3

2. Legal Developments p.3
2.1 Impact on Private Equity p.3

3. Regulatory Framework p.4
3.1 Primary Regulators and Regulatory Issues p.4

4. Due Diligence p.5
4.1 General Information p.5
4.2 Vendor Due Diligence p.5

5. Structure of Transactions p.6
5.1 Structure of the Acquisition p.6
5.2 Structure of the Buyer p.6
5.3 Funding Structure of Private Equity Transactions p.6
5.4 Multiple Investors p.6

6. Terms of Acquisition Documentation p.6
6.1 Types of Consideration Mechanisms p.6
6.2 Locked-Box Consideration Structures p.7
6.3 Dispute Resolution for Consideration Structures p.7
6.4 Conditionality in Acquisition Documentation p.7
6.5 “Hell or High Water” Undertakings p.7
6.6 Break Fees p.7
6.7 Termination Rights in Acquisition Documentation p.8
6.8 Allocation of Risk p.8
6.9 Warranty Protection p.8
6.10 Other Protections in Acquisition Documentation p.8
6.11 Commonly Litigated Provisions p.8

7. Takeovers p.8
7.1 Public-to-Privates p.8
7.2 Material Shareholding Thresholds p.9
7.3 Mandatory Offer Thresholds p.9
7.4 Consideration p.9
7.5 Conditions in Takeovers p.10
7.6 Acquiring Less Than 100% p.10
7.7 Irrevocable Commitments p.10
7.8 Hostile Takeover Offers p.10

8. Management Incentives p.10
8.1 Equity Incentivisation and Ownership p.10
8.2 Management Participation p.11
8.3 Vesting/Leaver Provisions p.11
8.4 Restrictions on Manager Shareholders p.11
8.5 Minority Protection for Manager Shareholders p.12

9. Portfolio Company Oversight p.12
9.1 Shareholder Control p.12
9.2 Shareholder Liability p.12
9.3 Shareholder Compliance Policy p.12

10. Exits p.12
10.1 Types of Exit p.12
10.2 Drag Rights p.13
10.3 Tag Rights p.13
10.4 IPO p.13

1. Trends

1.1 M&A Transactions and Deals

Following four years of rapid growth since 2014, the private equity (PE) industry in the People's Republic of China (China or the PRC, which, for the purpose of this chapter only, excludes Hong Kong SAR, Macau SAR and Taiwan) started to slow down from 2018. This trend continued in 2019 and the first half of 2020. It was reported that both the number and the total value of PE investment transactions in the first half of 2020 saw a decline of approximately 30% and 20%, respectively, on a year-on-year basis, while the average value for each investment remained at the same level. Beijing, Shanghai and Guangdong continued to lead in the number and value of PE investments. The number of PE-backed exit transactions in the first half of 2020 decreased slightly by 7% year over year. IPO and trade sales remain the most popular exit routes for PE investors. In particular, boosted by the registration-based IPO process of Sci-Tech Innovation Board ("STAR Board"), PE exits by way of IPO have seen a significant rise by 85% and constituted approximately 75% of all exit transactions. There were around 119 IPO exits in total in the first half of 2020, one third of which were completed on the STAR Board.

There are many factors that contribute to this downward path, including a general slowdown in China's economic growth, uncertainties involved with the escalating tension between China and the United States, and the COVID-19 pandemic in particular, which deals a hard blow to many industries. Fundraising seems to be more difficult, which inevitably leads to fewer transactions and lower investment values. It is predicted that the downward path is unlikely to change significantly in the second half of 2020.

On the other hand, the Chinese government has continued its efforts to promote PE investments and facilitate PE exits by adopting a series of new policies, such as accelerating capital market reform, opening up further to foreign investments, and relaxing foreign exchange controls. In particular, the launch of STAR Board in 2019 significantly facilitated PE investments and exits in hi-tech areas. Similarly, the ChiNext Board – China's Nasdaq-style board of growth enterprises – also launched a registration-based IPO mechanism from June 2020, which is also anticipated to bring more opportunities and flexibility for PE investors' future exits from growth companies.

In addition, the financial fraud by Luckin Coffee triggered a crisis of confidence in US-listed Chinese companies and pushed the US government to take a series of restrictive measures. This may affect other US-listed Chinese companies and those heading for US listing. It is predicted that more Chinese companies may turn to Hong Kong or China for IPOs, and this may affect exit channels and opportunities for foreign PE/VC investors in the long run.

1.2 Market Activity

In the first half of 2020, information technology, healthcare and life sciences, internet, and semiconductor and electronic equipment continued to be the most popular industries by both number and value of PE transactions in China. The IT industry continued to lead in the number of PE transactions. Motivated by China's efforts to improve the country's semiconductor self-sufficiency, the semiconductor and electronic equipment industry attracted the most PE investment capital. The healthcare and life sciences sector also saw a significant growth in investment capital due to the COVID-19 pandemic and relevant policies in response to the pandemic.

2. Legal Developments

2.1 Impact on Private Equity

The Foreign Investment Law took effect in January 2020 and has officially established a new administration scheme for foreign investments based on "national treatment" subject to a "negative list", and replaced the prior approval by or filing with the Ministry of Commerce (MOFCOM) with an ex post information reporting system. For investments not involved in the negative list, a generally equal regulatory regime is applicable to transactions by foreign investors and domestic ones. Foreign investments that do fall within the negative list will be subject to approvals by competent regulatory authorities for particular industries (if applicable) and the State Administration for Market Regulation or its local counterparts (SAMR). The new administration scheme has significantly simplified governmental procedures for foreign investments and enhanced the competitiveness of foreign PE funds. Furthermore, the PRC government has further shortened the negative list and improved the level of openness in such industries as certain services, manufacturing and agriculture sectors.

Following the launch of STAR Board and the Chinese Deposit Receipts (CDR) scheme in the first half of 2019, China has further accelerated the reform of its capital market. In particular, China amended the Securities Law to gradually implement a registration-based IPO system across the whole capital market. It is noteworthy that, in February 2020, the China Securities Regulatory Commission (CSRC) relaxed restrictions on refinancing by listed companies, allowing qualified strategic investors to enjoy a higher price discount and a shortened 18-month lockup period. CSRC also clarified rules for issuing shares or CDR on the A-share market by offshore companies with red chip ownership structures or VIE structures, and allowed shares with different voting rights to be listed on STAR Board and

ChiNext Board under certain circumstances. All these legal developments in the capital market are believed to help to enhance the competitiveness of the A-share market and provide more investment opportunities and more flexible exit channels for PE investors.

From a practical perspective, such previously controversial investment terms in PE investment as the valuation adjustment mechanism (VAM) and redemption arrangement have received more support from competent PRC courts and administrative agencies. Taking VAM as an example, CSRC started to allow IPO applicants to keep VAM clauses between investors and the founding shareholders under certain circumstances, instead of asking the parties to cancel all such clauses before an IPO application. In addition, the Summary of the National Court's Work Conference on Civil and Commercial Trial released by the Supreme People's Court in November 2019 (which sets out court trial guidance on typical cases) generally confirmed the validity of VAM agreements between a target company and its investors, but the enforceability of such VAM arrangements is still subject to factors such as whether the target company has enough profit to fulfil the cash payment and whether the payment would adversely affect creditors' rights, among others, and should be determined on a case-by-case basis.

Finally, China has continued to push forward and streamline reforms on foreign exchange control and administration systems. In October 2019, the State Administration of Foreign Exchange (SAFE) lifted restrictions on non-investment types of foreign-invested enterprises (FIEs) using capital account funds to make onshore equity investments, so long as the investment project is true and complies with the negative list for foreign investments and other relevant rules. To some extent, this may provide more structural and fund flow flexibility to foreign PE investors.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Formation and Operation of PE Funds

PE funds formed under the Chinese laws are generally administrated by a self-regulatory industrial association, namely the Asset Management Association of China (AMAC), which is in charge of the registration and filing of the fund managers and the funds under their management. Depending on different organisational forms, the PE funds should comply with such applicable PRC laws and regulations as the Partnership Enterprise Law, the Company Law, the Trust Law and/or the Civil Code, which govern, among other matters, the formation, governance structure, operation, liquidation and distribution of PE funds. PE fundraising and investment activities are also subject to the various rules and regulations released by CSRC and AMAC. In particular, according to the new Private Equity Fund Filing Guidelines released by AMAC at the end of 2019, investors in PE funds should be "qualified investors" (eg, the net asset of an institutional investor should be no less than RMB10 million, with no less than RMB1 million invested in any single PE fund). Furthermore, AMAC has introduced various restrictions on the business activities of the PE funds in China. For example, PE funds are generally not allowed to engage in regular or operational private lending, debt investments in a disguised form of equity investment, or secondary market investments without explicit permission to do so under the applicable rules. In addition, RMB PE funds are required to have an operating term of no less than five years (actually, seven years or longer is encouraged).

Antitrust Filing/Merger Control

The Antitrust Bureau of SAMR is the government agency in charge of the antitrust review of business concentrations or merger control under the PRC antitrust law regime, which generally includes the Anti-Monopoly Law, the Measures on Filings of Business Concentrations and the Rules on Filing Thresholds for Business Concentrations, among others. A PE-backed transaction will be subject to a merger control review (AML filing) if it involves an acquisition of control over the target company, and if the revenue of the parties involved meets the relevant thresholds. In practice, if an acquirer obtains veto rights over matters that have a decisive influence on the target company (such as its business plan and annual budget), it is likely to be deemed as having acquired "negative control" of the target company, even if it holds only a minority interest therein.

Restrictions on Foreign Investments

As mentioned in **2.1 Impact on Private Equity**, investments made by foreign PE funds in China are subject to restrictions or prohibitions under the negative list. The negative list has divided business sectors into two different categories: restricted and prohibited. Foreign PE funds may still make investments in the restricted sectors after satisfying certain requirements (for example, foreign-invested medical institutions are only allowed to be formed as Sino-foreign joint ventures rather than wholly foreign-owned enterprises), after gaining prior approval from or being reviewed by regulatory authorities in charge of particular industries (if applicable) or SAMR. No foreign investor is allowed to hold equity interests directly or indirectly in any target company engaging in any prohibited sector (such as online publishing, online audio-visual program services and genetic diagnosis and treatment). To avoid the restrictions under the negative list, foreign investors may, in practice, realise an M&A transaction through a series of contractual arrangements with the target company (known as a variable interest entity – VIE), as opposed to direct or indirect ownership structures. The VIE

structure has been widely adopted in the TMT industry. As mentioned in **2.1 Impact on Private Equity**, the PRC government has recently opened a door for offshore companies with VIE structures to issue CDR on the A-share market.

National Security Review

An M&A transaction in which foreign investors collectively take control of a domestic Chinese company engaging in such sensitive sectors as military or national defence, important agricultural products and/or key infrastructure will be subject to the PRC national security review. MOFCOM and the National Development and Reform Commission (NDRC) are the regulatory authorities leading the national security review. However, the PRC government has not yet released any official guidance on which sensitive industries are subject to national security review. In practice, a foreign PE investor may need to consult with the competent regulatory authorities if it plans to perform a transaction involving a change of control on a case-by-case basis. In practice, it is rare for publicly disclosed transactions to be subject to national security review, with one recent noteworthy case being Yonghui Superstores' acquisition of Zhongbai Holdings Group; this acquisition obtained merger control approval from MOFCOM in August 2019 but was finally aborted, purportedly related to the national security review process initiated by NDRC, although Yonghui Superstores was silent on the reason. Furthermore, based on the Foreign Investment Law, the national security review will apply to all foreign investments in PRC companies that are engaged in sensitive industries. Meanwhile, China may take counter measures against restrictive measures adopted by other countries against PRC companies. The guidance on sensitive industries is expected to be released soon.

Foreign Exchange Controls

Even though significant efforts have been made to streamline foreign exchange procedures (such as allowing general FIEs to make equity investments with their capital account funds), transactions by foreign investors are still subject to various foreign exchange controls and restrictions, including (without limitation) restrictions on the usage of the funds available in target companies' capital accounts (which are generally not allowed to make external lending, nor to build or purchase real properties that are not for self use), and those on cross-border loans and guarantees between PRC target companies and their foreign shareholders.

Other Rules and Regulations

There are also various other PRC laws and regulations that may be applicable to PE-backed transactions. Special qualifications for the investors, and approval, registration and/or filing procedures, as well as special information disclosure requirements, may be applied, depending on the various aspects of the target company, such as its business sector, whether or not it is a public company, and whether or not it involves a special ownership structure (such as a PRC state-owned enterprise).

4. Due Diligence

4.1 General Information

The scope and level of legal due diligence in an M&A transaction is generally flexible, and is highly dependent on such factors as the target company's development stage, the corporate structure, whether an auction process is involved, the bargaining power of the relevant parties, and other dynamics of the transaction. In general, the higher the transaction value or equity stake involved, the more detailed the legal due diligence would be. If a PE investor only intends to purchase a small stake in a target company, it tends to adopt a high-level due diligence. On the other hand, if it proposes to acquire a significant stake (eg, more than 20%), it usually prefers to conduct full-blown due diligence. For listed companies, special rules should be carefully reviewed and evaluated to ensure compliance, particularly those governing insider information and disclosure.

A routine PRC due diligence exercise generally focuses on customary issues, such as incorporation and the history of the target company, the shareholder structure, operational licences and permits, material assets (including fixed and personal assets, real properties and intellectual properties), material contracts, labour and employment, environmental protection, production safety, disputes, penalties and legal proceedings. Depending on the industry characteristics of the target company, some PE investors may request to conduct separate due diligence on specific aspects such as Foreign Corrupt Practices Act investigations, environmental health and safety assessments, patent stability assessments, IT system security evaluations, and data security assessments.

4.2 Vendor Due Diligence

In most M&A transactions in China, the buyers generally tend to engage their own counsel to conduct independent due diligence on the target companies. However, when the exit is conducted through a bidding process and/or when the seller only holds a minority interest in the target company and the target company or controlling shareholder is less willing to co-operate with a third party's due diligence, the seller would strongly prefer a vendor due diligence in order to control costs and the timetable of its exits. The buyer and its advisers are generally less willing to provide full credence to the vendor due diligence report and would be more careful in dealing with the representations and warranties from the seller side. For example, they may request the incorporation of the vendor due diligence report as a part of the seller's representations and warranties.

5. Structure of Transactions

5.1 Structure of the Acquisition

Acquisitions by PE investors are typically carried out through either a private sale agreement or an auction process. Judicial auctions are not commonly seen in China. The auction process is less likely to be adopted if the target company is a public company, as there is a higher possibility of information leakage, which will affect the transaction price (unless the target company's trading can be suspended under some permitted circumstances, such as where the transaction involves a change of control, like the Gree Group's recent disposal of the shares of Gree Electric Appliances). If the target company is a public company, transactions are often completed through private placements, block trading or tender offers, in addition to private agreements.

In a privately negotiated transaction, the parties usually set out the key commercial terms in the term sheet (which is usually non-binding); they may open new issues or reopen the terms addressed in the term sheet based on the investors' due diligence findings and other deal dynamics during the documentation process. In an auction sale, the investors tend to focus on more essential terms in their offers, in an effort to secure the transaction. If the target company is a public company, there are generally fewer flexibilities for the transaction structure and terms, due to the more stringent rules governing insider information and shareholders' rights, among other matters.

5.2 Structure of the Buyer

The structure of the PE-backed buyer will be determined by various factors, including the structure of the transaction as a whole, tax efficiency, liability segregation, information disclosure, and efficiency of management. In general, China has a less flexible regulatory regime for the incorporation, organisation and governance of relevant legal entities. A PE fund in China is normally formed as a flow-through limited liability partnership under PRC laws, and an additional structure would generally increase management costs and other potential tax burdens. Thus, such a fund more often participates in an acquisition directly, as a direct buyer. Foreign PE investors usually prefer to establish a special purpose vehicle for an acquisition (most commonly in tax havens such as the British Virgin Islands or Mauritius), and are less likely to be directly involved in the acquisition documentation.

5.3 Funding Structure of Private Equity Transactions

In general, China has a more stringent financing system that involves more expensive financing costs and more qualification requirements, especially for a private (as opposed to state-owned) borrower. As such, it is not common for PE investors to use leveraged bank loans to complete a transaction in China. Furthermore, sellers in China are generally reluctant to accept a closing condition regarding the obtainment of financing or equity commitment letters by the investors.

As the PE industry is relatively young in China, the majority of PE funds lack adequate experience in post-closing management, and their value added to the target companies is not yet apparent. Furthermore, following a transaction involving a change of control, the target company is normally required to operate for three more years before its IPO, and the controlling shareholder is generally required to be locked up for three years after an IPO (as opposed to one year for minority shareholders). As such, most PE investors (except for some industrial funds or government-backed M&A funds) tend to take a minority stake in a transaction in China. With the development and materiality of the PE industry in China, however, more PE funds are willing to hold a majority stake in China.

5.4 Multiple Investors

Many M&A transactions in China involve a consortium of PE investors, which is particularly driven by the shortage of quality target companies and soaring valuations for a limited number of unicorn enterprises in recent years. Depending on the deal-specific dynamics of the transaction, a buyer consortium led by PE funds may include their major limited partners, other affiliates, existing investors of the target company and unrelated third-party co-investors.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Completion accounts, fixed price and estimated valuation with performance-based adjustments are more typically used to price PE transactions involving a non-public company in China. For a transaction involving a public company, the purchase price is generally fixed at the time of announcement, subject to certain statutory restrictions. For example, the purchase price of a public company through a private agreement should be no less than 90% of the closing price of such company on the trading day immediately before the execution of the share purchase agreement, and the new share subscription price for a qualified strategic investor should be no less than 80% of the average price during the period of 20 trading days prior to the pricing benchmark date.

When there are greater uncertainties for the post-closing performance of a target company, the transaction parties may adopt a more flexible consideration mechanism, such as performance-based valuation adjustment mechanisms, earn-outs and/or

deferred payment. These kinds of flexibilities are not uncommon in China's PE transactions (but are rarely seen in public target companies).

Each of these consideration mechanisms has, to some extent, reflected the risk allocations between the seller and the buyer in a transaction. On the one hand, a PE seller generally prefers a fixed price, in order to avoid uncertainties and limit the period from signing to closing as much as possible. On the other hand, a PE buyer would generally like to adopt completion accounts, price with valuation adjustment mechanisms, earn-outs and/or deferred considerations as protections against future uncertainties.

In general, a PE seller and a corporate seller do not disagree too much in terms of consideration mechanisms, while a corporate buyer (compared to a PE buyer) is more likely to offer a higher price and better consideration in favour of the seller, given the potential strategic advantages and synergies with the target company.

6.2 Locked-Box Consideration Structures

The locked-box consideration structure is not commonly seen in the PRC PE investment market. The relevant discussions and practices with respect to leakage during the period from the pricing date to the closing date are very limited.

6.3 Dispute Resolution for Consideration Structures

In order to determine the relevant accounts in a timely manner in the case of the completion accounts mechanism, and to avoid disputes, the parties would usually specify the composition of pricing-related items and the specific process to follow in order to determine the value of such items in the transaction documents. For example, the transaction documents typically provide the following, among others:

- that an auditor would be appointed if the parties cannot agree on the completion accounts;
- the mechanism for determining such an auditor; and
- the buyer's right to conduct an independent audit.

6.4 Conditionality in Acquisition Documentation

The closing conditions of PE transactions vary significantly, depending on the deal-specific dynamics. In general, basic closing conditions for PE investments commonly include power and authorisation to execute and perform the transaction, complete legal title of the subject shares, the obtainment of internal and external approvals or consents, true and complete representations and warranties upon signing and closing, no material adverse changes from signing to completion, etc. Financing of the closing funds is not commonly seen as a closing condition in China.

PE investors may require additional closing conditions, based on their due diligence review and other deal-specific concerns. For example, they may request the completion of a certain restructure, the transfer of significant intellectual properties, and the rectification of certain non-compliant activities, as may be applicable. For acquisitions by foreign investors, the closing conditions of buyers often include the successful opening of certain special purpose foreign exchange accounts by the PRC sellers.

Whether third-party consent will be required as a closing condition mainly depends on the target company's contractual obligation in this respect and whether a failure to do so will have a material adverse impact on the target company. In practice, commercial banks or certain major customers of a target company may require prior consents in the case of a material change of the target company (such as a change of control); otherwise, the banks may accelerate the repayment of loans and the customers may terminate their contracts with the target company early, or cancel the target company's vendor qualifications, which may materially affect the target company.

6.5 "Hell or High Water" Undertakings

"Hell or high water" undertakings are relatively rare in China. Instead, if the parties reasonably believe that a certain regulatory condition (such as a government approval for merger control, national security review or foreign investment in restricted sectors, registration by SAMR or the opening of certain special purpose foreign exchange accounts, etc) is necessary prior to the closing, they would usually accept such a requirement as a closing condition. If such requirement cannot be fulfilled prior to the agreed longstop date, the non-breaching party will generally be allowed to terminate the purchase agreement without liability, usually without a break fee. To avoid abuse, the purchase agreement is usually specific to the regulatory condition, and will typically oblige the relevant party(ies) to make a certain effort to fulfil the regulatory condition as soon as practical.

6.6 Break Fees

In conditional transactions with a PE-backed buyer in China, it is not common to see break fees in favour of the sellers. In limited situations where break fees do apply, a PE investor is more likely to ask for reverse break fees, subject to a deal-by-deal negotiation of course. In a PRC law-governed transaction, break fees are often treated as liquidated damages in nature, which in principle should not exceed 30% of the non-breaching parties' actual losses, according to prevailing judicial practice. Therefore, if the break fee is set too high in a transaction, the

breaching party is likely to request the courts to reduce it to a reasonable amount.

6.7 Termination Rights in Acquisition Documentation

Termination of an acquisition by a PE seller or buyer normally occurs prior to the completion of the proposed transaction or the receipt of necessary governmental approvals (if applicable), and is typically triggered upon circumstances such as the occurrence of material adverse events, the discovery of undisclosed material negative matters, significant policy changes, and failure to satisfy closing conditions before the longstop date, among others.

6.8 Allocation of Risk

PE buyers tend to require a comprehensive and detailed list of warranties and specific information disclosures from the sellers in the transaction documents. In addition to the indemnifications provided by sellers for their warranties and certain covenants, PE investors usually try to minimise their investment risks by building in price adjustment mechanisms, deferred payments, escrow arrangements, and preferential and flexible exit mechanisms in the transaction documents (such as anti-dilution rights, tag rights, drag rights, put option and redemption rights, and liquidation preference), among others. In exit transactions, PE sellers usually seek clean exits by limiting the scope of their warranties and liabilities as much as possible.

As for the limitations on liabilities, sellers usually wish to set de minimis, basket, caps and time limits to the claims for their indemnification liabilities. PE sellers rarely accept strict payment conditions, payment by instalments and escrow accounts for indemnities on exit.

6.9 Warranty Protection

As mentioned above, a PE seller seeks to minimise the scope of their warranties and the subsequent indemnifications for the sake of a clean exit. A PE investor holding only a minority stake in a target company (which is common in China) may only accept fundamental warranties concerning its due authorisation and shares to be sold. Such an investor is less likely to agree on warranties on the operational aspects of the target company, and, in terms of the financial and other material assets of the target company, a PE seller's warranties are normally limited to its knowledge as a minority shareholder. If a PE seller is a majority shareholder, its warranties would then be more comprehensive and would regularly be subject to the management's knowledge, as the target company is normally operated by the management. Furthermore, a PE seller would push for all due diligence data as disclosures, subject to negotiations with the buyer. Since the management is normally not a party to the transaction, it rarely makes warranties directly to buyers. Whether the buyer is PE-backed or not does not generally make a difference to warranties offered by a PE seller.

The seller's liabilities for warranties are typically subject to de minimis, basket, caps and time limits, among others. The amount set for the relevant de minimis, basket and caps varies from deal to deal, depending on the transaction value, the asset value of the target company and, of course, the bargaining powers of the parties. Time limits or survival periods for indemnifications vary for different warranties: normally up to five years (occasionally longer) for fundamental warranties, two to three years for other warranties, and applicable statutory limitations for some specially negotiated items. In addition, except for the specially negotiated items, the seller's indemnifications are generally not applicable to issues that have been disclosed or otherwise become obvious to the buyers prior to the signing.

6.10 Other Protections in Acquisition Documentation

To increase the enforceability of the seller's indemnifications, in some transactions a buyer may withhold a portion of the purchase price in an escrow account until the lapse of a certain time period (eg, the expiry of the survival period). For matters with higher risks, the buyer may request the seller to eliminate such risks before closing, adopt instalment payments or even request a deduction of the purchase price against such risks. In some cross-border transactions, PE transactional parties may also seek to purchase warranty and indemnity insurances (W&I Insurances) to minimise their potential risk exposures. Though still not common, an increasing number of China-related transactions are using W&I Insurances, which are generally purchased through foreign insurance companies as they are not yet widely available from the Chinese counterparts.

6.11 Commonly Litigated Provisions

PE investors generally prefer to choose arbitration as the dispute resolution proceeding in PE transactions, especially in cross-border transactions, as arbitration is generally deemed to be more flexible and equitable, with better confidentiality in China. Arbitration institutions located in Beijing, Shanghai, Shenzhen, Hong Kong and Singapore are the more typical choices. In PE transactions, warranties, indemnities, earn-outs, redemptions and valuation adjustments are more frequently disputed.

7. Takeovers

7.1 Public-to-Privates

Although legally feasible under PRC laws, public-to-private transactions are quite unusual in the current Chinese capital market, mainly for the following reasons:

- the current regulatory system allowing for delisting is too general and lacks implementing rules;
- the time-consuming and stringent IPO review process makes public shell companies highly valuable;
- A-share listed companies feature more concentrated ownership structures; and
- the lack of a "squeeze-out" mechanism (please see **7.6 Acquiring Less Than 100%** for more details).

In practice, going-private precedents in the Chinese market so far are mainly conducted by large-scale state-owned enterprises for internal restructuring and group-level listings. Going-private transactions that are more commonly seen in the US or UK markets predominated by PE investors, existing shareholders and/or management teams are still rare in China.

It is noteworthy that delisting in the Chinese capital market has recently become more normalised and marketable, mainly due to such reasons as the implementation of the registration-based IPO system, the decrease of the value of public shell companies and the improvement of the delisting rules. The delisting of 22 companies from the A-share market within the first half of 2020 signalled an accelerated trend of delisting. Though most companies were delisted from the A-share market because of weak financial performance, it is expected that delisting due to typical public-to-private transactions will emerge in the future.

7.2 Material Shareholding Thresholds

According to the Administration Measures for Takeover of Listed Companiesas amended in March 2020 and other applicable PRC laws, an investor of a listed company should comply with different levels of disclosure obligations, depending on the percentage of shares so acquired by it. In general, an investor's disclosure obligation will be triggered if its shareholding in a listed company reaches or exceeds 5% of the company after the proposed acquisition, where the investor should file a written report within three days ("Notice Period") to CSRC and the stock exchange, notify the listed company and make an announcement accordingly ("Initial Disclosure"). Following the Initial Disclosure, the investor should comply with similar disclosure obligations ("Subsequent Disclosure") every time it, on an accumulated basis, acquires or disposes of 1% of shares of the company through concentrated bidding or block sale systems, or of 5% or more shares of the company through private agreement; details for such Subsequent Disclosure may vary, depending on the investor's post-completion shareholding in the company. In addition to these disclosure obligations, an investor with 5% or more shareholdings in a listed company should generally suspend trading of the company's shares for a certain period (typically including the Notice Period and three working days after the announcement date) every time the accumulated shareholding change in the company obtained through concentrated bidding or block sale systems reaches 5%. Violation of these disclosure obligations will subject the investor to prohibition from exercising voting rights of the shares so acquired in a 36-month period.

7.3 Mandatory Offer Thresholds

Under the PRC regulatory regime, if an investor intends to increase its shareholdings in a listed company after acquiring 30% of its outstanding shares, a mandatory tender offer to all other shareholders to acquire all or part of the remaining shares of the company should be made. If an investor intends to indirectly acquire no less than 30% shareholdings in a listed company (such as a takeover of the controlling shareholder of the company), a general offer for all remaining shares of the company should be made.

Several statutory exemptions are available for these mandatory tender/general offers (such as acquisitions between two parties under the control of the same entity, or restructurings to preserve the public company from serious financial difficulties, a subscription of newly issued shares, a gradual increase with a small amount of stocks each time, and a continuous increase in the stake after acquiring 50% of outstanding shares). Moreover, the amended Administration Measures for Takeover of Listed Companies replaced the prior approval for such statutory exemptions with an "ex post supervision" mechanism. Mandatory takeovers are less common in the PRC market than in other mainstream foreign markets and, when triggered, statutory exemptions are often applied.

7.4 Consideration

Cash consideration is much more commonly used in PRC public takeovers, except for backdoor listing deals (including reverse mergers by absorption). The PRC laws have provided various requirements and restrictions to allow other forms of considerations in a transaction involving a public company. For example, if a buyer would like to offer an equity interest in a private company as the consideration, it must simultaneously provide a cash consideration as an alternative. If the buyer would like to pay with corporate bonds, such bonds should be publicly issued and tradable in the open market for no less than one month. Foreign buyers' choices are further limited due to regulatory limitations on strategic foreign investment in listed companies, foreign exchange control and cross-border share swaps. In practice, foreign PE investors usually choose to pay with cash in PRC takeovers.

It is noteworthy that the draft Revised Rules for Strategic Foreign Investment in Listed Companies issued for public comments in June 2020 also proposed to streamline regulatory requirements and simplify the approval/filing process for cross-border share swap with respect to strategic foreign investments

in listed companies. With the official launch of such regulations, it is anticipated that share payments will see a rise in foreign investments in A-share listed companies.

7.5 Conditions in Takeovers

There are no statutory restrictions on the closing conditions of public takeovers under PRC laws. In practice, compared to those applicable to the acquisition of private companies, closing conditions in PE-backed takeovers commonly focus on matters that are necessary for the effectiveness of the transaction, including the following:

- obtaining the applicable governmental approvals, registrations and third-party consents;
- obtaining all necessary internal approvals and waivers;
- proper execution and delivery of the main transaction documents; and
- no material adverse change and no material breach as of the closing date.

Like in other non-takeover PE transactions, the obtainment of financing as a condition is unusual in takeovers.

Deal and regulatory processes for public takeovers in the Chinese market are quite different from those in the mainstream foreign capital markets. In general, there is no explicit requirement for the board of directors (or other corporate authority) of the target public company either to consider other unsolicited offers or to "go-shop" after the relevant agreement is signed or an offer is made. Consequently, it is not common to see such deal security measures as break fees, match rights or force-the-vote provisions, which are more popular in US or UK takeover deals.

7.6 Acquiring Less Than 100%

In a public takeover, if a bidder does not seek to obtain 100% ownership of the target company or to convert it into a private one, it generally will not be able to enjoy preferential shareholder rights that are disproportionate to its post-closing shareholdings in the company, based on the "one share one vote" principle provided in the Company Law.

For public takeovers, instead of having a "squeeze-out" mechanism in favour of the bidder, the existing PRC regulatory regime provides a "sell-out" right to the minority shareholders of the target companies. Under the "sell-out" mechanism, the minority shareholders of a list company are entitled (but not obliged) to sell all of their remaining shares in the company to the bidder, on the terms provided by the bidder in the tender offer, if the post-closing capitalisation of the company no longer satisfies the requirement for a listed company. The lack of any "squeeze-out" mechanism and detailed implementing rules governing the custody and exercise of shareholder rights over the delisted shares held by minority shareholders is regarded as one of the major legal obstacles for going-private transactions in the PRC market.

7.7 Irrevocable Commitments

Under PRC laws, if a shareholder holding at least 5% of the outstanding shares of a listed company (ie, a "Major Shareholder") makes any formal commitment with respect to the sale of the public company's shares, it shall disclose such commitment in a timely manner, and the commitment should be clear, specific and enforceable. In practice, for the sake of a stable market and more flexibility, a Major Shareholder is less likely to enter into any formal legal document before the execution of definitive transaction documents. In exceptional situations where an auction process is involved, a Major Shareholder may choose to announce its intention to sell, in order to publicly solicit buyers, and would generally apply to suspend the trading of the company's shares in order to freeze the transaction price if possible.

7.8 Hostile Takeover Offers

Hostile takeovers are not common in the PRC capital market, although no specific restriction in this connection is provided under PRC laws. This is mainly due to the fact that PRC-listed companies generally feature a capitalisation that is highly concentrated to one single shareholder, with the majority of the remaining shares being scattered among individual investors. In addition, the new CSRC rules that an investor with 5% or more shareholdings in a listed company will be subject to a disclosure requirement with respect to every 1% change of its shareholdings in the company would make it more costly and inefficient for a hostile takeover conducted through the centralised bidding system or the block trade approach. Typical takeover precedents mainly include the takeover of ST Shenghua by ZheMinTou TianHong in December 2017 (which is generally believed to be the first successful hostile takeover in the PRC market) and the takeover of ST Kondarl Group by Kingkey Group in November 2018. That said, there has been an ongoing shareholding structure reform to reduce ownership concentration involving PRC-listed companies, and battles for control rights have also gradually increased in recent years. It is possible that hostile takeovers may see a rise in the Chinese market in the future.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Share incentive plans or the like (employee stock ownership plan – ESOP) are one of the core commercial concerns in PE transactions in China. A private company may adopt such forms as stock options, restricted shares, phantom equity, etc. An option pool typically accounts for 10-15% of the total shares of a private company (on a fully diluted basis), among which

options reserved for the management team usually account for 50-70% of the total pool. For a PRC-listed company, the total shares under all valid ESOP shall be no more than 20% of the company's total shares for a company listed on STAR Board or ChiNext Board, or 10% for a company listed on other A-share boards.

As required under the PRC IPO rules and prevailing practice, except for eligible pilot innovation enterprises to be listed on STAR Board, any company applying for A-share listing shall terminate its existing ESOP, with all outstanding options either cancelled or fully exercised prior to the IPO application, so as to ensure a clear capital structure. It is noteworthy, however, that pursuant to the latest Q&As of IPO review released by CSRC in June 2020, it is expected that CSRC will expand the pilot rules and experience of keeping qualified pre-IPO ESOP continuously valid after IPO from STAR Board to Main Board and ChiNext Board.

8.2 Management Participation

As private companies in China usually have a relatively concentrated ownership structure and the founders normally retain absolute control over the companies, management participation in acquisitions of private companies remains uncommon in practice. Thus, currently available rules and regulations focus mainly on management participation in the reform or acquisition of state-owned companies and listed companies. Based on this, and subject to restrictions and requirements in respect of managements' fiduciary duties to the target companies and the fairness and openness of acquisition terms and processes, sweet equity and institutional strips are rarely seen in PE-backed MBO deals in the PRC market, compared to the US or UK. In China, the management of a target company typically participates in the proposed PE investment through teaming up with a PE investor to purchase shares of the target company at the same or similar price, assuming they have sufficient funds, or through excising ESOP adopted by the target company post-closing if the management does not have sufficient funds or is unwilling to co-invest with the PE investors.

It is noteworthy that in the ownership reform of Gree Electric Appliances, in which the state-owned parent company disposed of its controlling shareholding in Gree Electric Appliances through an auction process in late 2019, the PE bid winner, Hillhouse Capital, has reached a series of co-operation agreements with the management team of Gree Electric Appliances. In addition to options granted under ESOP, the management team obtained partnership interests in the GP and LPs of the investment entity through complicated multi-layer ownership structure arrangements, through which the management team are believed to obtain certain decision-making powers over the listed company as well as investment returns from future performance growth of Gree Electric Appliances. Though the acquisition is not a typical MBO, to some extent it demonstrated a trend of management teams' willingness and intentions to participate in the distribution of investment returns with PE investors.

8.3 Vesting/Leaver Provisions

Vesting/leaver provisions for management shareholders are typically applicable to shares obtained under ESOP, and the company or the controller shareholder is generally entitled to acquire management's shares upon the termination of his/her employment. Leaver provisions are typically divided into "good leaver" provisions and "bad leaver" provisions. A "good leaver" usually refers to termination of the management due to such reasons as retirement, disability, death, etc, while other circumstances are generally considered to result in a "bad leaver". Generally, unexercised options/shares will be cancelled under both situations, while exercised shares held by a "good leaver" will commonly be redeemed by the company at the exercise cost or fair market value or net asset value, or will continue to be held by the "good leaver" until the occurrence of exit events, and exercised shares held by a "bad leaver" will be redeemed by the company at fair market value or exercise cost (whichever is lower), and the company is normally entitled to deduct from the redemption price an amount equal to damages (if any) caused by the "bad leaver" to the company.

Four years with a one-year cliff is a typical vesting schedule for options granted to management team – ie, vesting will occur periodically over a four-year period after the first anniversary of the grant date. Additionally, vesting conditions of options granted to management teams often include the achievement of certain performance goals.

8.4 Restrictions on Manager Shareholders

Management shareholders are customarily requested to sign non-compete and confidentiality agreements before closing, and are subject to the obligations of non-compete, non-solicitation, confidentiality, non-disparagement, full-time commitment, etc. For key management shareholders, continuous employment for a certain time period after the transaction may also be required. In practice, a company may impose a non-compete obligation on a leaving management shareholder based on his/her capacity as the company's shareholder rather than as an employee or a management member, in order to avoid certain regulatory requirements applicable to a leaving employee under the PRC Labour Law (which generally requires a company to compensate the leaving employee on a monthly basis for his/her non-compete undertaking, and limits the non-compete period to two years).

8.5 Minority Protection for Manager Shareholders
Generally, protective measures available for a management team as minority shareholders are very limited. In circumstances where the management holds a significant stake in a target company and/or has significant influence over the company's operation, the management shareholders may ask for board seats or veto rights on material corporate actions of the target company.

To ensure a smooth exit, PE investors in an M&A transaction are reluctant to offer management shareholders the right to control or restrict their exit. On the other hand, however, given that management's co-operation and support on issues such as due diligence and the review or confirmation of relevant warranties, etc, appear to be quite necessary for a smooth exit, and that the proposed buyer may request retention of the management, it is not uncommon in practice for the management to play an influential role in some aspects of the exit of PE investors.

9. Portfolio Company Oversight

9.1 Shareholder Control
As mentioned above, PE investors in China are more commonly seen to seek a minority stake in the target companies, and normally achieve a certain level of control over the target companies through the following arrangements:

- Director appointment – depending on the stake held by them in the target companies, PE investors would normally request the right to appoint a certain number of directors or observers to the board, supervisors, and/or members of board committees. Where a PE shareholder has a relatively large stake, it may have a right to nominate senior managers, such as the CEO, CFO, COO, chief legal and compliance office and/or company auditor, to better protect its interests.
- Veto rights – if a PE shareholder does not control a target company, it will normally request veto rights over major corporate actions, including change of corporate capital/structure, charter documents, core business, board size and composition, annual budget, business plan, material investments, disposal of material assets, related party transactions, employee incentives plans, listing plans, etc.
- Information and inspection rights – in addition to the general information rights enjoyed by all shareholders according to the Company Law, a PE investor often asks for additional rights to oblige the company to periodically provide financial statements and operation reports to the PE investor. Some PE shareholders may also ask for inspection rights to access and inspect records and books of portfolio companies, either by themselves or by a third-party auditor.

As discussed above, PRC public companies are generally subject to the "one share one vote" principle in the Company Law, and PE shareholders of public companies are normally not able to enjoy preferential shareholder rights that are disproportionate to their shareholdings.

9.2 Shareholder Liability
Generally, it is rare for a PE shareholder to be held liable for a portfolio company's liabilities, unless it is pursuant to the doctrine of "piercing the corporate veil" – ie, if the PE shareholder abuses the portfolio company's independent status to evade debts and seriously damages the rights and interests of the portfolio company's creditors.

9.3 Shareholder Compliance Policy
From a compliance perspective, a due diligence review prior to the transaction is not uncommon for PE investors. However, whether or not to impose their internal compliance policies on a portfolio company would depend on a number of other factors, such as the compliance risk level associated with the portfolio company's industry, the sufficiency of the portfolio company's existing compliance policies, risk susceptibility by the PE investors, and non-compliance issues identified during the due diligence process. In practice, leading international PE funds and major domestic investment institutions are more likely to require the portfolio companies (especially those engaged in industries with high compliance risks) to adopt and maintain relevant compliance policies after transactions, to their satisfaction.

10. Exits

10.1 Types of Exit
The typical holding period for PE transactions in the Chinese market ranges from five to eight years, subject to the specific dynamics of each deal. Common exit routes for PE investors include IPO (including backdoor listing), trade sale, share transfer, repurchase by controlling shareholders or redemption by target companies. As of the end of June 2020, the most common exit routes appear to be IPO (which has recently seen a significant rise due to continuous reforms in the Chinese capital market) and trade sale. Considering the market and regulatory uncertainties associated with the listing process, a PE investor pursuing an IPO exit normally considers other exit alternatives at the same time, such as trade sale, repurchase by major shareholders or redemption by target companies.

Whether PE investors will reinvest upon exit mainly depends on the provisions of their constitutional documents and the deal-specific dynamics. In general, if PE investors exit within

six months after the investments, they are likely to apply the proceeds received from the exits to invest in other projects.

10.2 Drag Rights

Drag rights are one of the most typical arrangements in PE investments, though they are not a necessity. Whether to include drag rights in favour of the PE investors in a transaction mainly depends on the rounds of investments, the bargaining powers of the parties and other deal dynamics. For institutional investors (such as PE funds) that intend to include the trade sale as one of their exit alternatives, drag rights are of particular importance. In practice, it is not uncommon to see PE investors exit by exercising their drag rights. CVC's acquisition of South Beauty in 2012 is a good sample.

The conditions for exercising drag rights in PRC deals do not differ much from those in deals conducted in other jurisdictions, and normally include the following:

- shareholding ratio requirement – drag rights will not become exercisable unless and until approvals by shareholders with certain shareholding percentages are obtained (such as shareholders representing at least 50% of the voting rights) or the proposed shares for transfer reach a certain percentage of all issued shares of the target companies (such as more than 50% of shares);
- the valuation requirement – drag rights will not become exercisable unless and until the valuation of the target companies reaches a pre-agreed minimum amount; and
- the time requirement – drag rights will not become exercisable unless and until the target companies fail to complete a qualified IPO within an agreed time period (such as two or three years after the last equity financing).

In M&A transactions with multiple PE investors, the exercise of drag rights is usually a highly negotiated term, and is more commonly decided by a majority of the PE investors (or the PE investors holding a majority of the shares of such investors).

10.3 Tag Rights

As mentioned above, PE investors are reluctant to grant influential rights to management shareholders with respect to their exits. Thus, unless the management shareholders have strong bargaining power, PE investors rarely agree on tag rights only in favour of the management shareholders, although they usually ask for tag rights in the case of exit of other shareholders, particularly controlling shareholders, founder shareholders or important management shareholders. For PE investors' exits from portfolio companies with a relatively dispersed ownership structure or having undergone several rounds of equity financing, the triggering event for exercising tag rights in favour of other shareholders (if any) is normally set as a change of control or agreed trade sale event of the portfolio companies, while PE investors would try to relax the triggering threshold for tag rights in their favour. Normally, exit rights enjoyed by institutional co-investors are generally consistent with those of the PE investors.

10.4 IPO

In China, on an exit by way of IPO, the lock-up periods applicable to PE investors are typically one year (for minority shareholders) or three years (for controlling shareholders) after the IPO. It is noteworthy that, for a company without an actual controller, the shareholders whose shares, ranking from high to low, collectively constitute 51% of all issued shares of the company prior to an IPO will be subject to a 36-month lock-up period (except for the shareholders who are qualified venture capital funds).

Besides these lock-up arrangements, a transfer of pre-IPO shares on the secondary market by a shareholder via the block trading or the centralised bidding system is also subject to certain restrictions. For example, the share reduction plans shall be publicised by the selling shareholder in advance, and the total shares sold in every three months (the "Restriction Period") shall be no more than 1~2% of the total issued shares of the listed company. It is noteworthy that, pursuant to new rules issued by CSRC in March 2020, for a PE investor filed with AMAC the Restriction Period applicable to its sale of pre-IPO shares in certain qualified listed companies (such as hi-tech public enterprises) will be in inverse proportion to the time period of its pre-IPO shareholding (for example, the sale of pre-IPO shares by a PE investor with an over 60-month shareholding period will not be subject to any Restriction Period).

The independence of an IPO applicant (including independence in terms of assets, businesses, organisational forms, personnel and finance) and the fairness of its related party transactions are among CSRC's major concerns when reviewing and assessing its IPO application. An IPO applicant should disclose and make commitments in its prospectus that it has met the basic requirements in terms of company independence. Though the controlling shareholder of an IPO applicant is not obliged to enter into any "relationship agreement", it may voluntarily provide a commitment letter on the independence of companies and the fairness of related party transactions with an attempt to accelerate the IPO process.

Han Yi Law Offices is based in Shanghai and is one of the most active and knowledgeable resources in the PRC private equity investment community. It is a leading Chinese boutique law firm specialising in the formation and deployment of private equity and venture capital funds, M&A, securities, banking and finance, and foreign-related dispute resolution. With some 20 lawyers, Han Yi Law regularly represents world-class private equity investors, venture capitalists, active industrial investors, hedge funds and PRC state-owned investment institutions targeting essentially all major industry areas in a wide variety of private equity transactions, including buyouts (leveraged and non-leveraged), early and late-stage venture investments, restructurings, going private and recapitalisations, and exit transactions. The firm has a proven track record of structuring and executing innovative and complex cross-border private equity and venture capital investment deals and M&A transactions involving buyouts, follow-on acquisitions, IPOs and trade sales, among others.

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