(enter keywords / 输入关键词) Go Advanced Search
Subscriber Info Renew
Welcome, JOHN LIEBESKIND Logout

Renew e-Alert About Us Events Useful Links RSS Feeds Contact Us

Change font size: A A A

Latest issue: July/August 2010

Subscribe | Free Trial
Free e-alert
Full Contents
Back Issues

Sectors
Banking & Finance
Capital Markets
Company Structures & Regulations
Competition Law
Contract Law
Dispute Resolution
Employment
Energy, Natural Resources & Environment
Government
Infrastructure & Construction
Insurance
Intellectual Property
IT/Media/Telecoms
M&A
Manufacturing
Property
Retail & Distribution
Tax
Trade
Transportation
Others

CLP Magazine
Features & Analyses
Full Text Translations
Awards & Rankings
Legislation Digest
Latest News
Deals & Dealmakers
People & Places
Business Law Bulletins

My Account
Personal Details
Email Newsletters
Change Password

Information
About Us
Advertising
Reprint
Contact us
Help

Resources
Asialaw.com
Industry Links
AsialawProfiles.com

China Law & Practice is published by
Asia Law & Practice

Distinctive M&As

As the acquisition of a Chinese company by a foreign investor is treated differently under PRC law than a purely domestic M&A, counsel need to be mindful of several issues that are often overlooked

Issue: May 2010

Keywords (click to search): [M&A] [timing] [completion] [indemnity] [time limits] [Hualian]

Add Comment Email Article Print Article

Unique legal issues may arise when a foreign investor acquires a PRC company. The possibility of transactional risk increases as these issues may go unnoticed by lawyers representing both sides of the deal. One of the main reasons for this lies in the fact that an acquisition of a domestic Chinese company by a foreign investor is treated in PRC law as distinct, in many ways, from a purely domestic acquisition where both parties are Chinese.

Practices normally adopted in the structuring and negotiation of a cross-border acquisition may need rethinking when the target is a domestic Chinese company. Here are three specifications counsel should pay closer attention to:

Timing of completion

A typical acquisition in the UK is structured in such a way that exchange and completion appear to be two key procedural milestones where certain events would occur by agreement of the parties to ensure its smooth completion. This practice has been introduced by some foreign buyers into China and has become increasingly accepted by the domestic seller and their counsels. However, the completion may cause problems if not carefully structured and arranged. Timing of the completion is of such an example.

Completion, according to English practice, happens when the buyer pays the purchase price in consideration of the title to the transferred shares. While the buyer makes the payment, the seller hands over the signed stock transfer form and the share certificate to the buyer for registration. In China, things are made different by law. The stock purchase agreement (SPA) and the joint venture contract (JV contract), which is the equivalent to the shareholders' agreement, will usually provide that they will not become effective until approved by the relevant approval authority, usually the Ministry of Commerce of the People's Republic of China (Mofcom) or its authorised local subordinates. This effectively means that exchange and completion cannot happen simultaneously, and the conditions precedent usually need to be agreed on. Secondly, completion may not happen the same way as in the UK.

Although China's *PRC Company Law* (中华人民共和国公司法) provides that a stockholder whose name has been recorded on the register of members of the company may assert and exercise his rights as a stockholder in reliance of the register, it fails to clarify whether the title to the stocks passes upon the transferee's name being entered into the register of members. While the law is relatively vague, for the purpose of transactional security, the general practice in a domestic acquisition is to treat the date when a re-registration is completed as the time when the Buyer formally becomes the owner of the target company. There is no stock transfer form that needs to be delivered and stamped before the re-registration, and the payment of the price may remain subject to statutory requirements where the buyer is a foreigner or where the targeted stocks are state-owned property.

This makes the normal form of completion unworkable. While the statutory requirements on payment terms may look to be in favour of the foreign buyer (as the payment could be, and in practice usually is, made *after* the re-registration), it has been observed in such acquisitions that the completion has frequently been set to happen sometime after the re-registration. This may cause problems. If one material condition is not satisfied after the re-registration and the deal is not completed, both the target company and the seller may be left in a difficult position. This is mainly because the target company, after the re-registration, is treated in PRC law as a new company in many ways.

If the acquisition is not complete and the buyer elects to terminate the SPA, the target company will be in danger of being liquidated, as the JV contract would normally be structured to automatically terminate at the same time. The termination of the JV contract and the SPA (the legal basis of the target company as a "new company") would effectively lead to its liquidation. Even if the JV contract contains no such automatic termination clause, the failure to make the payment within the statutory time limits would mean the target company would be unable to operate normally.

On one hand, without paying the price, the buyer is not entitled to any equity interests in the company and is legally prohibited from taking control of the company. On the other, the buyer has become a *de facto* stockholder of the company after the re-registration and the board may not be able to operate without the appointment of directors from the buyer. From the seller's point of view, he may also find himself no longer being the stockholder, and at the same time not entitled to the purchase price. The seller may reasonably feel resentful if the conditions that are not satisfied are beyond his control. For example, the company might be sued or be investigated by the government before completion, thus leading to the breach of a "no litigation" condition. From the buyer's point of view, he might have obtained protection under such an arrangement that might look good contractually but in fact be detrimental commercially. However, such an arrangement is not rare in the acquisition of a domestic company by foreign investors.

To solve this problem, completion should be set to occur after the SPA and JV contract are approved and effective, but before the re-registration. The SPA may nevertheless impose upon the seller an obligation to require the target company apply for the re-registration after completion occurs. This will not normally be resisted by the seller as the re-registration is largely a matter of procedure.

Indemnity

Another problematic issue is the inclusion of the indemnity clause in the SPA. It is widely known that in English law, an indemnity clause in an SPA might give the buyer better protection than a warranty clause. This is because under an indemnity clause there is no obligation imposed upon the buyer to mitigate a loss and the test of remoteness will not apply. Such a clause has been frequently included in an SPA covering the acquisition of a domestic Chinese company, yet the implications under PRC law, the governing law of the SPA, have not been taken into account. PRC law regarding civil liabilities does not distinguish between claims under an indemnity and those under a warranty. The *PRC Contract Law* (中华人民共和国合同法) expressly provides for the foreseeability principle and imposes the mitigation duty on the claimants for losses resulting from a contractual breach. The inclusion of an indemnity clause and, in particular, the inclusion of warranties under the indemnity clause, may not achieve their intended purpose under PRC law. Another issue is that the commonly-adopted Chinese translation of the term "indemnity" is the same as that of "damages" or "compensation", which has different meanings under English law. Considering that PRC law is the governing law of such acquisition contracts and a Chinese version of all the documentation is required, such an inclusion may prove misleading to the buyer, if not the seller.

Time Limit

In English practice, it is commonplace to provide certain limitations on the seller's liabilities in an SPA for the acquisition of a Chinese company. However, some of them may not work as intended. For instance, a time bar clause may have been provided that no claim may be made for breach of warranty unless a notice of such

Latest News

- 2010.07.20
  Know your bank-trust products before investment
- 2010.07.20
  Full text translation - July 20 2010
- 2010.07.20
  New China legislation this week - July 20 2010
- 2010.07.20
  Mega-IPO for last of the state-owned banks
- 2010.07.20
  Sino-Ocean in US$900 million convertible securities issue

More...

Related Articles

Sino-Ocean in US$900 million convertible securities issue
20 Jul 2010

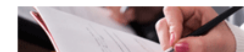
How to purchase PRC-listed companies
14 Jul 2010

Go green, go west, go high-tech
14 Jul 2010

Preparing for a Taiwan debut
14 Jul 2010

PRC clean energy company acquires stake in solar technology ...
14 Jul 2010

China Law & Practice Events



The 7th Annual Asia-Pacific IP Forum
01 & 02 September 2010
Location: Hong Kong

IFLR Asia Private Equity Forum
10 September 2010
Location: Hong Kong

China Law & Practice Awards 2010
16 September 2010
Location: Beijing

China Outbound Investment Summit 2010
16 September 2010
Location: Beijing

Most read

- China's Post-WTO Reforms in Financial Services: Achievements and Challenges
- Tentative Measures for the Administration of Overseas Investment of Insurance Capital
- Know your bank-trust products before investment
- China Law & Practice Awards 2008 - The Finalists
- Invitation and Submission of Bids for Construction Work for Construction Projects Measures

breach is made within an agreed period of time. While such a provision may be valid under English law, it is doubtful under PRC law as time bars are subject to statutory requirements, principally those contained in the *PRC Civil Law General Principles* (中华人民共和国民法通则), and may not be varied or contracted out by the parties to a contract.

The time bar for the lodging of a civil case generally is two years under PRC law, with certain exceptions depending on the type of the claim. A limited number of civil claims, like those against torts on state-owned assets which have not been entrusted to a citizen or a legal person to operate or administer, are exempt from time bars. Despite this, it has been seen that the time limitations clause, either shorter or longer than the statutory limitations, appears almost as a boilerplate in the SPA. If there could have been any doubt about its validity before, the latest judicial interpretation by the Supreme People's Court has given further clarification. The Supreme People's Court-issued *Provisions on the Application of the Time Bars in Civil Hearings* from September 1 2008 provides that any agreement to extend or shorten a time bar, or the waiver of benefits of a time bar to be in violation of law and will not be recognised by the court. Such a rigorous approach effectively puts an end to the once acceptable practice of making a provision for time limitations in the SPA.

The above discussion may also extend to such issues as termination, and reps and warranties among other things. While the acquisition of a Chinese company may go through similar transactional procedures and deal with the same legal issues as those completed under foreign law, it also involves distinctive issues and risks that may lay hidden in popularly-adopted practices. A careful analysis of these issues and risks is advisable before committing to a deal.

*Shawn He (*何生*), Hualian Law Firm (*北京华联律师事务所*), Beijing*

© Euromoney Institutional Investor (Jersey) Ltd 2010. All material subject to strictly enforced copyright laws.